FEEDBACK FORM

Name of undertaking: PaySys Consultancy GmbH

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): consulting (specialised on card payments)

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Participated in the questionnaire:

- Yes
- X No

Specific questions from Executive Summary:

A. Financial analysis of the industry

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

To answer this question, one needs to look at the costs in Europe relative to other parts of the world. We lack comprehensive knowledge of worldwide MSCs. But the case of the US seems to suggest that European MSCs are, on average not higher. With respect to debit, they are even lower.

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

When interpreting price differences, one has to take into account:
- Services included differ (for instance: sometimes terminals are included, sometimes not).
- Economies of scale
- Different payment habits
- Risk-depended costs may differ.

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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?

We see two potential problems that make it difficult to interpret the results:
First, data on payment costs is not always reliable.
Second, revolving credit should not be included.

Our own experience does not support the findings of the report. We have carried out benchmark analyses for German credit card issuers and found average profit margins that are much lower. Our experience also suggests that it is very difficult to get good and comprehensive data. Even in a project with just a few participants, it took months to ensure completeness and comparability of the data.

Particularly difficult to obtain are costs at the branch. Many issuers are branch banks. For these issuers, branches are involved to a different degree in sales activities, card distribution, customer service (card lost, stolen, not functioning, PIN forgotten, address change, etc. etc.). It is our experience that banks hardly ever have data on these costs at hand. If not explicitly asked for these costs (and hard pressed to provide estimates) their data will not include these costs. This problem is relevant for credit cards but even more for debit cards which are often not seen as a profit centre but as a by-product of the current account.

Also allocation of overhead costs are hard to compare. For stand alone card issuers or acquirers, the overhead costs can directly be drawn from the P&L accounting. In the case of issuing banks, direct cost of outsourced services are usually known, whereas internal costs and overhead costs are difficult to allocate to one product or the other.

In the case of credit cards, inclusion of revolving credit my strongly affect the results. We would argue that RC should be taken out of the inquiry because it basically belongs to the consumer loan business and not to the payment service. If card issuers make high profits from RC, this does not necessarily indicate that something is wrong in payment card markets but that something is wrong in markets for consumer loans.

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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?

In our home market, Germany, we do not think that profits are too high (due to market power). We know less about other markets but, again, we would argue that in these markets revolving credit should not be included. We would expect that without revolving credit, profits would come closer to “normal” levels in many other markets, as well.

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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?

The no surcharge rule clearly restricts the power of merchants to put a price tag on relatively expensive payment systems. Therefore, it is problematic.
(Some theoretical models suggest that surcharging is inefficient. However, the validity of these results is unclear because these models predict that if surcharging is allowed, all merchants will surcharge. Empirical evidence strongly contradicts this prediction.)

It is also often argued that the existence or non-existence of the no-surcharge rule does not matter because merchants usually do not surcharge. Without surcharging, however, consumers would not be aware of the full costs of the payment methods used. This view disregards the simple fact that many retailers offer a variety of payment methods – including expensive ones like credit cards – as a service for their clients. They do so in the same way as they offer free parking, free guarantees, etc.. (As far as we know, the impact of free parking on efficiency of local traffic has never been an issue for competition authorities.) We think that it should be left to merchants to decide whether and to what extent they want to charge for such services. That implies that surcharging should neither be forbidden (by the card schemes) nor prescribed (by law).

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

If competition is seen as the best way to guide an economy to efficient solutions than regulators should focus on barriers to competition rather than try to find optimal pricing rules.

Most economists seem to agree (supported by a wide variety of models) that in 2-sided markets cost-based pricing between the two parties on the supply side (issuer and acquirer) does not lead an efficient result. In fact, in two-sided markets the division of costs between the two sides must be fairly arbitrary as there is no separated service, delivered from one side to the other side. (If there is an online authorisation of a card payment who should pay: the merchant because he benefits in terms of lower risks from an online authorisation or the card holder because it is his service provider – the issuer – who provides the authorisation?) Accordingly, we do not see a compensation between both sides in the form of a "price" which should be cost based.~~.~~

With respect to merchant's pricing vis-a-vis consumers, see answer to previous question.

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

In the case of transactions in EUR, prices should be equal to national transactions (2560). Incidentially, the introduction of 2560 does not seem to have had a huge impact on the volume of x-border payments. Thus, pricing before the passing of 2560 does not seem to have had a strong negative impact.

B. Market structures, governance and behaviour

8. What market structures work well in payment cards?

If we purely look at price, the somewhat puzzling result is that interbank ventures which more or less acted as monopoly issuer and/or acquirer have sometimes build the cheapest networks. Examples that come to mind are the Dutch and the German debit systems.

When looking at the huge task of building an international payment scheme with wide acceptance and a big card holder base, clearly, the 4-party structure has performed best. It has achieved wider acceptance, a larger card holder base and offers lower rates to merchants and/or card holders than competing international 3-party systems. National debit systems that are also often organised as 3-party systems have, so far, failed to move outside national borders.

To some extent it seems, that new schemes often are organised as 3-party systems. As they evolve, they find it beneficial to develop in 4-party systems. The two large credit card networks are a case in point. Thus, optimality may depend on the position in the product life cycle a good or service is at the moment.

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

In many cases, payment networks without interchange perform badly:

In Germany, the ATM schemes is based on prices that are either commonly agree (0€ within ATM groups) or unilaterally fixed by the acquiring bank. The system has no incentive to post low prices for out of group withdrawls. Consequently, prices have been rising in the past years.

International credit transfers have been known for years to be slow, unreliable and expensive. The Commission has made its own surveys on the topic and regulated prices for within Eurozone transfers. X-border prices (excl. intra €-zone) are based on bilateral agreements between banks and fees that customers post vis-a-vis their own clients. In order to improve things, the ECB has proposed a few years ago to introduce an interchange based system.

While monopolistic interbank solutions have performed well in some cases (see question 8), in others they have led to very high prices.

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

Within: Agreement on a common interchange and common technical standards provides a basis for competition both, on the issuing and on the acquiring side of the market.

Between: Interoperability allows network co-existence and thus network competition. In the filed of cards, interoperability is particularly important with respect to the terminal-card interface.

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

The core issue is competition.

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

Normally, card schemes offer different types of licenses for instance principal license and affiliate licenses, where a principal may act as "group member" for its affiliates.

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13. What access conditions and fees are indispensable?

Costs that have to be recovered:
Brand, product development, central switch, c&s
Conditions:
Issuing: Here banking regulation usually makes issuing (granting of credit) a banking business,
Acquiring: access conditions are necessary because the scheme must make sure that acquirers are able to honour the guarantee vis-a-vis the merchant. Moreover, monitoring of merchants is important to limit risk against fraud or money laundering.

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

We see a trade-off between anti-trust concerns and costs.
From an anti-trust point of view, separation seems to be preferable. However, separation of functions increases the complexity of co-ordination. After all, the different functions have to be compatible and the whole structure has to evolve (the payment market, the payment technology is not static). In particular, for a scheme that is positioned internationally, the costs of co-ordination may rise exponentially with the number of participants that have to co-ordinate their systems.

C. Future market developments

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

For debit: SEPA
For credit: EMV

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

The necessary investments in new technology seem to favour large actors and drive the consolidation process in processing and acquiring.

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?

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?

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:

Interchange

Interchange seems to be a point of particular importance in this investigation. Therefore, we would like to highlight a few arguments:

The Commission has presented empirical evidence showing that interchange and card holder fees are not negatively correlated. The Commission argues that this result may be taken as evidence that interchange does have an effect on profits. Based on this evidence, the argument that interchange is a mere balancing device has been put into question. However, two points need to be taken into account when interpreting this result.

First: The result does not necessarily show that there is something wrong with interchange. As many economists have argued, **provided there is competition in both, issuing and acquiring**, interchange does not affect profits. (Note : this is a conditional statement, not an unconditional one as suggested in the first sentence of section 2.1.1 on page 56 of the report). Expressed in this way, the statement seems hard to refute. It also highlights the issue that from an antitrust point of view, barriers to competition in acquiring and/or issuing are crucial – not interchange. Therefore, we think, the evidence of barriers to entry in acquiring are much more relevant than the findings about interchange.

Second, in an empirical test, interchange income (not the rate) and fee income should be considered. The interchange rate by itself says little about the fees generated. For instance, a high rate will imply little income if card holders hardly use their cards. In this case, an issuer has to rely on cardholder fees to cover costs. Indeed, what we have seen in Germany is: falling average interchange fees, rising interchange income and falling card holder fees.

<u>Revolving credit</u>

There seems to be general agreement that revolving credit can be a very profitable product. However, as already argued above, revolving credit is a consumer credit product. It should not be mixed with payment card issues. If however, revolving credit s not separated, one should at least separate markets in which revolving credit is important with markets where it is not. After all, the business models for revolving credit cards are very different from the business models for charge cards.

<u>3-party systems</u>

3-party systems do not need an explicit interchange. However, from what is known about Amex or Diners prices, it seems clear that these schemes also shift costs from the issuing side onto the merchants. In this respect, we think that an evaluation of interchange should also take into account that competing 3-party systems are more expensive for merchants.

<u>General questions:</u>

1. Did you find the content of the report easily accessible and understandable?
   - x 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:
   - x about right;
   - not sufficiently detailed;
   - too detailed.

3. Did the information contained in the report was:
   - generally new to you/the payment cards industry;
   - x 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;

x• represent a mix of both aspects.

5. Did the report raised the right policy issues;

- yes, covered most of the key issues;

x• no, there were some significant issues left out.

Thank you for your contribution!