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VISA EUROPE

RESPONSE TO THE CONSULTATION ON THE EUROPEAN COMMISSION'S

INTERIM REPORT I

PAYMENT CARDS

21 JUNE 2006

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I. Introduction

Visa Europe, a European incorporated payment system owned and controlled by European institutions, has set out in this document comments on the European Commission's Interim Report I on Payment Cards published on 12 April 2006 as part of its sector inquiry under Article 17 Regulation 1/2003 on retail banking ("Interim Report").

As requested by the Commission, Visa Europe has kept its comments as short as possible and has therefore not dealt with all of the points raised in the Interim Report. Visa Europe has in this response to the Interim Report focussed in particular on market fragmentation, profitability and interchange fees[1]. Visa Europe is happy to discuss any of the points raised in the Interim Report in more detail with the Commission.

Visa Europe appreciates the importance of the Interim Report in the context of the completion of the Internal Market for Payments and, in particular for the achievement of the Single Euro Payments Area (SEPA). It also appreciates the hard work which has gone into the preparation of the Interim Report and the enormous amount of data which the Commission has had to assimilate in order to produce the Interim Report. However, Visa Europe considers that in the time available, the Commission may not have been able to fully understand a number of aspects of the payment cards market or to analyse appropriately and derive the correct conclusions from the data which the Commission has gathered.

II. Visa Europe

1. Visa Europe structure

Visa Europe is a European incorporated four-party payment card system owned and controlled by more than 5,000 members being both large and small European institutions. As a result of its co-ownership of the Visa International system, Visa Europe cards are accepted domestically in the EEA Member States, across European borders and internationally.

Visa Europe's ownership structure contrasts with that of MasterCard which is now a US publicly listed company. Following its IPO which was completed on 25 May 2006, MasterCard's focus may be more directed towards the short-term interests of shareholders rather than the longer term interests of the European market, in particular SEPA. The three main three-party systems Amex, Diners Club and JCB are likewise not European. Visa Europe's association model by contrast enables banks in Europe to serve local needs but at the same time provide a system, infrastructure and product to allow the European banking industry to evolve towards the SEPA vision.

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[1] Accordingly Visa Europe's silence on a particular point is not to be interpreted as any indication that it agrees with the statements or analysis set out in the Interim Report.

Visa Europe's structure also enables the system to offer highly efficient, cost-effective payment card solutions to all consumers of and participants in the Visa Europe system. Given the high level of functionality, greater utility and inter-operability of the Visa Europe system and its cost-effectiveness for participants, as a result of significant investment, Visa Europe offers an excellent value proposition to customers throughout the EEA.

2. Visa Europe's role in SEPA and the Internal Payments Market in Europe

Visa Europe's European ownership and structure, European Board and European management ensures that it is committed to the achievement of SEPA and the completion of the Internal Market for Payments for the whole of the EEA. Visa Europe in fact already meets all the main requirements set out in the European Payments Council ("EPC") SEPA Cards Framework, and will become fully compliant by 1 January 2007 – i.e. three years before the SEPA deadline of 2010 (and one year before banks are to start offering and customers should be able to acquire SEPA compliant payment card solutions).

The Internal Market for Payments as well as SEPA will create more dynamism and competition – enabling banks and others to provide a wider and better range of payment products to customers. This, in turn, will accelerate the move away from cash and cheques to more secure, more convenient and more efficient electronic and cross-border payments.

All Visa Europe's existing products can be used throughout Europe. In fact, international card systems[2] have been developed since the 1960's in a manner which ensures widespread use and acceptance of cards across the EEA based on commonly accepted standard rules. In this way, international card systems have the infrastructure to enable the realisation of the SEPA concept many years ahead of its time.

The level of investment and innovation across the European payment card sector should not be underestimated. Amongst its many achievements, Europe has pioneered the implementation of EMV chip technology, the authentication of e-commerce transactions, and the introduction of new card-based money transfer products. The development and adoption of EMV, which provides more secure card payments, has been adopted as a fundamental component of SEPA. The investment in EMV would not have taken place without the strong role played by the international card systems and the use of interchange and other measures to incentivise innovation as well as generate and manage growth.

In order to achieve a specific European solution for SEPA and to meet customers' needs and expectations, Visa Europe has also introduced V PAY which is a new "chip and PIN always" debit product platform developed especially for Europe. It is an

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[2] An international card system is defined in the Interim Report as a card system which has issuers and acquirers operating in several countries. As noted above, Visa Europe considers itself a European payment system.

additional option that Visa Europe provides to member banks, which can co-exist with their existing debit products and which will help the banks to achieve the SEPA objectives. It is initially aimed at those Member States with a domestic debit system that will have to become SEPA Cards Framework compliant in the coming years.

The European Payments Consulting Association (EPCA) has awarded the first prize in the EPCA/ECR Excellence in Payments Innovation Awards to V PAY, for being the payment solution that has added the most to the development of SEPA.

3. The role of regulation in the Internal Market for Payments and SEPA

Visa Europe believes that following the achievement of the Internal Market for Payments and SEPA objectives a large number of the potential concerns referred to in the Interim Report will be eliminated. Accordingly, Visa Europe would also urge the Commission to ensure the adoption of an appropriately framed Payment Services Directive so that European payment providers are in a position to deliver the Internal Market for Payments and SEPA goals on time[3]. Visa Europe also urges the Commission to support the work being carried out by the European Payments Council in relation to SEPA.

As Visa Europe has explained to the Commission in response to the Consultation Paper on SEPA Incentives published on 13 February 2006[4], differences in regulation across Member States will make it impossible for any payment system to fully achieve the objectives of SEPA and an Internal Market for Payments, as it will not be possible to offer identical products across all Member States even if the local market conditions move sufficiently close together.

Accordingly it is imperative that the Commission insist on consistent, minimalist regulation of payment card systems at a Member State level and that the Commission provide clear guidance in this regard. As discussed in Section IV.1.3 below, there is a grave danger that inconsistencies in the past in the way in which interchange has been dealt with by regulators/competition authorities, and the potential inconsistencies which are developing through a number of pending and expected national antitrust proceedings, may seriously undermine the achievement of SEPA and lead to further market fragmentation[5].

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3 Visa Europe in principle supports the Commission’s proposal for a Directive on Payment Services but has reservations as to the broad scope of the Directive i.e. applying the same principles to all non cash means of payment as this will lead to overregulation and confusion. Visa Europe also has certain reservations regarding the introduction of Payment Institutions. See further Section V.10.2 below.

4 Visa Europe’s comments on the Commission Consultation Paper on SEPA Incentives published on 13 February 2006 were submitted to DG Markt on 28 April 2006. (See Annex 1.)

5 Formal investigations into interchange are currently ongoing before the national competition authorities (and/or competition courts) in Austria, Poland, Portugal, Spain and the UK (although the OFT’s decision against MasterCard was set aside by the Competition Appeal Tribunal on 19

Furthermore, it is imperative that the European Commission does not take any steps, which would make the achievement of the SEPA goals more difficult. In particular, the Commission needs to consider the impact which a reduction in interchange levels would have on issuing banks and their ability to make the substantial programme of investment and development which the industry has agreed to in order to facilitate the achievement of SEPA by 2010. Accordingly, if payment card systems are forced to reduce fee levels this will not only impact on the optimal use of those payment systems but also on the ability and willingness of banks to make the investment necessary in order to achieve SEPA.

In general, Visa Europe believes that inappropriate regulation of interchange is also contrary to good policy principles because it dampens incentives to invest by not allowing flexibility or the ability to obtain an adequate return on investment. For example, interference with how a payment system operates may also have effects on innovation.

The Commission must also ensure that whatever further steps it may take, it ensures that these are based on the concept of a competitive and efficiency-promoting level playing field between all means of payment.

In an open four-party payment card system, such as Visa Europe, there is competition in both issuing and acquiring and the need for a relationship between issuing and acquiring banks to ensure a smooth functioning of the payment system. In contrast, in a closed three-party system (such as Amex or Diners Club) cards are instead issued and merchants acquired by the payment system itself (or via banks acting on behalf of the three-party payment system) and therefore the intra-brand competition which exists in a four-party system does not exist in a three-party system[6].

Three-party systems are also generally much more vertically integrated than four-party systems as the Interim Report recognises[7]. Banks using the Visa Europe payment system are, for example, free to process transactions in-house; to outsource processing to a third party processor; to use domestic processors; or to avail of the processing services offered by Visa Europe. This allows competition within these functions.

The structure of Visa Europe's system promotes the participation of numerous players from all Member States whilst at the same time ensuring maximum security of the

June 2006). The authorities in Germany, Hungary, Ireland, Lithuania and Norway are also considering or have expressed interest in interchange.

6 There are exceptions with regard to acquiring where local arrangements (outside of Visa Europe's control) have resulted in the existence of a sole acquirer for payment cards in those Member States. Visa Europe itself has not set up joint ventures, nor does it regulate how members organise themselves in a domestic market.

7 See pages 88-89 of the Interim Report. Although some three-party systems, notably American Express, have started to license banks to issue their payment cards and are adopting some aspects of the open four-party model, they remain comparatively free from regulation. For further details see Section IV.4.7.

system. This allows the banks in the system to develop numerous efficient, safe and cost-effective products enabling consumers and businesses, given the right incentives and information, to switch away from less efficient means of payment such as cash and cheques, thus generating positive welfare effects for society as a whole.

This in turn will enable the further development of competitive and efficient financial services markets, vital for the European economy and the achievement of the Lisbon agenda as the opening words of the Interim Report recognise.

III. Executive summary of Visa Europe's concerns on the Interim Report

The Interim Report gives cause for concern on various grounds. This is developed more fully in what follows in this document. Confidence in the Interim Report is undermined by the presence in it of simple errors and evident inconsistencies – quite apart from key conclusions which, as Visa Europe will show, cannot be supported by the evidence the Commission has gathered and presented.

The value of the Interim Report is compromised in particular by the following[8]:

- it suggests that lack of competition may be the cause of <u>market fragmentation</u> without fully analysing the underlying causes and effects of inter-country differences. Variations in fees across Member States are evidence of adaptation to the historical, economic and cultural differences in the various countries concerned rather than of market power or a lack of competition;

- the Interim Report's <u>econometric analyses</u> of the determinants of the merchant service charge and cardholder fee are flawed and unreliable;

- the Interim Report relies on an inappropriate measure of <u>profitability</u> to conclude that there is high and persistent profitability in allegedly relatively mature markets and infers erroneously that such profitability is due to the existence and exercise of market power, whereas in the light of the fundamental flaws in the profitability analysis, no reliable conclusions can be drawn from it;

- the Interim Report's analysis of <u>interchange fees</u> is based on incomplete and unreliable data and a misunderstanding of the economic rationale for interchange in four-party systems. It ignores the benefits that payment card systems provide to merchants and underestimates the consequences of not having an appropriate interchange fee on the structure and operation of four-party card payment systems. It does not consider the damage that removal or reduction of interchange would have on competition and consumers;

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8 Obviously, Visa Europe has not had access to the underlying data and therefore has not been able to verify its validity.

- the Interim Report includes prejudicial comments such as interchange being a "tax" on merchants and consumers or being used to "extract rents from merchants". These comments reveal nothing other than the Interim Report's misunderstanding of the way in which payment card systems operate in reality;

- the Interim Report's analysis of the likely impact of the removal of no surcharging rules is incomplete, especially as regards customers' confidence in payment cards and, as a result, on the possible increased use of cash.

Should the Commission consider any further action in relation to payment cards, Visa Europe would consider it essential for the Commission to first correct the errors and misunderstandings in the Interim Report. Secondly, any action taken must promote a level playing field and a consistent solution for all payment instruments across the EU. At the same time, to be consistent with the SEPA objectives, the Commission should encourage measures enabling consumers to move away from less efficient means of payment such as cash and cheques, including for example by ensuring the removal of national legislation which promotes the use of cash.

IV. Major issues

1. Market fragmentation

1.1 Introduction

The Interim Report observes that there are significant variations in the level of interchange, merchant services charges and cardholder fees across Member States[9].

The reasons for differences in the various Member States are manifold and these differences do not necessarily indicate a lack of competition either between payment card systems themselves, or between payment card systems and other payment methods, as would appear to be implied by the Interim Report[10].

Moreover, though there clearly are inter-country differences and some reasons for these are set out below, the operation of the Visa Europe system (e.g. in respect of pricing) in each Member State is nevertheless fundamentally driven by the same forces and influences. These include the need to encourage both types of consumers (i.e. merchants and cardholders) to participate in the two-sided system; and the need for minimalist Visa Europe-wide rules to co-ordinate the activities of members on the two sides, and to ensure, as far as possible in a de-centralised organisation, that the structure of prices on the two sides (i.e. the MSCs on one side and cardholder fees on the other) is optimal for the system. This 'structure of prices' is determined *inter alia* by demand elasticities on each side. These are bound to differ from one Member State to another.

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[9] See pages iv and v of the Interim Report, for example.

[10] See, for example, pages iii - iv and 31 - 33 of the Interim Report.

1.2 Analysis

a) Differences across Member States

Contrary to the SEPA vision for the future, EU Member States have to date continued to show significant differences economically, socially, politically and technologically. Differences in interchange levels, merchant service charges and cardholder fees between Member States are not a cause of market fragmentation but reflect it.

Banks must be able to respond to local circumstances – such as the level of development within local economies, the prevailing payment habits of local populations, differences in technological development, the circumstances of local retailers, etc.

Member States are at markedly different stages of development in terms of propensity to use payment cards as opposed to cash or cheques. The large differences in the use of different payment instruments in the different Member States is illustrated in Annex 2 which shows on an EU Member State level, the number of transactions carried out per inhabitant using different payment instruments (excluding cash). The degree of penetration of payment cards and other payment instruments varies quite significantly from Member State to Member State. For example payment cards account for 60% of all payments (excluding cash) in Denmark but only 10% in Austria. Cheques account for about 30% of all payments (excluding cash) in France but less than 1% in a number of EU countries, including Belgium, Denmark, Austria, Luxembourg, Finland, Czech Republic and Latvia[11].

Payment cards differ as to the degree of maturity in the various Member States. But in no case, as can be seen already from payment cards' share of expenditure in the EEA and indeed from growth rates, can cards be considered a mature business[12]. In the UK, the number of merchants accepting Visa cards increased significantly between 2000 and 2004. Also in the UK, for example, one of the Member States with the most developed card usage, it is understood that 80% of all payments below £30 are cash.

Differences between Member States may also be due to differing cost structures and service levels. For example, in some countries, the merchant service charges will include terminal rental, telecoms, maintenance and other services while in other countries merchants will usually purchase or hire the necessary equipment from third parties to facilitate card acceptance. Merchant service charges may also differ both between and within Member States because of differences in settlement terms (i.e. number of days to settle a transaction), recruitment, processing, transaction proof and capture, merchant servicing (including risk management), merchant bankruptcy and fraud write-offs. Blending may also be a relevant factor, which, as Visa Europe understands, is not uniform across Member States.

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[11] ECB Blue Book, 2006. Figures for cash were not available.

[12] Cf. the Interim Report's reference to "mature markets", e.g. see page 62.

Differences between Member States also exist, as recognised in the Interim Report[13], partly as a result of historical evolution and the different ways in which payment systems, in particular domestic debit systems, were designed and have evolved to meet the needs of local national markets in a pre-Euro environment.

Domestic debit cards were predominantly conceived as national systems with local rules and commercial structures. Many were specifically designed as a low cost payment mechanism linked to bank money transmission accounts. Often these were implemented in a closed manner and with little thought to international operability.

As shown by Table 1 below, each national system has developed its own standards, infrastructure, and rules with wide variations in acceptance frameworks, commercial structures and technologies. Often, the technical and security solutions adopted are unique to a particular national scheme which may inadvertently prevent cross-border interoperability and reinforce barriers between different national markets.

Country / Region	Debit System Name	Parties		MIF		MSC		Domestic Brand	Scheme Rules	Risk Management
		Originally	Current	Originally	Current	Originally	Current			
Austria	Bancomat	3	4	No	Yes	No	Yes	ICS[14]	Local	OL
Belgium[15]	MisterCash/ Bancomat	3	3	No	No	Yes	Yes		Local	OL
CEE Nations[16]	Visa/MC	4	4	Yes	Yes	Yes	Yes	ICS	ICS	OL
Denmark	Dankort	3	4	No	No	No	Yes		Local	OL
Finland	Pankikikortii	3	3	No	No	Yes	Yes		Local	OL
France	Visa/Carte Bleue	4	4	Yes	Yes	Yes	Yes		Local	SOL
Germany	ec-Karte	3	3	No	No	No	Yes		Local	OL
Greece	Visa/MC	4	4	Yes	Yes	Yes	Yes	ICS	ICS	OL
Ireland	Laser	4	4	Yes	Yes	Yes	Yes		Local	SOL
Italy	Pagobancomat	4	4		Yes	Yes	Yes		Local	OL
Netherlands	PIN	3	4	No	No	Yes	Yes		Local	OL
Portugal	Multibanco	4	4	No	Yes	No	Yes		Local	OL
Spain	Visa/Maestro	4	4	Yes	Yes	Yes	Yes	ICS	Local	variant OL
Sweden	Visa/Maestro	4	4	Yes	Yes	Yes	Yes	ICS	Local	OL
UK	Visa	4	4	Yes	Yes	Yes	Yes	ICS	Local	SOL
UK	Switch/Maestro	4	4	No	Yes	Yes	Yes	ICS	Maestro	variant SOL

Notes: OL – online; SOL = semi-online

Source: PSE Consulting Research

Table 1 : Analysis of European Debit Card System Differences

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13 See pages iii and 29 of the Interim Report.

14 International Card Systems.

15 Similar: Bancomat in Luxembourg.

16 Including Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia.

Over the last 40 years, Visa Europe has attempted to remove obstacles created by national differences by setting a clear framework for payment card issuing and acceptance across all of the Member States. In many respects, its members can be credited for their investment in achieving sophisticated pan-European interoperability ahead of its time. However, in so doing, Visa Europe members must of necessity adapt to local market idiosyncracies in order to compete on price and level of service.

Given the factors set out above, it is not surprising that the Interim Report found differences in card usage and fee levels across Member States.

b) Differences between debit and credit cards

At a number of places in the Interim Report, the Commission apparently seeks to compare *credit* card systems, such as the Visa Europe credit card payments system, with domestic *debit* card systems. It concludes, for example, that the fees charged for credit cards are higher than debit cards resulting in increased profitability. However, the Commission fails to take account of the fact that the structure and functionality of the two card payment systems are not the same and that they are based on totally different cost structures.

In particular:

- Credit cards, while to some extent competing with debit cards, offer a different function to debit cards – namely the inherent feature of an unsecured extended credit facility and interest-free period which incur additional cost. The credit facility offered by credit cards is valued by merchants and cardholders alike and serves a different purpose to the payment service provided by a debit card;

- Debit cards are provided as an ancillary part of a banking current account whereas credit cards are a standalone product. Because of their role within the wider banking relationship, many of the costs associated with debit cards may be allocated across other banking services. Accordingly, the apparent costs involved in debit cards may not reflect the entire costs involved. Credit cards, by contrast, generally have to bear the entire costs independently.

- Credit cards also require different and more expensive authorisation and fraud control procedures. Whereas a debit card transaction is dependent upon there being sufficient funds in the bank account (unless an overdraft facility has been agreed), a credit card transaction requires a detailed creditworthiness assessment and a cross-check as to the available credit limit. The costs of risk management and fraud checks are more expensive for credit cards which do not have the relative security of a deposit account.

- Some domestic debit systems may have arrangements that operate by way of an alternative to interchange fees e.g. sharing the profits of the operating company.

Given that credit cards and debit cards are different as regards end-user demand and cost levels and structures, there is no rationale for expecting their fees to be the same or similar.

1.3 Conclusion

There are clear and logical reasons for differences found by the Interim Report in the functioning and fee levels of payment cards across the EU. Payment card systems clearly cannot act independently of local specifics. To succeed they must adapt to them whilst at the same time maintaining their core operating principles.

Although banks should be free to determine strategy and pricing according to local conditions, it is important that the legal framework within which they must operate is the same throughout the EU to ensure consistency and to allow Member States to move closer together as economic conditions evolve. Unfortunately, existing differences in regulation at a Member State level can increase the level of market fragmentation and prevent banks and payment card systems from operating within a similar framework across the EU. In some Member States national legislation favouring the use of cash and cheques or preventing banks and other market players from charging for these means of payment adds to the differences between Member States.

Differences in national regulation or in the implementation of EU law, and particularly differences in the regulation of interchange, will make it more difficult for banks from one Member State to issue payment cards in another Member State. In Member States where the level of interchange is heavily regulated and is likely to hinder the efficient growth of the system, local banks will adapt their behaviour accordingly. Hence, differences in Member States' regulation of interchange are likely to distort cross-border trade and reduce the ability of banks to expand across Europe.

To the extent, therefore, that the Commission considers that any future regulation of payment cards is necessary, Visa Europe would strongly urge the Commission to be clear about cause and effect and the importance of consistency of approach.

2. Profitability analysis

2.1 Introduction

The Interim Report makes certain observations about the profitability of card issuing and card acquiring[17]. In particular, it believes that it has identified high and persistent profitability in relatively mature markets which (together with other evidence collected on entry barriers) suggests the existence and exercise of market power in these markets. It queries the necessity of interchange given its findings on profitability[18].

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[17] See, for example, page iv of the Interim Report.

[18] See page 77 of the Interim Report.

The Interim Report's conclusions on the profitability of issuing and acquiring are based on wholly inappropriate data. The analysis does not provide a safe basis from which to draw any inferences. The Interim Report's observations on profitability or how profitability levels might indicate anti-competitive behaviour or the role of interchange are, in Visa Europe's view, entirely misdirected.

Some key concerns about the analysis in the Interim Report as regards its profitability analysis are set out below.

2.2 Analysis

a) Introduction

The Interim Report's "Profitability Analysis"[19] is bound to attract much attention. It purports to show that banks participating in card payment systems in the 25 Member States have been making very large profits, more so on the issuing side, and more on credit cards than on debit cards. Moreover, the Commission claims that its findings indicate that the issuing business in 20 of the 25 Member States would have had positive profits in 2004 even if the interchange (or "MIFs") had been set at zero[20].

Before examining in more detail what the Interim Report has done, it is important to note that the Interim Report itself enters several caveats that emphasise the limitations of its analysis. These caveats are likely to be ignored in public references to the Interim Report's evidently dramatic headline conclusions. Indeed, this is exemplified in the speeches made by Commissioner Kroes on the Sector Inquiry preliminary results on 12 April and 6 June 2006[21].

The Interim Report has chosen a so-called "profit ratio" as its measure of profitability, as is explained in Section IV.2.2b) below. In some of the analyses, the profit ratios of individual banks are averaged for each Member State. The Interim Report states that some of these averages "are based on a limited number of observations, which means that results may not be entirely representative of profit ratios for a given country". Additionally, the Commission has "no way of assessing whether results are driven by 'outliers' in the sample"[22]. Indeed, the total number of banks is 83 for acquiring business and 136 for issuing business (i.e. an average of less than 4 and 6, respectively, per Member State).

The discussion in the Interim Report of some of the results reveals disturbing shortcomings. Some examples of this are noted here.

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19 See Chapter VII of the Interim Report.

20 See page 70 of the Interim Report.

21 Commissioner Neelie Kroes, speech on 6 June 2006 at Eurofi Conference on Retail Financial Services in Europe on "Tougher competition in retail financial services: a threat or a promise?", speech on 12 April 2006 on "Payment Cards Competition Inquiry – preliminary results".

22 See pages 65 and 67 of the Interim Report. The phrase "not entirely representative" is a euphemism. Some averages may not be representative at all. There is no way of knowing.

(i) The Interim Report comments on a distribution of the profit ratios for credit cards for a single year (2004) of 136 issuers[23]. It reports that "only 20 issuer institutions reported a negative profit rate". However, although the 136 issuers are not identified by country, it nevertheless concludes: "In the light of these results, it is clear that the credit card issuing business was very profitable in all 25 Member States in 2004"[24]. The next set of data presented in the Interim Report[25] shows that 2 of the 25 Member States had average profit ratios of less than 10%, which does not suggest that issuing was "highly profitable" (in terms of the profit ratio) in those countries.

(ii) The second example also concerns profit ratios in credit card issuing. Graph 40[26] shows the average profit ratios for each Member State in each of the five years 2000 to 2004. Visual examination of the data for each Member State suggests that the year-to-year changes follow a variety of patterns: there is a tendency in some countries for the average to go down, and in others for the average to go up (with different apparent rates of decrease or increase); in some other countries for there to be little year-to-year change; and in yet others for there to be no discernible pattern at all. The Interim Report's comment is as follows – and it is highly problematic: "From the analysis of this graph, it is apparent that profit patterns were relatively consistent over this period in almost all countries. More importantly, these results suggest that … the magnitude of profit ratios is not related to the different stages of the business cycle in each market but rather follows a medium-term trend"[27]. No information is given as to the dating of "the different stages of the business cycle" in any country; and for at least 9 of the Member States no clear "trend" in the average profit ratio is discernible.

(iii) It is not clear whether the Interim Report distinguishes between consumer cards and commercial cards. Commercial and consumer cards are, however, at very different points in their evolution and represent very different volumes of transactions and often average transaction values.

b) The Interim Report's measure of profitability: the "profit ratio"

Visa Europe now turns to a detailed consideration of the measure of profitability the Interim Report has chosen to use, namely the "profit ratio". It will be shown that the Interim Report's work on issuers' and acquirers' profitability is flawed in a number of

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[23] See subsection 2.1.2 of the Interim Report and in particular Graph 38 on page 67 of the Interim Report. The latter states that the distribution "reveals that 68 out of 136 issuers reported profit ratios higher than the median value (61.4%) of the sample". Indeed, by definition, a half of the observations in a sample must have values higher than the median value.

[24] See page 67 of the Interim Report (emphasis added).

[25] See Graph 39 on page 67 of the Interim Report.

[26] See page 68 of the Interim Report.

[27] See page 68 of the Interim Report

fundamental respects not only because of the choice of an inappropriate measure of profitability itself but also because of the manner in which that measure has been specified and calculated. Visa Europe demonstrates why the Commission should not place any weight at all on its Interim Report's profitability analysis.

(i) The Interim Report explains: "For the purpose of the inquiry, both issuing and acquiring institutions were requested to report their total revenues and total costs associated with the issuing and acquiring of credit and debit cards"[28].

(ii) The Interim Report defines the "profit ratio" as follows: it is the "revenues" minus the "costs", expressed as a percentage of the "costs". Separate profit ratios are calculated for issuing and acquiring, and also for credit cards and debit cards[29].

(iii) It will be noted that the "profit ratio" is quite different from a rate of return on capital or similar measure.

(iv) The cost of capital employed in the particular activity is omitted from the calculation of costs. (A minor exception is noted below.) This has serious implications in the present context. The issuing of credit cards is a more capital-intensive activity than the issuing of debit cards because the former involves the provision of credit to cardholders (i.e. those who are revolvers, not transactors). Moreover, issuing of credit cards is more capital-intensive than acquiring. Thus, even if the profit ratio were otherwise a sound measure of profitability, the omission of the cost of capital employed would invalidate comparisons of profitability based on it, for example, as between credit card and debit card business, and between credit card issuing and credit card acquiring. Yet the Interim Report makes much of such comparisons, emphasising that, according to its analysis, credit card business is more profitable than debit card business, and credit card issuing is more profitable than credit card acquiring. Further, for the same reason, inter-country comparisons also are compromised.

According to the Interim Report, in the issuing business "total revenues are given by interest charged, interchange fees, cardholder fees, currency conversion fees, income from co-branding, and 'other type of incomes'"[30].

(i) The item "interest charged" presumably refers to the interest paid by revolver cardholders on their credit card borrowing. However, as already noted, the issuer's costs of financing that credit are not included among the costs. There is an obviously misleading inflation of profitability in the Commission's measure. The Commission appears not to be aware of this anomalous

[28] See page 63 of the Interim Report.

[29] The Interim Report does not show separate profit ratios in respect of the issuing (acquiring) of the cards of different four-party systems.

[30] See page 63 of the Interim Report.

treatment: the revenues from lending are included, but the associated costs are excluded[31].

(ii) The item "other type of incomes", according to the Interim Report, "aims to capture any other relevant type of income …, as perceived by the respondents"[32]. This item is a recipe for inconsistency of measurement as between the individual issuers, which affects comparability of profit ratios between banks, and also the comparability of the weighted-average profit ratios across Member States. For example, in some countries acquirers receive substantial revenues from the sale or leasing of POS terminals. Some acquirers receive revenues for processing services they provide to other card systems. There is no indication in the Report how such revenue streams have been dealt with by respondents.

According to the Interim Report, in the issuing business "total costs include costs for the provision of a free funding period, card production and transaction processing costs, billing, fraud, credit losses, costs related to rebates, staff costs and "other type of costs""[33].

(i) The item "costs for the provision of a free funding period" presumably includes the cost to the issuer of money advanced to the merchants on behalf of transactor cardholders. It is odd, and anomalous, that this element of cost is included among the relevant costs, while, as noted above, the cost of financing the borrowings of revolver cardholders is not included.

(ii) It is not clear whether the item "costs related to rebates" refers to the issuer's costs of administering the rebates systems, or whether it includes the costs of the grants made to cardholders. If it refers to the latter, it is not stated how the costs are calculated.

The Interim Report recognises that "[t]he measurement of the profitability of a specific activity is typically subject to problems related to the allocation of costs that are common to other activities"[34]. In the present case, however, the Interim Report believes that the problems have been largely avoided because the allocations were "made by the respondents", that is "by those who best know their own business". The Interim Report is satisfied that for this reason "the measurement of profitability has to be considered reliable"[35]. This is naïve. The fact that each bank knows its own business does not ensure that there will be uniformity of treatment of common costs. The Interim Report's cavalier approach to the treatment of common costs displayed

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31 Another instance in the Interim Report of anomalous treatment may be noted. Although the interest charged to borrowing cardholders is included in the issuer's revenues, it is not treated as part of the 'cardholder's' overall fee, i.e. the "price" paid to the issuer (see above, paragraph II.3).

32 See page 63 of the Interim Report.

33 See page 63 of the Interim Report.

34 See page 63 of the Interim Report.

35 See page 63 of the Interim Report.

here is in sharp contrast to the Commission's attitude to the treatment of common costs in the cost studies Visa Europe carries out in terms of the Commission's Decision of 24 July 2002 ("2002 Visa Exemption Decision")[36] concerning Visa Europe's intra-regional MIF. There, the Commission (and Visa Europe) have been assiduous in seeking to ensure that all the participating banks adopt appropriate cost-allocation procedures.

c) "Profitability vs interchange fee"

Section 2.1.4 of Chapter VII of the Interim Report is headed "Profitability vs interchange fee". It concerns credit card issuing. Its main statistical findings are that the majority of issuers would have made profits on credit card issuing even if they had received no revenues from interchange fees i.e. if the MIFs had been zero, of the 100 issuers which had provided the necessary data and which had positive profit ratios, 62 would "nevertheless remain profitable". Twenty of the 25 Member States would have had positive average profit ratios if interchange fees had been zero.

The discussion above has already demonstrated that the profit ratio is not an appropriate measure of profits or profitability. Accordingly, the particular exercise the Interim Report has carried out should be disregarded. Visa Europe therefore confines itself to a few observations on the exercise[37].

The figures given in the Interim Report indicate that 62 out of the 118[38] issuers which provided the necessary data would, in the Interim Report's words, "nevertheless remain profitable" without any interchange revenues. The Interim Report seems to have inferred from this that the 62 issuers would not have had to have different (and higher) cardholder fees in 2004 than they actually had, and that, therefore, in this particular respect, the interchange revenues (and therefore the additional profits) they actually received were not necessary to retain their credit cardholders in the system. This assumes, unrealistically, that an issuer does not require to have a certain minimum profit level to remain an issuer. The Commission ignores this issue.

The Interim Report concludes that its exercise does "partially invalidate one of the main results of the theoretical [economic] models…"[39]. The exercise shows, it is claimed, that many issuers – and also their cardholders – need not have been "subsidised" by acquirers in the form of high interchange fees: with lower, or even zero, interchange fees, their cardholders would have been cardholders and, to that

36 Commission Decision of 24 July 2002 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA agreement (Case No. COMP/29.373 – Visa International – Multilateral Interchange Fee).

37 It is noted that the analysis is for one year only, the year 2004. Data presented in Chapter VII of the Interim Report shows quite considerable variations in annual average profit ratios in several Member States (e.g. Graph 40). Further, the analysis is based on a group of only 100 issuers: these seem to have been included non-randomly, and to have been taken from a larger sample of 136 issuers, itself unlikely to be a random sample.

38 The 118 includes 18 issuers which were not profitable anyway, as measured by their profit ratios.

39 See page 70 of the Interim Report.

extent, system output would not have been affected. However, about half of the issuers in the sample would have been rendered unprofitable (or more unprofitable than they were) with a zero interchange fee. And, moreover, to repeat, the profit ratio is not an appropriate measure of profits or profitability, and the exercise is misdirected.

Finally, the Interim Report incidentally states as follows (in the chapter on "Profitability"): The cost structure "for most of the acquirers surveyed raises the question whether reasons other than scale may be responsible for the high concentration of the acquiring business in some countries, such as the existence of interchange fees"[40]. This suggestion that interchange fees may be responsible for high concentration levels in acquiring is misconceived. Since acquirers pass through the interchange to their merchants, interchange does not affect the cost structure of acquirers and so it cannot affect the structure of the acquiring industry, i.e. the number and size distribution of acquiring businesses in a given country. This is the case whether the interchange is relatively high or relatively low.

2.3 Conclusion

In summary, (i) the Commission has failed to ensure that the underlying data on which it relies is robust; (ii) the Commission has selected an inappropriate, and consequently misleading, measure of profitability; (iii) it has also introduced perplexing complications in its detailed specification for the measurement of the profit ratio; and (iv) it seems to have done little to prevent possibly serious inconsistencies in the data on which its analyses are based.

3. The Interim Report's econometric analyses

3.1 Introduction and some general considerations

In Annex 5 of the Interim Report the Commission presents various econometric analyses. The aim of that annex is to analyse in greater detail the determinants of the three "system fees (merchant service charge, interchange fee and cardholder fee) as well as the interrelation among them"[41]. In fact, there is nothing in the Annex on the determinants of interchange fees, nor on the interrelations among the three fees.

The analysis of the determinants of the merchant service commission (the MSC), is discussed in Section IV.3.2 below, and then the analysis of the determinants of the cardholder fee in Section IV.3.3 below.

First, however, Visa Europe notes some general matters pertaining to both Sections IV.3.2 below and IV.3.3 below.

(i) There is no discussion in Annex 5 as to whether or not the samples are random samples. There is no reason to suppose that the samples are random.

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40 See page 77 of the Interim Report.

41 See page 1, Annex 5 to the Interim Report.

(ii) Throughout the Interim Report the Commission lays stress on evident differences among the Member States, and believes that this may reflect "market fragmentation". If this is so, it is not clear that in its econometric work the Interim Report has avoided the "apples-and-pears" problem. This question is not addressed in the Annex. Yet in the two multiple regression analyses[42], the estimation, by econometric analysis, of the quantitative importance of the interchange (or "MIF") as a determinant of the MSC and the cardholder fees relates, as it were, to the "average" Member State. Is there such a thing?

(iii) There is no separation in the econometric analyses between credit cards and debit cards[43], nor between consumer cards and commercial cards. There are therefore further apples-and-pears problems[44].

(iv) The Interim Report explains that in a number of Member States there is only one acquirer for each system, that single acquirer being owned collectively by the issuers. This means that in those countries the distribution to the issuers of the profits of the acquirer is a mechanism for transferring funds from the acquiring side to the issuing side – a mechanism distinct from interchange. It would be surprising if this does not affect the setting of interchange fees in those Member States. If it does make a difference, that factor should have been allowed for in the analyses – it is not.

(v) In one table there are entries for three three-party card systems (American Express, Diners Club and JCB) as regards interchange fees[45]. This is puzzling as three-party systems do not have interchange fees.

3.2 The merchant service charge

The Annex claims that the multiple regression analysis shows that the interchange fee has a statistically significant positive relationship with the MSC (having allowed for the effects of other factors included in the analysis)[46]. The relevant coefficient differs materially from one another in the four alternative estimations. The coefficient ranges from 0.9 to 0.3 – a coefficient of 0.3 means that a 10% change in the MIF brings about a 3% change in the MSC.

Visa Europe need not examine these general results. The Annex also includes estimations for several individual countries, including the United Kingdom. A fixed effects regression analysis[47] shows a very low coefficient on the interchange fee for the UK (0.13). It is, moreover, not statistically significant. This result is compatible with there being no positive relationship between the MSC and the MIF.

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42 See Tables 10 and 16 at pages 9 and 13, respectively of Annex 5 to the Interim Report.

43 See Section IV.1.2b) on the differences between credit and debit cards.

44 See page 2, Annex 5 to the Interim Report.

45 See Table 7, page 6 of Annex 5 to the Interim Report.

46 See Table 10, page 9 of Annex 5 to the Interim Report.

47 See Table 12, page 11 of Annex 5 to the Interim Report.

The results reported for the UK are such that it is simply not possible to have any confidence in the results of the regression equations pertaining to the pooled data from the 25 Member States.

3.3 The cardholder fees

The determinants of the cardholder fees are analysed econometrically in Section 3.2 of Annex 5 of the Interim Report.

In addition to the general observations made in Section IV.3.1 above a further point should be noted.

A change in the interchange fee takes effect throughout the network on a given date. Issuers, on the other hand, are unlikely to make any consequential changes in cardholder fees on that date. Rather, some of those fees may be changed only once a year (e.g. the annual cardholder fee, where applicable), and changes in other fees may be spread out over a period. There is a time lag between cause and effect. The Interim Report does not test for such a lag (or lags) and does not allow for it in the estimations of the effect of changes in interchange fees on the level of cardholder fees.

Most importantly, however, the econometric work is crucially flawed by the fact that the Interim Report has specified and measured the average cardholder fee in an unacceptable way. The calculation of the average cardholder fee is based on the aggregate of a number of specified fees. These fees are obviously payments by cardholders to issuers and are properly included in the "price" the cardholder pays. Revolver credit cardholders also pay interest charges to issuers: they also are certainly part of the price those cardholders pay to their issuers. Nevertheless, the interest charges are not included among the aggregated fees. Further, no allowance is made for the discounts and other rewards granted by issuers to the transactor credit card cardholders. Those discounts and rewards clearly serve to reduce the price those cardholders pay. As there are likely to be material differences across the 25 Member States in respect of the proportion of revolvers to transactors, and of the amounts of discounts etc given to transactors, the impact of this incorrect treatment is likely to differ materially in different countries. The treatment, which is not discussed in the Interim Report, undermines the econometric work carried out in respect of cardholder fees.

There really is no point at all in trying to identify, using econometric analysis, the determinants of a "price" which demonstrably is mis-specified, is not a relevant price and cannot serve as a reliable surrogate for one.

3.4 Conclusion

Visa Europe's discussion leads it to urge the Commission to jettison its main results reported in Annex 5, and not to base any conclusions, let alone practical measures, on them. The same applies also to the Interim Report's main results of its profitability calculations, as set out in Section IV.2 above.

4. Setting of interchange fees

4.1 Introduction

The Interim Report challenges Visa Europe's and other card payment systems' view that interchange fees are necessary for the (optimal) operation of card payment systems. It has observed that several national systems operate without an interchange mechanism[48].

The Interim Report further states that interchange fees lead to a transfer of revenues from acquirers to issuers and thereby distort price competition between acquiring banks. They are said to have an effect similar to a "tax" on each payment with a card at a merchant outlet and largely determine the fees charged to cardholders and merchants and, hence, restrict competition. The Interim Report also suggests that interchange fees may (also) be used as a tool to extract rents from merchants. In this context, the Interim Report indicates that the setting of interchange fees could possibly be a matter of market power (or the market not working effectively) in some EU Member States, given the strong country divergences in interchange fee levels[49].

In Visa Europe's view, the economic analysis in the Interim Report is neither robust nor convincing. Visa Europe does not consider that the level of interchange in the Visa Europe system indicates either a lack of competition or market power, or an ability to extract rents from merchants. Even if the profits properly measured were higher than average (which is not accepted for the reasons set out above), the only way to analyse this would be to carry out detailed assessment of the position in each Member State in the EU which the Interim Report has not done.

4.2 Analysis of economic literature on payment card systems

The burgeoning theoretical economics literature on payment card systems tends to be focused on the determinants of the interchange fee and so on the output of the system. Particular attention is given to the question of whether and in what circumstances the privately-optimal interchange fee will be different from the socially-optimal fee.

The analytical models have it in common that the level of the interchange fee affects the prices on the two sides of the "two-sided" system. The two prices are, respectively, the (net) fees paid by the cardholder to the issuer, and the merchant service charge (MSC) the merchant pays the acquirer. The output of the system depends on the combined effect of the two prices. It is the "structure" of prices in the system that matter.

The Interim Report reviews the theoretical literature[50]. Visa Europe will not go over the whole of this ground, but merely offers comments on issues where the Interim Report has misunderstood the literature. But before it does this, Visa Europe needs to

48 See page 26 of the Interim Report.

49 See page 32 of the Interim Report.

50 See pages 6-12 of the Interim Report.

point out a glaring gap in the Interim Report's review. The Interim Report does not refer to a major feature of the literature and its variety of economic models. This feature is that the models all imply that an interchange fee based on issuers' costs, or on a sub-set of them, will not be socially-optimal and so will not generate the socially-optimal output (except by chance).

The Interim Report summarises the theoretical literature in these terms[51]:

> "To summarise, therefore, two competing assessments can be distilled from the economic literature on interchange fees in payment card systems: either that their effect is neutral and provides efficient incentives for card issuers to expand output; or that high interchange fees offer a means of transferring rent (which cannot be competed away) from acquiring to issuing banks".

This statement, however, misrepresents the nature of the theorising reflected in the economic literature and its implications.

It is not the case that there are some analytical models that point to the first of the Interim Report's two "competing assessments", and another set that points to the second assessment. Rather, a model does not have a single outcome. With its given formulation, a model can have a range of outcomes, these depending on the particular assumptions put into it. Thus a model typically can show that, according to the assumptions fed into it, the socially-optimal interchange fee can be the same as the privately-optimal fee, or higher than it or lower than it. In this way, the models help to identify the factors that can be important in indicating which particular one of the three outcomes is likely in a given situation.

The value of the theoretical literature is not in doubt. Nevertheless, it is a mistake to suppose that one can, as it were, read off directly from the literature to the specifics of a particular situation (e.g. in a particular Member State), and so determine which of the Interim Report's two "competing assessments" is the one that should be applied to that situation.

Visa Europe now addresses an important issue where the Interim Report has misunderstood or misapplied the theoretical literature.

(i) The economic models typically assume that a change in the MIF is passed through <u>fully</u>: from the issuer directly to the cardholder; and from the acquirer directly to the merchant.

(ii) Such an assumption simplifies the construction and articulation of a model. But this simplification does not mean that the results derived from the model are of no help in understanding and analysing a situation in which there is not a full pass-through on one side or on the other side (or on both sides).

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51 See page 17 of the Interim Report.

(iii) The Rochet-Tirole definition of two-sided industries reproduced in the Interim Report[52] assumes full pass-through of the MIF on each side. Yet in practice there may not be full pass-through, for example, on the issuing side. Issuers may find that they can increase their issuing business by using, as it were, part of an increase in the level of a MIF to recruit more cardholders, and not pass through the whole of the increase directly to its cardholders. But this does not mean that the MIF does not perform its role, which is to encourage a desired change in the structure of the system's prices. Nor does a partial pass-through necessarily increase the issuers' profit margin or profits (as compared with what they would be with a full pass-through).

(iv) The Interim Report refers to a proposition to the effect that the privately-optimal MIF may be "too high" and above the socially-optimal MIF if merchant fees (MSCs) increase along with interchange fees but issuers do not pass the additional interchange fee revenue back to cardholders[53]. If additional revenue is less likely to be competed away when received on the issuing side than on the acquiring side, then it would be privately-optimal to increase the MIF.

(v) However, even if the pass-through of a change in the MIF is lower to cardholders than to merchants, it does not follow that issuing in that particular situation is less competitive than acquiring (so that issuers are less likely than acquirers to compete away an increase in interchange revenue). The factors affecting the relative extent of pass-throughs of a change in the MIF on the two sides are not the same as the factors affecting the degree of competition on the two sides, issuing and acquiring[54].

4.3 Analysis of data used

The Interim Report appears to base its analysis of interchange on the data represented by Graphs 4 to 11 of the Interim Report. Visa Europe has been unable to verify the accuracy of these graphs as it does not have access to the underlying data. However the usefulness of the graphs is questionable given the fact that a number of different products appear to be blended together and averages arrived at. It is also possible that the data provided to the Commission is not as accurate as the Commission would like and could, for example, include inter-regional rates where the Commission has requested intra-regional rates. For example, Graph 5[55] of the Interim Report shows an increase in Visa Europe's average intra-regional debit rates from 2003 to 2004 although Visa Europe did not increase intra-regional debit rates during this period.

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[52] See page 6 of the Interim Report.

[53] See page 8 of the Interim Report.

[54] Visa Europe reverts to some of these subjects in Section IV.4.5 below.

[55] See page 22 of the Interim Report.

This is a good example of the danger of using weighted averages which are used frequently throughout the Interim Report. A weighted average may show an increase even if the value of each of its individual components has remained unchanged.

The graphs presented in the Interim Report furthermore look only at the years 2000 to 2004 and do not take into account changes since 2004. A number of Visa Europe's intra-regional and domestic interchange rates have, for example, been reduced since 2004 to reflect the principles of the 2002 Visa Exemption Decision[56].

4.4 Visa Europe's rationale for interchange

The interchange fee in a four-party system such as Visa Europe's is designed to optimise the use of the particular four-party system. If there were no interchange fees or equivalent payments, each issuing bank would have to recover all its costs from the revenue it received from cardholders. It would have to adjust its issuing activities accordingly, so as to bring its costs and revenue into balance.

Visa Europe has set out arguments on the rationale for interchange in its responses to the sector inquiry questionnaires and elsewhere. It does not propose to repeat this in further detail here. Given the flaws in its analysis (see in particular Sections IV.2 above and IV.3 above as well as the following), the Interim Report does not undermine the validity of Visa Europe's position.

It is not clear on what basis the Interim Report has evaluated what the situation would be if no interchange fees were charged. Without the possibility to charge interchange fees, four-party payment systems would look very different. In particular, it is likely that cardholder fees could increase, and/or benefits to cardholders be reduced with the possible result that cardholders would give up their four-party payment cards or use them less. The number of members participating in the system could reduce, and thus so would overall output. Product quality, variety and thus competition and innovation could be commensurately compromised. Further, members might migrate to three-party systems or possibly "closed loop" systems. Three-party systems are typically more selective with regard to participation and charge higher fees to merchants[57] and cardholders. Thus on the Interim Report's reasoning this could lead to higher prices to consumers as a whole.

The Interim Report claims that "interchange fees are not intrinsic to the operation of card payment systems, as several national systems operate without an interchange fee"[58]. The Interim Report omits to say that all such systems (i.e. in Finland, Luxembourg, Denmark, and the Netherlands) are debit card systems, not credit card systems. Moreover, debit cards are an "accessory product to current accounts"

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56 By contrast, MasterCard's rates which are not subject to regulation by the Commission, have remained higher.

57 See page 45 of the Interim Report.

58 See page 32 of the Interim Report.

whereas credit cards are not. This may allow issuers of debit cards in certain circumstances to operate without apparent interchange fee income[59].

Critics of four-party systems and their interchange fees often claim that the interchange fees collectively set by the member banks reflect a restriction of competition and market power. The usual objection to restriction of competition or the exercise of market power in product markets is that they reduce the output of the products in question. With four-party payment cards, however, the critics object that interchange arrangements serve to increase the output of the products in question.

The fact that critics (including some regulators) have such apparently contradictory positions suggests that what is true for "one-sided" markets is not necessarily true for "two-sided" markets. This reinforces Visa Europe's view that regulators should pay special attention to the distinguishing features of two-sided markets, notably in the case of payments cards. Thus, the effects of interchange should be considered as regards the prices on the two sides taken together and not only as regards the price on one side in isolation.

4.5 Allegations made in the Interim Report

a) Introduction

In this section, Visa Europe specifically addresses the following statement included in the Interim Report's "Summary and Analysis of the Findings":

> "*Interchange might alternatively be analysed as a means to transfer rents collected by acquirers facing possibly an 'inelastic' merchant demand to the issuing side. The fact that interchange, to a large extent is passed through to merchants, together with the lack of a strong correlation between the level of cardholder fees and that of interchange fees, seems to be in line with possible extraction of rents and their transfer from the acquiring to the issuing side*".[60]

Expressed rather more colloquially and bluntly, this statement is to the effect that interchange serves to transfer money to issuers from acquirers who extract it from merchants, who, in turn, collect it wholly or in part from consumers. In this way, interchange fees are a tax on merchants and consumers, the proceeds going to the banks[61]. Moreover, issuers tend to give only some of the additional money to their cardholders. The remainder they keep for themselves.

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59 See further, Section IV.1.2b) above.

60 See page 142 of the Interim Report.

61 According to Competition Commissioner Kroes, "these high [payment card] fees are then passed on to consumers as a kind of tax" (speech on 6 June 2006 at Eurofi Conference on Retail Financial Services in Europe on "Tougher competition in retail financial services: a threat or a promise?"). In her 12 April 2006 speech on "Payment Cards Competition inquiry – preliminary results", Commissioner Neelie Kroes said that "[b]anks collectively set fees that "tax", businesses, and ultimately all consumers, for every card payment" and " [I]n general, banks charge up to 2.5% on every retail purchase with a payment card, the equivalent of a tax on consumption.".

The Interim Report seems to favour this interpretation of the nature and effect of interchange fees (more so, of course, the effect of "high" interchange fees). Visa Europe therefore puts forward its assessment of the general statement (quoted above), which in its view cannot be sustained.

The characterisation of interchange as a mechanism for transferring profits ("rents") from acquirers to issuers is logically linked to another characterisation of interchange, although the Interim Report does not specifically make the link. Critics of payment card networks often claim that those consumers who use payment cards in "merchant" establishments are subsidised by other consumers who pay, for example, by cash.

The allegation of cross-subsidisation is indeed made in the Interim Report. For example, it is taken for granted that the interchange fee is "a cross-subsidising factor among different payment instruments"[62].

This cross-subsidisation occurs, it is said, because merchants bear the burden of high payment card interchange fees, which they then pass on to their customers in the form of higher prices; and these higher prices are paid equally by cash and payment card payers. It is further argued that the costs to merchants of accepting payment cards is higher than their costs of accepting cash, largely because of high interchange fees. It follows that the alleged cross-subsidisation would not occur if interchange fees were set at a suitably lower level.

Thus, to combine the two linked characterisations of interchange, a "high" level of interchange serves to enrich issuing banks at the expense of merchants and their customers, especially those of their customers who use (allegedly) "cheaper" payment instruments such as cash.

b) **Interchange fees are not a "tax"**

The considerations that cause Visa Europe to reject the generalisation that interchange is a mechanism for transferring profits from acquirers to issuers include the following:

(i) Merchants who pass through 100% of their MSCs (which can be said to "include" the MIF) to their customers are unlikely to suffer detriment. Merchants who pass through less than 100% of their MSCs obviously absorb the remainder. Visa Europe observes, incidentally, that merchants' pass-through of interchange fees to their customers has not been subject to scrutiny in the context of the use of payment instruments.

(ii) The Interim Report claims that its profitability analysis demonstrates that issuers make large profits, notably so on their credit card business; and that issuers' profitability is higher than acquirers' profitability, though the latter "is quite satisfactory overall"[63]. However, Visa Europe has shown in Section IV.2 above that the profitability analysis is fatally flawed: it is based, for example,

[62] See, for example, page 10 of the Interim Report.

[63] See page iv of the Interim Report.

on an inappropriate measure of profitability, the "profit ratio". The analysis has to be disregarded.

(iii) Furthermore, the discussion of profitability in the Interim Report fails to deal with an obvious question: if issuing is so lucrative, how is it that the supposed "excess profit" is not competed away? The Interim Report itself observes that the "issuing side of the payment card market yielded no evidence of excessive concentration across the EU-25 Member States", and that "[g]enerally, issuing is characterised by a high number of market players of varying size"[64].

(iv) The Interim Report makes much of its finding that increases in the MIF are by no means fully passed through by the issuers directly to their cardholders. This is an essential element in the scenario in which interchange is regarded as a mechanism for increasing the profits of issuers. Insofar as the Interim Report relies on its econometric analysis of the determinants of the level of cardholder fees, Visa Europe has shown in Section IV.3.3 above that this would be relying on a fragile crutch. In the relevant econometric estimations, the cardholder fee is seriously mis-specified, and cannot serve as a proxy for the average cardholder fee that cardholders pay issuers. In any event, there are sound business reasons why issuers may not pass through to their cardholders the whole of an increase in the MIF in the form of reductions in cardholder fees or increases in rewards that cardholders value. An issuer may, for example, use, as it were, part of the increase to spend more on promoting its business or on recruiting more cardholders – both of which, in due course, are likely to lead to an increase in the use made of the network, thereby increasing its efficiency and benefiting cardholders and merchants generally. For this reason, it does not follow, as the Interim Report implies, that the remainder of the increase in the MIF which is not passed through directly to cardholders simply goes to swell the issuer's profits.

(v) The Interim Report also makes much of a particular proposition developed in the economic literature. This proposition is that owners of a four-party system will prefer to set a higher rather than a lower interchange fee. This is so if, other things being equal, additional interchange revenues are less likely to be competed away by issuers than they would be by acquirers. The proposition is fine. But naturally it cannot tell us how frequently the necessary conditions are present in the real world. The Interim Report has not shown that, generally, competition is less effective on the issuing side than on the acquiring side, and that issuers are less likely than acquirers to compete away additional profits. On the contrary, its analysis of concentration and number of firms in issuing suggests that issuing is likely to be the more competitive of the two activities[65]. If this were generally the case, then the proposition under discussion indicates that the owners of the system would prefer lower rather than higher interchange fees, other things being equal.

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64 See page 86 of the Interim Report.

65 See pages 86-87 of the Interim Report.

To summarise, it would be wrong to conclude either from economic theory or from evidence presented and analysed in the Interim Report that the interchange fee is used generally (or frequently) to increase the profits of issuing banks at the expense of merchants and their customers.

c) **Alleged subsidisation of users of payment cards**

The argument that there is cross-subsidisation in favour of payment cards – which contributes to the supposed excessive usage (of credit cards in particular), relies primarily on merchant cost studies that purport to show that merchants' costs of accepting payment cards typically are higher than their costs of accepting cash. And, since the merchant typically simply pools its payment instrument costs, customers who use the supposedly cheaper payment instruments receive no advantage as compared to customers who use the more expensive payment cards. There is no incentive for consumers to use the cheaper cash, and so resources are used wastefully.

There are several weaknesses in this cross-subsidisation argument and the empirical evidence associated with it.

(i) Merchants' cost studies predominantly relate to retailing. It would be wrong to extend the results of these studies to cover other merchant categories such as hotels or government agencies, which are likely to have different cost structures.

(ii) The cost studies ignore any direct benefits that merchants derive from accepting payment cards as compared to cash. For the cross-subsidisation question, the net costs (i.e. after deducting benefits) and not the gross costs should be considered. From the merchants' point of view, the quality of different payment instruments is unlikely to be the same, e.g. as regards convenience and security. (For a detailed discussion of merchants' benefits see below footnote 79 and Annex 4.)

(iii) Merchants engaged in some branches of retailing do not or cannot accept any alternatives to payment cards. Examples include merchants engaged in on-line transactions or over-the phone business. It makes no sense to talk about cross-subsidisation in such situations.

(iv) Many consumers sometimes pay by cash and at other times by payment card. Much of the so-called cross-subsidisation simply cancels out.

(v) Consumers who do not have payment cards or cannot use them (e.g. because they have reached their credit limit) may shop at merchants who do not accept cards, and so cannot be victims of cross-subsidisation.

In any event, it makes no economic sense to focus exclusively on the merchants' costs when considering the various alternative payment instruments. The costs of other parties need to be taken into account, notably those of consumers themselves. Indeed, if one wants to arrive at some quantification of the social efficiency of the different payment instruments, one has to take into account not only the costs incurred by the various parties involved in the production and consumption of payment instruments, but also the benefits to those parties. It is understandable, of course, that retailers may be concerned about the costs they actually incur. But from the economic perspective it is absurd for politicians, regulators and commentators to be blinkered and to concentrate on merchants' costs alone.

In addition to the studies quoted by the Interim Report[66] which suggest that paper-based payments e.g. cash are more costly than electronic payments, Visa Europe is aware of a recently published study that attempts to cover comprehensively the costs as well as the benefits of all participants in the supply and consumption of the various payment instruments. It deals with three retail sectors in the United States. The study by Swartz, Hahn and Layne-Farrar[67] shows that relying on merchant cost studies alone can lead to very different conclusions about economic efficiency or welfare than when costs and benefits are comprehensively taken into account. The study measures the costs and benefits for each party (consumers, merchants, banks and government) involved in each different payment instrument. The study finds that for smaller transaction sizes, there is not one payment instrument that distinguishes itself by being clearly more socially efficient than the other payment instruments. For large transaction sizes, credit cards have the lowest net social costs of all the payment instruments included in the study, including cash.

In all, the cross-subsidisation argument is not tenable.

d) Application to three-party systems

Visa Europe also wants to draw attention to another point raised in the Interim Report. The Interim Report refers to the fact that banking institutions typically supply a number of different payment instruments to their clients. There is evidence that the prices banks charge their clients do not accurately reflect the differences in the banks' costs of providing the various payment instruments. There is therefore some cross-subsidisation[68]. To the extent that there is such cross-subsidisation due to banks' pricing practices, the merchants' actually-incurred costs for different payment instruments are distorted. The Interim Report observes that the banks' pricing practices "might imply that credit and debit cards are cross-subsidising other means of payment"[69].

In concluding the present Section IV.4.5, Visa Europe wants to emphasize that, in principle, the argument that the interchange fees of four-party payment card systems (and especially credit card systems) give rise to the enrichment of issuers by "taxing" merchants and consumers, can be applied, *mutatis mutandis* to three-party systems. Three-party systems and the four-party systems tend to follow a similar pricing

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66 See pages 10-12 of the Interim Report.

67 Garcia-Swartz, Daniel D. Hahn, Robert W., Layne-Farrar, Anne, "The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics", *Review of Network Economics*, Vol. 9, Issue 2 – June 2006, page 95.

68 See pages 10-12 of the Interim Report.

69 See page 10 of the Interim Report.

strategy. It seems, indeed, that the three-party systems have higher merchant fees than Visa Europe. The three-party systems do not have interchange fees. A four-party system needs interchange fees in order to help achieve the optimal combination of the prices on the two sides of the system, i.e. the combination of the MSCs paid by merchants and the fees paid by cardholders. A three-party system does not need interchange, as the owner sets the prices directly.

Similarly, the cross-subsidisation argument can be applied, in principle, to three-party systems. That argument depends essentially, as has been seen, on the level of the fees the merchants pay and on the fact that merchants typically do not differentiate in their pricing to their customers according to the payment instrument the latter use.

In any event, neither the alleged "taxation" of merchants and consumers in favour of card issuers, nor the alleged cross-subsidisation at the expense of customers who pay by cash depends on payment card systems having market power and exercising it. A small payment card system is able to follow the same pricing policy as that adopted by the largest payment card system. Diners Club charged merchants 7% on their bills when it started up in 1950 and had merely a few hundred cardholders[70].

Finally, Visa Europe wants to make it clear that the points made here relating to three-party systems do not imply that the allegations of "taxation" and "cross-subsidisation" are thereby somehow validated. The allegations are not tenable, whether or not they can, in principle, be levelled at three-party systems as well as four-party systems.

4.6 The impact of the regulation of interchange in Australia

Whilst recognising the limitations of inter-country comparisons it is interesting to note the impact of regulation of interchange in different jurisdictions.

The undesired and unintended consequences of price regulation and interference with a payment system's ability to set interchange appropriately are illustrated by the regulation imposed in Australia in 2003 by the Reserve Bank of Australia which forced certain banks and payment card companies to reduce interchange fees. There has been little evidence that these reductions have been passed on to consumers by merchants. Instead banks have offset some of their lost revenue by increasing card fees and scaling-back reward point systems, leaving most consumers worse off[71]. Furthermore, the fact that surcharging is now allowed in Australia, increases the risk that cardholders will pay twice for using their cards, once in the form of increased cardholder fees and again at the till, in the form of a surcharge on their purchase.

In addition, there is evidence that three-party payment systems, such as American Express and Diners Club, have unfairly benefited as a result of the changes.

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70 See D. Evans and R. Schmalensee, "Paying with Plastic: The Digital Revolution in Buying and Borrowing", Second Edition. MIT Press: Cambridge, MA. 2005, p. 181.

71 According to Dr. Philip Lowe, Assistant Governor, Reserve Bank of Australia, the value of reward points has fallen from around 0.8% of the amount spent to 0.65% of the amount spent. See remarks made at the House of Representatives Standing Committee Review of the Reserve Bank and Payment System Board annual reports 2005, 15 May 2006.

According to Reserve Bank of Australia data, American Express has already achieved a 15-20% increase in its market share since the introduction of interchange regulation for the four-party payment systems. To protect their customer base, some Australian banks responded to the Reserve Bank's credit card regulation by entering into commercial agreements to offer their customers Amex and/or Diners Club cards[72].

A recent article by Chang, Evans and Swartz[73] which assesses the impact of regulatory intervention in Australia, highlights that the short-run results of the interchange fee cap are (i) issuers have increased the fixed price for cards; (ii) merchants have experienced a small reduction in costs but the evidence suggests this has not been passed on in the form of lower consumer prices; (iii) there has been a significant transfer of profits to the Australian merchant sector at the expense of issuers and cardholders; and (iv) banks have shifted volume from the regulated association systems to the unregulated proprietary systems. There is relatively little evidence that the intervention has affected the volume of credit card transactions in Australia as intended by the regulation. Similarly it appears that banks have only raised fixed fees but have not increased per-transaction fees. Accordingly the regulatory intervention in Australia has resulted in the distortion of competition between three and four-party systems to the detriment of Australian consumers without achieving the public policy objectives of the Australian regulator. As pointed out by Chang, Evans and Swartz, the fact that banks and merchants did not react to the price intervention in the manner expected by Australian regulator, illustrates the need for caution and further study, before considering the impact of price regulation in, say, a particular Member State or in the generality of Member States. In any event, it does not follow that the responses by banks will be the same in nature and extent in any particular Member State as they have been in Australia in the short term.

4.7 The regulation of interchange by the Commission

The Commission's interventions in relation to interchange to date have also caused market distortions as a result of one-sided enforcement. This is particularly true for the different interchange treatment of Visa Europe vs. MasterCard. The Commission itself has concluded that since the 2002 Visa Exemption Decision, MasterCard's fees have considerably exceeded Visa Europe's interchange fees[74]. Whilst Visa Europe has reduced its rates in accordance with the 2002 Visa Exemption Decision, the Interim Report notes that "*MasterCard cross-border rates remained unregulated, which allowed the network to keep interchange fees significantly above the rates of Visa*"[75]. This has led to a considerable competitive disadvantage for Visa Europe.

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72 See remarks by Mr. David Bell, CEO, Australian Bankers Association at the House of Representatives Standing Committee Review of the Reserve Bank and Payment System Board annual reports 2005, 15 May 2006.

73 Chang, Evans and Swartz, "The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia", *Review of Network Economics*, Vol. 4, Issue 2 – December 2005.

74 See, for example, pages 21, 22, 24 and 27 of the Interim Report.

75 See page 21 of the Interim Report.

If the Commission proposes to regulate four-party systems, but not three-party systems, in the future, there would be a similar unfair distortion of inter-system competition.

Amex's current strategy includes the maintenance of its own distributive business, directly run by the company, as well as the drawing up of agreements with some of the most important banks of the country concerned (e.g. Bank of Ireland or the Portuguese bank BCP). Those agreements, which can concern both issuing and acquiring, generally provide for the exclusivity of the banking partner, who becomes the sole Amex partner in the country in which it operates (it being understood that Amex can compete, through its own distributive channel, with that partner). The form of the cooperation between the chosen bank and Amex could be the grant of a licence (e.g. in Ireland) or the creation of a joint venture (e.g. in Israel and in Switzerland). The spreading of such bilateral agreements makes the operation of the Amex system more and more similar to that of four-party payment systems, such as the Visa system, with which the Amex system can therefore compete more effectively.

The operation of three-party payment systems has, to Visa Europe's knowledge, never been closely examined by regulators, in particular not in relation to merchant fees. In this connection, three-party payment systems can apply higher merchant fees than those applied in four-party payment systems. Such a situation results in a competitive disadvantage for Visa Europe since the enforced reduction of the MIF within the Visa Europe system leads an increasing number of banks to enter into agreements with three parties systems such as Diners and Amex, which may offer better revenue prospects. Higher fees also allow three-party systems to fund the offer of more attractive cards, such as those including more favourable loyalty or rewards programs, thus increasing their competitive advantage. By contrast, the reduction in the number of members within the Visa Europe system will undermine its cohesiveness and the willingness of remaining members to invest in further innovation.

4.8 Need to clarify confusing messages

A number of findings and conclusions of the Interim Report are unclear or confusing and appear to represent a significant departure from the 2002 Visa Exemption Decision. In Visa Europe's view these issues should be clarified to ensure that market players are able to act in line with the Commission's position. The most obvious and important examples are the following:

- Visa Europe would like to know whether the Commission supports a broader acceptance of payment cards and regards the stimulation of payment card transactions/electronic payments (to replace less efficient cash and cheques) as efficiency-enhancing and desirable for society as a whole, as appears to be the case from the Commission's SEPA and Payment Services Directive proposals. If this is the case, Visa Europe queries why the Commission has not to date intervened to remedy distortions in the market in favour of cash (caused in some cases by national legislation) which hinder effective competition between different means of payment[76].

- The Interim Report suggests that making information on the interchange fee differentials more transparent may create some limited pressure on networks to lower interchange fees[77]. As required by the 2002 Visa Exemption Decision, Visa Europe adjusted its rules to allow member banks to disclose to merchants the level of interchange fees and the relative importance of three categories of costs should merchants request that information (and now also publishes this information on its website). The Interim Report does not appear to have analysed whether or not this commitment has been effective in reducing the Commission's competition concerns.

- In the 2002 Visa Exemption Decision, the Commission obliged Visa Europe to introduce a flat fee per transaction for debit cards. The Interim Report appears to suggest that an ad valorem fee for debit cards might be preferable[78]. It seems that the Commission does not intend to insist on flat fees for debit card transactions anymore. It would be helpful for the Commission to clarify its position.

- According to the 2002 Visa Exemption Decision, Visa Europe must set interchange fees for credit and debit cards by reference to "cost benchmark caps" calculated on the basis of cost studies. The Interim Report does not explicitly support this practice. The Interim Report does not recognise Visa Europe's compliance with the 2002 Visa Exemption Decision but questions the need for interchange in general. Visa does not understand why the Commission no longer regards the 2002 Visa Exemption Decision as ensuring "an economic efficiency-enhancing" interchange.

- Unlike in the 2002 Visa Exemption Decision, the Interim Report by referring to payment cards as a "tax" appears not to fully recognise the significant benefits to merchants of accepting payment cards. There are however many benefits to the merchant of accepting cards which translate into reduced costs, improved efficiency, lower risks and increased revenues and profits[79].

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[76] See page 144 of the Interim Report.

[77] See table on page vii of the Interim Report.

[78] See page 32 of the Interim Report.

[79] Merchants can avoid, by accepting credit cards, the costs and risks inherent in providing their own unsecured credit facility in-store (without which they would otherwise not make a sale to a customer who has no directly available funds). By accepting any cards merchants minimise the disadvantages associated with handling cash. Merchants are provided with a secure and efficient electronic payment method that guarantees prompt same-day payment even in event of fraudulent use or customer default. In fact, many retailers, in the absence of the interest-free period provided by credit and deferred debit cards (in addition to the revolving function on credit cards), would not be able to offer their own in-store unsecured facility.

- Finally, the Interim Report does not differentiate between Visa Europe's and MasterCard's position, notwithstanding the fact that MasterCard's interchange fees are set apparently in disregard of the 2002 Visa Exemption Decision.

4.9 Conclusion

Visa Europe has demonstrated that the Interim Report's analysis of interchange as it currently stands is unreliable and provides no basis on which to take action. Visa Europe is, however, happy to assist the Commission in clarifying its thinking on interchange going forward.

5. Different interchange fees according to merchant segment

5.1 Introduction

The Interim Report has observed that divergences in interchange fees between merchant segments may provide indications that the setting of interchange fees could possibly be a matter of market power in some Member States[80]. This is a misunderstanding of the market reality.

Before considering different merchant service charges, it should be noted that Visa Europe does not determine directly merchant service charges, though it influences them through interchange. MSCs are primarily a matter for its member banks. In the Visa Europe system, in most Member States interchange rates are uniform for all merchant segments (except for the special case of airlines), but in other Member States they are to some extent differentiated. Such differentials may be designed to optimise usage of Visa cards, or may simply be a reflection of bargaining strength of certain merchant segments.

5.2 Analysis

The Interim Report's observation that acquirers in the same country may pay roughly half the interchange fee for credit card payments at a petrol station than for a credit card payment to an airline[81] does not suggest that the setting of interchange fees could be a matter of market power, at least as far as Visa Europe is concerned.

Visa Europe does not itself set specific interchange fees for petrol stations[82].

The international reach of the Visa card payment system brings incremental sales, including from overseas and "virtual" customers, leading to higher revenues and profits. Retailers that offer cash-back facilities on debit card transaction and benefit from increased sales stemming from this service.

For further details, see Annex 4.

80 See page 32 of the Interim Report.

81 See page 23 of the Interim Report.

82 As apparently implied by the Interim Report on page 23.

Visa Europe notes that in a number of countries special interchange rates or MSCs for other sectors have also been identified in the Interim Report[83]. Visa Europe could imagine that banks in these countries thought it necessary and appropriate to have, for example, lower rates for sectors which have high transaction values or high volumes or higher rates where there is higher risk. Given the relationship between interchange fees and MSCs, acquirers can be incentivised to acquire more merchants in these sectors by an accordingly reduced interchange fee. Some sectors which are characterised by low card acceptance may also need incentivisation through low MIFs. In other words, demand conditions on the acquiring side may justify lower interchange fees for particular merchant segments: the Visa system gains more volume, without other merchants suffering.

Visa Europe also believes that different interchange fees according to merchant sectors are often caused by strong buyer power of large and highly concentrated merchants. This highlights the complexity faced by the Visa Europe system in setting the interchange fee in order to encourage both types of users (i.e. merchants and cardholders) to participate in the system.

Supermarkets and petrol stations typically have high levels of fraud and low levels of online authorisation. It is in the Visa Europe system's interests to encourage them via lower interchange fees to adopt new technology which would reduce fraud.

The T&E sector traditionally attracts higher MSCs because of the higher risk associated with international usage and greater potential for commercial failure and fraud. Such risks increase the propensity for chargebacks and customer refunds, resulting in higher MSCs.

5.3 Conclusion

The above shows that there may be several different reasons for differentiating interchange fees according to merchant segment. Differentiation itself, however, does not mean that the four-party systems have market power, as the Interim Report suggests.

6. Prohibition on co-branding

6.1 Introduction

The Interim Report makes a preliminary observation that the prohibition on co-branding with networks deemed to be competitors might limit actual and potential competition between networks[84]. This observation is based on the view that the prohibition might hinder national debit systems from entering into competition with Visa and MasterCard[85].

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83 See page 24 of the Interim Report.

84 See page 122 of the Interim Report.

85 See pages vii and 143 of the Interim Report.

Whilst the creation of further cross-border networks might well lead to greater competition at the EEA-wide level, it would seem that the Interim Report may not have fully considered the effect of its suggestion on co-branding in the long term[86].

6.2 Analysis

Visa Europe permits co-branding with national debit systems and with non-banks. With a view to facilitating the SEPA initiative, Visa Europe is prepared to engage in co-branding on a cross-border basis and allow its co-branding partners to conclude bilateral agreements with other national debit systems to effect cross-border transactions between different Member States.

Visa Europe would like to know, however, if the Commission is suggesting that competition rules oblige it to also enter into co-branding arrangements with direct competitors like MasterCard and Amex. Would not the obligation to co-brand with a European-wide operating payment system amount to the same thing?

Visa Europe is concerned that co-branding between competitors may be detrimental. Its reservations are founded on the need to preserve inter-system competition and to avoid unfair competition through free-riding. The blunting of competition between competing networks would reduce the incentives for Visa Europe and its members to invest in brand differentiation and technological innovation to the detriment of consumers and the Visa system as a whole. Co-branding could also reduce competition between issuers e.g. leaving limited room for monoliners and leading to consolidation in favour of incumbent banks which hold the banking relationship with cardholders. Contrary to the finding in the Interim Report, co-branding with competitors could in effect *limit* competition between the two or more networks which are co-branded on the same card. The prohibition on co-branding between international or European competitors would accordingly be pro-competitive rather than anti-competitive.

6.3 Conclusion

If the current efforts being made by national systems to increase cooperation and interoperability in order to achieve the SEPA goals are successful, this will increase competition and benefit European consumers. The Commission must however, in Visa Europe's view, ensure that any efforts by either the Commission (or the European Central Bank) to support initiatives by the national systems to cooperate with other systems do not reduce competition in the long run.

86 Although Visa Europe would normally refer to this type of co-branding as "co-badging" it will in this submission use the terminology of the Interim Report and refer to "co-branding".

V. Other issues

7. No surcharging/no discrimination

7.1 Introduction

The Interim Report observes that the prohibition on merchants to charge customers for paying by card, i.e. surcharging, may hinder the development of alternative non-cash payment instruments, as the true costs are hidden from the consumer via cross-subsidisation[87]. The Interim Report also observes that consumers do not receive relevant price signals to chose the most efficient means of payment[88].

The Interim Report does not, however, consider fully the impact of the removal of no surcharging rules, in particular on the use of cash and cheques, which may represent the least efficient means of payment for society as a whole.

7.2 Analysis

The Interim Report suggests that regulation of no surcharging rules may need to be explored[89]. Where regulatory intervention has occurred recently in some jurisdictions, the results are interesting to observe, despite the limitations of inter-country comparisons.

a) Impact of the recent abolition of no surcharging rules in other jurisdictions

One recent example of the impact of abolishing no surcharging rules is the experience in Denmark following changes to the Danish Payment Act, which permitted from 1 January 2005 charging only a capped MSC to merchants and to surcharge Dankort (the Danish national debit system) transactions. The total number of Dankort transactions fell from 42 million in January 2004 to 33 million transactions in January 2005 following the introduction of surcharging. Similarly, the average number of Dankort transactions per card fell from 175 in 2004 to 167 in 2005 due to customers fears of being surcharged. Due to opposition from cardholders, pre-election debate created political pressure to change the legislation again with the result that surcharging has not been allowed on Dankort transactions since March 2005 and on any Danish issued card since June 2005. The following graph illustrates the sharp drop in Dankort transactions in January and February 2005 as a result of surcharging or fears of surcharging.

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87 See pages vii and 125 of the Interim Report.

88 See page 144 of the Interim Report.

89 See page 124 of the Interim Report.

Number of Dankort transactions Dec. 2004 – Dec. 2005

Although the Danish Competition Authority estimated that only approximately 19% of (mainly the very large) merchants initially surcharged in Denmark, the effect on cardholders across the board was substantial as it resulted in the loss of certainty for cardholders that a payment card could be used anywhere which accepted that particular payment card, without penalty or unpleasant surprises and consequently without damage to the payment card's reputation.

No surcharging rules ensure certainty and transparency, and freedom for merchants to surcharge means the loss of that certainty. Any surcharge, regardless of the amount, can be expected to reduce the utility of cards to cardholders. Accordingly, even though surcharging where it is permitted may only affect a minority of transactions[90], it can still have profound effects on the reputation and reliability of the payment card system which can consequently lead to a reduction in the number of cardholders and/or card usage, in particular, as cardholders will tend to "blame" the system and not the merchant if they are surcharged.

In Australia, following regulatory intervention in 2003, payment card systems are no longer able to prohibit surcharging. In the limited time in which surcharging has been permitted, one can observe the following effects of note.

First, cardholders are paying more for card usage at certain merchants but there is no evidence that consumers who use other means of payment have received any benefit from reduced prices as a result of merchants' ability to charge cardholders more.

Secondly, merchants tend to apply the same surcharge for all cards, regardless of what it costs to accept that particular card. The blended surcharge rate means that Visa cards would, on the Interim Report's view, effectively "subsidize" the use of

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90 This was recognised by the Commission in its decision of 7 August 2001 in which it negatively cleared, inter alia, Visa's no surcharging rule. OJ L 293-24 of 10.11.2001. See also page 124 of the Interim Report.

American Express and Diners cards which have much higher merchant service charges than Visa cards.

Thirdly, experience has shown that customers are most likely to be surcharged where they are "captive" card-using customers. A captive card-using customer is one who, on a particular buying occasion, does not have ready access either to a non-surcharged means of payment, such as cash, or to a card-accepting merchant who is not levying a surcharge. The high cost to cardholders is particularly onerous where merchants, taking advantage of the fact that the customer may have no choice but to pay with a payment card, seek to make a profit from surcharging by imposing a surcharge with no reference to what it costs the merchant to accept the card. Foreign and out-of-town consumers are those likely to be most at risk.

Although the incidence of surcharging is low[91], significant damage can be caused to a payment system as explained above.

b) **Inefficient switching to expensive means of payment**

Removal of no surcharging rules is likely to have the undesirable effect of promoting the use of cash, on which there would be no surcharge, and discouraging the use of payment cards, which the Commission has recognised provide a more efficient means of payment than cash and cheques, thus generating negative welfare effects for society as a whole[92].

This would clearly not be in line with the objectives set out by the Commission in the Impact Assessment in relation to the draft Payment Services Directive which seeks to steer consumers to the most efficient means of payment.

Whilst recognising that surcharging may be limited, Visa Europe believes that the removal of no surcharging rules is more likely to result in an increase in the use of cash rather than have any impact on encouraging other types of electronic payment.

As regards alternative non-cash payment instruments, if the Interim Report's observation that surcharging, where this is permitted, is not widespread, why would the existence of this rule in practice hinder the development of alternative non-cash payment instruments, as the Interim Report claims?

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91 According to the Reserve Bank of Australia, survey evidence suggests that less than 5% of merchants surcharge. See remarks by Dr. Philip Lowe, Assistant Governor, Reserve Bank of Australia, made at the House of Representatives Standing Committee Review of the Reserve Bank and Payment System Board annual reports 2005, 15 May 2006.

92 See page 7 of the Consultative paper on SEPA Incentives, 13 February 2006.

c) Removal of no surcharging rules on payment cards will not lead to meaningful cost transparency for consumers

The removal of no surcharging rules will not ensure that true costs of using different payment instruments are revealed to consumers. This is so for various reasons, including the following:

(i) Experience shows that surcharging, when permitted, is limited.

(ii) Surcharging merchants will not necessarily equate the surcharge they levy to the MSCs they pay.

(iii) The removal of the rule will not disclose merchants' costs associated with each of the other payment instruments.

7.3 Conclusion

The Interim Report is correct that the Commission must be careful before drawing any hasty conclusions on the impact or abolition of no surcharging rules[93]. Visa Europe would encourage the Commission to consider all aspects of the issue much more fully before considering any action which could have more harmful than helpful effects.

8. Cardholder fees

8.1 Introduction

The Interim Report makes a number of observations on cardholder fees. Having separated cardholder fees into four types it then concludes, in particular, that "fees" vary significantly across countries and suggests that this might be the result of a lack of competition and market integration[94]. It also notes that "business" cardholders pay on average significantly more than "consumer" cardholders for credit cards in international card systems (on a fee-per-card basis)[95], that international card systems' debit fee-per-card fees are higher than domestic systems' debit card fees[96] and that fees for credit cards are higher (on average more than double) than for debit cards[97]. The Interim Report also suggests that empirical evidence casts doubt on the hypothesis of an inverse relationship between cardholder fees and interchange fees.

8.2 Analysis of cardholder fees in general

Visa Europe would point out that it does not set cardholder fees directly. As for merchant service charges which are determined by acquirers, cardholder fees are

93 See page 124 of the Interim Report.

94 See page 61 of the Interim Report.

95 See pages 54-55 and 61 of the Interim Report.

96 See page 59 of the Interim Report.

97 See pages 58 and 61 of the Interim Report.

determined independently by issuer members. Nevertheless, Visa Europe would make the following general points.

The fact that business cardholders pay higher fees than consumer cardholders is a reflection of the fact that the business product (commercial/corporate/purchasing cards) at least in the Visa Europe system is a different product to the consumer card. The cards have different functionalities and purposes. That different products are priced differently is hardly unusual given that the demand elasticities are likely to be different.

Visa Europe is not entirely clear about which fees the Interim Report is referring to on pages 58-59. Where Visa Europe co-brands with other cards, such co-branded cards would normally attract the national system's debit card fee. Which Visa Europe debit card fee the Interim Report is referring to in these cases is therefore not obvious. To the extent that the fees concerned reflect the cross-border functionality of the cards – i.e. the functionality contributed by the Visa badge, comparing this with the domestic function would be comparing apples and pears. The Interim Report also refers in this section to "Visa Electron". It should be noted, however, that a Visa Electron card is an on-line fully authorised product and therefore can be issued as a debit, a deferred debit or a credit card depending on the issuer's requirements.

As regards variations in fee levels across countries, reference is made to the comments set out in Section IV.1.2a) above. No conclusion of lack of competition can be drawn from national variations in cardholder fees.

Furthermore, as regards the difference between credit and debit card fees, this has been explained above in Section IV.1.2b) above. As for the Interim Report's comments on correlation between interchange fees and cardholder fees, reference is made to Section IV.3 above.

In light of the above, no meaningful conclusions can be drawn from the Interim Report's analysis of cardholder fees.

9. Different merchant service fees for different customers

9.1 Introduction

The Interim Report observes that small merchants on average pay considerably more for payment card acceptance than large merchants[98]. In theory, the Interim Report acknowledges that this could be explained by lower costs for signing up merchants with higher transactions volumes. However, it also questions this conclusion since a comparison of price differentials between large and small merchants in the international systems (MC/Visa 70%, Amex 50%, JCB 40% Diners 35%) with those in domestic debit systems (7% on average) indicates that scale is possibly not the main reason. Therefore, the Interim Report comes to the preliminary conclusion that possibly smaller merchants pay a "premium" for accepting MasterCard and Visa

98 See page 50 of the Interim Report.

cards. This could be a measure for the exercise of market power by banks within a given system[99].

9.2 Analysis

At the outset, Visa Europe would clarify that it is not responsible for setting differentials in MSCs which are a matter for its acquiring members[100]. However, Visa Europe would make the following comments concerning MSC differentials.

Visa Europe is not entirely clear about how the Interim Report would have arrived at separate MSCs for Visa Europe's cards when the Interim Report notes that blending appears to be widespread across the EU[101].

Comparisons between different international systems are unreliable when their market coverage differs. As the Interim Report notes[102] Amex's acceptance tends to be confined to large international companies in the T&E sector, where it can impose higher MSCs. JCB and Diners Club have similar market coverage in the EU. By contrast, Visa is a "mass market" payment card system that encourages acceptance by all merchants, regardless of their size and market sector. Accordingly, the stock of merchants for Visa is likely to include a higher proportion of smaller retailers, and this will distort the comparability of MSC differentials. One would expect the range of MSCs to be wider for Visa Europe.

In addition to issues of "scale", acquiring smaller merchants involves different cost structures and service levels. Aside from the higher initial signing-up costs in the form of marketing and account set-up, acquirers also bear higher fixed costs in respect of small merchants, associated with personal account management, servicing and other overheads. Smaller merchants tend to have higher incidences of fraud and bad debts than large merchants and therefore incur higher authorisation and processing costs. Small merchants require more assistance with terminals and processing errors leading to higher processing costs.

By contrast, larger merchants often have their own integrated terminals and perform more payment processing themselves. For instance, they may carry out some authorisation, enhanced risk management functions and consolidate transaction processing. Accordingly, larger merchant acquirers may pay lower MSCs to reflect their contribution to those functions.

Finally, the Interim Report fails to consider the extent to which large merchants may have greater bargaining power than smaller retailers and may therefore be able to negotiate lower MSCs with their acquirers by playing one bank off against another.

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99 See pages 50-51 of the Interim Report.

100 The impression created by statements on, for example, pages v and 37 of the Interim Report is therefore misleading.

101 See, for example, page v of the Interim Report.

102 See page 35 of the Interim Report, fn. 56.

10. Financial institution requirement

10.1 Introduction

The Interim Report regards the common practice of card payment systems to reserve card issuing and merchant acquiring to credit institutions or entities controlled by credit institutions (financial institutions) as a practice that may inhibit processors from entering the acquiring business and from competing with banks[103].

The Interim Report does not however appear to recognise why this practice exists.

10.2 Analysis

a) Rationale for financial institution requirement

Visa Europe believes that a rule requiring an applicant to be organised under the commercial banking laws of the relevant country and to be licensed to accept demand deposits (or to be controlled by another such organisation) in order to be eligible for membership in a system like Visa Europe has to date been the only viable, certain and efficient way to ensure the secure and sound functioning of its payment system.

b) Payment Services Directive

The necessity for the rule may change after a new regulatory regime is introduced via the Payment Services Directive provided this can guarantee adequate prudential supervision for non-banks.

The current draft of the Directive envisages the creation of "Payment Institutions" as a new category of payment service providers. Payment Institutions will be regulated and supervised to some degree, however the imposition on Payment Institutions of capital requirements, or limitations on business activities is currently very unclear and complicates the assessment of a Payment Institutions' continuing financial operational capabilities. Visa Europe strongly believes that more specific requirements and limitations for Payment Institutions are needed in order to create a truly level playing field amongst payment service providers and to safeguard the security of payment systems[104]. The latter concern is also shared by the European Central Bank.

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[103] See page 106 of the Interim Report.

[104] According to the proposal, all payment service providers including Payment Institutions should have access to payment systems such as Visa Europe, based on objective and proportionate criteria. As there would be no limitations on Payment Institutions in terms of the business activities which they could engage in, apart from providing payment services, they would not face any capital requirements and they would be able to operate through tied agents or subsidiaries. This would make it extremely difficult to conduct a proper risk assessment of Payment Institutions and their impact on a payment system as well as on its participants and users as a whole. It is consequently equally difficult to mitigate such risks in an objective and a proportionate manner.

c) **Non-banks currently participate in payment card systems**

Finally, it should also be noted that in any event Visa Europe clearly does not currently prevent non-bank acquirers from participating in the Visa Europe system. Non-bank acquirers, for example, third-party processors, are able to enter into commercial agreements with Visa Europe members for the provision of acquiring services. Agreements range from simple agreements for the outsourcing of particular services to the creation of joint ventures to full "fronting" arrangements where the bank acts as a "front" for the non-bank acquirer which takes full and direct responsibility for all elements of the acquiring service. Non-bank acquirers have not been short of potential partners in several Member States.

Accordingly, the financial institution requirement does not prevent non-bank acquirers from participating in Visa Europe's card system.

11. Technical barriers

The Interim Report suggests that diverging technical standards across the EU may hinder acquirers, processors and terminal vendors from operating efficiently on a pan-European scale. It notes that there appears to be significant scope for efficient convergence of technical standards in the payment cards industry[105].

Visa Europe strongly supports the Commission's aim and efforts to remove technical barriers. The co-existence of different technical rules and standards between the national systems may inhibit cross-border competition of merchant acquirers and processors in the EU.

Initiatives to eliminate technical barriers would be greatly welcomed by Visa Europe and its members to eliminate difficulties of this nature.

Visa Europe
21 June 2006

[105] See pages vi and 120 of the Interim Report.

ANNEXES

TO

VISA EUROPE'S

RESPONSE TO THE CONSULTATION ON THE EUROPEAN COMMISSION'S

INTERIM REPORT I

PAYMENT CARDS

INDEX

OF

ANNEXES

ANNEX 1

VISA EUROPE'S COMMENTS

ON THE COMMISSION CONSULTATION PAPER

ON SEPA INCENTIVES PUBLISHED ON 13 FEBRUARY 2006

28 APRIL 2006

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COMMENTS

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28 APRIL 2006

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EXECUTIVE SUMMARY

Visa Europe has set out below, by way of general remarks and answers to selected questions relevant to payment cards, comments on the Commission's consultation paper on SEPA incentives, published on 13 February 2006. In summary Visa Europe has made the following comments and suggestions:

- Visa Europe, a European incorporated payment system, owned and controlled by European banks, fully supports an Internal Market for Payments and the achievement of SEPA. Payment cards such as Visa's cards are well ahead of other means of payment in terms of meeting the SEPA vision. Visa Europe products therefore already facilitate the achievement of SEPA. In order to achieve a specific European solution for SEPA and to meet customers' needs and expectations, Visa Europe has also introduced V PAY which is a new "chip and PIN always" debit product platform developed especially for Europe.

- Visa Europe applauds and welcomes the work that has been carried out by the European Payments Council (EPC). The decisions taken by the EPC and the milestones as defined today are a clear exponent of the banking industry's commitment to meet the 2008 and 2010 deadlines.

- Visa Europe does not believe that it is necessary for the Commission to consider additional regulatory steps in order to achieve SEPA. In fact, further regulatory measures could interfere with market forces and could have adverse consequences on the ability and willingness of banks to offer SEPA products which are of the highest possible standard.

- In order to assist in the achievement of SEPA the Commission should:

  - Allow market forces to determine the best and most efficient means of achieving SEPA;

  - Continue to clearly and visibly support the vital work being carried out by the EPC and the industry;

  - Ensure that the principles of better regulation are adhered to. Accordingly the Commission must ensure that any regulatory measures apply only to those payment instruments, and only to those areas, where a specific problem has been identified;

  - Not introduce new requirements that may delay the implementation of SEPA by the industry (e.g. e-invoicing);

  - Ensure a clear and accurate communication programme is in place so that end-users are willing to take the steps necessary to take up SEPA compliant products;

  - Ensure clear and consistent regulation of payment cards and other payment instruments at a Member State level;

- Ensure that regulation does not distort competition between different types of payment providers or payment instruments.
    - To ensure a level playing field all payment service providers, whether they are banks or non-banks, must be subject to the same prudential requirements;
    - All national legislation which favours one means of payment over another must be abolished. Banks must be free to use pricing as a steering mechanism to incentivise end-users to use more efficient payment means and to reduce reliance on payment methods with high economic costs, such as cash and cheques.
- Inappropriate price regulation or interference with the level of interchange fees which can be paid between two banks involved in a four party payment card system must be avoided to prevent distortion of competition between four party payment card systems and other payment methods.

I. GENERAL REMARKS

Visa Europe is a European incorporated payment system, owned and controlled by European banks, which fully supports an Internal Market for Payments. An Internal Market for Payments will create more dynamism and competition – enabling banks to provide a wider and better range of payment products to customers. This, in turn, will accelerate the move away from cash and cheques to more secure, more convenient and more efficient electronic payments.

Market Forces and Self-regulation

Visa Europe believes that banks and inter-bank organisations need to be free to make commercial decisions regarding their business activities. It is under these conditions that they will have the greatest incentive to innovate and invest in payment systems. Visa Europe is extremely wary of prescriptive solutions.

If the operating rules for payment systems are imposed from outside (or, worse still, if payment systems are regarded as a public utility) investment and innovation will inevitably be curtailed. In creating an internal market Visa Europe therefore advocates a "minimalist" approach in terms of regulation. Visa Europe wants the European industry to unite around a package of key conditions. It should then be left to individual banks and inter-bank organisations to determine how best these conditions can be met.

The benefits and efficiencies to be achieved through self-regulation have been recognised by the European Central Bank (ECB) and the Commission. Self-regulation has been facilitated by the creation of the EPC and the work which has been carried out by that organisation.

Visa Europe considers that it is premature for the Commission to raise concerns that there may be a failure on the part of the banking industry to self-regulate. There is a danger that if the Commission raises doubts with regard to the banking industry's ability to deliver best of breed and innovative SEPA compliant solutions, this may undermine the efforts currently being undertaken by the banking industry[1].

In order to facilitate the achievement of the SEPA objectives, Visa Europe would urge the Commission to build on the current momentum created through the achievements of the EPC and to encourage further steps toward even greater and more transparent self-regulation by working in partnership with the EPC and other stakeholders. As recognised by the ECB "*the SEPA can only succeed if all stakeholders involved in the process work toward the same goals and follow the same project plan with a set of agreed milestones*".[2] Any move by the Commission away from consensus and effective partnership with other stakeholders would in Visa

[1] See also ESBG Press Release 15, February 2006

[2] European Central Bank, Fourth Progress Report on SEPA, page 10.

Europe's opinion put the achievement of SEPA, as well as the achievement of a competitive, innovative and successful payments industry in Europe in jeopardy.

Better payment systems in Europe will increase the competitiveness of European business in line with the Lisbon Agenda. Accordingly the Commission must ensure that any steps it takes do not hinder the commercial freedom and effectiveness of payment systems to the detriment of European competitiveness.

Better Regulation Principles

The Commission has stated that it is committed to drive through "better regulation" principles in all policy making.[3] This means that the Commission should only consider regulation where a specific need has been identified and where regulation can be fully justified and specifically addresses the need identified. Many of the problems which the Commission may wish to address in relation to SEPA do not concern payment cards (for example, Visa payment cards have been successful in facilitating cross-border payments) and accordingly the Commission must ensure that it does not seek to impose solutions which, although appropriate for some payment instruments, are not appropriate for payment cards. If regulation is introduced it should not be blanket regulation applying to all payment instruments but should be tailored to address only the problems which have been identified in relation to specific payment instruments.

Visa Europe already meets the SEPA vision

Visa Europe believes that of the different payment products covered by the Consultation Paper, payment cards are well ahead of the others in terms of meeting the SEPA vision.

All Visa's existing products can be used throughout Europe. In order to achieve a specific European solution for SEPA and to meet customers' needs and expectations, Visa Europe has also introduced V PAY which is a new "chip and PIN always" debit product platform developed especially for Europe. It is an additional option Visa Europe provides to banks, which can co-exist with their existing debit products and which will help the banks to achieve the SEPA objectives. It is initially aimed at those Member States with a domestic debit scheme that will have to become SEPA and SEPA Cards Framework compliant in the coming years.

V PAY has been developed as a result of the specific market needs in Europe but has also been developed with SEPA and the Internal Market for Payments in mind in terms of functionality, business, licensing and pricing principles.

The European Payments Consulting Association (EPCA) has awarded the first prize in the EPCA/ECR Excellence in Payments Innovation Awards to V PAY, for being the payment solution that has added the most to the development of SEPA.

In order to allow not only consumers but also businesses (corporates and SMEs) which play a critical role in the growth of the European economy and the realisation

[3] See the Commission White Paper Financial Services Policy 2005 – 2010.

of the Lisbon Agenda to fully benefit from the internal market, Visa Europe provides bespoke payment solutions, such as Visa Business or Visa Corporate which can be used Europe-wide and globally. As well as providing a cost-effective and convenient way of conducting transactions, the payment-related data services allow sellers and buyers to reduce payment and collections costs and streamline their cash management.

Through the Visa Purchasing card Visa Europe also provides businesses and governments with a highly effective tool to simplify internal purchasing processes, increase productivity and save money on a Europe-wide and global basis.

Visa Europe already meets virtually all requirements set out in the EPC SEPA Cards Framework, and will become fully compliant by 1 January 2007 - i.e. one year before the deadline set by the EPC.

II. SPECIFIC QUESTIONS RAISED FOR DISCUSSION

Scope of Visa Europe's Comments

Given that Visa Europe is only concerned with payment cards, it has limited its comments on the Consultation Paper concerning SEPA Incentives to areas that directly concern payment cards. Visa Europe has, as requested by the Commission concentrated on the questions raised in Section 6 of the Consultation Paper and addressed in particular questions 49 to 52. However where appropriate, Visa Europe has also included comments under other headings. Visa Europe will respond separately to the Commission's sector inquiry interim report on payment cards and payment systems published on 12 April 2006 ("sector inquiry interim report on payment cards")[4].

6.1 Governance and Consultation

Visa Europe fully supports the work that has been carried out by the EPC. Although Visa Europe is not itself a member of the EPC, it has established a productive relationship with the EPC in general, and with the Cards Working Group in particular. In response to question 4, Visa Europe considers that the existing structures for the consultation of stakeholders on an ad hoc basis ensure that Visa Europe, and others, are able to contribute where appropriate.

Visa Europe considers that the consultation by the EPC of other stakeholders is productive and that non-EPC members are not unfairly excluded from the system.

In response to question 6, Visa Europe believes that the governance of the EPC is functioning well, taking into account in particular the large number of members and countries involved. Visa Europe does not believe that it would be necessary to open EPC membership to all payment service providers. However, wider consultation

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[4] The interim report on payment cards and payment systems was published on 12 April 2006 and is available at http://europa.eu.int/comm/competition/antitrust/others/sector_inquiries/financial_services/

could be beneficial, provided that other stakeholders are willing to engage in a proper and purposeful manner.

If it is considered that further consultation of stakeholders is desirable, the EPC may wish to consider wider consultation through the Payment Systems Market Group (PSMG), a working group created by DG Internal Market.

Adoption and offer of "best of breed" SEPA products

6.2 How can we ensure that products themselves meet the vision?
6.3 Adoption and offer by banks and card schemes of SEPA products
6.6 How to ensure adoption of SEPA products by users?
6.8 How can we ensure that SEPA products can be improved over time?

Given the considerable overlap between the four sections above, Visa Europe has dealt with all four sections together.

As a general remark, Visa Europe is confident that the commitment shown by the EPC and the European banking community will deliver the desired products in a timely manner.

In order to ensure that products meet the SEPA vision, that banks offer SEPA products which are taken up by end-users, and that SEPA products can be improved over time, SEPA needs to be driven by market forces.

Provided SEPA is based on free market principles, market players will ensure innovative and "best of breed" products to the benefit of the users of such products. Any attempt by the regulator to mandate a minimum service level, as suggested by question 15 of the Consultation Paper, may reduce standards to the lowest common denominator and/or stifle long term competition to innovate and improve products. There is a danger that a minimum service level would become the standard or expected service level and would reduce competition between payment providers to provide the best service or most attractive product.

In deciding which products to provide to their customers, banks and inter-bank organisations must be free to choose from a range of different suppliers and solutions – giving them the opportunity to compete on the basis of service, price and utility.

To respond in particular to question 29, end users will adopt SEPA products if those products meet their needs. Provided payments are regarded as a commercial business, payment providers will have the incentive to ensure products meet customers' needs.

If banks could not make an acceptable return on their payments business, they would have no incentive to invest in the necessary infrastructure. Equally, they would have no reason to continuously innovate – which would be to the considerable detriment of all participants. The level of investment and innovation across the European payment card sector should not be underestimated. Amongst its many achievements, Europe has led the world in the authentication of e-commerce transactions, the implementation of EMV chip technology, and the introduction of new card-based lending propositions.

A clear distinction needs to be drawn between system/scheme rules and rules governing products. Visa Europe accepts that at a scheme level some common rules are necessary to ensure the interoperability of different schemes, however there can be no justification for regulating the type of products which a bank can offer. It is only by giving banks the freedom to provide value added services and products that the best products will be made available to end-users.

Banks must be able to respond to local circumstances – such as the level of development within local economies, the prevailing payment habits of local populations and the circumstances of local retailers as well as being able to respond to local needs for fraud prevention purposes. The strong differences between spending patterns in the different Member States today is illustrated by the figures attached at Annex 1 which show on an EU Member State level, the number of transactions carried out per inhabitant using different payment instruments.

Although banks should be free to determine strategy and pricing according to local conditions, it is important that the legal framework within which they must operate is the same throughout the EU to ensure consistency and to allow national markets to move closer together as economic conditions evolve.

The Commission should be aware that efforts to regulate the types of products available or the conditions of their introduction, including the timing of their introduction, may stifle competition and reduce the incentive for market players to ensure that the most innovative products are available on the market place as quickly as possible. The suggestion on page 24 of the Consultation Paper that all SEPA products should be made available on the same date to avoid first mover disadvantage, suggests that the Commission fears that it may not be in banks' interest to offer SEPA products. This is surprising and contrary to Visa Europe's view that competition among providers, to make the best and most desirable SEPA products available before your competitors do so, will be a driving force behind the successful achievement of SEPA. To prevent the introduction of SEPA compliant products before an agreed date would therefore be to the detriment of the SEPA timetable.

In response to question 20, Visa Europe does not believe that the Commission needs to make compliance with the SEPA Cards Framework mandatory for all payment service by a particular date as the decisions taken by the EPC at the 8 March 2006 Plenary demonstrate that the industry is committed to deliver.

The Commission and other public authorities can contribute to SEPA by ensuring that suitable communication programmes are put in place, just as with the launch of the euro, so that awareness and appropriate customer demand is created for SEPA products which will help to increase the momentum of national migration.[5] The Commission must also accept, that in some countries, electronic payments are already very efficient today, and that therefore it may not be possible to improve the

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[5] See also speech given by Charlie McCreevy, Commissioner for Internal Market and Service, "Banking regulation: Next steps", French Banking Federation Conference, Paris, 21 March 2006.

domestic experience of the end-user. On the contrary, in order to achieve the SEPA objectives consumers may have to change old habits (for example, use the necessary BIC or IBAN numbers) without clear benefits in the domestic context, in which the large majority of payments are made. Accordingly the Commission must ensure end-users are open to SEPA, while at the same time avoiding the creation of false expectations.

6.4 How can public authorities contribute to the standard setting process?

Visa Europe considers that appropriate SEPA standards are necessary and that the best parties to deliver those standards are the banking industry and inter-bank organisations working within the framework of the EPC. The Commission has also recognised the benefits of leaving standards to market forces in both the Impact Assessment on the New Legal Framework[6] and the sector inquiry interim report on payment cards[7]. Visa Europe urges the Commission to give the EPC sufficient time to set interoperable standards, before considering regulation in this area.

For certain aspects, like card and terminal certification, it is essential to ensure that the SEPA standards are compatible with the existing global standards. Any conflict with global standards for international payment cards would have an adverse effect on the global competitiveness of European industry in conflict with the objectives of the Lisbon Agenda and would therefore be a step in the wrong direction.

Although Visa Europe strongly supports appropriate standardisation, market players must remain free to implement value added features within those standards as they see fit to ensure a variety of different and competing products are brought to market. Differences in implementation will also ensure continued innovation and competition at every level provided adequate information is available to others to enter this business.

The ISO 8583 standard provides a good example of the type of standardisation which Visa Europe would recommend. Almost all European markets use this standard for authorisation of card payment transactions. However, the standard is designed such that sufficient room exists for product differentiation and adaptation to local usage patterns and preferences.

SEPA standards should also be compatible with EMV standards. Visa Europe has suggested to the EPC that it would be helpful to agree on a memorandum of understanding between EPC and EMVCo to ensure appropriate standards.

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6 The Commission's impact assessment in relation to the draft New Legal Framework Directive provides that "*The Commission considers that for the moment it is not necessary to intervene directly in the relationship between providers and relevant arrangements on technical standards and infrastructures. There is certainly a market co-ordination problem but industry will address this problem in its SEPA program. Therefore, at the current point in time, the Commission considers it not necessary to mandate a specific standard or rules for payment schemes and the setup of the payment system.*" Annex to the proposal for a Directive of the European Parliament and of the Council on Payment Services in the Internal Market, Impact Assessment, {COM (2005) 603 final}, page 36.

7 See pages viii and 117 of the sector inquiry interim report on payment cards.

6.5 How can we ensure effective competition in the processing of payments?

Visa Europe already separates payment system management from operational matters such as processing. Both activities have a distinct and fully transparent pricing structure and members have a clear understanding of how much they pay for which service. In order to ensure competition, it is important that pricing remains a competitive matter for payment systems.

In line with the SEPA Cards Framework, Visa Europe is committed to a pricing structure that makes no distinction between domestic and intra-European transactions, regardless of the currency of the transaction. This position has been communicated to the EPC.

Accordingly the concerns expressed by the Commission in the sector inquiry interim report on payment cards, in relation to the vertical integration of card payment systems, and the possible barriers which this creates for new entrants, do not extend to the Visa payment card system. Moreover, Visa Europe believes that the implementation of the SEPA Cards Framework principles by the industry will remove any remaining barriers that may still exist in some markets.

6.9 How can we ensure effective competition in SEPA?

Question 49 – What obstacles hinder effective competition in card payments in SEPA? What can be done to ensure greater competition in card payments in SEPA?

Despite the fact that card payments have witnessed significant growth levels, they still account for only a minority of payments in Europe.

Obstacles which hinder effective competition in card payments include:

- legal uncertainty as to the regulation of four-party payment systems[8];
- inconsistent regulation at a European and national level either of the same four-party payment system or of different four-party payment systems resulting in market distortions (e.g. different interchange treatment of Visa versus MasterCard);
- regulation of four-party systems which distorts competition with three-party systems and other payment instruments;

8 Two types of payment card systems can be distinguished: four-party systems (for example, Visa and MasterCard) and three-party systems (for example, American Express). In a four-party system, the four parties comprise the cardholder, the member bank that issued the Visa card to the cardholder (the issuing bank), the merchant (the supplier of the goods or services), and the member bank that contracted with the merchant for the merchant to accept the card (the acquiring bank). In a three-party system, the proprietor is responsible for all activities in the supply of its system's services. It issues all the cards and acquires (signs up) all the merchants in the system. In both cases, two categories of users (consumers) use the payment services of the system: cardholders (buyers of goods and services) and merchants (suppliers of goods and services).

- fraud and lack of trust in the system;
- operational and technical barriers;
- legal requirements which favour cash and cheques, as noted in the Consultation Paper on SEPA incentives and a potential lack of political willingness to tackle cash subsidisation issues;
- lack of information and transparency on the real cost of cash; and
- inconsistencies in relation to the national implementation and enforcement of Community rules.

In order to meet the true potential of an Internal Market for Payments, Visa Europe believes several conditions must be put in place:

– *Payments must be regarded as a commercial business*

As mentioned above, unless banks can make a reasonable return on their payments business, they will have no incentive to invest. If the payments sector were ever to be viewed as a public utility, innovation would come to a halt and potential efficiency gains could never be realised.

Ultimately, banks might consider withdrawing from the payments business altogether, leaving the task to governments or public services.

– *Operational and technical friction must be removed*

The industry needs to make a collective commitment to remove any technical and operational barriers to market entry.

In the longer term, it is inevitable that some of the more rigid elements of the processing infrastructure will need to be modified. It is therefore fortunate that the creation of an internal market coincides so closely with the move to EMV-chip technology.

Thanks to EMV, Europe's banks are now uniting around a single card and terminal standard. Indeed, if it were not for EMV, the required harmonisation would have been extremely challenging, if not impossible, to achieve.

As noted in Section 6.4, Visa Europe urges the Commission to give the EPC sufficient time to set interoperable standards, before considering regulation in this area.

– *Legal uncertainties must be eliminated*

Today the legal basis for electronic payments differs widely from country to country. To make the Internal Market for Payments a reality, clearer and more consistent legislation, as well as the consistent application thereof, is a pre-requisite.

Assuming it is applied consistently across all Member States, the New Legal Framework for payments if adopted could resolve much of the uncertainty. However a legal framework which covers all means of payment may prove to be unworkable in practice. For example, the considerations and justification for regulating the various means of payment are very different. Additionally, the factors which apply to one particular means of payment may not be applicable to another means of payment, nor to payments as a whole.

What is more, the chosen format for the New Legal Framework, a Maximum Harmonisation Directive, still allows for some room for interpretation when it is implemented nationally. Therefore, it may not achieve the necessary level of modernisation, simplification and harmonisation across all Member States. Visa Europe's view is that a Regulation may be a more appropriate tool.

As recognised in the Commission's impact assessment in relation to the draft New Legal Framework Directive[9], it is also important to give legal certainty to providers so that they can set up cost-efficient, fully automated straight-through processing of payment services without fear that efficient operation could be hampered by legal disputes.

Similarly, there is an urgent need for the consistent regulation of payment systems under competition law rules and Visa Europe would urge the Commission to take an active role to ensure consistent regulation across the EEA in this regard.

– *Price regulation needs to be avoided*

If regulators seek to interfere with the level of interchange fees which can be paid between two banks involved in a four-party payment system there may be unforeseen and undesirable effects. There is a real risk that regulation may force four-party payment systems to become three-party systems. Similarly, a distortion in competition between four-party and three-party systems may cause banks to leave four-party systems in favour of three-party systems or to stop providing payment card services entirely. These three-party systems and non-bank providers may be more selective with regard to participation and may not be European or interested in pursuing the objectives of SEPA and the Internal Market for Payments.

[9] Annex to the proposal for a Directive of the European Parliament and of the Council on Payment Services in the Internal Market, Impact Assessment, COM (2005) 603 final.

– *Regulation must not prevent a level playing field.*

As well as taking care not to distort competition between three and four-party payment system providers, regulators must ensure that they do not distort competition between different types of payment providers. In order to ensure a level playing field all payment service providers, whether they are banks or non-banks, must be subject to similar prudential requirements[10]. A failure to ensure a level playing field will lead to a distortion of competition as well as prudential risk.

– *Transparency and freedom to price must be an option for banks*

All payment systems carry a cost. And, paradoxically, those that are often perceived to be a free service (namely cash payments) have, according to national central bank studies[11], the highest economic costs.

Consequently, Visa Europe urges the Commission to take the necessary steps to ensure that national measures which favour the use of cash and cheques are removed.

Question 50

a) Do we need interchange fees in card payments?

b) Could not both sides to the payment directly charge the payment service provider according to the principle of shared cost?

Interchange fees in a four-party card payment system are necessary in order to maximise the use of the payment system given the two-sided nature of a four-party payment system, the interdependence between issuing banks and acquiring banks, and the network externalities which impact on the system.

For a transaction to occur, it is necessary to have a cardholder who wishes to make a purchase with a card and a merchant who is willing, and able, to accept that card. The more cardholders there are, the more attractive the system is to merchants, and the more merchants there are which accept the card, the more attractive the system is to cardholders. In view of the two-sided nature of the system and the network externalities which impact on that system, interchange fees are set at the level considered to optimise the functioning of the system.

The level of interchange fees influences issuing banks and acquiring banks to make appropriate changes in the level of their activities of recruitment of cardholders and recruitment of merchants and in the levels of their cardholder and merchant fees. Thus, the absence of an interchange fee, or an inadequate or inappropriate

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10 See EPFSF Speech by Gerard Hartsink, Chair EPC, "Payment Services Directive as a step towards SEPA", 21 February 2006, page 6.

11 Sveriges Riksbank, "Do prices reflect costs? – A study of the price and cost structure of payment services in the Swedish banking sector 2002", October 2004. Norges Bank, "Cost and Income in the Norwegian payment system 2001", September 2003. The importance of these reports is recognised by the Commission in the SEPA Incentives Paper and the sector inquiry interim report on payment cards.

interchange fee, would result in the Visa system, for example, being unable to function at its optimal level, and indeed would threaten the continued existence of the Visa card payment system in its current form. Visa Europe does not agree with the analysis of interchange fees in the sector inquiry interim report on payment cards. Among other things, the interim report fails to appreciate the importance of an interchange fee in influencing the behaviour of banks and in providing the correct incentives so as to ensure that the payment card system as a whole is optimised and to take into account the fact that interchange fees are only one of the many factors which influence cardholder fees and merchant service charges. Visa Europe will address separately the issues raised in the interim report.

Inappropriate interference by the Commission with regard to interchange, could have unforeseen consequences on the ability of four-party payment card systems to operate effectively.

The reference to shared cost in question 50 b) is based on a misconception as there are two payment service providers involved in a four-party payment card system. Moreover, it is not clear to Visa Europe what is meant by "*the principle of shared cost*". Although shared costs may have been considered in the context of other types of payments, they are clearly not relevant in the context of payment cards. As explained above in relation to interchange, in Visa Europe's view no sharing of costs between the "two sides" will be compatible with efficiency and the maximisation of the competitive impact of the Visa system unless the "sharing" takes account of inter alia, factors on the demand side (both the demand of merchants and the demand of consumers for the system's services) and the inter-relatedness of demand (since each card transaction involves a merchant and a cardholder).

Furthermore, in the Visa system, the issuing bank provides services which are of benefit to the merchant, although the issuing bank does not have any direct relationship with the merchant through which it could recover the costs involved. Similarly, the acquiring bank provides services which are of benefit to a cardholder, although it does not have a relationship with the cardholder. Accordingly in the absence of an interchange fee it would not be possible to ensure an adequate balance in or optimisation of the payment system or an appropriate "sharing" of costs.

Question 51 – Should card scheme rules which prevent price discrimination between payment instruments at the point of sale (e.g. no surcharging rules) be banned?

Removal of no surcharging rules, for example, Visa's rule, could have the undesired effect of promoting the use of cash, on which there would be no surcharge, thus discouraging the use of payment cards, which the Commission has recognised provide a more efficient means of payment. A removal of the no surcharging rule would therefore not be in line with the objectives set out by the Commission in the Impact Assessment in relation to the draft New Legal Framework Directive which seeks to steer consumers to the most efficient means of payment.

In Visa Europe's view, no surcharging rules also have an important role to play in ensuring that a payment card can be used anywhere which accepts that particular payment card, without penalty or unpleasant surprises and consequently without damage to the payment card's reputation. In other words the no surcharging rule ensures certainty and transparency.

With a no surcharging rule, cardholders would be vulnerable to surcharges by merchants. Any surcharge, regardless of the amount, can be expected to reduce the utility of cards to cardholders.

Question 52 – Should scheme rules that limit cross-border issuing and acquiring be banned?

Visa Europe's rules are designed to facilitate and do not limit cross-border issuing and acquiring activities. However Visa Europe does ensure adequate information and quality control protections are in place with regard to cross-border issuing and acquiring.

Question 53 – Direct Debit

This question is not relevant to Visa Europe as it concerns direct debit transfers and not payment cards.

The project for Interchange fees for Direct Debit which has agreed to seek to develop a possible model for interchange concerns direct debit transfers only and will not be of any interest with regard to interchange fees in relation to payment cards. Furthermore Visa Europe would like to bring to the Commission's attention that it is inappropriate to refer to an interchange fee in the context of direct debit transfers. A more appropriate term would be inter-bank fee.

Question 54 – What barriers exist for competition in processing? What measures are necessary to ensure commercial interoperability of processors/infrastructure providers and create a level playing field for competition?

As stated above in Section 6.5, Visa Europe believes that any barriers which may exist today in relation to processing will be removed following implementation of the SEPA Cards Framework drawn up by the EPC.

6.10 How to ensure repositioning of cash and cheques?

Following a number of studies carried out by national central banks[12] and other organisations, it is now well recognised by the Commission and others, that cash and cheques are considerably more expensive, in terms of total resources used by all participants, than electronic payments.

However, as recognised in the Consultation Paper on SEPA incentives, banks in a number of Member States are not free to introduce cost based pricing. Visa Europe would strongly encourage the Commission to ensure the removal of national legislation which limits the commercial freedom of banks to introduce cost based pricing where they so wish.

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[12] See op cit note 11.

Greater consumer awareness of the cost of cash and cheques as well as a move by banks to price accordingly (although such pricing should be left to each bank to decide on a commercial basis) are likely to be the most effective means of encouraging a reduction in the use of cash and cheques to the benefit of more cost-efficient means of payment and thus to the benefit of a more competitive European economy.

6.12 E-invoicing

The Commission refers to e-invoicing in the SEPA consultation paper. While Visa Europe recognises the wider benefits of automated invoicing, this is an issue that falls outside the scope of SEPA. Invoicing is different from payments and should be dealt with by a separate initiative. Any attempt to include e-invoicing in the SEPA work plan at this stage will inevitably lead to implementation delays and will be counter-productive to the Commission's objectives.

III. CONCLUSION

Visa Europe supports the work of the EPC in seeking to achieve the SEPA vision and believes that an effective partnership between the EPC, the Eurosystem, the Commission and other stakeholders will ensure that banks and inter-bank organisations will be able to meet the SEPA objectives set out by the EPC. Visa Europe does not share the reservations that have been expressed by the Commission, in documents and at conferences, regarding the commitment to SEPA by the European banks and the likelihood that SEPA will be delivered in a timely manner.

Visa Europe would welcome the opportunity to be consulted further by the Commission during the summer of 2006 and to participate in the hearings scheduled for 3 October 2006.

ANNEX 2

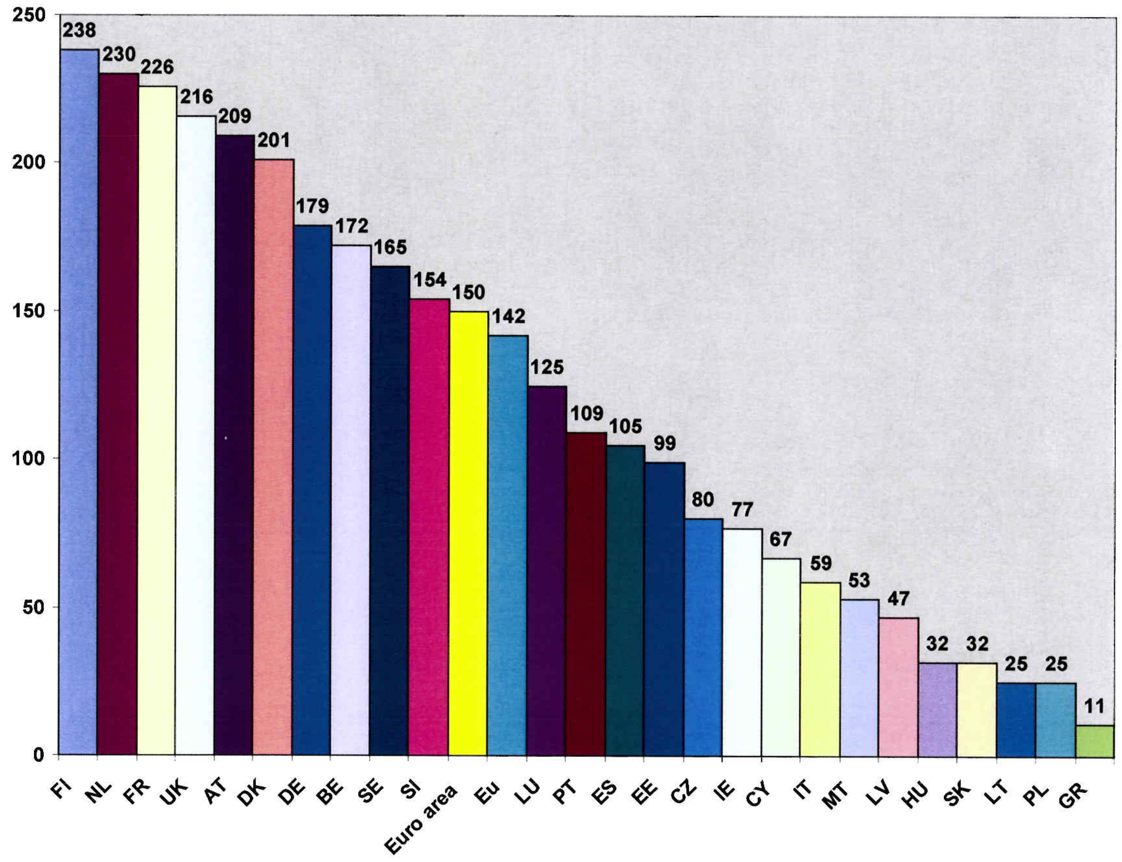
SPENDING PATTERNS ACROSS THE EU

VISA

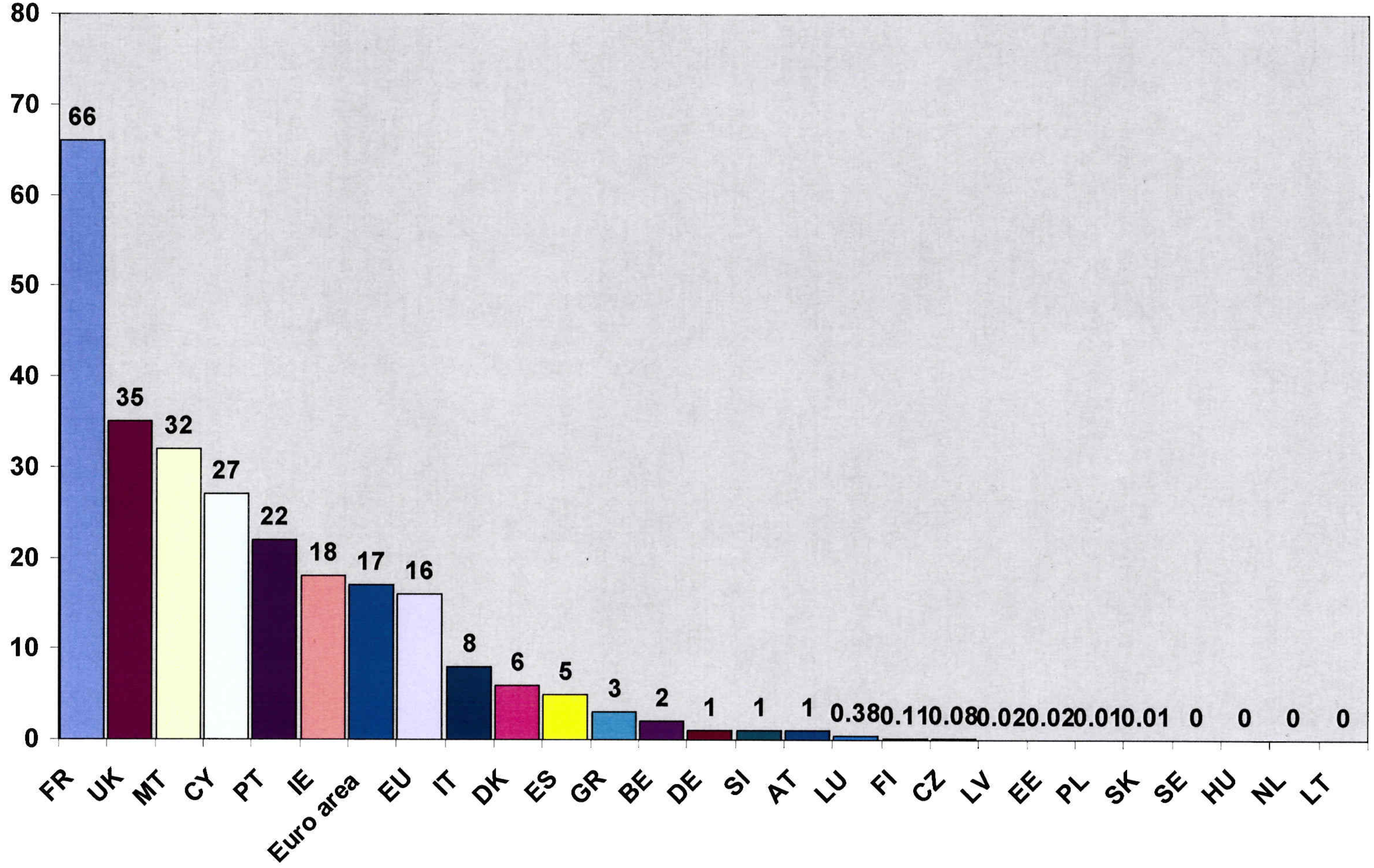
Annex 2
Spending patterns across the EU

ECB Blue Book, March 2006

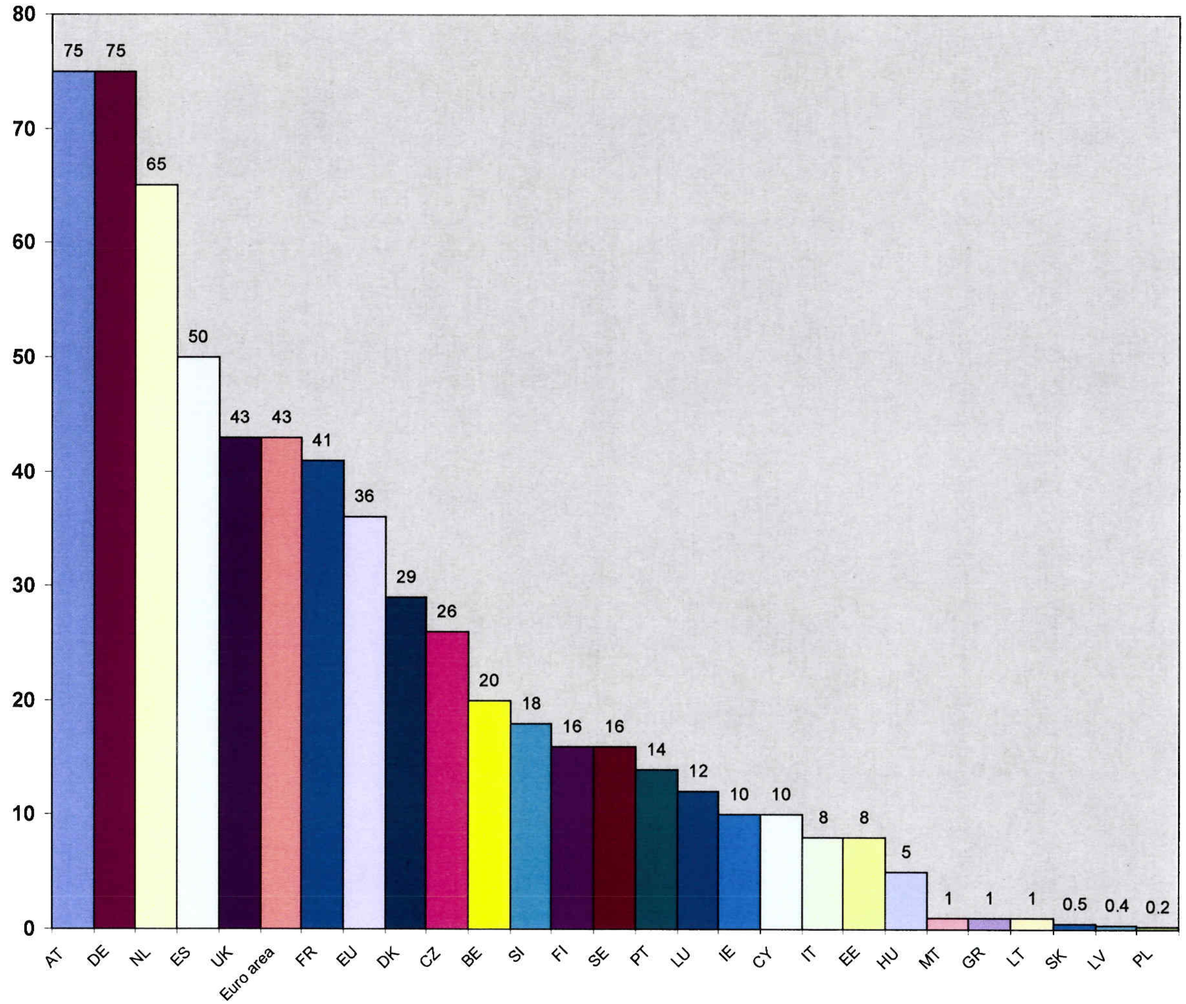
Number of transactions per inhabitant: Total for 2004



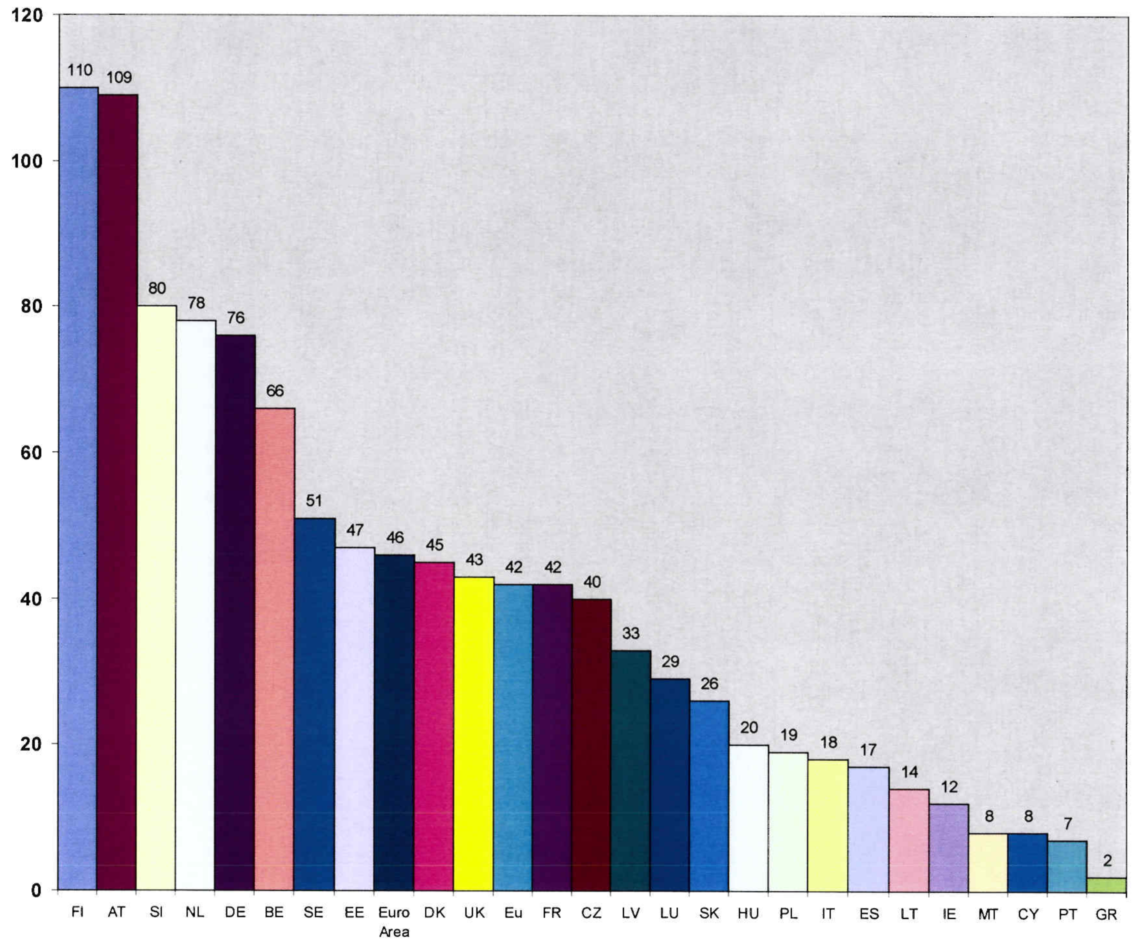
Number of transactions per inhabitant:Cheques 2004



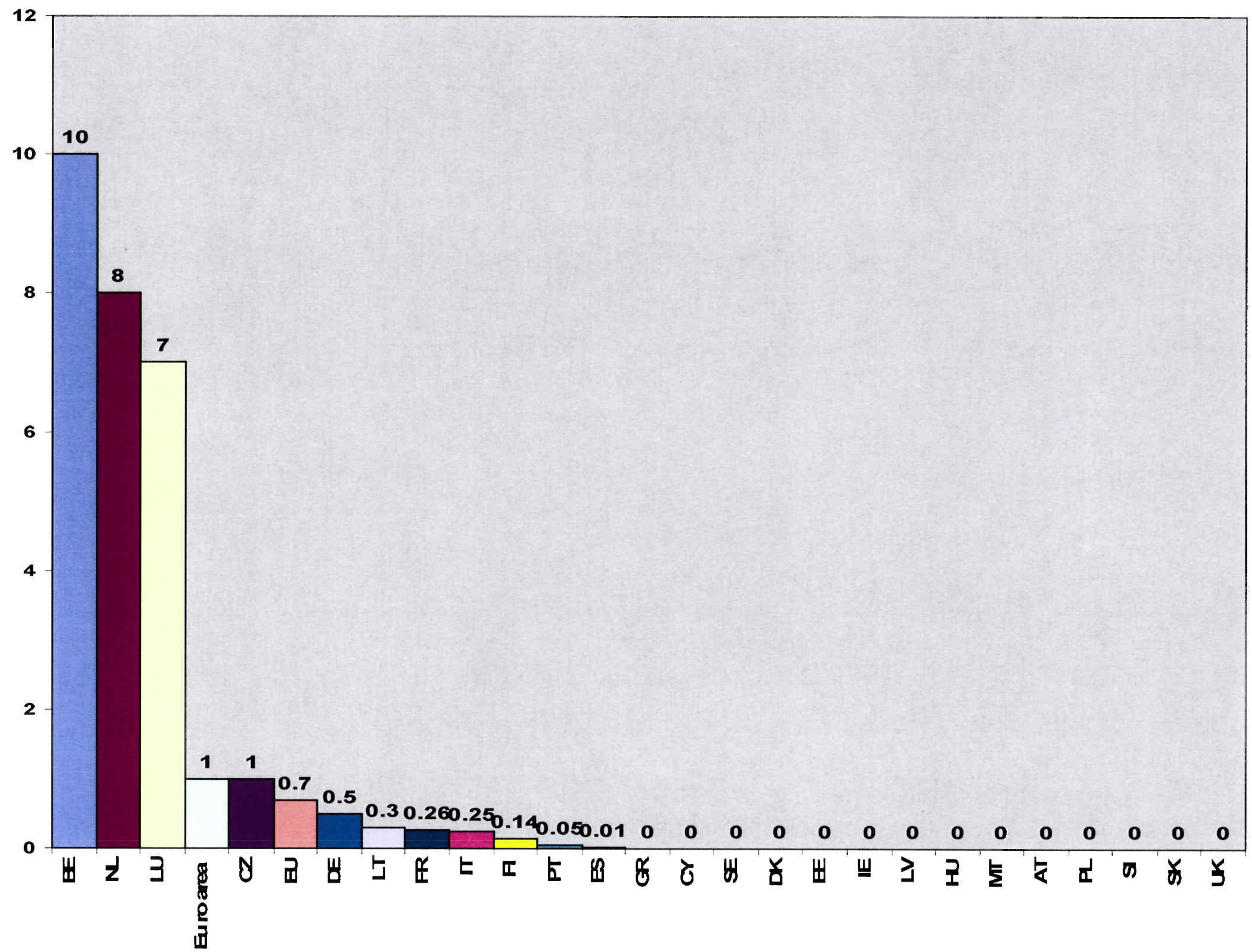
Number of transactions per inhabitant: Direct Debit 2004



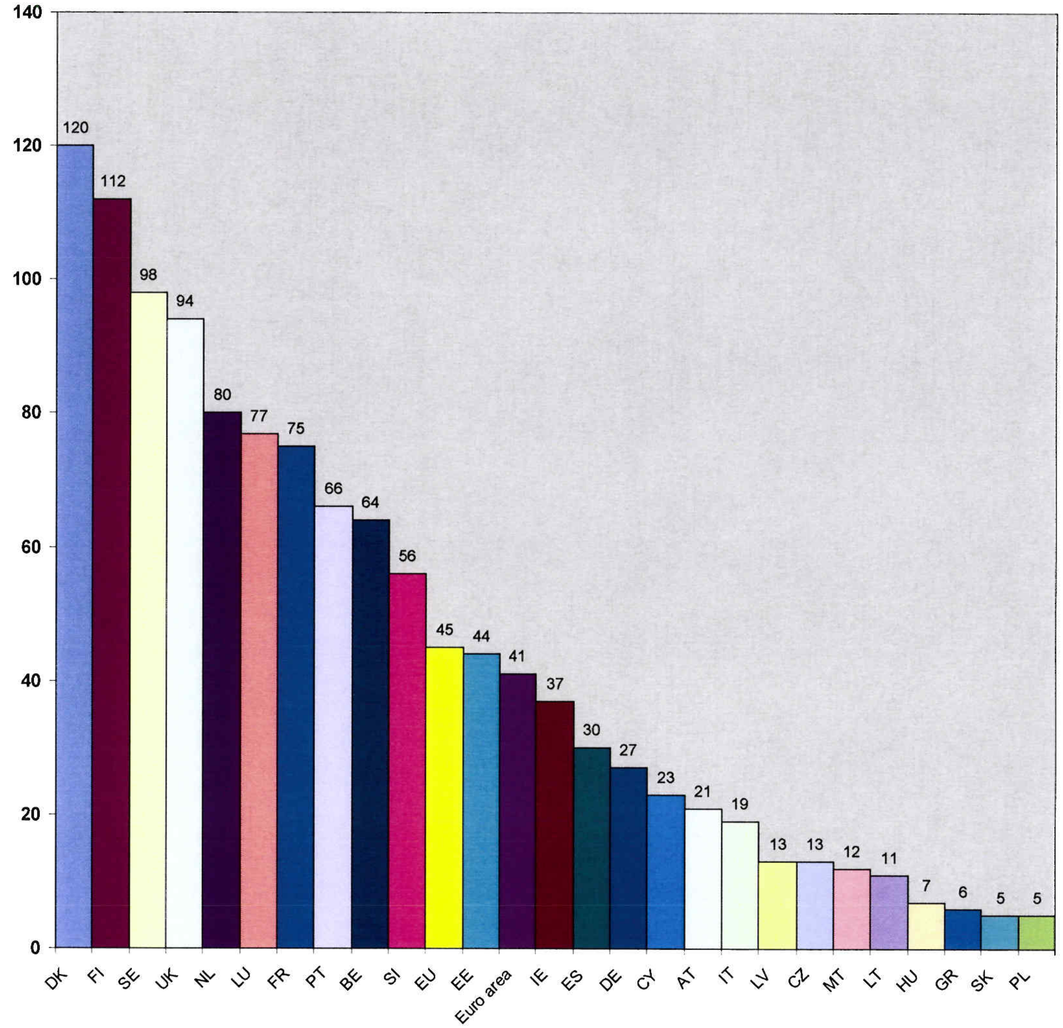
Number of transactions per inhabitant:Credit Transfers 2004



Number of transaction per inhabitant - e-money 2004



Number of transactions per inhabitant:Payments by credit/debit cards 2004



ANNEX 3

BENEFITS TO MERCHANTS OF ACCEPTING PAYMENT CARDS

BENEFITS TO MERCHANTS OF ACCEPTING PAYMENT CARDS

Description	Merchant Benefit	Benefit Provided by	
		Acquirer	Issuer
Card acceptance, authorisation and transaction processing	▪ Faster than cheques, displaces cash, less cash in the safe, fewer visits to bank, less till snatches, lower staff fraud	●	●
	▪ Increased security checks as to creditworthiness, credit limit and fraud		●
	▪ EMV to reduce cardholder fraud and improve identity checking	●	●
Reconciliation, statementing and billing	Simple end of day and monthly reconciliation with bank account	●	
Interest-free period	▪ Immediate payment despite time taken to process transaction and obtain payment from customer.		●
	▪ Merchants avoids costs of extending credit and lost interest revenue during the interest free period.		●
Merchant support services	▪ In some nations free terminals, maintenance and telecoms	●	
	▪ Call centre support for adjustments, disputes and merchant queries	●	
	▪ Chargeback process to enable dispute resolution	●	
	▪ Fraud monitoring to reduce cardholder fraud	●	
Settlement	Direct, automatic, easily checked and reconciled	●	●
"Payment Guarantee"	▪ Guaranteed funds after authorisation, eliminates bad debt (as with cheques) and fraud		●
	▪ Financial risk with issuer via the acquirer not with merchant		●
	▪ Prompt payment typically T+1/+2 across EU	●	
	▪ Reduces cashflow and improves liquidity	●	●
	▪ Reduced fraud/bad debt		●
Generation of new revenues and profits	▪ Increased sales through spontaneous purchases enabled by revolving credit lines		●
	▪ Higher sales values (ATV) particularly white/brown goods and in T&E		●
	▪ New business/customers as well as tourists which generate increased benefits		●
Reduced operational costs	▪ Lower merchant staff costs as cash/cheques displaced		●
	▪ Lower bank charges as cash/cheques displaced		●
	▪ For large major reduction in back office processing and CIT costs	●	
	▪ Enables merchants to manage cash-flow, manage stock and target promotions	●	●
New market sectors	▪ Enables MOTO and internet purchases and building of new businesses	●	●