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Note to: European Commission
DG Competition

5 October 2006

CONSULTATION ON INTERIM REPORT II: CURRENT ACCOUNTS AND RELATED SERVICES

Please find attached the APACS response to the Commission's consultation on the Retail Banking Sector Inquiry Interim Report II.

Name of Organisation:

APACS the UK Payments Association

Type of Organisation:

APACS is the UK payments association, a trade association of institutions delivering payment services to end customers. It provides the forum to address co-operative aspects of the payment services and other payment related developments. APACS and its Members welcome the opportunity to comment on the Commission's Interim report.

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Country:

United Kingdom

Although APACS did not receive a request for information as part of the sector inquiry, this response has been prepared in consultation with the Cheque and Credit Clearing Company Limited and with BACS Payment Schemes Limited ('BPSL'), both of which received and responded to requests for information.

1 INTRODUCTION

APACS is pleased to provide this input to the consultation on the Retail Banking Inquiry's Interim Report II - Current Accounts and Related Services. APACS is the UK trade association for payments and for those institutions that deliver payment services to customers. It is also the banking industry voice on payments issues such as plastic cards, card fraud, cheques, electronic payments and cash. It provides a forum for banks to come together on non-competitive issues to bring change and to develop banking services for the future. More details on APACS can be found at our web site www.apacs.org.uk.

This response has been prepared in consultation with the Cheque and Credit Clearing Company and with BACS Payment Schemes Limited ('BPSL').

2 SUMMARY OF MAIN POINTS

Section 3 below provides some overall observations on Interim Report II. It gives an update on recent major developments to the governance of UK retail payment systems following the recommendations of the Payment Systems Task Force. It also raises some conceptual issues around the analysis in the Report, specifically that it needs to distinguish between schemes and infrastructures and that it makes little sense to consider cards issues in isolation from current accounts and related services. In Section 4 we point out some factual inaccuracies in Interim Report II and make some other specific comments.

In Section 5 we give our response to the issues for consultation listed in Section 10.3 of Interim Report II. The issues of relevance to APACS are those given in Questions 6, 8, 9 and 10.

In regard to access issues our main points are:

- we do not believe that access to credit databases is in itself a significant barrier to entry to retail banking provided new entrants have equal access to data and are not discriminated against;
- access criteria to the UK retail payment systems are risk-based, are fair, open and objective and the minimum necessary to encourage competition amongst participants. Recent scrutiny by the UK Competition Authority (the Office of Fair Trading or 'OFT') did not reveal any concerns amongst indirect participants over access;
- the question of access to the BACS system for non-banks has been considered by the Payment System Task Force (see Section 3.1) and its recommendations are being implemented. Similar changes are under consideration in the Cheque and Credit scheme.

In regard to competition in clearing and settlement and in retail banking, our main points are:

- there is a clear separation of scheme and infrastructure in the UK retail payment systems, which delivers considerable benefits to the members and users of those systems;
- a 2003 market study by the OFT concluded that "it appears unlikely that the level and structure of clearing scheme tariffs alone could be the cause of substantial anti-competitive effects on final customers".

In regard to SEPA our main points are:

- APACS Members support the approach adopted by the EPC whereby there will be a clear separation of scheme from infrastructure in the context of SEPA;
- we believe that, taken together, the SEPA Cards Framework and the EPC's planned standardisation activities provide a good foundation for the development of a highly competitive cards market.

We are happy to discuss the contents of this submission with the Commission if that would be helpful and for it to be published on the Commission's web site and attributed to APACS.

3 OVERALL OBSERVATIONS

3.1 The Governance of UK Payment Systems

As summarised in Section 8.1.3 of Interim Report II, competition issues in payment systems in the UK were considered in the 2000 Cruickshank review of banking services and in a 2003 market study by the OFT. We would like to take this opportunity to update the Commission on more recent developments as there have been, and will be, major changes to the structure and governance of payment systems in the UK.

The 2003 OFT study noted that the UK payments industry had undertaken a number of self-regulatory reforms in addressing some of the concerns raised in the Cruickshank report. In order to establish how much change there had been, and whether there should be more, the Chancellor of the Exchequer announced in October 2003 the establishment of the Payment Systems Task Force (the 'Task Force'). The Task Force's remit is to identify, consider, and seek to resolve competition, efficiency and incentive issues relating to payment systems, particularly looking at network effects of existing payment mechanisms. The Task Force is chaired by the OFT, and brings together payments industry, retail, consumer and business representatives.

The Task Force operates through the establishment of working groups to research specific issues, and to report back setting out options or recommendations for change. Three working groups have reported to the Task Force, two of which looked at competition issues associated with the BACS retail payment system and the third examined the LINK ATM network. A fourth working group, the *Cheque Working Group,* is at the time of writing this submission nearing the completion of its activities.

APACS, BPSL and the Cheque and Credit Clearing Company are amongst the payments industry representatives on the Task Force. All have played a leading role in the Task Force and its working groups and, where appropriate, in implementing its recommendations.

APACS has proposed to the Task Force that a new high-level, strategic body with responsibility across the payment markets be created. This body, provisionally know as the Payments Industry Association (the 'PIA'), would have responsibility for driving forward innovation in payment schemes, for taking a strategic view on the future direction of payments, for ensuring that the payment system as a whole is open and accountable, and for maintaining the integrity of payment services in the UK. PIA membership would be open to all payment service providers in the UK and it would be governed by a Board of senior figures from the payments industry and independent directors under an independent Chairman. The view of APACS is that the introduction of the PIA would address any outstanding payment systems competition issues in the UK, including those identified in the Cruickshank report. Its implementation would mean that the Task Force could in effect complete its agenda and be stood down.

Other key conclusions and changes to the UK retail payment systems arising from the OFT market study and the work of the Task Force are given in Section 5 of our response. More details on the Task Force and its working groups are available from the Task Force's web site:
http://www.oft.gov.uk/Business/Payment+systems+task+force/default.htm

3.2 Competition in Retail Payment Systems: Schemes and Infrastructures

In Section 8.1.1, Interim Report II rightly distinguishes between the payment scheme and payment infrastructure activities within a payment system. However, the subsequent discussion and analysis does not fully carry these distinctions through (see Section 3 below for some instances of this). In any investigation into the competition aspects of payment systems it is crucial that these distinctions are properly understood and taken into account. For instance, separation of scheme and infrastructure can promote competition in the provision of infrastructure services, both to the schemes themselves and to the payment service providers which are members of those schemes.

The APACS model for the retail payment systems in the UK is one where there is competition at two levels: between payment service providers in the provision of payment services to end users, and between processors in the provision of infrastructure services. In the UK there is a clear separation of scheme and infrastructure in the retail payment systems. As you will see from our responses to the specific questions posed in Interim Report II, we believe that this delivers significant benefits to the UK payment markets.

3.3 Card Issues

We continue to be disturbed by the seemingly artificial separation of card issues (subject of Interim Report I) from current account and related services (subject of Interim Report II), although Interim Report II does include discussion of some aspects of payment cards and ATMs.

The earlier examination of debit cards in isolation, and in respect of their payment functionality alone, risks reaching inappropriate or flawed conclusions, particularly given that debit cards are a fundamental and increasingly dominant feature of the current account product. Given the dual use of debit cards as a current account payment option and cash acquisition instrument it is essential that they be considered as central to the current account product. For example, in Section 6.3.3 relating to banks' income from account management fees and fees for payment transactions, figure 33 specifically excludes payment card transactions at POS and ATM, which, from a typical UK current account point-of-view, will inevitably result in a flawed analysis.

Likewise, the earlier examination of credit cards in Interim Report I considered credit cards purely from the point-of-view of their payment functionality without considering the lending aspects of the product. Some lending related issues of significant importance to credit cards, such as credit database access, have appeared in Interim Report II, which again creates the potential for confusion and inappropriate, flawed or inconsistent conclusions.

4 FACTUAL ERRORS AND OTHER SPECIFIC COMMENTS

In this Section we make a number of separate points on Interim Report II, including the identification of a number of factual errors.

In customer choice and mobility in the current account market (page 9), it is estimated that 7.8% of EU consumers and 12.6% of SMEs moved their current account in 2005, and that this is judged as being low. However, the basis for this judgement is not clear, especially as some might consider the figures high.

With regard to consumer protection rules and banking competition (Section 3.3.4), please see our response to Interim Report I where we discuss local laws. For example, we believe that heightened awareness amongst consumers of Section 75 of the Consumer Credit Act is increasingly skewing the UK payment market (particularly for e-commerce transactions) towards credit cards at the expense of debit cards and current accounts and other payment methods.

Whilst Interim Report II does comment on the unreliability of the figure of 140 million used for the number of current accounts in the UK, that data appears to have been be used in a number of places in the report such as Figures 11 and 12 to draw comparisons between the UK and other countries. APACS data [1] is that the figure of 140 million (or an average of 2.9 per adult) is overstating the total number of current accounts by a factor of around 2, and hence that all such comparisons are misleading.

There are also a number of inconsistencies between the data produced in Figures 31 and 32, and APACS and ECB Blue Book data. APACS data is that there were around 16 cheques written per personal current account in 2004, and around 34 direct debit payments per personal current account. We were also surprised to see from Figure 32 that the levels of cheque use per current account in Sweden were roughly half those in the UK, as the Blue Book reports levels of cheque use in Sweden at 0.00 per capita in 2004.

In section 8.2.5 it is stated that the BACS system is operated by Voca Limited. Following the separation of scheme and infrastructure in December 2003, Voca Limited operates the ACH infrastructure by which BACS scheme transactions are processed, and the BACS schemes are managed by BACS Payment Schemes Limited (BPSL).

In section 8.2.7 it is stated that one of the eligibility criteria in the UK for the payment schemes is to become a shareholder of the owner of the infrastructure. This is not the case for the UK's retail payment systems. There is no requirement on members of BPSL, the scheme company, to become shareholders in Voca, the infrastructure company, and vice versa. In the case of cheques and paper credits, the physical processing of paper items is the responsibility of the direct members of the scheme, most of whom have shared processing facilities which have been outsourced to third party commercial suppliers. The Cheque and Credit Clearing Company is the scheme company and is concerned with access criteria, determination of the rules, standards and procedures and compliance therewith. It contracts with third-party commercial suppliers for the provision of an inter-bank data network exchanging cheque clearing data and for the operation of a centre to exchange paper items.

It should also be noted that the Cheque and Credit Clearing Company is a scheme company for Great Britain and not the whole of the United Kingdom. The clearing of Northern Ireland cheques and credits are operated under a separate scheme by the Belfast Bankers Clearing Committee (BBCC). We understand that this clearing was not examined as part of the Inquiry.

5 APACS RESPONSE TO SPECIFIC QUESTIONS

There are four questions which are of relevance to APACS: numbers 6, 8, 9 and 10.

5.1 Access to Credit Databases and Payment Infrastructures

[1] APACS market research and card issuer data on the number of debit cards in issue.

"Q6. Access to credit databases and payment infrastructures are sometimes cited as a barrier to entry in retail banking markets. Are there significant barriers to access which merit further investigation?"

5.1.1 Access to Credit Databases

We do not believe that access to credit databases is in itself a significant barrier provided new entrants have equal access to data and are not discriminated against. In addition we believe that the access to credit data for organisations (from other Member States) should be provided on the same reciprocal terms as for those operating within that state.

In the UK, reciprocity means that members supply records on all available accounts within a portfolio (within the constraints of current legislation) and, in return, they may look at all the other credit records, for any type of product (to the same level of data) for customers applying to them. To some extent, concerns over cross-border access to credit databases are misplaced. Despite the proposed Consumer Credit Directive it is unlikely that a cross-border market in mass-market credit will develop as envisioned by the Commission i.e. where an individual will approach and be accepted by a lender in a different state. This is because credit-scoring systems assess risk by reference to distinct (and fairly large) pools of customers. For example, if a single French-based consumer approached a UK lender, the lender would have no way of gauging the risk of lending to that person even if they had cross-border access to a local credit record for that individual. Ad hoc consumer credit loans will usually make no commercial sense for the lender, making cross-border access to credit databases irrelevant.

Nevertheless, we would argue that a cross-border credit market already exists, having been achieved through cross-border mergers, joint ventures and solus scale market entry (i.e. entry by a business into a market on a solo basis), the pace of which has been increasing in recent years. Such an approach allows for recruitment of local staff with local expertise who are able to guide the business efficiently through the culture, risks and legal systems in that market.

Provided that a new entrant has the same access to credit databases as existing domestic lenders then there is no reason for access to such databases to be a barrier to entry given that the playing field will be level. Whether the quality and maturity of content of the database is a deterrent to market entry is another matter, particularly where a lender's 'home' database is comparatively sophisticated and comprehensive. Notwithstanding the above, other considerations exist that are more important to cross-border lending or establishing a presence in another market and may be seen as more immediate barriers to entry into a new market. For a UK lender looking to expand into another European market these barriers to entry would include:

- different or difficult debt recovery procedures;
- different local laws and regulations, such as the interpretation of data protection legislation;
- different structures in each member state of statutory and self-regulatory bodies that govern and regulate the industry;

- difficulty in acquiring customers arising from inertia, habit and familiarity with, and loyalty to, established providers.

5.1.2 Access to the Cheque and Credit Clearing System

It should first be noted that access to the retail clearing systems for credit institutions was one topic considered in the OFT's 2003 market study. The OFT noted that many respondents to its enquiries regarded competition between settlement members for indirect members' agency business in Cheque and Credit and in BACS as intense. Further, the responses from indirect members did not express any concerns with the level of agency fees.

There are 11 settlement members of the Cheque and Credit Clearing System and over 400 agency arrangements with indirect members. Indirect members clear and settle their cheques and credits through commercial agency arrangements with settlement members and do not have direct access to the clearings. The large number of agency arrangements would suggest that lack of direct membership is not preventing banks from entering the cheque and credit clearing market in GB. Settlement members do not determine centrally the costs that all banks will have to bear to use the infrastructure (Section 8.4.3) as agency arrangements are bi-lateral commercial arrangements.

However, if indirect clearers wish to become direct members, the access criteria are not a barrier to entry to the payment system. The Cheque and Credit Clearing System is subject to Bank of England oversight because of the size of the values passing through the system. The Bank requires the system to comply with the CPSS Core Principles for Systemically Important Payment Systems. Access criteria are determined with reference to Core Principle IX. The access criteria are risk-based criteria which are fair, open and objective and the minimum necessary to encourage competition amongst participants, without compromising the system's safety. Criteria which did not meet this assessment might be deemed a barrier to entry.

As the clearing function is not separated from the settlement function in the Cheque and Credit system, all direct members are settlement members and so their financial strength and stability is of paramount importance. This means that all our members are authorised credit institutions with settlement accounts at the Bank of England and with sufficient financial strength and stability to enter into the scheme's committed liquidity and loss sharing arrangements (they can also be public authorities but none have applied to join).

The settlement members are the largest issuers of cheques but there is no minimum level of activity required to be a member, a criterion which might make it more difficult for a new entrant to join the system (as suggested by the Inquiry at Section 8.2.7). Nor is there a requirement on members to become shareholders of an infrastructure company (please see comment above), which might also be deemed a barrier to entry (also as suggested by the Inquiry at Section 8.2.7). They are, however, required to become shareholders of the scheme company which is the mutual governance structure for making collective decisions in the co-operative space.

In conclusion, access criteria are fair, open and objective and the minimum necessary to encourage competition amongst participants, without compromising the system's safety and the charging structure is set so as to create a level playing field which should not act as a deterrent to new members joining.

The Inquiry further commented (Section 8.4.4) that exclusion of non-banks means that non-financial institutions (such as some processors and some customers) are not involved in payment system decision making and thus the payment system may develop in ways that do not meet the needs of a significant sector of users. The Cheque and Credit Clearing Company has for many years engaged actively with stakeholders including cheque processors, cheque printers and software developers. The Company intends to formalise and extend these relationships through the development of an Affiliate membership proposition for cheque processors, cheque users and other providers of cheque services.

5.1.3 Access to the BACS system

The OFT's conclusions in its 2003 market study regarding the levels of competition in the provision of agency services in BACS have already been noted above. There are currently over 400 agency arrangements in the BACS system. It should also be noted that, as is the case with Cheque and Credit:

- the Bank of England assesses BPSL's access and governance arrangements against the minimum standards set out in the CPSS Core Principles for Systemically Important Payment Systems;
- BPSL has no minimum volume criterion.

The Task Force's *BACS Access and Governance Working Group* considered a number of concerns raised in the Cruickshank report around access to the BACS system. The Working Group recommended that BPSL should establish an Affiliates Interest Group so that users could raise issues directly with the BPSL Board; that a formal consultation process should be introduced for potential major changes; and that a broader, more user-based objective for BPSL should be introduced. All three recommendations were accepted by the Task Force and were subsequently adopted by BPSL.

The Working Group also considered the issue of membership of the BACS schemes for non-financial institutions, which relates to the 'need to be a bank' issue discussed in section 8.4.4 of Interim Report II. The Working Group considered a new form of 'clearing' membership which would allow access to the BACS scheme, but with fewer risks to the system. For prudent risk management purposes BPSL settlement membership is currently restricted to credit institutions. The potential benefits of clearing membership would include access to the wholesale tariff, access to the Board, and better provision of information. It could also lead to greater competition, if non-financial institutions are able to offer services through their membership of BACS. The Working Group concluded, after consultation with heavy users of BACS, that there was little interest in shown by any company in becoming a clearing member at that time, but that clearing membership should remain an option, to be considered further only if there is firm interest shown in it in the future.

Through the Working Group, BPSL brought forward proposals to allow government departments to become full settlement members of the scheme, subject to complying with all the rules. The Working Group found that there was only limited interest in the proposals from government departments. It recommended that, as with the proposals for clearing membership, the issue could be considered further in the light of any firm interest becoming evident.

5.2 Competition in clearing and settlement services and in retail banking services

> **"Q8. Are there features of the payment industry that limit competition either at the level of provision of clearing and settlement services or the provision of retail banking services? Please indicate areas that merit further investigation."**

Although Interim Report II poses this question in the context of SEPA, we would like to comment in the context of the UK's retail payment systems.

OFT 2003 market study examined the questions of whether scheme charges dampened inter-bank rivalry and whether there might be indirect anti-competitive effects facilitated by such coordination. It found that the costs and wholesale charges associated with clearing schemes are a relatively small part of the estimated total costs of providing the relevant payment services to final customers. The OFT concluded that "it appears unlikely that the level and structure of clearing scheme tariffs alone could be the cause of substantial anti-competitive effects on final customers".

5.2.1 Cheque and Credit

As discussed above, there is a clear split between scheme and infrastructure in the cheque and credit payment system, so that members own the scheme but not the infrastructure. The separation of scheme from infrastructure delivers considerable efficiency and other benefits to the Cheque and Credit Clearing Company and to its members. For instance, there is a competitive market in the provision of cheque processing services to members and there is periodic re-tendering for the provision of the inter-bank data network, with the most recent re-tendering resulting in a change of supplier.

5.2.2 BACS

The work of the Task Force has specifically addressed competition issues in the provision of clearing, settlement and retail banking services in the BACS system. The *BPSL Access and Governance Working Group* considered the potential benefits from the separation of scheme and infrastructure. It noted that the key benefits include:

- the ability to attract investment into the infrastructure from sources other than the current owners, the scheme members;

- the incentive for the independent infrastructure to seek profitable business opportunities which may be outside the services provided to the payment scheme;
- the removal of the conflict of interest that may arise when the infrastructure wishes to provide a service which may compete with a service provided by a scheme member bank;
- membership of BPSL is less expensive as it no longer requires ownership of a share in the infrastructure;
- the ability of the scheme to choose an infrastructure provider other than the incumbent to improve the service to users and/or reduce the cost.

The *BPSL Innovation Working Group* considered 'the scope for, and costs and benefits of, innovation' to the BACS system. The main conclusion of its report, which was published in May 2005, and the recommendation of the Task Force was that a faster payments service be introduced in the UK for telephone banking and Internet banking payments, with the ability to accept standing order payments. The payments industry subsequently agreed that this new service will be in place by the end of 2007 and that it will enable customers to transfer funds in a matter of hours and, potentially, in near real time; this is a significantly better proposition than that originally requested by the Task Force. APACS has formed an 'Implementation Group' to oversee and manage the introduction of the new service.

The reports from the two Working Groups can be found at:
http://www.oft.gov.uk/Business/Payment+systems+task+force/publications.htm

5.3 Interchange Fees

> **"Q9. Are interchange fees necessary for the development of payment instruments (credit transfers and direct debits) in the EU?"**

APACS has no view on whether interchange fees are necessary for the development of payment instruments in the UK, and we have restricted our response to this question to a description of the current situation in the UK, which is that there are no multi-lateral interchange fees within either the BACS payment schemes or Cheque and Credit.

5.4 Industry Initiatives and SEPA

> "**Q10. Are there issues related to industry initiatives in the context of SEPA that should be assessed from a competition viewpoint?"**

APACS Members support the approach adopted by the EPC whereby there will be a clear separation of scheme from infrastructure in the context of SEPA - a model that has already been implemented within the UK. The expectation is that institutions adhering to the new SEPA Credit Transfer and Direct Debit Schemes will be able to select the clearing and settlement mechanisms (CSMs) best suited to their needs, rather than being tied to one particular service provider. This model should provide an environment in which CSMs compete to win business from the Scheme Participants, which in turn should encourage innovation and improvements in efficiency and cost-effectiveness. Competition should also be facilitated due to the fact that the SEPA Schemes will operate according to a core set of rules around which Scheme Participants will be able to develop products and value-added services to meet end users' needs.

SEPA also requires interoperability between multiple CSMs. A key enabler of this will be application of the SEPA Data Model, which defines a set of common data elements aligned with those used in UNIFI (ISO 20022) XML messages. It is worth noting that card standards are also mostly developed within ISO. The UK Payments Industry supports the adoption of ISO20022, which promotes convergence around common standards. ISO is an open process allowing any party, not just banks, to participate in a framework that is governed by fully documented and proven procedures[2].

In the European Commission's consultative paper on SEPA Incentives paper (DG Internal Market and Services, 21 March 2006) a question was raised as to how the principle of separation between schemes and infrastructure might be enforced in a cards context, particularly with regard to the international schemes. Such a question could also be considered from a competition viewpoint. However, our response would be the same, namely that Visa, Maestro and MasterCard transactions can be, and are, carried across networks other than the schemes' own. Our experience offers the Commission evidence that separation is achievable, since the UK banks have for many years exchanged transactions using a variety of routings.

The UK has never operated on the basis of a single, monopoly card scheme (and currently has two main debit card schemes, Visa and Maestro, and 2 main credit cards schemes, Visa and MasterCard). Yet competition in the cards industry between banks, between schemes and between processors in the UK has, for many years, been vigorous. This has created a highly sophisticated, innovative and dynamic environment with a wide range of product offerings for both domestic and cross-border transactions available to the consumer. We believe that, taken together, the SEPA Cards Framework and the EPC's planned standardisation activities (looking at, for example, cardholder to terminal, card to terminal, terminal to acquirer and acquirer to issuer) provide a good foundation for the development of a highly competitive cards market.

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[2] ISO/IEC Directives, Part 1, Procedures for the technical work ISO/IEC; Part 2, Rules for the structure and drafting of International Standards (see www.iso.org/directives)