POSITION PAPER

EUROPEAN SAVINGS BANKS GROUP (ESBG)
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DG COMPETITION INTERIM REPORT ON PAYMENT CARDS AND PAYMENT SYSTEMS

EUROPEAN SAVINGS BANKS GROUP

1- Introduction

ESBG welcomes the opportunity provided by DG Competition to submit remarks on the "Commission's sector inquiry into the payments cards industry". As an association of banks and national sector banking associations, ESBG will of course not take a view on conclusions directly or indirectly formulated in the Interim Report as regards pricing nor the respective competitive situations of any given scheme or bank. ESBG will however remark on the approach taken, on academic background available with respect to the debate on interchange, and on a significant market development underway.

2- Remarks on the approach

To begin with, ESBG wishes to make 3 remarks about the approach taken:

a) cards are not the sole methods to make point-of-sale payments, and these methods of payment vary significantly from country to country.

The table below identifies a range of payment methods generally used for point-of-sale transactions and their average usage per capita throughout the main EU markets. As one cannot assume that the needs for point-of-sale transactioning differ so significantly across the key EU countries, this table serves also to highlight the – uneven – importance of cash payments. It should be noted that there is no intent with this table to point to a "benchmark", i.e. to highlight "best of class" or other users, but merely to stress that for due reasons payment methods, and payment market organizations, differ vastly throughout the EU, as a result of decades of local legislation, expression of local preferences and requirements, and development of local infrastructures – often with the involvement of the responsible, local supervisory authorities.

Non-cash payment transactions per capita – for (potentially) face-to-face transactioning

	France	Germany	Italy	Netherlands	Spain	UK
Cheques	66	1	8	0	5	35
Debit cards	75	23	12	77	16	62
Credit cards	0	4	7	3	14	33
E-money	0	0	0	8	0	0
ATM withdrawals	20	29	8	30	22	42
TOTAL per capita	**161**	**57**	**35**	**118**	**57**	**172**

Source: ECB 2004 Blue Book

b) cards are not only used for immediate or differed payments, but also for making cash withdrawals at ATMs.

The Interim Report almost exclusively focuses on debit and credit cards. This dismisses the significant usage of cards as means of making cash withdrawals at ATMs, an important convenience factor for cardholders, and a functionality which for them it is difficult to segregate from the payment capability.

c) the European card market is undergoing profound change.

The Interim Report has been issued in April 2006 – almost 8 months after an initial version of the SEPA Cards Framework was approved by the European payment banking industry. The Interim Report fails to acknowledge that this industry has committed, as part of the SEPA project, to bring by January 2008 changes to the card services banks and cards schemes provide to merchants and cardholders and that, at the time of the Report's publication, significant changes in the organization of the European card market were already underway.

3- Remarks on considerations regarding interchange fees

The Interim Report's includes a significant review of academic literature on the subject of interchange fee. ESBG would suggest that it would be valuable to also take into consideration other academic literature – at times from authors already quoted in the Interim Report – see Annex to this document - that recognizes:

- The importance of rules, contracts, merchant and customer pricing, governance of infrastructure, and many other factors as influencing interchange. The latter can by no means be treated in isolation of all conditions that contribute, or form barriers to competition. This constitutes the "multivariate factor" to be taken into consideration. Provided the existence of a number of pre-conditions, interchange is considered by the literature as a necessary mechanism.
- Because of these competition aspects, because of the social dimension of payments in general, there is a good case for regulatory vigilance as far as interchange is concerned. Yet intervention should always be founded on demonstrated, "serious market failure".
- There is no economic rationale for interchange to be strictly cost-based, nor to be only cost based: interchange acts as a balancing factor but can also spur investments by one side of the market or another.
- Interchange should not be merely considered as a fee for a service. It is a balancing factor, but is it also a price, as proposed by some regulators.
- The level of interchange appears to be independent of the relative concentration of players in a given market, as well as of the relative size of a given player in a given market.
- A key assumption in most models is also that merchant demand corresponds to social benefits, meaning that merchants do not accept cards for strategic reasons only, which generally cannot assumed to be the case. However, as regards the service offer by banks, one has to acknowledge that – at least at the beginning of the transition period to the pan-European payment instruments, their offer will not correspond to strategic

benefits, as these instruments are deployed as the consequence of a political (instead of a business) case. This biased variable introduces distortion in free market based models. The implications of this distortion on interchange and its effects have to be taken into consideration.

- In opposition to some authorities, no strong case has been made by academics against "differentiated" pricing of goods and services at point of sale (i.e. in function of the payment instrument chosen by the consumer).
- What is surprising is that authorities generally continue to approach the problem of interchange at the level of a single payment instrument, not taking into account the other payment instruments available in the market, which should normally compete against each other, and the fact that how these are administered and promoted also impacts the equilibrium of the payment instrument under consideration.

4- The SEPA Cards Framework

During 2005 the European banking payment industry developed and adopted the SEPA Cards Framework (or: "SCF"). The savings banks community actually provided the chair and the secretariat of the EPC Working Group responsible for that development. The objective of the SCF is to spell out "*high level principles and rules*[1] *which when implemented by banks, schemes, and other stakeholders, will enable European customers to use general purpose cards to make payments and cash withdrawals in euro throughout the SEPA area with the same ease and convenience than they do in their home country. There should be no differences whether they use their card(s) in their home country or somewhere else within SEPA. No general purpose card scheme designed exclusively for use in a single country, as well as no card scheme designed exclusively for cross-border use within SEPA, should exist any longer*".

More specifically, the intended deliverables of the SCF are that:
"Merchants must be allowed the choice of which SCF compliant card acceptance mark(s) they wish to accept and which acquirer(s) they wish to contract. This merchant choice may not be artificially constrained by legal, technical, or procedural issues, nor a lack of transparent price information – rather, the merchant should be able to take a commercial decision based on the value that card scheme acquirers can provide".
And:
"SEPA cardholders[2] *should be able to pay with a given card product (or make cash withdrawals) with the same level of ease and convenience, and the same terms and conditions, anywhere throughout SEPA. SEPA cardholders should be encouraged to consider their card(s) as the preferred instrument – compared to e.g. cash or cheques - to make payments for goods and services".*

To achieve these objectives the SCF recognizes that "*a three-tier model is essential to progress the deployment of SCF compliant payment transactions and ATM withdrawals with cards:*

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[1] Rules: for the purpose of this Framework rules shall mean such rights and obligations that will be accepted either by banks and card schemes as a consequence of them being spelled out in the present Framework and from time to time updated, or as a consequence of banks' participation in one or several card schemes.
[2] SEPA cardholder: any customer to whom a SCF compliant card is issued and who is authorized to use the card.

(i) *Tier 1- The Framework itself. This addresses the high-level principles necessary to provide a strong, market driven response to the expectations expressed by the EPC, the European Central Bank and the European Commission regarding the building of SEPA. It is intended as a document to which banks and card schemes operating in SEPA must commit, in order to remove market barriers and strengthen competition for themselves and their providers of technical infrastructures and payment services within the EU card industry;*

(ii) *Tier 2 – The card schemes. The interests of SEPA and the wider European cards market will be most effectively driven forward by strong competition between cards schemes. The strategies of the existing schemes towards SCF compliance and/or any proposals to create new schemes or brands lie in the competitive domain. The role of the Framework is therefore to provide a context within which card schemes and their members, as well as alliances between card schemes, have to operate to ensure interoperability and competition;*

(iii) *Tier 3 - The providers of technical infrastructures and payment services. Efficient and low cost processing of transactions with cards is in the interest of all parties, and strong competition between providers is essential. The role of the Framework is therefore to set out the high-level principles that will encourage such competition as well as technical interoperability".*

As such the implementation of the SCF in European markets between 2008 and 2010 (considering that all significant national communities, as well as international schemes, have already expressed their commitment, and that schemes begin to re-organize activities e.g. unbundling processing as a result) will address – to the extent possible at the time of its writing, in particular with regards to payment legislation (i.e. in a "pre-Payment Services Directive" phase) and competition legislation - the barriers identified by the Commission's Interim Report under Section E, namely:

- Barriers for acquirers and other service providers? Barriers for issuers?
  The SCF Art. 3.2.2.b) disposes that "*All SEPA banks must be able to offer basic card payment product and services throughout SEPA on the basis of a single license from each card scheme without the requirement to obtain individual licenses for each SEPA country….. At their discretion, banks must be able across SEPA to enter solely into an issuing license. At their discretion, banks must also be able across SEPA to enter solely into an acquiring license*".

- Governance arrangements that may risk reducing competition between banks within a card payment system?
  The SCF Art. 3.2.2.a) disposes that "*each card scheme must allow banks to participate on the basis of transparent and non-discriminatory criteria. In particular, these criteria may no more distinguish between banks subject to supervision in the same country as the country of registration of the said card scheme, and banks subject to supervision by supervisory bodies from other SEPA countries, and conducting their business in the other SEPA countries*".

- Practices which may reduce competition between card payment systems?
  The SCF Art. 3.2.2.a) disposes that "*Card schemes commit to provide their participants with SEPA-wide, transparent pricing structures ("scheme fees"), that will endeavor to allow for participation by the greater number of banks. In this context "transparent" shall mean that the nature of the service or activity*

thus remunerated is unambiguous for the scheme participant or user: prices may not be presented in a bundled[3] *manner when referring to services or activities of a different nature. Whilst recognizing investments made in any scheme's brand, scheme participation and licensing fees will be open to competition. Within SEPA there may be no differentiation between "national" services and "cross border" services*".

5- Conclusion

With these remarks, ESBG wishes to acknowledge the Interim Report as a fact finding exercise, presenting one view of the "as is " situation across EU markets.

As stated, ESBG would suggest that additional dimensions be taken into consideration. But, as all market participants are currently revising their plans for the future, ESBG wishes to stress that it is of utmost importance that potentially distorting regulatory intervention is avoided so that market participants are allowed to make such critical decisions in a stable regulatory environment.

[3] Not in a bundled manner: as processing and clearing must be separated from a scheme's brand management and governance, scheme participants must also be charged separately for these different services and functions.

ANNEX:

The amount of research available on this topic is staggering. Research has been retained on the basis of its relevance in the context of the present discussion, of its wide and open availability, of the fact that as much as possible it formulates (a) market model(s), and is widely quoted.

A.1- Rolnick, Smith and Weber[4] discuss the lessons from one of the first documented banking systems: "*even if one views the Suffolk experience as supportive of the notion that the free market can be an efficient provider of payment services, we do not see that one can conclude that the free market will lead to the efficient provision of payment services under any possible configuration of market conditions. A general implication is that the incumbent monopolist will be able to earn monopoly profits over an extended period if it enjoys some type of strategic advantage over potential entrants*". This may result from some form of barrier to entry, including rules and technical requirements, and/or from direct or indirect *predatory* pricing, such as mandatory, non remunerated, guarantee deposits, so that the service provider could exploit non only economies of scale but also economies of scope. The research further suggests that a mere threat of predatory pricing can suffice to create the desired behavior. But the research also concludes that "*the presence of a monopoly – natural or otherwise – in no way necessarily implies that any economic efficiency were associated with the operation of the banking system under consideration*".

A.2- Gans and King[5] developed a model (which they apply to credit cards, yet consider general enough to be applied to any payment instrument) with an emphasis on its generality and robustness. Through the model they demonstrate that 1) "*interchange fees are neutral in terms of societal welfare regardless of the degree of bank or merchant competition provided merchants can set separate cash and credit prices or provided that customers have competitive cash options for any good or service they wish to purchase*" – in other words interchange fees are always neutral in the absence of constraints such as a no surcharge rule, and 2) even in situations of imperfect competition between merchants, schemes "*might not want to raise the interchange fee to create a cross subsidy between cash and credit customers* and that *even in the presence of a no surcharge rule, the setting of interchange fees only creates competitive concerns if there is inadequate retail level competition*".

The demonstration by Gans and King strongly suggests that one way for competition authorities to alleviate concern about banks manipulating credit card fees is to allow for differentiated pricing of a good or a service in function of how it is paid for: cash, payment card, or another payment instrument. It is a general observation that authorities often take the opposite stance.

A.3- Rochet and Tirole[6] investigate the economic determinants of interchange fees in payment card systems and the potential need for their regulation. They lay out the basic economic principles for choosing an interchange fee. Among other things, they demonstrate that the proposal for a cost-based regulation of interchange fees relies on an erroneous,

[4] Lessons form a Laisser-Faire Payments System: The Suffolk Banking System (1825-58), Arthur J. Rolnick, Bruce D. Smith, and Warren E. Weber, May/June 1998

[5] The Neutrality of Interchange Fees in Payment Systems by Joshua S. Gans and Stephen P. King, University of Melbourne, 15 May, 2002

[6] An economic Analysis of the Determination of Interchange Fees in Payment Card Systems, by Jean-Charles Rochet and Jean Tirole, Review of Network Economics, June 2003

vertically organized, model of the payment card industry. The authors remind readers that in the absence of specific bilateral agreements between acquirers and issuers, card schemes set default values for interchange fees, fees which differ across countries and across transactions types.

Starting from the example of proprietary systems (i.e. three-party systems), they show that "*profit maximizing fees take into account many factors: the system cost of a transaction (including both issuing and acquiring activities), the intensity of competition with other payment card networks and other payment instruments, and finally the values of demand elasticities of both cardholders and merchants. Charging different prices to different users, while resulting from profit maximization, is not a distortion due to market power: it is a socially efficient way of recovering the common cost while providing services to a larger number of users than would be otherwise the case. It may even happen that one side of the market is left entirely free of charge. For example cardholders are often exempt of transaction fees. This happens when cardholders are highly resistant to transaction charges*".

Moving then to four-party systems, the authors show that "*the scheme's influence in the determination of final user prices is only indirect in a cooperative system: it goes through the setting of the default value of the interchange fee between member banks*". In contrast to proprietary systems, neither the customer fee, nor the merchant discount, is set by the scheme, and the interchange fee goes to the issuer. The authors demonstrate that "*although socially optimal and privately optimal interchange fees may sometimes differ, there is no systematic bias between them. In specific environments (linear demands, constant margins) they actually coincide. There is no reason to think that privately optimal interchange fees are higher or lower than socially optimal ones*".

Regarding the impact of a non-discrimination rule (between merchant prices for payment with cards, and with other payment instruments), the authors conclude that "*banning this rule cannot be a substitute for an interchange fee*". However theirs' (and others') considerations regarding the topic of non-discrimination rule often rest on the assumption that banning the NDR rule would result in surcharging card users. Actually, as in most countries cash and cheque users do not internalize these instruments' costs (or the full cost) as there no direct bank charges for these instruments, the lifting of a publicly or privately imposed non-discrimination rule could well result in a more competitive pricing of electronic payment instruments compared to cash or cheques.

The authors finally stress that *the "interchange fee is not a fee for a service". Unlike the fee for service in a vertically organized industry, the interchange fee affects not only the marginal cost of merchants, but also the size of the cardholder clientele and the usage of cards*. 3 factors play a role:

- "*Network externalities: even a monopoly issuer (respectively, a monopoly acquirer) would not benefit from a very high (respectively, very low) interchange fee*", as this would discourage either merchant acceptance or card holding.
- "*Within network competition*": even in situations of "imperfect pass through", "*issuers gain little directly from an increase in the interchange fee and would loose if this increase induced a substantial fraction of merchants not to take the card. The fact that an increase in the interchange fee is partly competed away reinforces the benefits to issuers from exercising restraint.*

- *Between networks competition":* generally speaking this can be seen as *"an additional force that restrains card schemes from distorting their price structure. However this benefit of competition does not exist when systems are associations whose not-for-profit status prevents exercise of market power. Competition therefore alters the price structure (the allocation of cost between the two sides of the market) rather than the price level".*

The authors then conclude that "*there is no economic rationale for cost-based regulation of interchange fees. The idea of a cost-based regulation of interchange fees erroneously relies on a model of vertically organized market, in which an "upstream unit" supplies an intermediate input to a "downstream unit", which then serves the final consumer. The analogy is based on the idea that the issuer (the upstream unit) supplies a service (cardholder servicing, and transaction guarantee) to the acquirer (the downstream unit), who then handles the merchant. This vertical view ignores the reverse direction: issuers also serve a category of end-users, the cardholders, and thus can in no way be treated as "upstream units".*

Getting both sides on board, "*both from a business and from a social perspective*", requires balancing, an act which "*bears little relationship with accountants' notions of cost allocation. Quite generally, platforms in multi-sided markets charge price structures that are rather unrelated to standard cost allocations. These price structures are not socially indifferent: rather they are critical to the exploitation of network externalities*.

It seems odd for competition-conscious authorities to deprive open-access cooperatives of the ability to use the interchange fee and non-discrimination rule instruments that are necessary to perform the balancing act, and thereby to destroy the level-playing field in their competition with closed-access, proprietary, for-profit platforms that do resort to an (implicit) interchange fee and to the non-discrimination rule".

There can be of course no guarantee that whilst "*an association's members, whether predominantly issuers or acquirers, have the socially worthwhile objective to bring on board both sides of the market*", the card scheme, "*whoever controls it, will pick just the socially optimal interchange fee. But this feature is not specific to the payment card industry: no industry ever engenders the socially optimum decisions".*

The authors then observe that the "*standard approach to public intervention in industries involves two steps:*

(1) the theoretical identification of a serious market failure and the validation of its empirical relevance,

(2) the identification of the least distortionary way of addressing the market failure and a check that the remedy will not be worse than the illness".

The regulation of some industries "*has been traditionally based on (part 1) a broad intellectual consensus that certain segments represent national monopolies and provide their users with incentives to charge largely inflated, distortionary prices. Concerning part 2 there are been much debate as to the proper mode of regulation as well as again a broad consensus that regulation itself introduces non-negligible distortion Yet, most economics feel strongly enough about part 1 that they are willing to accept the need for regulatory intervention in those industries, in spite of the concomitant regulatory distortions".*

A.4- Bergman[7] reviews two-sided network effects, bank interchange fees and the allocation of fixed costs. He recognizes that, "*to achieve optimal network effects, a fee structure that effectively taxes one type of final customers (e.g. merchants that accept card payments) in order to subsidize another category of customers (e.g. cardholders) may have to be implemented. The latter, in turn, may necessitate a multilateral pricing agreement between the banks*". The underlying and standing question in such an environment is whether, as completely independent competition is not possible in the provision of payment services where banks need to cooperate extensively – "*such close cooperation at one level may not give the banks the opportunity to cleverly design system fees and multilateral fees in such a way that downstream collusion is induced. This could for example be achieved in raising the appropriate marginal costs, so that incentives are created for the banks to raise final-customer prices and so that excess profits are generated elsewhere in the system*".

Discussing the 2 existing "generations" of research (the "simple" model", and the model taking into consideration market power), Bergman, whilst acknowledging that e.g. merchants with market power (with a positive price-cost margin) may have strategic reasons to accept cards, and that these strategic reasons do not correspond to social gains, returns to first-generation modeling assumptions and considers the impact of fixed system costs (in opposition to the literature assuming that there are only marginal costs associated with payment systems).

Bergman builds his model taking into consideration that payments instruments is a market with two-sided network effect where, in a parallel to trading marketplaces, "*buyers may indirectly benefit from there being a large number of other buyers, as this will attract a large number of sellers – and vice versa*". This typical situation can be further compounded by indirect network effects in one-sided markets, as occurs e.g. with single-bank ATM networks. In this situation, more usage may increase "welfare" (in terms of denser ATM network) of the individual cardholder, yet congestion may result in a direct negative effect.

For modeling purposes, "*if both groups (i.e. merchants and cardholders) pay purely on a per-transaction basis, then the number of merchants that accept cards is irrelevant for the decision to become a cardholder and the number of individuals that hold cards is irrelevant for the merchant's decision to accept card payments. If a fixed annual fee was introduced, then the number of merchants that accept cards would of course be relevant when a consumer decides whether to adopt cards or not. A corresponding condition would hold for merchants, if they were to pay a fixed annual fee*".

Developing the model, Bergman proposes that "*in welfare generating systems, the socially optimal linear transaction prices will be such that the combined revenues of the acquirers and the issuer will be lower than their combined costs, and that the second best price structure (the optimal price structure in the absence of subsidies) can be achieved with the interchange fee*. In the latter situation, *subsidies will tend to flow towards the issuing side of the market if cardholders demand is more elastic than merchants' demand and if the difference between the average valuation of the merchants and the acquirers' cost in equilibrium is high relative to the difference between the average valuation of the cardholders and the issuers' cost – also evaluated in equilibrium*. As already noted by Schmalensee (2002), *if both acquirers and issuers are perfectly competitive, there are no reasons for them to have any particular preference over the interchange fee at all*".

[7] Two-sided network effects, bank interchange fees, and the allocation of fixed costs, by Mats A. Bergman, 3 January 2005

Bergman then successively discusses bilateral monopolies (who "*will price above their marginal costs*"), proprietary systems (or two-sided monopolies – where "*interchange plays no role*"), and one-sided monopolies where "*there is market power on one of the two sides of the market: in this situation welfare is found to be higher than under bilateral monopoly (and a zero interchange fee), but lower than under competition (and no interchange fee). Indeed, if the issuer holds monopoly power vis-à-vis the cardholders, while the acquiring side is competitive, there appears to be good reasons to think that the issuer will hold monopoly power also with respect to the acquirers. If this is the case, it can set an interchange fee that will determine the price on the acquisition side of the market. Since the interchange fee is paid to a monopolist, however, it will have no effect on the issuing side of the market.*

There is no single "correct" way to allocate fixed central system costs between issuers and acquirers. A concern can also be banks' willingness to incur fixed costs in the central system in order to reduce marginal processing costs; this willingness will be greater under a proportional cost distribution scheme. The policy conclusions to be drawn are that if entry barriers are not too high, fixed costs should be allocated in proportion to the number of transactions. This will facilitate entry which in turn will put a downward pressure on prices. In addition the banks will have better incentives to make investments in technology that reduces marginal costs. On the other hand, if entry barriers are high, or if entry is impossible, the welfare consequences of allocating fixed costs in proportion to the number of transactions appears to be more problematic. This method of cots allocation will now tend to raise prices, although there will still be a positive incentive effect on investments".

A.5- Weiner and Wright[2] first also challenge the simple, vertically organized presentation of the card industry in which issuers sell services to acquirers, who in turn sell to merchants, on the grounds that "*issuers also service cardholders, and that the interaction of cardholders and merchants is essential to creating a valuable service. Thus the interchange fee is not a price for a single service, but acts as a balancing instrument*" which effects may at times be limited by e.g. the nature of acquirer competition which impacts the pass-though rate and timing of interchange fees to merchant fees. "*With limited pass-through of interchange fees, the net effect may also be to decrease acquirers' profits and increase issuers' profits. In this case, it may also lead to more promotion of card services by issuers and less promotion of card services by acquirers. To the extent that the increase in merchant fees exactly equals the decrease in card fees, the interchange fee will change the structure of fees but not the overall level of the issuers' and the acquirers' fees. To the extent that the increase in merchant fees does not match the decrease in card fees, changing the interchange fee will change the structure of fees and, at the same time, change the overall level of the issuers and acquirers' fees*". This leads them to conclude, together with Schmalensee, that interchange revenue will flow to the high cost side of the business, and to the side which has less demand.

The authors also note that none of the proposed models incorporates the possible use of interchange fees to spur investment by issuers and acquirers. "*It is possible that interchange fees could promote greater investment on one side of the market or another. This arises if the pass-through of interchange fees to end-users is less than perfect so that issuers and acquirers retain some profits, and interchange fees can affect these profits directly*". In this case, an increase in the interchange fee will increase issuer's profits, making issuers more likely to promote (and possibly invest in) the development of the particular card network.

Weiner and Wright further attempt to validate models through empirical evidence. Such attempts are however constrained by the lack of systematic data on interchange fees (preventing e.g. empirical analysis of the determinants of interchange fees). Therefore their analysis focused on trying to find whether there is any simple relationship between interchange fees and issuer, or system, and market concentration. The conclusion drawn from data comparison from 20 countries worldwide is that there is no such obvious relationship: "*this could simply be because issuer concentration does not proxy at all for market power…. Rather, it implies that any relationship must be more complex, involving several factors that determine interchange fees, such as the "balancing" factors as well as country-specific factors (e.g.)"*. A similar picture emerges regarding the relationship between interchange fees and the difference between issuing concentration and acquiring concentration, also showing that acquiring is more concentrated than issuing for most countries reviewed. "*This seems at odds with the assumption used in some of the theoretical work in which issuers were assumed to have market power but not acquirers. Of course, other factors than market concentration can determine market power. The fact acquirers have to negotiate with large retailers in private suggests they may be more competitive than concentration measures alone imply"*. Finally, no obvious relationship between interchange fees and the proportion of card transactions realized with one or the other international scheme emerges. "*The relative size of Visa to MasterCard does not seem to be related to the average level of interchange fees, unless it is part of a more complicated relationship"*. This conclusion could be extended to competition between different payment instruments.

Finally academics also discuss the impact of decisions taking by supervisors, such as the Reserve Bank of Australia. Chang[8] reviews the 2002 RBA intervention that drastically lowered the charges merchants paid to 4-party schemes (and at the same time prevented merchants to charge different prices for goods or services paid for by different payment instruments). The RBA considered that[1] "*co-operative behavior between competitors which involves the collective setting of prices is rarely permitted in market economies. Prima facie, such behavior is anti-competitive and, where it is allowed, it typically requires some form of dispensation by competition authorities on the basis that there are offsetting benefits to the public"*. At the same time, however, the RBA recognized that "*interchange fees can play a role in redressing imbalances between the costs and revenues of issuers and acquirers in four corner credit card schemes"*. But the RBA's intervention was based on the belief that the card scheme fees were too high and it interpreted findings from theoretical models showing that companies may have private incentives to set interchange fees that are higher than the rate that maximizes the value of card transactions to society as a whole. The RBA thus proposed a regulatory scheme for interchange fees that was based on cost factors, rather than on demand factors, and that, as far as costs are concerned, only considers those incurred on the issuer side.

Chang challenges the RBA's decision by highlighting "*three principal mistakes*:

- *First the RBA failed to demonstrate a significant market failure resulting form interchange fees"*. It did not establish that "*interchange fees exceeded the socially optimal level or that competition was somehow impaired"*. In particular the same theoretical models as used by the RBA also show that "*privately set interchange fees could be at the socially optimal level, or could be too low"*.
- Second the RBA decision ignored a key implication of two-sided markets. As even the expert of the RBA acknowledged in his report, "*there is no economic rationale for setting fees based solely on costs. There is little reason to believe that it is optimal to*

[8] Interchange fees in the courts and regulatory authorities, Howard H. Chang, NERA Economic Consulting.

set the interchange fee equal to either an issuer's marginal cost of a card transaction or zero". This means that "*because the socially optimal interchange fee depends on both benefits and costs, regulation based on costs alone will not produce efficient pricing – except by chance"*. This highlights again the risks of ignoring demand conditions.

- Finally the RBA exempted proprietary system from the regulation on interchange: "*American Express and Diners Club, on the other hand, do not have collectively determined interchange fees. Whether they have an internal transfer mechanism or "implicit" interchange fees is not relevant; the three party card schemes do not have a process under which competitors collectively agree to set a price which then affects, in a uniform way, the prices each of the competitors charges to third parties"*. Chang opines that this approach reflects a lack of understanding of two-sided markets. The mere fact that card schemes set interchange fees as "*a collective act by their members, who are horizontal competitors, does not imply that they have chosen a pricing structure that harms the collective interests of their customers"*.

About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of €4,345 billion (1 January 2004). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. For decades ESBG members reinvest *responsibly* in their region and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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FEEDBACK FORM

Name of undertaking: ESBG (European Savings Banks Group)

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): European Credit Sector Association

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Participated in the questionnaire:

- 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?

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

C. Future market developments

Please see remarks in the attached Position Paper

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?

D. Potential solutions to market barriers

Please see remarks in the attached Position Paper

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

Please see remarks in the attached Position Paper

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

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

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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?

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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?

General comments:

Please see remarks in the attached Position Paper

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;

   - no

Thank you for your contribution!