

American Express Submission to the Financial System Inquiry

American Express, as a non-banking institution, has held a unique position in the financial sector during the past twenty years. It is pleased to have the opportunity to place on record comments and reflections on the financial services industry based on that experience. The submission broadly covers the following areas for consideration:

I. Introduction

II. The Necessity for Reform

III. Fundamental Principles for Regulatory Reform

IV. Recommendations

V. Conclusion

Appendices

I. Introduction.

1.0 American Express, as a global travel and financial services provider, has been involved in the global financial services sector since it invented the first stored value product known as the American Express Travellers Cheque in 1891. The company first came to Australia in 1956 to service cruising travel customers and has since that time expanded its operations to include the American Express chargecard products, foreign exchange, lines of credit, travellers cheques in a number of different currencies including the Australian Dollar Travellers Cheque, electronic cash transactions, and the American Express credit card.

1.1 It is important to reflect that the 1981 Committee of Inquiry into the Australian Financial System, known as the Campbell Committee, started from the view that the most efficient way to organise economic activity was through a competitive market system which was subject to a minimum of regulation and government intervention.

1.2 Indeed the beginning and final chapters of the final Campbell Committee Report expressed this sentiment. The Report was the crucial first step towards deregulation of the Australian financial system.

1.3 The Campbell Committee found that the community was receptive to a more open and flexible financial system free of intrusive government controls and regulations, while at the same time recognising government responsibility to ensure stability and confidence. Charged by the then Treasurer, the Hon John Howard MP, to canvass 'whether present levels of regulation and government involvement were appropriate' the Committee focused on those areas of government intervention which had a significant bearing on the efficiency of the financial system.

1.4 Although reducing the level of government involvement was the main thrust of the "Campbell Committee", it also identified those developments in the financial system which are now, a decade and a half later, subject to inquiry. In particular:

- * *Innovation in financial technology and markets*
- * *Consolidation of financial intermediaries*

1.5 As an active participant in the Australian, regional and global financial system, American Express International is well-placed to contribute to the current Financial System Inquiry. In the period between the "Campbell" and "Wallis" Committees American Express has expanded its financial products and operations in Australia considerably. It has experienced the benefits of the technological advances which have occurred during this time, and equally it has experienced the vagaries of the regulatory frameworks which oversee such products and developments.

1.6 This initial period of deregulation enabled American Express in a short space of time to expand its range of financial products offered to its customer base to include the Australian Dollar Travellers Cheque; lines of credit; and more recently the

Australian issued credit card. Additionally, it was able to utilise new technologies to service its merchant base by the introduction of electronic data capture machines (EDC's) to electronically capture data at point of sale. Some 13,000 devices which process charge, credit and debit transactions have been installed around Australia, New Zealand and the South Pacific.

1.7 In developing this transaction processing capacity, American Express has entered into reciprocal sharing arrangements with both major and second tier banks as well as switching organisations (who provide access to specific merchant networks) together with direct merchant host links as a means of acquiring our transactions and providing reciprocal access to other card issuers and networks.(Appendix 1)

1.8 Notwithstanding this deregulatory period of the Australian financial system, American Express has, along with many other financial service providers, been impeded by the lack of national uniformity in certain areas; inconsistency between different pieces of legislation; a variety of tax treatments; and an overall market whose rules have resulted in not all industry sectors being treated equally.

II. The Necessity for Reform

2.0 Whereas it was relevant at the time for the Campbell Committee to focus on an essentially domestic market situation, the Wallis Committee is facing a situation which is more global in nature and which has been transformed by technology; product innovation; and the entry of many new players into the financial services industry.

2.1 The issuance of plastic cards is but one case in point. Once the province of banks and charge card issuers, the world market has become highly competitive in terms of product and new entrants from outside the financial sector. Products such as credit cards, charge cards, and debit cards (on-line and off-line) as well as a wide variety of stored value card products, both magnetic stripe and IC-based (phone cards, mass transit cards, "electronic travellers cheques" campus cards, resort cards etc) are now readily available. New entrants to the industry include Telstra, AT&T, GE Capital and GMH, along with many retail sector issuers. Thus the market is not only increasingly competitive it also involves new entrants who are not from the 'traditional' financial sector.

2.2 Overall the situation is such that a fundamental blurring of products, services, and providers has occurred. Whether such products are deposit products, mortgage products, superannuation products, or managed funds the offerings come from many and varied sources, such as banks, credit unions, building societies, insurance institutions and finance companies.

2.3 These developments have been paralleled, and in some cases made possible, by advances in technology making it easier for companies to reach consumers. They have enabled many consumers to transact their financial matters increasingly at a distance or in locations other than that of the originating institution. The subsequent closure of many bank branches has been testimony to the efficacy of distance transactions.

2.4 This in turn has raised questions about consumers rights, needs and redress mechanisms in accessing such services and has given rise to a multitude of reports by government and consumer organisations alike. eg “The Social Responsibility of Banks” from the Prices Surveillance Authority, and “Smart Cards: Big Brother’s Little Helpers” from the Privacy Committee of New South Wales.

2.5 Notwithstanding such concerns the development of electronic cash, smart cards, stored value cards, and the Internet have added new dimensions and consumer concerns to the product opportunities which are being presented.

2.6 All this has meant that the financial services industry is in a state of constant change. Further, while there has been a dramatic increase in the number and type of financial products it is clear that it is only the beginning. Eventually cards may not be needed at all. “Electronic commerce” with “electronic money” is well on its way to becoming a reality. The ‘next age’ is already being ushered in with new developments in telephony and interactive cable/satellite services, with computer software companies already providing consumers with a great deal of choice in these matters.

2.7 While the market has been in a state of permanent flux the financial regulatory structures which govern such activities have remained relatively static. The industry is essentially compartmentalised according to institutional type in a plethora of State and Federal legislation; in various codes of conduct.

2.8 For example the EFTS Code of Conduct is regulated by the Australian Payments System Council under the auspices of the Reserve Bank of Australia. While the overall intent is to ensure compliance with the Code the underlying assumption is that only banks and deposit-taking institutions offer an EFTS product. Hence the annual compliance check-list is so couched that non-bank issuers can comply only in terms of the spirit of the Code rather than to its exact letter. This situation will become increasingly common as more non-deposit taking card issuers provide an EFTS capability. Such a capability may be linked to an existing financial institution, as in the case of American Express, or it may be purely to send an electronic transmission of money, such as through Australia Post, or alternatively it could be used to draw down a line of credit.

2.9 As a non-banking financial institution American Express is currently regulated by a variety of regulations which include both Federal and State jurisdictions. eg The Cash Transactions Act; Foreign Exchange Act; Credit Acts (various); Privacy of Credit Reporting; Financial Transaction Reports Act; Federal Reserve Bank Regulations; and the EFTS Code of Conduct. All form part of the regulatory framework governing a non-banking financial institution.

2.10 Where regulation occurs in different jurisdictions confusion and contradictions arise. For instance the Privacy of Credit Reporting which is a piece of Federal legislation is at odds with State Credit legislation. In the former there is a prescribed process to protect and to restrict access to, and reporting of, financial records. In the State credit legislation there is an inherent philosophy that credit providers are responsible for ascertaining the creditworthiness of individual consumers before

extending them credit. This becomes difficult to achieve given the restrictions under the Federal Privacy (Credit Reporting) Act.

How this should be achieved is left to the credit provider who may find that sources of information are now made more difficult or denied.

2.11 How all these matters are handled will have profound implications for Australian consumers, for market competition and economic efficiency, and for the safety and soundness of the financial system. Hence the Inquiry is a timely and important initiative.

2.12 American Express International strongly supports appropriate moves to deregulate the industry; to ensure an 'open' regime in which all providers of financial services have equal access to the marketplace subject to appropriate prudential oversight; and to maximise consumer choice by keeping the industry competitive and free from dominance by any one group of financial services providers

III. Fundamental Principles for Regulatory Reform

3.0 The perennial challenge facing financial regulatory authorities is to ensure that the regulatory system, regardless of how it is structured, achieves an appropriate balance of the following public policy objectives:

- i.** the safety and soundness of the overall financial system,
- ii.** protection of the consumer
- iii.** competition and anti-trust policies designed to foster an environment of healthy competition, including open access to the payments clearing system
- iv.** the overall economic efficiency of the marketplace.

3.1 American Express supports the view that there is a need for functional versus institution-based regulation; and secondly that there is a necessity for a strong, consistent competition policy in financial services.

Functional Regulation

3.2 By 'functional regulation' we mean an approach whereby an entity's activities dictate the regulatory scheme under which it operates. 'Institution-based regulation', by contrast, is the approach which has evolved over time as a result of which the regulatory scheme applicable to an entity is a function of its charter and form of organisation. We believe that in the financial services environment that now exists with its diversity of participants, functional regulation is the only approach that assures consistency in the regulation of all market participants.

3.3 Taking the functional perspective it is possible to observe that many of the developments of the past 15 years can be accommodated by a thoughtful redeployment off existing regulatory approaches that have historically been proven effective. In this connection it should be noted that many of the basic financial functions in the

marketplace, such as deposit taking, loans, storing value etc, remain relatively unchanged, regardless of the technology used to deliver those products. eg the movement from paper products to plastic cards to electronic commerce. An analogy would be using a personal computer to write a letter to a friend. Here there is no *functional* difference between using the computer or using a typewriter or pen or even a piece of chalk. The act of writing a letter remains the same; all that has changed is the technology of *how* the letter is written.

3.4 One instructive example is ‘stored value’ products, which date at least as far back as the invention of the travellers cheque by American Express in 1891. In the 100 years since then, these products have evolved from a purely paper-based form to include card products such as telephone cards, campus cards, ‘electronic purses’, and various types of ‘smart’ cards. The sheer variety of stored value products and providers in the marketplace is evidence that one need not be a bank, or even a deposit-taking institution, in order to be a viable issuer. Nor is there any reason why a provider, regardless of industry classification, should not be expected to satisfy reasonable prudential and consumer concerns relevant to the issuance of that particular product.

Indeed, traditional stored value products, such as travellers cheques, are currently issued all over the world, and their non-bank issuers are already subject to appropriate prudential regulation and oversight. The regulations are not precisely the same as those for banks, nor should they be, given the differences in their overall business structures. However it must be recognised that in many cases the regulatory paradigms are effective and equally applicable to product variations engendered by advances in technology. In the United States, for example, more than 20 State regulatory authorities have already indicated to American Express that a stored value ‘electronic travellers cheque’ would be regulated under the same State money transmission laws that currently govern paper-based travellers cheques and money orders.

3.5 The point is that within a *functional* regulatory environment, the focus is on the product and its underlying function, not on whether the product is issued by a bank or a non-bank. Furthermore, the degree and scope of prudential regulation must be *appropriate* to the actual risks involved. It would make little sense to bar non-banks from issuing specific financial products merely because they are different from banks. At the same time, the prudential and regulatory requirements placed on them should not be a mere extension of banking regulation, but should be tailored to the actual level of risk associated with issuance of that particular product. This functional approach would go a long way toward eliminating regulatory gaps and anomalies that currently exist.

3.6 In the current environment of converging products and providers a strong argument can be made to treat similar products similarly, regardless of who provides them or how the products are distributed to consumers and applying the same practical and prudential analysis to similar products. In theory any market player should be permitted to offer any financial product provided it conforms to appropriate regulatory requirements.

3.7 Just as specific products can change while the underlying function remains constant, so product providers themselves can change while offering identical products in the marketplace. This is due to the evolving nature of the marketplace and to government regulatory developments. An example of the former would be if a manufacturer were to decide to branch into instalment loans on its manufactured products, and subsequently then developed an expertise in credit. Using such an expertise a manufacturer could then offer a range of credit products such as a card product. General Electric has evolved a robust credit business in just this way.

3.8 Functional based regulation is currently not present in Australia . Different regulators are essentially responsible for different financial institutions ie the Reserve Bank of Australia regulates banks, the Australian Financial Institutions Commission regulates credit unions and building societies, while the Insurance and Superannuation Commission regulates insurance companies.

3.9 The regulatory differentiation between banks and non-banks, and between deposit-taking institutions (DTI's) and non deposit-taking institutions (non DTI's) has also resulted in a highly exclusionary and anti-competitive level of access to the payments clearing system on which the financial system itself rests. The Australian payments clearing system is conducted by the Australian Payments Clearing Association (APCA) under the auspices of the Reserve Bank of Australia. The resultant Australian Payments System Council has members from APCA which traditionally includes banks, as well as more recently building societies and finance companies as members of APCA. In addition there are separate categories for consumer groups, and Telecommunications and Retailer representation.

3.10 APCA membership has been traditionally restricted to that of banks, although in recent years membership has been broadened to include other deposit-taking institutions, including the credit unions' industry association (CUSCAL), and even Australia Post. While there is an opportunity for associate (nonvoting) membership for other types of participants in the payments clearing system such as American Express (which is an associate member of APCA), lack of full membership status means automatic exclusion from the activities of the Australian Payments System Council (APSC) and thus from discussions and decisions regarding policies on payments settlement and clearing matters.

3.11 No non-deposit taking institutions can access the payments clearing system except via associate membership in APCA which means that one must rely entirely on an institution that is a full member, such as a bank. In other words, access to the electronic networks must be via an institution which, as the line between products and issuers blur, is increasingly likely to be a competitor.

3.12 In the market for financial services, this situation bestows considerable market power on those entities who control access to and use of the payments clearing system offering an opportunity for full APCA members to exercise that market power to the competitive disadvantage of their nonmember competitors. This could be achieved by instituting prohibitive fees and charges either for access to the networks or for payments clearing transactions, or by creating new rules and policies which otherwise

discriminate against non-members. Either of these developments would severely cripple competition in the financial services market, with consequent ramifications for consumers as well as providers.

3.13 Clearly the replacement of institution-based regulation with functional regulation would require, for the sake of consistency, that the institution-based approach to the payments clearing system also be changed. The result would be wider participation in the payments clearing system that is based not on institutional category or charter, but on meaningful participation in the market for financial transactions. Hence, all prudently conducted commercial ventures involved with the payments clearing system to a material degree would be entitled to full membership in APCA on fair and reasonable terms, and the APSC would be required to draw from a much wider industry including market participants currently excluded from the Council.

3.14 American Express is not suggesting that membership should be granted without any provision made for potential risks to the system. What is being suggested is that, just as nonbanks issuing a particular product ought to submit to prudential regulation appropriate to the level of risk involved, similarly nonbanks should be granted membership in the payments clearing system subject to prudential requirements that are appropriate to the actual systemic risks involved, which would undoubtedly differ according to the level and nature of a particular institution's activities in the system.

3.15 It must be noted that any such requirement should be determined solely by the regulatory authorities and not by the nonbanks' competitors who control access to the payments system (which is currently the case).

3.16 Similarly, industry codes of practice should be revised to reflect the fact that products which are similar or fundamentally the same are now issued by many different types of institutions.

3.17 In order to be effective, functional regulation would need to take place at the national level to avoid the ambiguity and inconsistency caused by major differences in regulation between State and Federal jurisdictions. The current situation, which gives rise to many pieces of inconsistent legislation, including taxation (FIDs and BADs) and consumer protection, is a cause for major concern to many national and international financial institutions which view Australia as a market where the lack of a critical mass requires that they be able to distribute and market products on an undifferentiated basis in all regions of the country. Such providers would benefit from being able to operate nationally without having to make continual costly adjustments to accommodate regulatory differences at all levels and across a wide variety of issues.

Competition Policy

3.18 American Express believes it would be detrimental to the industry and to consumers if, in the course of deregulating the financial services industry, Federal Government competition monitoring and compliance should be weakened or

dismantled. Rather it is argued that the more deregulated the industry becomes, the greater the imperative to build safeguards into the system to ensure competitive equality and discourage abuse of market power by dominant market participants.

3.19 It is important that the competition authority with its expertise in this area maintain an independent watchdog role with sufficient resources and enforcement powers to continue to be effective in the financial services market. It makes sense that such an authority should be separate and distinct from any prudential regulatory authority.

3.20 Nonbank financial institutions have traditionally occupied a somewhat disadvantageous position in the financial regulatory framework, either falling between the cracks altogether or being subtly (and not so subtly) discriminated against due to their nonbank status. This has led to potentially dangerous situations from a competition standpoint. A prime example would be the second-class citizenship of non deposit taking institutions within the Australian payments clearing system, where there is a total dependence on competitors for access to and use of the system.

3.21 So far no serious issues of abuse have arisen in the Australian situation. However, a similar situation in Canada which developed several years ago resulted in serious abuse of market power. There the abuse of market power arose with regard to the Canadian electronic services network which had been created by the Interac Association and controlled by Canadian banks. A case was brought against Interac by the Bureau of Competition Policy. It was found that Interac had:

- ***put in place a structure and membership criteria that discriminated against non-financial institutions, including third-party processors and retailers and against non-members;

- ***imposed *excessively* high fees for new members wishing to join Interac

- ***unnecessarily limited the services that could be provided over the Interac network, thereby depriving consumers of the benefits of innovation.

As a result the Canadian government required that “membership in Interac be opened on a non-discriminatory basis and that members are prohibited from engaging in specified anti-competitive acts.” (Appendix 2)

3.22 It is not only the payments associations which have the potential to undermine competition in the financial services industry. Recently a case has arisen involving the two dominant international card associations, Visa and MasterCard. Such a case has the potential for repercussions on a global scale also encompassing the Australian marketplace.

3.23 In January, 1996 American Express and Dean Witter Discover lodged a complaint with the European Commission regarding the intention of the Visa International Board to introduce a by-law prohibiting members of the Visa Association from issuing American Express cards, Discover cards, or any other card deemed to be in competition with Visa. (Since most major banks issue both Visa and MasterCard the latter was apparently to be exempted.) Failure to adhere to this by-law would have resulted in expulsion from the Association.

Since most of the major banks held long-established Visa portfolios, which would have been forfeited were they expelled from the association, the introduction of the by-law would have had the effect of precluding member banks from ever becoming issuers of other card products. Without the ability to negotiate agreements with interested banks to issue its cards, American Express would have been denied access to a distribution mechanism and the competitiveness of its own network would have been severely jeopardised.

The European Commission launched an investigation, and in July announced its conclusion that ***“Visa’s proposal, if adopted, would have infringed the EC competition rules because it would have restricted competition between international cards systems as well as between banks which issue cards riding on those systems. The Commission is determined to ensure that payment card markets are kept open and that access by new competitors is not impeded.”*** (Appendix 3)

Following this decision the European Board of Visa voted against imposing any such restrictions on its members. However it is believed that other regional boards of Visa, including the Asia-Pacific Board are seriously considering the imposition of such a restriction. As a result, in various locations around the world, American Express has experienced a considerable ‘chilling’ effect on member banks which had been in preliminary discussions with us.

3.24 Shortly after the EC decision the Asia-Pacific Board of MasterCard International was reported in the media to have passed a resolution in an effort to prevent banks in the region from issuing American Express cards and any other cards deemed to compete with MasterCard (although, notably, they have specifically excluded Visa and Diners from this restriction). Referencing such issuance as ‘not appropriate’ the MasterCard spokeswoman was reported in *Cards International* as saying that in the event of a member bank issuing an American Express card “The issue would be brought before the board for a discussion about whether any sanction would be imposed”.

Despite a qualifying rider about being subject to specific country laws the spokeswoman is reported as saying ***“It is certainly the spirit of the board discussion that we want to discourage members from seeking a competing program franchise distribution relationship”*** (Appendix 4)

3.25 Both card associations in Asia-Pacific are scheduled to meet shortly, and it is widely expected that similar matters will be put before the Board members for action.

3.26 It is clear that when associations interfere with the freedom of members to choose which products and services they may offer and to impose or threaten sanctions then such conduct is unconscionable, coercive and totally unacceptable within a competitive financial services industry.

3.27 As the European Commission observed, not only does such action restrict competition between card networks, but it also restricts competition between individual bank issuers. Since it is often smaller, regional, or specialised bankcard

association members which are keen to develop new product lines and to expand their business, it is clear that such an anti-competitive policy is strongly biased in favour of the larger and most powerful banks at the expense of the rest of the membership.

3.28 In order to prevent the above types of undesirable situations from developing in Australia American Express strongly urges that: *a). The payments clearing system by fully opened to all market participants on fair and equal terms and subject to regulation appropriate to the degree of systemic risk involved, and b). the competition authority retain independent oversight of the financial services industry.*

IV. Recommendations

American Express respectfully submits that the Committee consider the following recommendations for changes to the financial regulatory system:

4.0 Replace the current institution-focussed legislative and regulatory system with one that regulates according to product function regardless of the nature of the issuing institution.

4.1 Take steps to ensure that all payments and clearing systems, whether administered by the government or by private entities under government supervision, are fully open to all market participants on equal and reasonable terms.

4.2 Strengthen the power of the Federal competition authority to ensure competition is maintained and to prevent abuses of market power.

4.3 Provide for a national system to legislate/regulate financial services to eliminate inconsistencies between different jurisdictions.

4.4 Revise industry codes of practice to reflect the fact that products which are similar or fundamentally the same are now issued by many different types of institutions.

Conclusion

It is clear that there are aspects of the current regulatory system which are in demonstrable need of reform. At the same time it is the view of American Express that due skill and care are needed to ensure that any reform of the financial regulatory system stays true to the spirit of the Inquiry and remains fundamentally a deregulatory exercise, ie regulation should not be extended to areas which are currently unregulated but are being handled in a demonstrably professional and prudential manner.

American Express is willing to come before the Inquiry to answer any questions, and to clarify or amplify any points raised in this submission. Equally American Express approves this submission being publicly available on the Internet or via copies made available from the Inquiry.

For further information contact ***Di Collins, Director of Public and Consumer Affairs, American Express. ph: 02-9271-1780. fx: 02-9271-2554***

September, 1996

Appendices

1. EFTPOS and the American Express Network
2. Interac Case
3. European Commission Ruling and media
4. Media report on MasterCard Actions

Appendix 1.
EFTPOS and the American Express Network

Appendix 2.
Interac Case

Appendix 3.
European Commission Ruling and media

Appendix 4.
Media Reports on MasterCard Actions