

**BANCA INTESA'S COMMENTS TO
THE COMMISSION'S INTERIM REPORT 1 ON PAYMENT CARDS
OF 12 APRIL 2006**

1. Introduction

The Intesa Group is one of the largest Italian banking groups, with a strong presence in new Member States like Hungary, where Central-European International Bank - CIB is the fourth largest bank, and Slovakia, where Všeobecná úverová Banka - VUB is the second largest bank.

Payment services are core for the Intesa Group, which is a main player in the payment card business, both on the issuing side and on the acquiring one. To make an example, in Italy the whole Moneta card system is owned and managed by Setefi S.p.A., which belongs to the Group.

The Intesa Group praises and appreciates the work of the European Commission, which has been very accurate and thorough. Furthermore, we greatly value the open and transparent procedure that the Commission has chosen to follow in order to produce its definitive report on this important issue.

However, we would like to stress that any analysis on credit and debit cards should be made with a forward-looking perspective, and consequently should refer not only to mature markets but also to the features of expanding markets, such as those of some new Member States.

Banca Intesa and the Intesa Group take the chance of this consultation to express their views by answering to some of the questions set forth by the Commission in its Interim Report 1 on Payment Cards.

2. Answers to the questions of the Interim Report 1

Q1. *Are high merchant fees a competitiveness issue for EU economy?*

In Banca Intesa's opinion merchant fees have a two-fold purpose:

- i) they remunerate the costs incurred by acquirers; and

- ii) they attribute acquirers some margins to be invested in the development of payment systems. It is thanks to these margins that acquiring banks can invest to combat frauds, to ensure the continuity of the payment network and to increase the overall efficiency of the payment card network.

Even in the context of a modern payment market, such as the Italian one, there are still significant improvements to the payment system to be carried out, which can be financed *inter alia* by means of the acquirers' margins. However - as the graph 23 at page 48 of the Interim Report shows - the need for investments, hence the required margins, hence the level of merchant fees, are due to decrease over time, given that more and more investments are being completed. This means that the market adjusts the level of merchant fees to the need of investments itself. In this scenario it is likely that in the long run the acquirers' margins will further thin up.

Therefore, we conclude that merchant fees higher than the mere costs borne by acquirers do not raise any competitiveness issue for EU economy. On the opposite, they are a positive factor, as they allow the payment industry to finance strategic and forward-looking investments, with the view of further developing and improve the system, by spreading investment costs in a fair manner among merchants.

Q 2. Are there compelling justifications for the comparatively high level of merchant fees observed in some parts of the EU 25?

Notwithstanding a partially harmonized regulatory framework, payment markets within the European Union differ significantly among themselves, depending on the fact that each Member State has evolved differently in this respect. To make an example, in some countries cheques are still used a lot, whereas in other countries paper instruments have *de facto* been abandoned. This entails that, *ceteribus paribus*, in the latter country the card industry will be more spread, more developed, more efficient and thus merchant fees will be cheaper.

In some countries merchant fees are higher than elsewhere as a consequence of objectively different structures, procedures and efficiency levels. This fact can be merely regarded as a piece of evidence that the relevant market for the purpose of payment cards is still national and not yet European, rather than as a competition issue.

Also the price difference of merchant fees between (i) small v large merchants, (ii) credit v debit cards and (iii) merchant sectors depends on the structural features of each of these markets and is not "the measure for the exercise of market power by banks within a given system", as the Interim Report suggests at page 51.

There follows the synthetic description of the objective reasons leading to the price differences observed by the Commission.

PRICE DIFFERENCE	REASON
Small v large merchants	<ul style="list-style-type: none"> ➤ significant scale economies flowing from the higher turnover and proportionally higher use of payment cards for large merchants ➤ purchase and maintenance costs for the POS/ payment terminals on the large merchants (but not on the small ones)
Credit v debit cards	<ul style="list-style-type: none"> ➤ more complex operating system and procedures in the case of credit cards (e.g. charge back, referral) ➤ credit losses ➤ funding/financial costs
Merchant sectors	<ul style="list-style-type: none"> ➤ level of risk ➤ average amount of payment transactions ➤ in the charity sector, banks operating under cost for policy reasons

Q 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?

According to our analysis, there is a number of justifications to charge the interchange fee to acquirers:

- Technological investments: thanks to the interchange fee and the consequent margins, the card issuing business generates profits which are normally invested to improve the payment technology (e.g. chip contact less, new terminals);
- Product innovation: the profitability of the business stimulates card issuers to innovate the payment system by introducing new efficient and safe payment products, for instance designed for Internet or for small/micro amounts;
- Cost allocation: the bargaining power of professional merchants is higher than the one of consumer card holders. As a matter of fact, in Italy there are indeed some acquirers offering services under price to some merchants, because of the bargaining power of the latter and the high level of competition in this market. From this perspective, it is fairer to charge merchants, rather than card holders. Furthermore, in absolute terms merchants benefit from the access to a card payment network more than

card holders (e.g. they save on the management of cash, on theft protection and on fraud costs);

- Prevention of frauds: thanks to the investments that also issuers are doing on the safety of the card network and the decrease in the use of cash, the prevention of frauds has become more effective;
- Systemic efficiency: although from the perspective of a card user cash may be a more efficient payment method in a number of cases, taking into account the huge costs borne by the banking system to manage cash, from a systemic perspective it is overall more efficient not to use cash and instead to resort to card-based payment systems.

According to the pattern we have observed in a number of countries, interchange fees help developing a market without affecting the level of competition in that market. The more markets develop the lower prices and fees become, as proved by the significant decrease of merchant fees in the last years.

For this reason, we would suggest the Commission to be extremely cautious before taking any action concerning the level of interchange fees in order to foster fair competition. As a matter of fact, it often happens that a market-driven process leads to a decrease of interchange fees, as a result of market development, economies of scale and reduction of costs.

The Commission should also make sure to tailor its analysis and potential action to the specific features of a market, such as volumes, structure (domestic debit v international credit), financial costs (e.g. duration of the free period), risk level and behaviour trends of the average credit holder. In fact, all these objective factors concur to determine the level of interchange fee.

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

Banca Intesa is convinced that the pricing policy with respect to payment systems should be driven also by policy and general interest issues, such as the possibility to trace payments and the prevention and fight of frauds. In this respect, electronic payments are clearly to be preferred to cash and paper ones. Consequently, also the pricing should encourage electronic payment instruments, even though in some circumstances they could not be overall the most efficient payment instrument at a given time.

As to the assessment of efficiency of a given payment instrument, in our experience this evaluation should not be made in a short term, but looking towards a long term period. In fact, although in non-mature markets credit cards may not be the most efficient payment instrument at the present time nonetheless they should be fostered in order to make the electronic payment market develop. Once this market is developed, then costs will naturally sink and hence card payment instruments will become efficient.

A major consequence of this policy and long-term efficiency reasoning is that card users should not be charged a “fee per transaction”, as this would be a major disincentive to the development of a safe card-based payment system. It is preferable to either do not charge users, or to charge them on a flat yearly basis.

Q 13. What access conditions and fees are indispensable?

Together with the merchant fee, we believe that the interchange fee is indispensable.

In fact shall the interchange fee be drastically and suddenly reduced or even abolished, then the card issuers would be in a situation to reduce their margins, given that no increase of the card-issuing fee would be sufficient to compensate their loss under the interchange fee. This would lead almost certainly to a significant decrease of every investment in the card payment sector, which would cease to be strategic for banks and other card issuers.

Therefore, in our view, in order to make sure that the card payment sector continues to develop and innovate, the interchange fee must be maintained.

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

In our view, there are currently too many differences in the processes, certification procedures and especially interconnection protocols between different systems, which make fix structure costs high.

In this respect, the SEPA project is valuable as it provides for the parallel coexistence of the existing domestic standards and a newly built international standard. This solution allows striking a balance between the need for simplification and harmonisation on a one side, and the preservation of the very cheap, widespread on a domestic level, and efficient national systems on the other side.

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

In our view, rather than an external intervention from a Regulator, the industry should be left free to find out the most efficient answer to this sort of dilemma. Banca Intesa supports the EPC and its SEPA project in this respect as it provides for a new “European” communication protocol, without wiping out national systems, which should be preserved in the light of their efficiency.

Avoiding a total substitution of national systems is a valuable option, given that a complete shift would entail very costly investments. On the other side, introducing a second European system is a good way to eliminate the current costs of communication and certification between different domestic systems.

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Brussels, 21st June 2006

FEEDBACK FORM

Name of undertaking: Banca Intesa S.p.A.

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): issuer and acquirer

Address: Via Monte di Pietà 8 – 20100 Milano – Head Office

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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?

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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?

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?

Banca Intesa is convinced that the pricing policy with respect to payment systems should be driven also by policy and general interest issues, such as the possibility to trace payments and the prevention and fight of frauds. In this respect, electronic payments are clearly to be preferred to cash and paper ones. Consequently, also the pricing should encourage electronic payment instruments, even though in some circumstances they could not be overall the most efficient payment instrument at a given time.

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

B. Market structures, governance and behaviour

8. What market structures work well in payment cards?

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

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

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

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

13. What access conditions and fees are indispensable?

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Therefore, in our view, in order to make sure that the card payment sector continues to develop and innovate, the interchange fee must be maintained.

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

C. Future market developments

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

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

D. Potential solutions to market barriers

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

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?

In our view, there are currently too many differences in the processes, certification procedures and especially interconnection protocols between different systems, which make fix structure costs high.

In this respect, the SEPA project is valuable as it provides for the parallel coexistence of the existing domestic standards and a newly built international standard. This solution allows striking a balance between the need for simplification and harmonisation on a one side, and the preservation of the very cheap, widespread on a domestic level, and efficient national systems on the other side.

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?**

In our view, rather than an external intervention from a Regulator, the industry should be left free to find out the most efficient answer to this sort of dilemma. Banca Intesa supports the EPC and its SEPA project in this respect as it provides for a new “European” communication protocol, without wiping out national systems, which should be preserved in the light of their efficiency.

Avoiding a total substitution of national systems is a valuable option, given that a complete shift would entail very costly investments. On the other side, introducing a second European system is a good way to eliminate the current costs of communication and certification between different domestic systems.

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:

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

Thank you for your contribution!