FEEDBACK FORM

Name of undertaking: **European Retail Round Table (ERRT)**

Industry The ERRT represents the interests of the following leading European retailers: *Asda Wal-mart, C & A, Carrefour, Delhaize Group, DSG International, El Corte Inglés, H&M, IKEA, Inditex, Kingfisher, Marks & Spencer, METRO Group, Royal Ahold & Tesco.* Together they employ 2.1 million people and have a turnover of €350 billion.

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Participated in the questionnaire:

- 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?

The high level of merchant fees is an indication of the inefficiency of the payment cards market. This inefficiency limits the competitiveness of the EU retail sector, reduces the purchasing power of Europe's consumers and serves to reward payment card schemes with excessive and unjustifiable profits.

A highly conservative estimate of how much the ERRT members pay between them is in the order of €1.4 billion per year[1] (the likely figure may well be nearer €3 billion). If the members of the ERRT were allowed have all their card transactions processed by the lower cost payment schemes, the €1.4 billion figure could be reduced by €800 million[2]. If the elements of the interchange fee covering the so-called 'payment guarantee' and the interest free-period – services which do not benefit the retailer - were also removed, leaving just the cost of processing, the savings would amount to €925 million. Such savings would allow retailers to invest more in serving their customers and offering lower prices. Although 'guesstimates', these figures reveal the impact of the excessively high merchant fees on Europe's leading retailers. The current rules underpinning the payment card schemes, sometimes with the past blessing of competition authorities, have allowed banks and payment card schemes to create a system in which merchants have no choice but to pay for services from which they do not benefit. Merchants are further prevented from shopping around the EU and getting the best deal for their customers.

The lucrative nature of the interchange fee system and the scheme rules surrounding that system have discouraged banks from investing in new, more efficient payment means.

[1] Assuming the following: ERRT turnover €350 billion, 20% on credit cards at 1.2% charge, 20% on debit cards: half at 10 cents per transaction and average basket of €30, half at 1.2% charge.
[2] Assuming ERRT turnover €350 billion, 20% on credit cards at 0.2% plus 14 cents charge and average basket €30; 20% on debit cards at 5 cents per transaction and average basket of €30; Total amount paid to the banks by ERRT companies for card processing €584 million.

Accordingly, the high level of merchant fees has a negative impact on the competitiveness of the retail sector, the banking sector and therefore the wider EU economy. In a sector such as retail where margins can be below 1%, the excessive cost of the fees is inevitably passed on to consumers. As a result, the purchasing power of Europe's consumers is reduced; again, this has an impact on wider economic growth.

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

The costs involved in processing transactions should be largely the same across the EU, regardless of the geographical location of the transacting parties. However, because cross-border acquiring is de facto impossible due to Visa & MasterCard's rule that the local interchange fee be applied, banks have been able to hide behind national borders to avoid competition from lower cost operators. The enormous variation in fee levels across the EU suggests that the price merchants have to pay to banks is not based so much on actual costs as on how much the market will bear. (The multiplicity of explanations for the interchange fee provided by financial institutions to the Commission would suggest that banks themselves are unclear as to whether the interchange fee is meant to be cost-based or not.)This market fragmentation is not justifiable in an internal market.

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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?

It is clear from the Commission's findings that current revenue transfers through interchange fees are excessive. The excessive nature of the fees could be for one of two reasons – either that too many or inflated costs are being passed through to merchants or because the interchange fee is not cost-based and banks have used the interchange system to extract excessive income from merchants. As a matter of principle, the fees merchants pay for card transaction processing should be based on the following:

- The fee must be limited to the cost of processing a transaction plus a reasonable profit margin, i.e. 'cost plus', (and processing should cover only that part of processing which benefits the merchant, so not including cardholder services such as sending out statements to cardholders). Other extraneous costs such as the interest free period, advertising etc must be excluded from the fee.
- The level of the fee and its cost basis must be transparent.
- The fee should be fixed and not *ad valorem* since the actual cost of processing is the same whatever the value of the transaction.

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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?

There is nothing wrong with a business being profitable. However, when high profits are sustained over a substantial period of time and are made possible because of a restriction of competition, it is clear that market power is being exercised. There is much academic debate about whether payment cards form a two-sided market, but no amount of theorising can justify what is effectively profiteering. Scheme rules have been so designed to maximise revenues for the card issuers; competition serves to reward issuers through higher fee income, rather than to drive down the prices paid by retailers and consumers. Where innovation has taken place, its intention and result has been to increase the profit stream for financial institutions. It has not resulted in long-term reductions in fee levels.

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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?

Perfect pricing transparency for consumers may be difficult to achieve and would limit the marketing freedom for retailers, banks and card schemes (for instance, merchants might want to incentivise one means of payment over another for commercial reasons). However, any 'marketing' arrangements would have to be based on a level-playing field between payment means. Currently, the scheme rules of Visa, MasterCard and others prevent there being a level playing field. In particular, the honour all cards rule (HACR) and the non-discrimination rule (NDR) significantly distort the freedom of retailers to send price signals to customers. The HACR means that retailers are obliged to accept expensive commercial cards (and any other of the multiplicity of cards that card schemes are introducing with higher merchant fees). Combined with the NDR, retailers have no choice but to reflect these higher merchant fees in prices for all consumers, regardless of whether consumers are paying by card or not.

The HACR can also provide card schemes with a way to force merchants to accept higher cross-border fees. For instance, the UK national debit card scheme Switch was recently rebranded as Maestro. At least for the moment, UK domestic Maestro transactions have continued to attract a fixed, per transaction fee (albeit subject to a significant increase). However, because of the HACR, merchants accepting domestic Maestro must now also accept international Maestro cards which carry an *ad valorem* fee which is much more costly for retailers and their customers. It is further feared that these *ad valorem* cross-border fees will be used as a precedent by MasterCard to justify switching domestic transactions to ad *ad valorem* basis too. (In the context of SEPA, it is vital that MasterCard is not allowed to use its cross-border *ad valorem* fee as the benchmark for what, in the internal market, are essentially domestic debit transactions. The purpose of the internal market in payment cards and SEPA must be to deliver greater efficiency and lower costs, not to provide Visa and MasterCard and their member banks with a yet more lucrative income source.)

When looking at the NDR, it is imperative that its success is not judged simply on whether retailers actually use discounting or surcharging at the point of sale. Giving retailers the right to surcharge or discount strengthens their hand in negotiations with acquirors about fee levels, where otherwise retailers have little influence on the level of merchant fees.

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

Cost-based pricing would undoubtedly promote the efficient use of payment instruments. However, it should be left to the merchant if and how cost-based pricing is communicated to customers. This then gives retailers the option of treating payment card costs in the same way they treat any other cost, i.e. integrated into the overall price of a product, or whether to highlight the cost of a means of payment through discounting, surcharging or some other marketing means (e.g. giving additional loyalty card points for using a certain means of payment). The fact that a retailer has the option of discriminating between means of payment will allow retailers to put pressure on payment services providers to remain competitive in terms of fee.

It should also be noted that price signals can be sent to consumers not just through the price they pay in store; cardholder fees paid to card issuers can also be instrumental here.

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

Price signals may not be passed on to consumers in most countries. However, the merchant fees merchants face for accepting cross-border cards are a major disincentive for retailers to accept such cards. This is especially true for international scheme debit cards; in those countries where there are non-Visa and MasterCard national debit card schemes, merchants are not obliged by the NDR to accept cross-border Visa and MasterCard debit cards. The high cross-border fees are therefore a significant disincentive for merchants – especially SMEs - to accept cross-border debit cards; their high pricing therefore has a substantial negative effect on cross-border card usage by consumers. The advent of cross-border alternatives based on efficient national debit card schemes would encourage more merchants to accept cross-border debit cards.

B. Market structures, governance and behaviour

8. What market structures work well in payment cards?

The best market structures in payment cards are those which deliver reliable services at a low price without the need for hiding behind anti-competitive practices to maximise income. This means that retailers must not be obliged to buy an indivisible bundle of 'services'; any fee must be fixed, not *ad valorem*, and must be based on transparent costs.

It is important that the regulatory structure does not favour any one structure of payment card scheme over another, rather it should facilitate competition between different kinds of schemeand allow for innovation. It is important that solutions based on four parties, three parties or private label cards or any other model are able to enter the market provided they are open, transparent, cost-based and not anti-competitive; payment system users should then be able to decide which scheme is most attractive. Regulation should therefore be 'structure neutral'.

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

The current interchange fee arrangement underpinning schemes such as Visa and MasterCard fails to deliver efficient outcomes. Competition between these schemes serves only to increase card-issuers' income and not to deliver efficient outcomes for all stakeholders in the payments chain.

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

Scheme rules should not be designed to exclude or frustrate new entrants. The 'closed shop' nature of certain card schemes has allowed banks to focus energy on maximising their income rather than investing in more efficient payment solutions.

Current governance arrangements in certain schemes allow for the interchange fee to be inflated to such a level that there is no incentive for participating banks to come to lower cost, bilateral arrangements.

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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)?

Removing the ability for card schemes to collectively inflate the interchange fee and include extraneous costs which do not benefit merchants would encourage banks to charge realistic merchant fees and to come to bilateral arrangements.

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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?

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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?

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C. Future market developments

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

The advent of SEPA will undoubtedly bring about significant structural change in the payment cards industry. However, those changes could go in one of two directions. On the one hand, there is a danger that SEPA will be a panacea for the international card schemes to swallow up more efficient national debit card systems. Visa and MasterCard offer more lucrative returns to card issuers due to their excessively high interchange fees. As a result Visa and MasterCard’s ready-made cross-border – and therefore SEPA-compliant – debit products provide a quick, but inefficient and expensive solution for meeting SEPA deadlines. The Belgian banking community has recently announced that it will go down this route. On the other hand, SEPA represents an opportunity for the more efficient national debit card systems to either work together or roll out their national schemes across borders. This is likely to offer a low-cost card scheme which provides greater efficiency and cost-effectiveness to all players in the payment card system. The recent announcement by Germany’s EC-Karte that its debit card would soon be accepted in Portugal and Italy is a positive development since it offers an alternative to the more expensive Visa and MasterCard debit cards. It is unfortunate, however, that this product uses an ad valorem fee rather than a fixed-per transaction fee; this practice should not be spread across the EU as it undermines – and threatens – the continued existence of efficient fixed-fee based systems.

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

Technological advances are certain to bring about significant changes in the way payments are actually made in the coming years. This may be an opportunity for new market entrants to offer lower cost and more efficient business models for payments. In any case, it is imperative that new technologies do not simply build on the anti-competitive basis of the excessive interchange fees.

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?

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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?

Please see the response to question 15.

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

Competition between schemes in SEPA can be strengthened in SEPA in the following ways:

- an obligation upon payment service providers to provide transparency about the fees they charge merchants;
- in order to give the more efficient national card schemes the opportunity to develop cross-border operations, it is imperative that the higher cost international card schemes are not permitted to use anti-competitive practices to maintain excessively high interchange fees based on extraneous costs;
- remove competition clearance for scheme rules which fragment the market and limit the freedom of merchants to pass on price signals to consumers and negotiate on equal terms with acquirors.

In any case, competition between existing and future schemes depends on the creation of a regulatory framework which allows for a 'level playing field' between payment systems provided they are open, transparent and cost-based. It is important that the regulatory framework does not block the entry into the market of innovative payment solutions which may be constructed in a different way to today's three and four party systems. Innovation will drive efficiency and competition to the benefit of all payment system users. Providing scope for new models helps not just new market entrants but also allows for innovation by incumbent schemes.

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

Interoperability must be a key feature of the SEPA-landscape. Technical protocols must be such that they allow for pan-SPEA solutions.

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23. What governance requirements should SEPA schemes meet?

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

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

Either regulation or legislation is required to limit the anti-competitive practices of some of the current card schemes. Cross-border acquiring is still restricted as a result of Visa and Mastercard's scheme rules that require the interchange fee of the country in which the transaction takes place to be applied. These rules must be changed if a real internal market and SEPA are to be created in the EU. Furthermore, it is clear that fees charged to merchants should not include extraneous costs unless that has been freely and explicitly agreed to by the merchant. Obligatory 'bundling' of services has been shown to work against the interests of merchants and consumers.

General comments:

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.