Twitter Thread by anshul gupta

anshul gupta
@anshgupta64

Visa Market Share - 52.6%
Amex Market Share - 19.6%

Visa Revenue 2022 - $29.3 B
Amex Revenue 2022 - $50.6 B

What is the secret of American Express?



Visa/Mastercard are card networks. Their main role is information sharing. When you swipe your card at a POS Machine, how does your credit card issuer know which merchant to transfer the money to?

Your card doesn't individually maintain a record of all merchants who can accept credit cards.

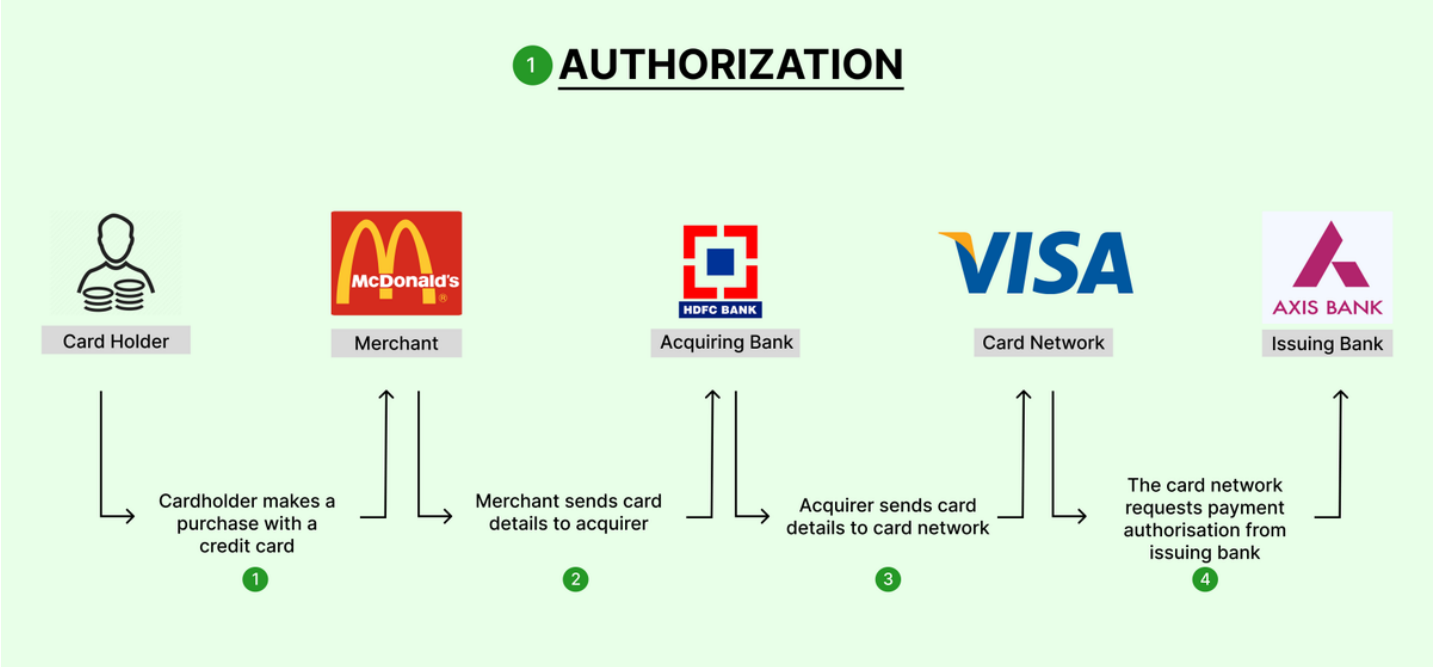
Instead it ties up with a card network e.g. Visa/MasterCard. Any merchant that has Visa as a network service provider can accept payments from a Visa card.

When the merchant's bank (acquiring bank) is registered on the card network, the network is completed. Card networks save banks the hassle of onboarding each merchant and maintaining the infrastructure.

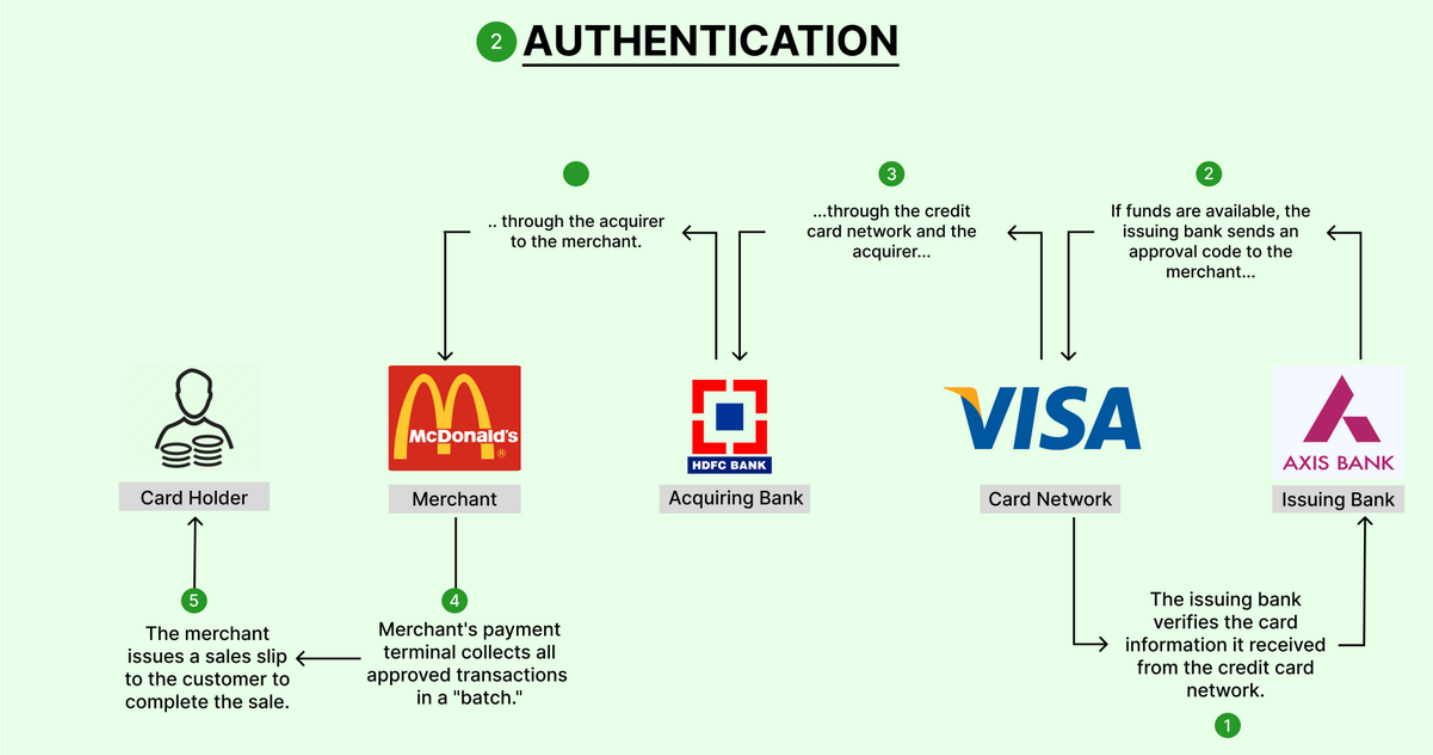
Let us see how a typical credit card transaction works.

There are 3 steps - Authorization, authentication and settlement.

Authorization
1) Cardholder uses their credit card to pay a merchant
2) Merchant shares card details with acquiring bank
3) Acquiring bank forwards these details to the card network
4) Network sends a request to the issuing bank to authorise the payment.



Authentication
5) Issuer validates the details, available limit, and if everything matches, it approves the transaction
6) Network sends the confirmation to the acquirer who in turn sends confirmation to the merchant
7) Customer gets a receipt to confirm the payment

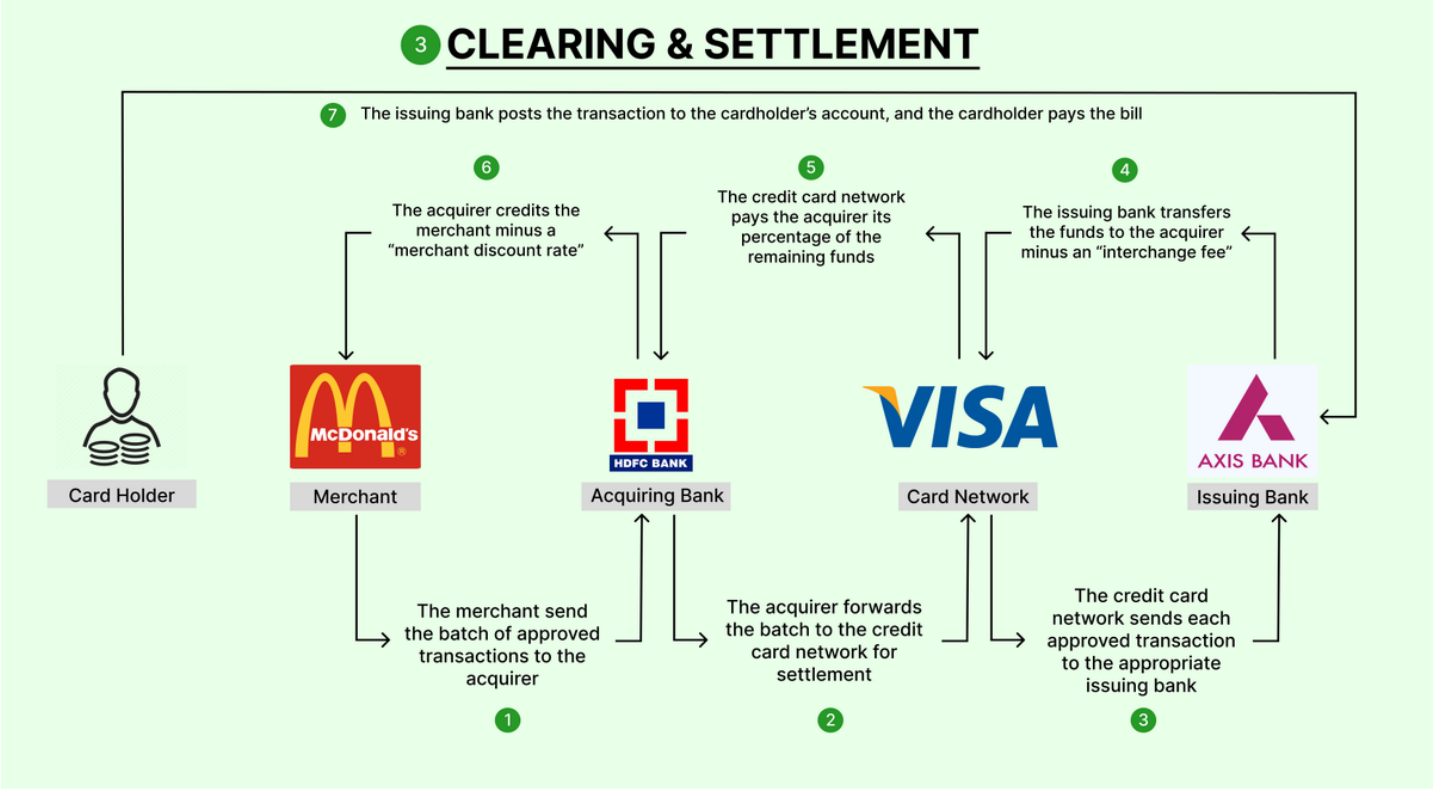


Settlement

8) At the end of the day, merchant sends all transactions details to the acquiring bank

9) Acquiring bank asks network to settle the transactions

10) Network sends payment request to the issuing bank



11) Issuing bank transfer funds minus interchange fee

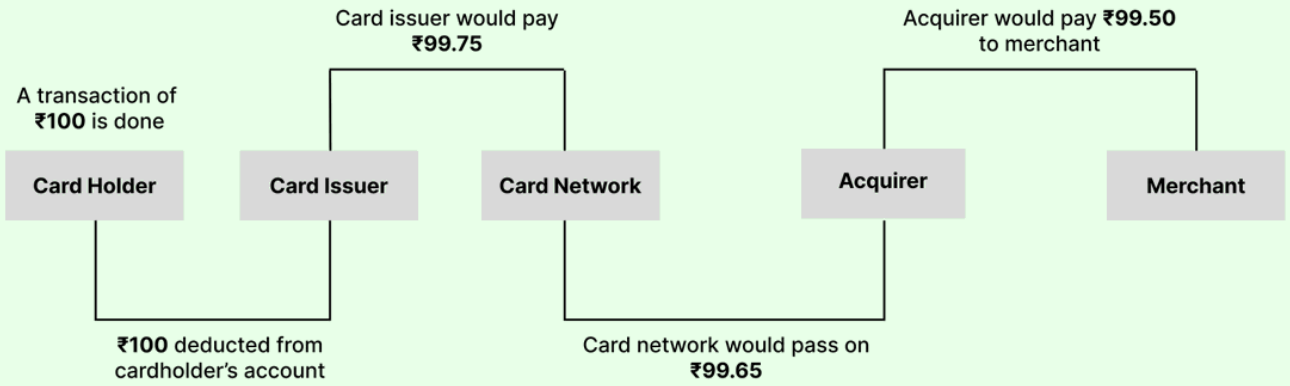
12) Card network takes a cut and transfers funds to acquiring bank

13) Acquiring bank transfers funds to merchant - merchant discount rate (MDR).

Merchants pay this MDR to receive credit card payments which increases sales and they don’t have to give credit to customers. Bulk of this MDR would go to the issuer since they are providing the free credit and taking the risk of customer default.

How MDR is distributed

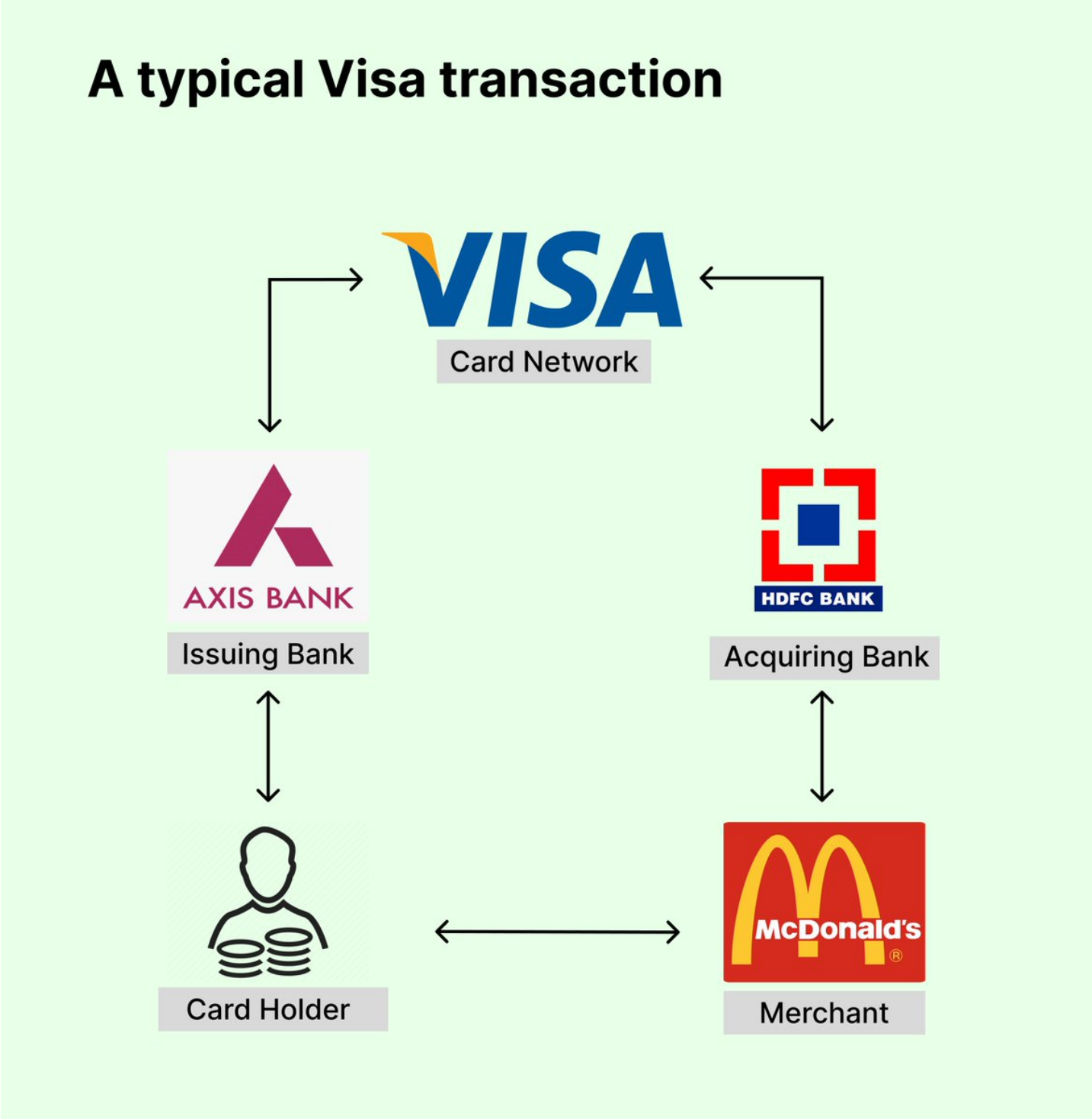
It is assumed that MDR levied on the merchant is 0.5% of the transaction value, and that this would be distributed among the card issuer (0.25%), acquirer (0.15%) and card network (0.10%) of transaction value to the three PSPs respectively.



Source: Discussion Paper on Charges in Payment Systems, RBI

The acquiring bank for its own services and Visa will also charge a small fee for maintaining this network.

Visa is like a toll collector where it charges a fee for transferring funds, similar to how we pay toll for using roads which is used for maintaining the roads.



How is Amex different?
As we saw, the biggest cut goes to the issuer and that is Amex's secret. American Express issues its own cards to customers. It acts as an issuing bank as well as the card network.

This is known as a closed loop system - where Amex controls each and every part of the transaction. It issues the cards, maintains the network, onboards each and every merchant individually and collects payments from cardholders.

This slows down the growth and volumes are lower but it gives Amex more control and a bigger role in the transaction. Visa/Mastercard work on an open loop system - they don't issue their own cards.

Any financial institution which is partnered with Visa can accept payment from Visa cards. You may have noticed that Amex cards are not accepted everywhere and almost all merchants accept Visa cards. This open loop system is one of the main reasons.

How does this affect American Express revenues? It earns from
- discount fees from merchants
- interest income
- annual card fees
- other fees (default penalties/forex/rewards)

American Express Company (Preli

Consolidated Statements of Income

(Millions, except percentages and per share amounts)

	Q4'22	Q3'22	Q2'22	Q1'22	Q4'21	YOY % change	FY'22	FY'21
Non-interest revenues								
Discount revenue	$8,183	$7,848	$7,873	$6,835	$7,149	14	$30,739	$24,563
Net card fees	1,625	1,541	1,481	1,423	1,344	21	6,070	5,195
Service fees and other revenue	1,181	1,169	1,265	906	1,134	4	4,521	3,316
Processed revenue	429	420	416	372	410	5	1,637	1,556
Total non-interest revenues	11,418	10,978	11,035	9,536	10,037	14	42,967	34,630
Interest income								
Interest on loans	3,623	3,164	2,707	2,473	2,356	54	11,967	8,850
Interest and dividends on investment securities	34	27	22	13	17	#	96	83
Deposits with banks and other	308	183	70	34	27	#	595	100
Total interest income	3,965	3,374	2,799	2,520	2,400	65	12,658	9,033
Interest expense								
Deposits	778	440	187	122	102	#	1,527	458
Long-term debt and other	429	356	252	199	190	#	1,236	825
Total interest expense	1,207	796	439	321	292	#	2,763	1,283
Net interest income	2,758	2,578	2,360	2,199	2,108	31	9,895	7,750
Total revenues net of interest expense	14,176	13,556	13,395	11,735	12,145	17	52,862	42,380
Provisions for credit losses								
Card Member receivables	244	165	138	80	74	#	627	(73)
Card Member loans	757	596	272	(111)	(9)	#	1,514	(1,155)
Other	26	17	—	(2)	(12)	#	41	(191)
Total provisions for credit losses	1,027	778	410	(33)	53	#	2,182	(1,419)
Total revenues net of interest expense after provisions for credit losses	13,149	12,778	12,985	11,768	12,092	9	50,680	43,799

Discount revenue from merchants and interest income is the main differentiator. Visa and Mastercard can’t earn interest income since they are just networks and not issuers.

Have a look at Visa’s revenue sources.

	For the Years Ended September 30,		
	2022	2021	2020
		(in millions, except percent	
Service revenues	$ 13,361	$ 11,475	$ 9,804
Data processing revenues	14,438	12,792	10,975
International transaction revenues	9,815	6,530	6,299
Other revenues	1,991	1,675	1,432
Client incentives	(10,295)	(8,367)	(6,664)
Net revenues	$ 29,310	$ 24,105	$ 21,846

While Amex earns from interest income, its real cash cow is merchant revenue (60%).

How does it earn so much from merchants?

Amex's whole main strategy revolves around getting customers to spend on its cards.

Amex earns substantial revenues from annual fees and high-spending cardholders. Amex invests these revenues in incentive programs and offers for customers. This leads to higher revenues for merchants and higher transactions.

Compared to other card networks, it charges a higher MDR but merchants are fine with it since they get access to a very premium customer base.

Amex prioritises merchants and builds many partnerships. One of its main partnerships is its co-branded card with Delta Airlines. Delta co-branded cards account for 9% of its global volumes and 21% of its loan portfolio.



Amex's closed loop system, also has its advantages like growing slowly compared to other card networks but it ends up with more control over its merchants and bigger take rate on each transaction.

This is a great strategy that has been working out for Amex. Do you think it will work out in the future?

My previous thread on how credit card companies make money. https://t.co/4E7ulft2US

> How does a credit card company make money?
>
> Most of us know how credit cards work but very few of us know how credit card companies make money and their business model. pic.twitter.com/IXyTqn5pva
>
> — anshul gupta (@anshgupta64) May 29, 2022