INTERIM REPORT OF THE EUROPEAN COMMISSION ON PAYMENT CARDS

COMMENTS OF DINERS CLUB INTERNATIONAL

20 JUNE 2006

1 INTRODUCTION AND SUMMARY OF COMMENTS

Diners Club International Ltd. ("Diners") welcomes the opportunity to comment on the Commission's Interim Report on payment cards. Diners is a U.S. company with its headquarters and principal place of business in Chicago, Illinois. Diners is a wholly-owned subsidiary of Citigroup Inc.

Background. The Diners Club network is a closed card (three-party) payment network that operates in the EU through a number of licensees. Each licensee takes over from Diners the responsibility for operating the Diners Club network in its territory, including issuing and acquiring. Licensees receive exclusive rights to conduct business in a territory of one or more countries for a specific renewable term. Licensees pay royalty fees based on annual transaction volume, fee assessments for network operating expenses, and contributions to an international promotional fund. For international transactions where a merchant under contract to a licensee accepts a Diners card in payment that has not been issued by that licensee, the licensee agrees to transfer the debt to the actual issuing licensee at a discount (the "Inter-Licensee Discount Rate" or "ILDR"). Likewise, where a card issued by a licensee is accepted for payment anywhere in the world, the acquiring licensee for the territory where the card is used pays the issuing licensee the amount of the charge, less the ILDR. The ILDR is set by Diners but no amount is payable directly to Diners.

Although Citigroup Inc. owns Diners, the Diners Club network is governed by a Global Board, composed of the CEOs of the five largest licensees, the CEOs of five elected representatives representing geographic regions, and Diners. The Global Board sets network level policies affecting all licensees. There is also an International Operations Policy Committee (IOPC) composed of elected licensee representatives who vote to enact procedural rules for operation of the network. Although Citigroup sets the agenda, it does not hold complete control as regards either the Global Board or the IOPC. Unlike other payment networks, all Diners Club licensees have the same status within the network and operate on the same basis.

The Commission should promote a single market for payment cards. Diners welcomes the Commission's initiative in seeking to promote a single market for payment cards. Significant scale economies are inherent to the payment card sector, since it is based on transaction processing. Artificial restrictions or barriers that isolate markets should be eliminated and standardization in the sector should be promoted.

In considering what policies to pursue in the payment card sector, the Commission should be mindful of the broader competitive and economic context. Payment cards bring considerable benefits to cardholders, merchants and the wider economy. Payment cards have provided a means for innovative channels of commerce to develop and flourish, including e-commerce. Any review of the payment cards sector should take into account the extent of these considerable benefits. Any Commission action that distorts the business incentives to participate in payment card networks could have the unintended consequence of limiting the benefits of payment cards and inhibiting future innovation. In particular, Diners believes that the Commission should not take steps to regulate merchant service charges, which properly reflect a wide range of factors that the Interim Report appears to ignore or incorrectly dismiss. In a sector that is as competitive as the payment cards sector, unwarranted downward regulatory pressure on merchant service charges would distort incentives and prevent the operation of free market competition. Recent experience in Australia does not seem to have demonstrated that price controls benefit consumers. In addition, cardholder fees differ in different markets and as between different schemes for good reason. Diners, for example, provides significant benefits to cardholders in the form of incentives and other programs that allow it to distinguish itself from and compete with Visa and MasterCard.

Three-party networks differ significantly from four-party networks, which are the main focus of the Interim Report. Diners notes that the main focus of the Interim Report is on four-party payment networks, rather than three-party payment networks, particularly on the issue of governance, but also concerning the data on interchange, merchant service charges and other fees. Although three-party payment networks compete with four-party networks and other payment methods, there are significant differences in the way three-party and four-party payment networks operate. Diners would be concerned if the Commission reached conclusions or took action for three-party payment networks based on findings that principally relate to four-party payment networks or that take insufficient account of competition between three- and four-party systems.

Measures to force open proprietary three-party networks such as Diners would actually damage competition, rather than promote it. While this does not at present seem to be the Commission's concrete intention, Diners would be extremely concerned if the Commission took steps that, directly or indirectly, required three-party payment networks to open. Here, the Interim Report fails to recognize the efficiencies that vertical integration can often bring. The forced opening of a three-party system like Diners would constitute unjustified and damaging interference with existing contractual relations that would not in the end promote the development of more efficient or less costly payment systems. Particularly in smaller markets, which are not very attractive for new entrants, the forced opening of a proprietary system such as Diners would likely damage competition, rather than promote it. Existing Diners licensees in all markets would be damaged through the loss of the value of their investment in the brand, investments which were sometimes made over decades. New issuers would, without having made any contribution to brand development, reap the benefits of these investments. Opening up three-party payment networks would also require significant additional investment to provide the technology and communications mechanisms between an increased number of issuers and acquirers – this would result in a major cost. In the case of Diners Club, this investment would have to be recovered through increases in fees to all parties in the payment network, including cardholders and merchants, which would be a real deterrent to doing business with the Diners Club network, given its small market share. The diminution of revenue to existing licensees, which already have a limited market presence in the European payment card sector, and the increased costs that would be forced on the Diners Club system, would damage the ability of Diners to compete effectively against larger four-party payment networks.

2 THE ROLE OF PAYMENT CARDS

Payment cards compete with other forms of payment, such as cash, cheques and direct transfers. Payment cards also provide broad benefits to cardholders and merchants, as well as the economy as a whole. The Interim Report does not take sufficient account of the wider context for the role of payment cards as one of many different competing forms of payment or of all of the benefits payment cards provide. Before any policy conclusions can be reached, the wider competitive context in which payment cards operate and their larger positive impact must be fully considered.

2.1 *Payment cards compete with other forms of payment*

Payment cards compete with other payment methods, including cash, cheques and direct transfer, from both a cardholder and merchant perspective. Although each alternative payment method offers different features to users, this does not mean that different payment methods do not compete effectively with each other.

Cardholders have access to a wide variety of payment methods and there are various ways in which merchants can accept payment. If the cost to cardholders of having and using payment cards increases, cardholders will be incented to use other forms of payment. Equally, if the cost to merchants of accepting payment cards increases, they can choose to request payment using other methods.

It is therefore essential, when assessing the competitive pressures to which payment cards are exposed, to take into account competition from other payment methods.

2.2 *Payment cards provide significant benefits*

Payment cards provide significant benefits to cardholders, merchants and the wider economy. Any action that has the consequence of reducing the use of payment cards, or increasing the attractiveness of (for example) other forms of payment, could result in reduced spending and reduced benefits to cardholders and merchants, running counter to Commission policy, in particular the Lisbon goals.

The principal benefits of payment cards to merchants include:

- Increased sales – Studies have shown that consumers with payment cards will spend more than consumers using cash only. Through payment cards, cardholders have a flexible payment option, which benefits smaller merchants in particular. This is because payment cards allow smaller merchants to compete with larger retailers that offer credit through (for example) store cards.

- Improved cash flow – Merchants accepting payment cards generally get same-day or next-day settlement, which compares favourably with other forms of payment.

- Improved security and ease of administration – Reducing the level of physical money (i.e. cheques and cash) that merchants have to handle improves security and reduces the opportunities for theft by employees. This in turn reduces costs to merchants. They have lower costs for insurance, cash handling charges, and other related expenses. Use of payment cards also alleviates the administrative burdens on merchants to track cash and ensure that there are sufficient amounts of cash to deal with customers on a day-to-day basis.

- Payment guarantee – Payment guarantees associated with payment cards protect merchants from cardholder default and fraudulent transactions. This is not the case with unguaranteed cheques, counterfeit cash or fraudulent cheques.

The principal benefits of payment cards to cardholders include:

- Flexible payment – By using credit cards, cardholders have the benefit of a pre-arranged credit facility that allows them to defer payment for goods or services over a convenient period.

- Ease of cross-border credit – Cardholders using cards issued under an international association brand such as Diners Club can use their card worldwide with minimal difficulty even if they do not have cash at hand.

- Improved personal security and consumer protection – Cardholders are less exposed to the risk of crime and fraud with payment cards than with cash. Credit cards offer cardholders additional consumer protection against unsatisfactory goods or services and protection from liability for fraudulent transactions made using their card.

- Wide acceptance – A large number of merchants accept cards issued by members of the major associations, including Diners Club, and so cardholders are able to use payment cards for a majority of their purchases across different jurisdictions.

A further benefit of payment cards to cardholders and merchants, and indeed the wider economy, is that payment cards have facilitated the development of new sales channels, most notably unmanned terminals, telephone sales and e-commerce. Fraud protection and the international acceptance of payment cards is essential to the development of e-commerce, which is an important part of the EU's drive to become the world's most dynamic and competitive knowledge-based economy.

3 COMPETITION BETWEEN CLOSED AND OPEN PAYMENT CARD SYSTEMS

The Interim Report suggests that four-party networks such as Visa and MasterCard do not directly compete with three-party networks.[1] While it is true that, as the largest payment networks, Visa and MasterCard exert a significant competitive constraint on each other, it is not true that three-party networks do not compete with four-party networks.

Although three-party networks and four-party networks operate in different ways, the end product is largely similar for both merchants and cardholders irrespective of the way in which the network operates. Cardholders do not make decisions as to which payment network to use on the basis of it being a four-party or three-party network. Similarly, merchants will not take this into account when deciding which cards to accept. Indeed, most customers and merchants will not be aware of the difference between three-party and four-party payment networks. Inevitably, given its small market share, practically all cardholders that carry a Diners card will also carry a Visa or MasterCard-branded card. This means that for every transaction made with a Diners card, the cardholder will have the choice of using Visa or MasterCard instead. Diners must offer consumers innovative incentives and programs in order to compete successfully.

Entities interested in entering a given card market have the alternative of becoming Diners licensees, rather than joining the Visa or MasterCard schemes. This may be particularly attractive in smaller markets already served by Visa and MasterCard issuers. Such new entry provides additional consumer choice and stimulates competition between card systems.

By not taking full account of the level of competition between networks, irrespective of how they operate, the Interim Report does not reflect the highly competitive nature of the payment card sector in Europe. Payment networks must constantly innovate and provide a greater number of services in order to remain attractive to existing and potential cardholders and merchants. If incentives for market participation become distorted, for example through

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[1] Interim Report, page 26, footnote 46.

regulation of cardholder fees or merchant service charge rates, competition between networks (and therefore the level of innovation) may actually be reduced. It would then become less attractive for smaller networks, in particular, to enter or expand in the EU.

4 MERCHANT SERVICE CHARGE

The Interim Report observes that Merchant Service Charges ("MSCs") differ between:

- smaller merchants and larger merchants;[2]
- various merchant sectors;[3] and
- Member States.[4]

The Interim Report also observes that MSCs:

- are higher for credit than debit cards;[5] and
- are higher for cards issued in international networks.[6]

The Interim Report concludes that the above factors "*may indicate that the market for card payment services is not working effectively in many Member States, to the detriment of businesses and consumers.*" However, the Interim Report does not appear to fully take into account the full range of factors that account for the differences in MSCs.

4.1 *The size of the merchant*

The costs of acquiring merchants are reflected in the merchant service charges applied to those merchants. The relative costs associated with acquiring smaller merchants are generally greater than the costs associated with larger merchants. Larger merchants

[2] Interim Report, page 35 *et seq.*
[3] Interim Report, page 40 *et seq.*
[4] Interim Report, page 45 *et seq.*
[5] Interim Report, page v.
[6] *Ibid.*

generally have higher sales volumes, and therefore generate economies of scale. Also, smaller merchants are generally higher risk than larger merchants.

In addition, larger chain merchants have greater negotiating power than unaffiliated merchants – the viability of a payment card may be jeopardised if those larger merchants refuse to accept a particular card. Thus, these merchants are able to negotiate lower MSCs.

4.2 *The activities of the merchant*

The risks associated with acquiring merchants differ according to the activities of the merchant. As the Interim Report identifies,[7] merchants active in certain sectors attract higher MSCs than others. Indeed, there is consistency across payment networks as regards those sectors attracting higher MSCs.[8] This reflects the objective risks involved in acquiring merchants in certain sectors. For example, MSCs are generally higher for restaurants, which reflects the higher risk factors associated with using payment cards in restaurants, including the fact that there are many temporary staff employed in the restaurant sector who have access to card details.

4.3 *The location of the merchant*

Different market conditions apply in each of the 25 Member States. Given the variety of these market conditions, it is not surprising that differences exist in MSC levels. Differences in MSCs between Member States are the result of a wide range of factors, including: (a) levels of usage; (b) differences in tax, legal and regulatory regimes; (c) accounting policies; (d) risk levels; (e) technology standards; and (f) scale.

In particular, MSCs are likely to be lower in those Member States where there is a robust market for payment cards and higher card usage. This allows the risks (and therefore the costs) of card usage to be spread over a larger number of transactions. In addition, in the underdeveloped card markets of emerging eastern European economies, there are fewer regulatory controls and thus there is a higher level of risk.

[7] Interim Report, page 41.
[8] *Ibid.*

4.4 *Credit and debit cards*

MSCs are generally higher for credit than for debit cards for a number of reasons, including the following:

- The risks associated with credit cards are greater than the risks associated with debit cards. The nature of debit cards is that they provide direct access to the cardholder's cash account. Thus the use of debit cards involves fewer risks to the issuer and merchants.

- Debit cards form part of a wider service offering, since they are a component of a current account. By contrast, credit cards are generally stand-alone products. A distorted picture is created by a direct comparison between MSC rates for debit and credit cards that does not take into account the broader package of financial services present for debit cards.

4.5 *International and national networks*

International networks provide a distinct benefit to both cardholders and merchants. Cardholders can use their card throughout the world, and local merchants can accept payment from customers from throughout the world. However, in order for international networks to operate effectively, robust technological support networks must be maintained. Large international merchants require settlement of charge transactions in multiple jurisdictions. In addition, merchant disputes with cardholders based in another jurisdiction are more difficult to resolve. There are also costs associated with foreign currency exchange in the context of international transactions. The various costs associated with providing international support for a payment card network are reflected in higher MSC levels.

5 CARDHOLDER FEES

The Interim Report finds that there are significant differences between cardholder fees charged in individual Member States, and that credit card issuance fees are higher than debit card issuance fees.[9] The Interim Report concludes that differences in issuance fees "*are significant and might be the result of a lack of competition and market integration,*" and that there is "*no strong negative relationship between the level of the fee per card and the level of interchange fee.*"[10]

The Interim Report fails, however, to assess the reasons for the identified differences in cardholder fees. For example, Diners Club offers its cardholders a variety of additional services and related products, including travel insurance, medical and legal assistance, rewards programs, and personal customer services such as translation and emergency lost card replacement as well as passport and visa assistance. A higher level of personal services provided by Diners Club is a significant factor that allows Diners to compete with alternative networks. Indeed, as noted above, Diners often must provide valued incentives in order to persuade cardholders to use their Diners Club card rather than their Visa or MasterCard, given its low market share.

It is inevitable that, should interchange fee rates be artificially reduced, cardholder fees would increase, or the level of additional services would be reduced. This would make it more difficult for Diners to compete. Although the Interim Report finds that there is not a perfect negative relationship between interchange and cardholder fees, the analysis followed to reach that conclusion is based on information relating to Visa and MasterCard only, and relates to a period during which interchange fees have remained relatively stable. It also ignores the example of Australia where, following the introduction of fee regulation by the Reserve Bank of Australia in October 2003, there has been a sharp increase in cardholder fees. Indeed, following the action of the Reserve Bank of Australia, it would appear that merchants failed to pass on lower merchant service charges to consumers, despite the arguments of merchants that lower fees would benefit consumers.

[9] Interim Report, page 52 *et seq.*
[10] Interim Report, page 61.

6 VERTICAL INTEGRATION

The Diners Club network is, as the Interim Report identifies,[11] integrated to the extent that Diners sets the parameters of access to the scheme and engages in the activities identified in the Interim Report. In addition, for most territories the same licensee acts as the issuer and acquirer for the vast bulk of transactions.

The Interim Report suggests that vertically integrated payment systems, such as Diners Club, may rule out "*potential competition between technical and financial service providers,*"[12] and that "*the separation of scheme ownership, network operation and the financial aspects of the payment cards business... pay be a first important step towards more competition within a POS card payment system.*"[13] It is not at all clear whether the Interim Report is seeking to recommend "de-integration" of proprietary three party schemes such as Diners. For the reasons set out in this response, Diners would oppose any steps towards such de-integration. This would reduce -- rather than increase – competition. Such a measure would artificially make schemes more similar, which would reduce diversity and tend toward dampening competition between schemes.

As the Interim Report itself appears to recognise,[14] integration creates considerable efficiencies. The fact that some payment networks are more vertically integrated than others does not necessarily harm competition – indeed, greater efficiencies create more opportunities for competition.

This is particularly the case for Diners Club. As explained, Diners grants licensees exclusive licenses to issue cards and sign up merchants for a term of years in a specific territory. The licensee has a duty to promote and develop the Diners Club brand. Exclusivity for its specific territory gives the licensee the business incentive to make the required investment in the brand. These arrangements also create a continuous relationship that helps Diners Club maintain a presence in key travel markets. This is especially important in the many territories in Europe in which there are few willing partners interested in and able to operate the Diners Club business. Exclusivity thus creates an opportunity for the licensee to invest

[11] Interim Report, page 89.
[12] Interim Report, page 94.
[13] Interim Report, page 90.
[14] Interim Report, page 94.

in the business and allows the licensee to realize a return compensating it for taking the risk of the business operation.

Integration creates a strong financial incentive and opportunity to be as efficient as possible in managing risk, both in regard to a cardholder's creditworthiness on the issuing side, and as concerns the risk of fraud at merchant outlets, on the acquiring side.

Significant levels of competition exist at all levels of the payment cards sector – the fact that some payment systems are more integrated than others does not harm the level of competition. The efficiencies resulting from vertical integration in fact enhance the ability of payment systems to compete against each other, which leads to greater innovation and greater benefits for cardholders and merchants.

7 CONCLUSION

Payment cards offer considerable benefit to cardholders, merchants and the wider economy. Any review of the payment cards sector should take into account the extent of these considerable benefits. No action should be taken – whether to artificially lower MSCs or cardholder fees – that would jeopardise these benefits, distort the incentives to participate in payment card networks, or inhibit future innovation.

The main focus of the Interim Report is on four-party payment networks, rather than three-party payment networks. Although in direct competition, there are significant differences in the way three-party and four-party payment networks operate. The Commission should not take action based on findings that principally relate to four-party payment networks that may have a significant impact on three-party payment networks.

Equally, the Commission should not take steps that, directly or indirectly, open up the three-party Diners Club payment network. This would have a negative impact on the investment of existing Diners Club licensees, require considerable new investment in technology and communications, and lead to higher cardholder fees and MSCs overall. In the end, this would damage the ability of Diners Club to compete effectively against the larger and more established four-party payment networks.