Financial analysis of the industry

1. Are high merchant fees a competitiveness issue for the EU economy?

2. Are there compelling justifications for the comparatively high level of merchant fees observed in some parts of the EU25?

3. In view of the apparent profitability of card issuing, is there a generally applicable justification for substantial revenue transfers through interchange fees in card payment systems?

4. Are the high profits observed due to innovation or do they arise from some kind of market power in a two-sided industry?

5. What pricing practices, rules and legal provisions distort price signals to consumers and the choice of the most efficient payment instrument?

6. Would cost-based pricing promote the use of efficient payment instruments and how could such pricing be implemented?

7. Do currently existing pricing practices have a substantial negative effect on cross-border card usage by consumers?

Market structures, governance and behaviour

8. What market structures work well in payment cards?

9. What market structures do not appear to work well / deliver efficient outcomes?

10. What governance arrangements can facilitate competition within and between card payment systems?

11. What governance arrangements can incentivise card payment schemes to respond to the needs and demands of users (consumers and merchants)?

12. What governance arrangements can allow minority participants or minority members to receive appropriate information and participate appropriately in decision-making?

13. What access conditions and fees are indispensable?

14. To what extent is separation between scheme, infrastructures and financial activities desirable to facilitate competition and efficiency?

Future market developments

15. Are significant structural changes to be anticipated in the payment cards industry?

16. What are the anticipated impacts on the industry of innovation and technological change?
<u>Potential solutions to market barriers</u>

17. How can structural barriers to competition, which may arise for instance from the integration of different functions within a payment system or from joint acquiring ventures, be tackled?

18. Are there compelling justifications for the identified possible behavioural barriers to competition?

19. How much need and scope is there for harmonising technical standards in the payment cards industry? How large are the potential benefits and costs of harmonisation?

<u>Lessons for SEPA</u>

20. What lessons (best practice) for the design of SEPA schemes can be learnt from existing national and international payment systems?

21. How could competition between schemes in SEPA be strengthened?

22. Which structural and behavioural barriers to effective competition between banks and payment service providers should be removed to achieve SEPA?

23. What governance requirements should SEPA schemes meet?

24. By what means can interoperable communication protocols, security and other technical standards be achieved and certification procedures be limited to the minimum necessary?

25. Do the removal of barriers to competition, the observance of pro-competitive governance and the creation of interoperable standards require (further) regulation?

<u>Intense competition in acquiring as the best guarantee for overall competitiveness in the card industry: no need to regulate the Spanish card business</u>

BBVA considers that most of the concerns raised by the Interim Report are removed (or largely diluted) <u>if strong competition at acquiring level exists</u>. Lively competition in the acquiring business is the most efficient instrument for keeping merchant fees low and promoting the enhanced use of payment cards on both sides of the market. More in particular, **competition in the acquiring activity renders interchange fees largely irrelevant** (even coupled with rules such as “no surcharge” or “honor-all-cards” imposed by international card schemes) **since, if sufficient competition exists, merchants may always find efficient and**

competitive providers of financial services and hence suffer no market power from card issuers.

Spain as the most competitive EU market in card acquiring

BBVA submits that the acquiring card business in Spain is amongst the most competitive in Europe (and probably the most competitive one):

(i) Spain is the Member State with the lowest concentration ratio in acquiring and the only one with a HHI concentration level below 2,000: as the Commission itself admits, "*an HHI of up to 2000 is assumed to raise no substantial competition concerns*"[1].

(ii) Spain is one of the EU Member States with the highest number of banks and financial institutions performing acquiring card activities[2].

(iii) Spain has the highest number of point of sale (POS) terminals in the EU in absolute and relative terms[3]: since card transactions are still infrequent and of a modest size[4], there is still ample scope for continued competition in acquiring.

(iv) Differently from other Member States, acquiring in Spain is done individually by each financial institution and not through inter-bank joint ventures.

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[1] Vid. Interim Report, pp. 79-80.

[2] Ibid. BBVA considers that currently more than 100 entities offer acquiring services in Spain.

[3] At the end of 2004 more than 1.07 million of terminals existed in Spain, almost one fourth of the whole Euro area. Vid. European Central Bank's Blue Book on Payment and Securities Settlement Systems in the European Union (March 2006, incorporating 2004 data) ("**Blue Book**"), p. 66.

[4] At the end of 2004 the number of card transactions per capita was 29.77, Euro area average being 41.48 transactions (vid. Blue Book, p. 37). The average value in Spain per card transaction was 51.9 Euros, the Euro area average being 55.9 Euro (vid. Blue Book, p. 53); finally, the value of card transaction per capita in Spain was 1,545 Euros in 2004, while the Euro area average was 2,318 Euros (vid. Blue Book, p. 55).

(v) Not surprisingly, the intensity and quality of competition in the Spanish card acquiring business is remarkably high:

- as shown in the Interim Report, and for debit card acquiring (a particular important activity in the Spanish card industry), the HHI index fell by almost 60% between 2001 and 2004: the Commission itself explains that smaller acquirers won a significant portion of market shares at the expense of market leaders;

- official data released by the Bank of Spain indicate that maximum and average merchant fees have steadily decreased between 2002 and 2005[5];

- often Spanish banks do not pass over to merchants the interchange fees (via merchant fees) but absorb themselves a portion of the interchange fees due to competitiveness of the acquiring business: official Bank of Spain's data confirm that merchant fees may be lower (and even significantly lower) than interchange fees[6];

- differently from other Member States, POS terminals are routinely supplied and maintained free of cost;

- the acquiring business for Spanish banks yields a slim profitability rate and even sustained loses[7];

- as repeatedly reported by Spanish press[8], merchant fees have already sharply decreased in 2006 due to the "Acuerdo Marco" on interchange fees signed by the

[5] Figures available at the Bank of Spain's website: http://www.bde.es/sispago/estadisticas.pdf

[6] In particular in the following sectors: (a) travel agencies (entire period 2002-2004), (b) supermarkets (2002), (c) hotels (entire period 2002-2004), (d) drugstores (entire period 2002-2004), (e) restaurants (2002 and part of 2003), (f) jewellery (entire period 2002-2004 except the last quarter of 2004), (g) car rental (entire period 2002-2004), (h) leisure and events (entire period 2002-2004 except the last quarter of 2004), (i) casinos (2002) and (j) retail (2002). Data available at Bank of Spain's website (http://www.bde.es/sispago/estadisticas.pdf).

[7] See for instance BBVA's response to the Commission questionnaire (Profit and Loss Statement for Acquiring).

Spanish financial and retail sectors in December 2005[9]. Indeed, and according to official data recently unveiled by the Spanish Government, small retailers paid in 2005 average merchant fees of 2.1% while in April 2006 they paid only 1% (i.e., 50% reduction in four months)[10].

It follows that the remarkable level of competition in the Spanish acquiring business renders the question of interchange fees (including their amount and method of fixation) largely irrelevant in Spain: intense and lively bank rivalry in acquiring activities effectively shields merchants vis-à-vis the impact of interchange fees and, in general, avoids the merchant-to-bank rent extracting effect criticised by the Commission in the Interim Report.

In sum, and taking into account that regulation should be kept limited to what is strictly necessary, it must be concluded that **the extraordinary level of competition in the Spanish acquiring business makes unnecessary to regulate the card industry in Spain, including the very existence and current level of interchange fees**. At most, it would suffice the application of competition rules if infringements exist.

Therefore, any hypothetical EU-wide regulation should include the corresponding safeguard clauses in order to take into account Spain's current and foreseeable degree of competition in the acquiring business: otherwise, the proportionality principle would be infringed.

Features of issuing and interchange fees in Spain support the above conclusion

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[8] Vid. "El Economista" (27 April 2006, p. 34); "El Mundo" (on-line versión) (26 April 2006); "La Razón" (27 April 2006, p. 60); "Cinco Días" (27 April 2006, p. 26); "Diari de Terrassa" (9 April 2006, p. 2 and 26 April 2006, p. 16, quoting merchant representatives); "La Verdad" (5 April 2006, p. 41); "Diario de Navarra" (10 April 2006, p. 10); "La Gaceta de los Negocios" (3 March 2006, p. 29); "La Vanguardia" (3 March 2006, p. 71); "El Economista" (3 March 2006, p. 21); "Expansión" (3 February 2006, p. 19); "El Punt" (3 February 2006, p. 36); "Cinco Días" (3 February 2006, p. 26); "El Mundo - La Crónica de León" (7 January 2006, p. 15); "Expansión" (9 January 2006, p. 11); "El Mundo" (Edición Cataluña) (9 January 2006, p. 34).

[9] The Acuerdo Marco is currently being reviewed by the Spanish competition authorities in the light of Article 81 of the EC Treaty.

[10] Statement by the Ministry of Commerce (Mr. Montilla) at the Parliament, of 26 April 2006. Available at the web page of the Ministry of Commerce (http://www.mityc.es).

Notwithstanding the above, the Spanish card industry presents some salient features in the issuing side and, in particular, regarding the interchange fees.

<u>Card issuing is a competitive activity in Spain</u>

It derives from the Interim Report and diverse official data and statistics that the issuing of payment cards in Spain is a competitive activity and that there is scope for continued competition in the future. No market power issue therefore arises.

(i) Spain has one of the highest ratios of card per capita of the EU[11].

(ii) Growth of the card issuing activity in Spain has been significant and sustained over time[12].

(iii) Spain is one of the EU Member States with the highest number of banks and financial institutions performing issuing card activities.

(iv) There is ample scope for competition among issuers given that card usage in Spain is still low[13]: such competition include, <u>inter alia</u>:

(a) Cardholder fees: in fact, and as reported by Spanish economic press[14], a "commercial war" on cardholder fees have been recently launched in Spain by some financial entities;

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[11] In 2004, the number of issued cards per capita in Spain amounted to 1.45, the EU average being 1.18 (Vid. Blue Book, p. 65).

[12] Compounded increase of payment cards issued between 2001 and 2004 amounted to 31.04% (Vid. Blue Book, p. 64). In 2005 issuance of credit cards rose by almost 15% (vid. Bank of Spain's website: http://www.bde.es/sispago/estadisticas.pdf).

[13] As already noted, the 2004 comparison between Spain and the Euro area was 29.77 / 41.48 (number of card transactions per capita), 51.9 / 55.9 (average value of card transactions) and 1,545 / 2,318 (value of card transactions per capita). Vid. Blue Book, pp. 37, 53 and 55.

[14] "Expansión" (3 April 2006, p. 21 and 8 April 2006, p. 15); "El Comercio" (29 January 2006, pp. 1-3); "Cinco Días" (21 January 2006, p. 12); "Expansión" (20 January 2006, p. 19); "Cinco Días" (20 January 2006, p. 22).

(b) Free funding period: issuers compete in grating to cardholders longer free-float periods;

(c) Innovation: Spanish issuers continuously develop and launch innovative and value-added cards, offering cardholders a wide array of financial advantages including universal (i.e., all purchases) and sectorial (i.e., purchase of certain goods) cash-back schemes, loyalty programs (i.e., acquisition of redeemable points), etc[15].

(v) Three-party card systems (in particular AMEX and Diners Club) are increasingly successful in Spain and a direct source of competitive constraints for issuers under VISA and MasterCard schemes.

In addition to the competitive nature of the card issuing activity in the Spanish market, the question of interchange fees presents some specific features in Spain which should inevitably affect any hypothetical EU-wide regulation.

Significant and continued decrease of interchange fees

(i) Official data released by the Bank of Spain indicate that interchange fees have steadily decreased between 2002 and 2005[16].

(ii) The "Acuerdo Marco" signed in December 2005 (see below) guarantees a sustained and significant fall of the multilateral interchange fees in 2006, 2007 and 2008. On average, the guaranteed reduction over the three-year period will amount to more than 50% of 2005 fees.

[15] BBVA considers that value-added features are currently the most important competitive factor in the Spanish credit card issuing business. See BBVA's response to the Commission questionnaire.

[16] Figures available at the Bank of Spain's website: http://www.bde.es/sispago/estadisticas.pdf

Multilateral interchange fees will, after a short transitional period, be strictly adjusted to issuers' costs and made consistent with EU competition principles

As noted, in December 2005 the Spanish financial sector (through the three existing card processing entities) and a wide array of merchant representatives signed the "Acuerdo Marco", which sets up the general principles governing (at short and long term) the multilateral interchange fees applicable to domestic payment transactions with cards. The main features of the Acuerdo Marco are the following:

(i) Distinction between credit and debit

The Acuerdo Marco contains different rules for the fixation of interchange fees applicable to debit card and credit card transactions.

(ii) Objectivity: interchange fees not higher than costs

Intra-system interchange fees (i.e., those applied between banks pertaining to the same processing entity) will not exceed, after 1 January 2009, the average of costs incurred by card issuers pertaining to each entity. Those costs will be included in cost studies to be prepared by audit firms by 31 July 2008 at the latest and which will be submitted to the competition authorities.

(iii) Transparency

The processing entities will reveal to merchants, at their request, the interchange fees applicable to the card transactions in their stores, the proportion corresponding to each cost category and the applicable maximum limit.

(iv) Primacy of bilateral interchange fees

Interchange fees regulated by the Acuerdo Marco will only apply to card transactions for which no specific fee exists as a result of a bilateral agreement between the two intervening financial entities.

(v) Maximum amount

Interchange fees regulated by the Acuerdo Marco will in any case be maximum values, hence being possible that lower interchange fees are agreed within each processing entity.

(vi) Transitional period, quantitative cap and effective fee reduction

The Acuerdo Marco envisages a transitional period (which is expected to last until 2008) until the application of the cost criterion. During the transitional period, multilateral interchange fees effectively applied may not exceed the quantitative caps contained in the Acuerdo Marco. In addition, the transitional period implies a significant reduction of the levels of interchange fees existing in 2005.

Quantitative caps depend on the volume of card transactions reached by each merchant in the preceding year. Maximum fees will thus depend on merchants' individual card usage irrespective of the affected commercial sector.

(vii) Stand still

If, by the entry into force of the Acuerdo Marco, intra-system interchange fees applied to transactions in a point of sale are lower than the corresponding quantitative caps, fees to be effectively applied will not exceed the amount effectively applied at the date of entry into force[17].

(viii) Inter-system fee diversity

According to the Acuerdo Marco, maximum multilateral interchange fees will not be commonly agreed by the three processing entities active in Spain (i.e., Servired, 4B and EURO 6000). Each entity will set its own separate fees, which will be applied by member banks in intra-system transactions.

[17] The above criteria apply directly to intra-system interchange fees. As to inter-system fees, their maximum amount will correspond to the weighted average of intra-system fees plus the weighted average of the interconnection fee of each processing entity (which may not exceed 0.06 Euros).

Interchange fees have been self-regulated by the affected market agents (financial institutions and merchants): no EU regulation is hence necessary in Spain

When discussing the successful implementation of SEPA, the Commission has openly admitted that self-regulation by affected operators is the preferred approach[18], provided that all interested stakeholders are involved.

BBVA submits that this is precisely the approach followed in Spain regarding interchange fees. As noted above, on 2 December 2005 an agreement (the "Acuerdo Marco") was signed by financial entities and merchants, the two sectors affected by interchange fees. The Acuerdo Marco sets precise limits and principles to the multilateral fixation of interchange fees in the short and mid terms and - as the Commission may well imagine - it is the result of long, intense and extremely detailed negotiations between banks and merchants. The representatives of both sectors have confirmed to the Spanish competition authorities that the Acuerdo Marco (i) is an efficient instrument for solving the inherent conflicts regarding interchange fees between the financial and commercial sectors; (ii) will enhance card usage in Spain; (iii) will benefit the development of retail activities, and; (iv) is compatible with Article 81 of the EC Treaty. The Spanish Government has expressly endorsed the Acuerdo Marco and has pointed out its positive effects for both merchants and consumers[19].

In addition, the Acuerdo Marco envisages a forum of cooperation between the financial and retail sectors regarding cards which will be chaired and supported by the Spanish Government (Ministry of Commerce). The goal of this forum (the "*Observatorio de los Medios de Pago*

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[18] "*The Commission supports to the greatest possible extent continued self-regulation by industry.* […] *A market-driven and self-regulatory is the preferred approach, because it allows the decisions to be made by the parties that have to act and that have most relevant information. It also makes future developments easier to manage*".

[19] "*The assessment by the Government of the application of the Agreement* [the Acuerdo Marco] *is highly positive, insofar as a more intense use of efficient means of payment will imply remarkable benefits for our economy and, in particular, for small retailers and consumers*". Vid. Statement by the Ministry of Commerce (Mr. Montilla) at the Parliament, of 26 April 2006. Available at the web page of the Ministry of Commerce (http://www.mityc.es).

Electrónicos en el Comercio en España") will be the continued monitoring of the card industry in Spain and, in particular, of card penetration and impact on the national economy[20].

If finally authorised by the competition authorities, the Spanish financial and commercial sectors would have reached a negotiated and card-enhancing solution to their long-standing discrepancies as to the appropriate amount of interchange fees. The new situation created by the Acuerdo Marco will provide both economic sectors the indispensable stability and certainty in order to successfully migrate to SEPA standards and requirements and reduce huge cash dependency (see below).

In short: the issue of interchange fees is subject to proper self-regulation in Spain by the two affected sectors (banks and merchants) with the express endorsement and support of the Spanish Government. This is a unique situation in the EU which seems to fit perfectly with the Commission's preferred approach regarding SEPA. Therefore, EU regulation of interchange fees in Spain is unnecessary and inappropriate.

A regulatory approach based on the elimination or substantial cut of interchange fees would improperly upset the entire card business model in Spain and other Member States and impose at EU level the "revolving" model

In the Interim Report the Commission notes the profitability levels of the issuing business in the EU and asserts that - in many cases - issuing would still remain profitable without income derived from interchange fees. The Commission concludes that interchange fees are in general not necessary for ensuring the economic viability of the issuing activity and hence the very existence of cards as means of payment.

BBVA considers that, rather than applying a straightforward and mechanical profitability approach (in order to determine in abstract which income is or not "necessary" for the provision of a certain financial service) as a basis for hypothetical EU-wide regulation, the

[20] The "*Observatorio*" has been formally created by decision of the Council of Ministers dated 2 June 2006.

Commission should carefully consider the different structures and features of the card issuing industry (and financial services in general) in the Member States. In this connection, two general business models may be differentiated:

(i) The "revolving model"

This business model conceives credit cards basically as an instrument for granting a personal loan to individuals (i.e., cardholders). Cards usually imply that cardholders obtain an extended credit facility (which is remunerated with an "ad hoc" interest) if the amount of debt incurred by the cardholder is not settled in full at the end of the prescribed period[21]. Consequently, for this model the essential income element is the financial interest charged by the card issuer to the cardholder (as a consideration for the use of the personal credit granted) rather than cardholder fees and even interchange fees. One example of this model is the United Kingdom.

According to Euromonitor 2002 data, credit cards issued in the UK borne zero cardholder fee. However, financial interests amounted to 69% of total income gained by issuers, the remaining 31% corresponding to interchange fees.

(ii) The standard model

In other countries, issuers and consumers generally conceive cards as a means of electronic payment rather than as a credit instrument. In those countries, consumers do not generally resort to consumption credit for ordinary purchases and wish to fully settle debts incurred by card use on a regular basis, without carrying forward outstanding debt and using credit card as a source of personal financing[22]. For this

[21] In "revolving" countries, cardholders pay a monthly flat amount in order to - partially - settle the debt incurred during the preceding month through the use of the card in the purchase of goods and services. The unsettled monthly debt is carried forward and made subject to an "ad hoc" interest; the outstanding debt (principal and interests) is reimbursed by the cardholder to the issuer along commonly agreed instalments.

[22] Official statistics show that the debt financial burden over the Spanish households is already very significant due to house acquiring expenditure: during the first 2005 quarter, 54,7% of families had difficulty in reaching next month with sufficient cash liquidity. Vid. "*Encuesta Continua de Presupuestos Familiares*" (www.ine.es).

model the essential income elements are non-interest concepts such as cardholder and interchange fees.

Germany, Spain, France and Italy follow this model. According to Euromonitor 2002 data, financial interests do not represent a significant (less than 15%) share of income gained by card issuers[23]. Non-interest income concepts (i.e., cardholder and interchange fees) correspond to the largest part of revenues. The interchange fee is the main income concept in all countries except in Italy (in which cardholder fees represent 51% of total income). Out of the four countries, Spain's cardholder fees represent the lowest share (26% over total income).

Aside from customers' preferences and habits, the generalisation in Spain of the revolving model seems particularly difficult also for legal and regulatory reasons. For instance, and differently from other Member States, Spanish law prohibits that accrued and unpaid interests may yield default interests themselves[24]. Spanish regulation also prohibits that credit card interests are capitalised daily, while in "revolving" countries such as the UK daily capitalisation is permitted and regularly applied by card issuers.

In addition to regulation, Spain has one of worst ratios of the EU in debt collection efficiency. According to the World Bank[25], the complexity of Spanish proceedings for debt recovery (index: 82,6) is well above the EU average (index: 55). Costs incurred in debt collection are huge in Spain[26]. The abolition - or significant reduction - of interchange fees and hence the imposition of a revolving card model

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[23] In particular: 14% (Italy); 4% (Germany); 13% (Spain); 3% (France).

[24] Vid. Article 317 Commercial Code.

[25] Vid. World Bank: "Doing Business in 2005: Removing Obstacles to Growth".

[26] Debt collection costs in Spain amount to 10,7% of income, EU average being 5,9%. World Bank: "Doing Business in 2005: Removing Obstacles to Growth".

based on consumer loan and interests would further increase those costs to the detriment of the Spanish financial sector's efficiency.

Moreover, card usage in Spain is considerably less intense than the "revolving countries", for example the UK[27]. The application of an interest-based card model is only workable in markets where cardholders spend high amounts of money via credit cards (and have little reliance upon cash[28]) and interests over unsettled sums may be significant. In the Spanish market, cardholders spend comparatively modest sums and interests over outstanding card debts do not imply issuers' main revenue stream.

In BBVA's view, the conclusion of the Interim Report that the issuing business will remain profitable in the mid and long term even without interchange fees is only correct for certain Member States, in which both card usage is intense and cardholders are accustomed to regularly paying financial interests: in this scenario, an hypothetical abolition of the interchange fees would not significantly alter the current issuing business model.

Conversely, in Spain (and other countries) the elimination of interchange fees would substantially upset the current card issuing business model, in the sense that issuers would need to re-balance their income mix basically through the levy of financial interests on cardholders for card usage[29]. Issuers should therefore either eliminate (or shorten) the free float period[30] or persuade their clients to accept partial settlement of card usage debts and to subject the remainder to financial interests. In any event, cards' actual advantages over cash

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[27] In 2004 figures, the average value per card transaction in Spain and the UK was respectively 51.9 and 71.3 Euros (vid. Blue Book, p. 53). The value of card transaction per capita in Spain and the UK was respectively 1,545 and 6,721 Euros (vid. Blue Book, p. 55). Finally, the number of transactions per card in Spain and the UK was respectively 20.05 and 40.84 (vid. Blue Book, p. 89).

[28] Cash penetration in the UK in 2004 amounted only to 18%, while in Spain was about 46%. Source: VISA. "PCE breakdown by market in 2004".

[29] The alternative of increased cardholder fees is not practicable in Spain. As noted in BBVA's response to the Commission questionnaire, above, cardholder fees applies by Spanish issuers are considerably low in view of the level of competition in the issuing business.

[30] In such a case, a valuable competitive factor would disappear.

would be lost and cash would entrench its supremacy to the detriment of EU and Spanish economy (vid. *infra*).

Cards and other electronic payment instruments still have a minor importance in Spain as compared with cash: a regulatory approach based on the elimination or substantial cut of interchange fees would consolidate cash dominance in Spain, contrary to Commission's stated goals

As already noted, and despite a very high penetration ratio of cards and terminals in Spain, the usage (value and frequency) of card transactions is still modest and well below the EU average. In particular, Spanish customers are heavily dependent on cash as a means of payment[31].

The Commission has recently stated that cash is an expensive and inefficient means of payment as compared with electronic payments and, in particular, payment cards:

> "*The Commissions' initiative will focus on electronic payments as an alternative to expensive cash. Modern electronic payments are recognised to stimulate consumer spending and economic growth. Best practice shows that modernisation of payment systems and increased use of the most cost-effective services can half the average cost of producing payments over a period shorter than ten years. If, for example, the use of cash would be reduced to the level of countries with the lowest usage, this would generate a surplus of EUR 5.3 billion*"[32].

It goes without saying that the effective introduction of card payment at the expense of cash is a goal which may substantially contribute to more efficient financial and retail markets. However, this profound change in consumer habits requires that people are persuaded to use cards more often and intensively when purchasing goods and services. Such a persuasion

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[31] It is considered that cash penetration (in terms of personal consumer expenditure) in Spain is 2004 was about 46%, EU average being 35%. In other major EU Member States cash penetration was significantly lower than in Spain (France: 22%; Germany: 31%; Italy: 38%; UK: 18%). Source: VISA. "PCE breakdown by market in 2004".

[32] Vid. Commission Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 97/7/EC, 2000/12/EC and 2002/65/EC Brussels, 1.12.2005 COM(2005) 603 final, p. 2.

requires in turn that financial institutions (and in particular issuers) commit significant investments, both technical and commercial.

Issuers must not only keep cardholder fees low and grant free-float periods but also develop commercially attractive value-added services attached to the use of cards, such as classic rebates over purchases and a wide array of fidelity rewards (including the acquisition of redeemable points). As noted, Spanish issuers are particularly active and innovative in the development and launch of such value-added services since those are of a particular competitive importance in the national market (vid. *supra*). In addition, and given that fraud and card forgery is more extended and sophisticated than ever, issuers must commit increased and continued investment in security technology applied to cards. Needless to say, the amount of investment needed in new card technology has been further expanded in the wake of the introduction of SEPA (vid. *infra*).

<u>**The significant investment needed to consolidate a more intense card usage in Spain to the expense of cash must be largely financed via interchange fees**</u> since alternative income sources are insufficient. Financial interests cannot reasonably substitute interchange fees in Spain (now or in the short and mid term): as noted, the "revolving model" is not practicable in Spain, where customers perceive cards as a means of payment (and not as a credit instrument) and are not generally accustomed to paying interests for the usage of cards. As to cardholder fees, it is clear that customers would be discouraged from accepting and using cards if the price to be paid (i.e., initial or annual fees) is increased.

It follows that interchange fees constitute in Spain the crucial stream of revenue needed to finance the continued and significant investments required in order to consolidate card usage and challenge cash supremacy. A regulatory approach based on the elimination (or sharp reduction) of interchange fees in Spain would directly undermine issuers' financial and commercial commitment to expand card use and would contribute to deepen Spanish customers' dependency on cash. This would be detrimental to the efficiency of payment systems in Spain and, in general, to the Spanish economy.

A regulatory approach based on the elimination or substantial cut of interchange fees would seriously undermine the successful implementation of SEPA and the SEPA Cards Framework

As the Commission well knows[33], the European Payment Council (EPC) and the SEPA Cards Framework (SCF) laid down precise and tight deadlines for the design, implementation and migration to SEPA-compliant payment cards. In particular, compliant cards, POS terminals and ATMs (based on EMV standard technology) must be available in the market by 1 January 2008 and migration to new products must be completed by the end of 2010.

As the Commission itself has admitted, the successful conclusion of the process will involve a significant and continued investment effort by financial institutions and, in particular, by card issuers:

> "*For realising the full potential of the Single Payment Market, industry has to play a pivotal role. It is the payment service providers, which will be faced with the challenge to find the best way to integrate national fragmented payment infrastructures, in order to benefit from the potential savings and offer new technologically advanced and efficient payment services. Similarly businesses will have to take steps to ready themselves to interact with these new payment systems. <u>This will require significant investments from providers and businesses</u>. However, payments industry has committed itself in the SEPA program to make these investments and to complete SEPA by 2010. The substantial benefits are considered worth the initial investment costs. The Commission's proposal will facilitate these investments and industry's work on SEPA*"[34].

More in particular, implementation and migration of SEPA-compliant products would require at least the following: (i) to adapt processing systems and software (and their operational maintenance) to EMV technology; (ii) to design and produce fresh chip-based personalised (with the user's name) payment cards; (iii) to train technical and commercial staff in the use of new technology and systems; (iv) to acquire the necessary hardware and software for the POS terminals and ATMs to work with EMV technology; (v) to effectively install in all

[33] Vid. in general Commission's Consultative Paper on SEPA incentives (Brussels, 13 February 2006).

[34] Vid. Commission Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 97/7/EC, 2000/12/EC and 2002/65/EC Brussels, 1.12.2005 COM(2005) 603 final, p. 3.

merchant outlets the new terminals (and to effectively remove the existing terminals), to train merchant’s employees and to undertake the necessary communication campaigns.

The Spanish card systems, in their reply to the Commission’s Consultative Paper on SEPA’s Incentives dated 30 March 2006, stated that implementation and migration costs would be especially significant in Spain in view of the country’s ratio of POS terminal and ATM penetration (the highest of the EU in absolute and relative terms) and card circulation. Only migration costs were estimated in 600 million Euros. The reply also explained that those costs could not be easily passed on to users and that the existence of interchange fees was therefore essential for the financing of the required investment.

The Commission has publicly stated its wish and will to facilitate investments needed to complete SEPA[35]. A hypothetical regulatory approach based on the elimination (or drastic cut) of interchange fees would seriously undermine the financial feasibility of the significant investment needed in order to conduct the implementation and migration phases of SEPA in Spain.

In addition, a successful migration to SEPA in Spain is even more unpredictable in view of the country’s cash supremacy and modest card usage. From the economic perspective, migration to SEPA will only bring overall benefits in terms of efficiency and cost savings if customers make an intense and regular use of cards as means of payment and hence reduce the cost of cash usage. As noted above, income based on interchange fees is a crucial tool for persuading consumers to abandon cash and use cards more regularly and intensively.

No structural barriers to entry in Spain

Individual (non-collective) issuing and acquiring

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[35] “*The Commission's proposal will facilitate these investments and industry's work on SEPA*”. Vid. Commission Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 97/7/EC, 2000/12/EC and 2002/65/EC Brussels, 1.12.2005 COM(2005) 603 final, p. 3.

Differently from other Member States cited in the Interim Report, issuing and acquiring activities in Spain are conducted separately and individually by financial institutions and not through joint ventures. This feature not only guarantees intense actual competition between incumbent banks (see above) but also facilitates foreign banks' entry in the issuing and acquiring business (since newcomers do not have to deal with a sole or dominant issuer / acquirer) as well as central cross-border issuing and acquiring.

<u>Effective functional separation between scheme ownership, infrastructure and financial services: limited structural integration in Spain</u>

The Interim Report assumes that there is a high degree of vertical integration in Spain between card scheme ownership, technical (processing) and financial (issuing and acquiring) services. BBVA submits that the relevant activities in the Spanish card industry are largely separated and non-integrated while leaving ample scope of competition.

(i) Scheme ownership

As admitted by the Interim Report, no domestic card systems exist in Spain[36]. Therefore, all payment card schemes operating in Spain are owned and governed by international organizations (VISA and MasterCard for four-party systems and AMEX and Diners Club for three-party systems). It follows that, differently from other Member States, national banks and processing entities do not own proprietary payment card schemes.

(ii) Technical / processing services

Processing activities for card transactions in Spain are not undertaken by financial institutions themselves nor by scheme owners. This task is conducted by three dedicated processing entities (i.e., Servired, 4B and EURO 6000) which own and operate separate

[36] Since - virtually all - cards issued by Spanish financial institutions are co-branded with international payment networks. Vid. Interim Report, p. 84.

networks and provide to both issuers and acquirers the necessary technical services for card transactions.

Therefore, and differently from many Member States with a single processing entity, three different processors exist in Spain which own and operate three country-wide networks. The three processing entities directly compete among themselves in providing card technical services to issuing and acquiring banks. Competition takes place by persuading national and foreign banks to adhere to one or another processing entity.

It is true that the three processing entities are ultimately owned by financial institutions and not by "independent" third parties. Nonetheless, no structure of control exists in the sense of competition rules: in other words, there is no financial institution which - solely or jointly - controls any of the existing processing entities. This feature grants those entities a considerable degree of functional and technical independence vis-à-vis their shareowners.

Both circumstances (i.e., the existence of three separate and competing country-wide networks and processing entities and their functional independence vis-à-vis their respective owners) exclude the emergence of barriers to entry regarding foreign financial institutions. Non-Spanish banks simply need to choose the processing entity to adhere to before starting the provision of issuing and acquiring card services in Spain. In fact, many foreign banks are members to the processing entities and receive exactly the same services than national banks[37].

(iii) Financial services (issuing and acquiring)

As already noted above, and differently from other Member States, issuing and acquiring are strictly individual activities in Spain. In addition, and as admitted by the Interim Report itself, the degree of concentration of the Spanish market is the lowest of

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[37] In particular, members to Servired include among others Deutsche Bank, Citibank, MBNA, Barclays Bank, Lloyds, Banco Espirito Santo and Halifax; members of 4B include ING, Cétélem and Carrefour.

the EU, with a large number of financial institutions (both national and foreign) fiercely competing in issuing and acquiring activities. Hence, current conditions closely resemble to a “perfect competition” scenario.

It follows that the assumption by the Interim Report that a high degree of vertical integration exists in the Spanish card industry (and, hence, that a material barrier to entry hinders penetration by foreign banks in the Spanish market) is not correct. No regulatory or other implications may be inferred from such an assumption.

The Commission should not impose other Member States’ domestic payment card systems as a benchmark in Spain (absence of domestic card systems in Spain)

The Interim Report repeatedly refers to certain domestic payment card systems existing in several Member States (Italy, France, Germany, Denmark, Belgium, The Netherlands, Hungary, Finland, Malta, Portugal, Slovenia and Ireland). The Interim Report asserts that domestic card systems are more efficient than international schemes (VISA and MasterCard) in terms of fees (interchange, merchant and cardholder) and profitability rates. All in all, the Commission seems to suggest that domestic systems could be used as a valid EU benchmark for hypothetical regulation of the card industry, in particular regarding interchange and merchant fees.

It is BBVA’s submission that this approach is inherently flawed. If - as stated in the Interim Report - one of the major objectives of the Commission is to reduce national fragmentation across the EU in the card industry, domestic schemes simply cannot be used as model business reference. The main feature of international card schemes is their global (and hence EU-wide) universality in terms of merchant acceptance and technical processing. Reliance upon domestic card schemes as an industry benchmark would seriously aggravate the current national fragmentation and force consumers to carry different cards depending on the EU Member States visited.

In addition, it is hardly surprising that fees are generally higher in international schemes. Both cardholders and merchants should pay a price premium in return of the world-wide reach that these card schemes provide as opposed to purely domestic systems. The idea that prices of universal schemes should resemble those detected in domestic systems seems misconceived[38].

In any event, and as the Interim Report states, no domestic card schemes exist in Spain since virtually all circulating cards are issued under an international brand. Domestic systems are entirely extraneous to the Spanish card model and any attempt to - directly or indirectly - extend to the Spanish market principles or values observed in other Member States' domestic schemes would be unjustified.

[38] Indeed, the Interim Report itself admits that "*a national debit payment system does not seem to be considered a competitor of an international credit payment system. Nor does a national debt payment seem to be considered a competitor of an international debit payment system*" (p. 121).

FEEDBACK FORM

Name of undertaking:BBVA

Industry (network, current/potential acquirer, current/potential issuer, processor, other third party provider (e.g. merchant service provider), merchant (industry needs to be specified), other): Current acquirer and issuer

Address:Goya 14 28001 – Madrid - spain

Country:Spain

Name of contact person:J A Merino Cantos

Phone of contact person: +34 91 3744293

Email of contact person:jamerino@grupobbva.com

Participated in the questionnaire: YES

- X Yes
- No

Specific questions from Executive Summary:

A. Financial analysis of the industry

1. Are high merchant fees a competitiveness issue for the EU economy?

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2. Are there compelling justifications for the comparatively high level of merchant fees observed in some parts of the EU25?

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3. In view of the apparent profitability of card issuing, is there a generally applicable justification for substantial revenue transfers through interchange fees in card payment systems?

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4. Are the high profits observed due to innovation or do they arise from some kind of market power in a two-sided industry?

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5. What pricing practices, rules and legal provisions distort price signals to consumers and the choice of the most efficient payment instrument?

6. Would cost-based pricing promote the use of efficient payment instruments and how could such pricing be implemented?

7. Do currently existing pricing practices have a substantial negative effect on cross-border card usage by consumers?

B. Market structures, governance and behaviour

8. What market structures work well in payment cards?

9. What market structures do not appear to work well / deliver efficient outcomes?

10. What governance arrangements can facilitate competition within and between card payment systems?

11. What governance arrangements can incentivise card payment schemes to respond to the needs and demands of users (consumers and merchants)?

12. What governance arrangements can allow minority participants or minority members to receive appropriate information and participate appropriately in decision-making?

13. What access conditions and fees are indispensable?

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14. To what extent is separation between scheme, infrastructures and financial activities desirable to facilitate competition and efficiency?

C. Future market developments

15. Are significant structural changes to be anticipated in the payment cards industry?

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16. What are the anticipated impacts on the industry of innovation and technological change?

D. Potential solutions to market barriers

17. How can structural barriers to competition, which may arise for instance from the integration of different functions within a payment system or from acquiring joint ventures, be tackled?

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18. Are there compelling justifications for the identified possible behavioural barriers to competition?

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19. How much need and scope is there for harmonising technical standards in the payment cards industry? How large are the potential benefits and costs of harmonisation?

E. Lessons for SEPA

20. What lessons (best practice) for the design of SEPA schemes can be learnt from existing national and international payment systems?

21. How could competition between schemes in SEPA be strengthened?

22. Which structural and behavioural barriers to effective competition between banks and payment service providers should be removed to achieve SEPA?

23. What governance requirements should SEPA schemes meet?

24. By what means can interoperable communication protocols, security and other technical standards be achieved and certification procedures be limited to the minimum necessary?

25. Do the removal of barriers to competition, the observance of pro-competitive governance and the creation of interoperable standards require (further) regulation?

General comments:

We describe our comments in the attached document

General questions:

1. Did you find the content of the report easily accessible and understandable?
   - yes, fully;
   - the report was too general;
   - the report was too technical.

2. Did you find that the level of detail in the report was:

- about right;
- not sufficiently detailed;
- too detailed.

3. Did the information contained in the report was:

- generally new to you/the payment cards industry;
- mostly known to you/the payment cards industry.

4. Did the market analysis in the report:

- confirm your views on the operation of payment cards market;
- challenge your/industry's views on the operation of payment cards market;
- represent a mix of both aspects.

5. Did the report raised the right policy issues;

- yes, covered most of the key issues;
- no, there were some significant issues left out.

Thank you for your contribution!