ROYAL BANK OF SCOTLAND GROUP SUBMISSION

CONSULTATION ON THE EC INTERIM REPORT I – PAYMENT CARDS

SECTOR INQUIRY UNDER ARTICLE 17 REGULATION 1/2003 ON RETAIL BANKING

CONTENTS

RBSG SUBMISSION

CONSULTATION ON THE INTERIM REPORT I – PAYMENT CARDS

SECTOR INQUIRY UNDER ARTICLE 17 REGULATION 1/2003 ON RETAIL BANKING

A. INTRODUCTION

A.1. The European Commission (“**the Commission**”) issued its Interim Report on payment cards on 12 April 2006 ("**the Interim Report**") and requested comments on its consultation by 21 June 2006. The Royal Bank of Scotland Group (“**RBSG**”) is responding to the Commission’s request in two sections:

(i) ‘Section D’ responds to the Commission’s 25 specific questions categorised under the following five sets of issues for consultation; namely: financial analysis of the industry, market structures, governance and behaviour, future market developments, potential solutions to market barriers and lessons for Single Euro Payments Area (“**SEPA**”).

(ii) ‘Section E’ addresses a number of additional issues raised in this Report that are not already covered in Section D. Section E covers these additional issues in the chapter order of the Report.

A.2. RBSG would like to thank the Commission for its ongoing efforts to promote competitive and efficient financial services markets within the European economy. As a participant and stakeholder in a number of EU markets, RBSG is pleased to have the opportunity to respond to the Commission as part of its consultation process. We hope that our comments on the Interim Report’s findings, and our responses to the Commission’s five sets of issues for consultation, will assist all stakeholders to develop a consensus on the appropriate way forward from here.

A.3. RBSG is a broadly based financial services group with operations spanning clearing banking, corporate banking, retail financial services, investment management and insurance, both in the UK and overseas. It is active in credit card issuing, merchant acquiring, consumer finance and supermarket banking. RBSG operates across Europe and has a presence in Austria, Belgium, Germany, France, Switzerland, Ireland, Greece, Italy, Scandinavia, the Netherlands, and Spain, in addition to the UK. RBSG employs approximately 140,000 people and serves more than 35 million customers Worldwide.

A.4. RBSG's most detailed knowledge of the payment cards business is in the UK and our starting point for answering the questions has therefore been the situation in the UK. However, we believe that most of our comments have general applicability, e.g. our views on the measurement of profitability are not UK specific.

B. EXECUTIVE SUMMARY

B.1. RBSG believes it is well placed to respond to the Commission's Interim Report, given its experience in offering payment cards services across Europe.

B.2. In its Interim Report, the Commission has made a number of interesting observations about the composition and conduct of the EU payment cards sector and the participants operating in this arena. We agree with the Commission's assessment that there are arrangements (some of them are legacy arrangements) operating in a number of countries that have the effect of dampening competition and would welcome future efforts by the Commission to address these issues.

B.3. In some areas, we have constructively challenged the Commission's arguments and findings (based on our different perspectives) and its conclusions, where we felt these conclusions were not supported by the weight of the Commission's own evidence or undermined by anomalies in the Commission's methodology (such as the use of the "weighted average" approach). For example, we have argued that the Commission does not advance sufficient evidence to reach the conclusions it has on topics ranging from the level of merchant charges, the level and role of interchange fees and the profitability of card issuers and acquirers.

C. GENERAL METHODOLOGY

RBSG has some overarching concerns about the general methodology that the Commission has adopted in the Interim Report and we therefore also have concerns about some of the conclusions that the Commission has reached.

C.1. The Commission has generally anonymised the Member States in the Interim Report. The fact that the Member States are generally not identified means that RBSG has not been able to comment on the accuracy of the Commission's preliminary findings. The original questionnaire to which we responded was a very detailed one and it would not be surprising if there were variations in the way participants answered the questions. By identifying the Member States in the report, market participants would be able to verify the validity of the conclusions. For example, RBSG has identified an incorrect conclusion in Chapter 15 in relation to whether UK credit cards offer an interest free period, see Section E for further detail. However, we were only able to identify this error because, unusually, Table 72 is identified as relating to the UK. We would therefore urge the Commission to identify the Member States in each of the tables contained within the Interim Report as the current anonymised version has limited RBSG's ability to comment meaningfully on the accuracy of the facts underlying the Commission's conclusions. It would also be helpful if Member States are identified in the forthcoming interim reports on retail banking and business insurance.

C.2. In some instances, the Commission has sought to conduct its analysis on the basis of the "weighted average" approach. For example, paragraph 3.1.3 of the Interim Report sets out that "*weights were calculated according to the respective turnovers for each respective interchange fee tier per EU-25 Member State*". This approach has inherent difficulties due to the significant differences between countries in terms of the mix of transactions (e.g. the quantity and size of the transactions, the breakdown of the transactions between sectors), the method of payment (e.g. internet, chip and pin, cards not present), the risk of fraud and default, technology, economies of scale and innovation (e.g. in chip and pin). This means that there are many factors which could influence the average interchange fee/merchant service charge ("**MSC**") within a country, which makes cross country comparisons difficult. It is unclear why the Commission has adopted this approach or whether the interchange fee tiers across different European countries are comparable.

C.3. Therefore, although RBSG has sought to respond to the Commission's specific questions, we believe any preliminary conclusions the Commission has arrived at need to be treated with caution. RBSG has expended a significant amount of management time reviewing the Interim Report and compiling this response. This response has been prepared to the best of RBSG's ability and RBSG has endeavoured to ensure the accuracy of all of its comments. We would, however, note that by responding to the Commission's questions, RBSG does not necessarily accept the appropriateness of the assumptions contained within a number of the questions.

C.4. Given the breadth and detail of the Interim Report, RBSG has made the decision to limit its comments to those set out in this response. This should not, however, imply that RBSG agrees with those observations, findings and analysis set out in the Interim Report on which RBSG has chosen not to comment.

D. RESPONSES TO SPECIFIC QUESTIONS IN THE REPORT

As a preliminary observation, RBSG found a number of the Commission's questions ambiguous and had difficulty in interpreting both the meaning and purpose of these questions. Nevertheless, RBSG has endeavoured, where possible, to respond on the basis of the most likely interpretation of the relevant question.

D.1. Financial Analysis of the Industry

Question 1:

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

RBSG's experience is primarily focused on the UK and it does not consider merchant fees to be high in this market. Accordingly, RBSG does not consider that merchant fees are a competitiveness issue in the UK.

The report does not identify the jurisdictions in which the Commission considers merchant fees to be "comparatively high" and a weighted average approach has been adopted. In that regard, we refer to our comments on General Methodology at Section C above. Further, the basis of the Commission's assumption that merchant fees are high is not clear nor has it indicated by what reference point merchant fees might be considered high nor in which Member States. RBSG is therefore unable to comment further on this topic.

Question 2:

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

RBSG does not consider merchant fees to be high in the UK. Given the lack of data in respect of the jurisdictions in which the Commission considers merchant fees to be "comparatively high", RBSG is unable to comment further.

Question 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?

In response, RBSG would make two broad observations:

(i) First, the Commission's analysis does not appear to be sufficiently robust to support its assertions in relation to profitability; and

(ii) Second, interchange fees (i.e. the mechanism by which revenue is transferred) have a sound economic justification and are intrinsic to the operation of payment cards schemes (including in the UK).

Each point is addressed in turn below.

D.1.1. The Commission's profitability analysis

We do not feel that the profitability analysis undertaken in the Interim Report provides sufficiently robust results to support the Commission's assertions in relation to profitability.

The analysis of profitability as a tool in competition investigations has gained popularity among a number of competition authorities, but the methodologies employed have in several cases lacked conceptual robustness. There are substantial measurement difficulties inherent in any analysis of this kind, and the translation of accounting profit into economic profit is far from straightforward. Conceptually, the correct approach would be to calculate an internal rate of return ("IRR"), but some competition authorities have opted for alternative methodologies such as comparing return on equity with a notional cost of equity.

Although superficially simpler to calculate, such comparisons are not intellectually robust. (See for example Fisher and McGowan: *On the misuse of accounting rate of return to infer monopoly profits*, American Economic Review ("**AER**") 1983 pp 82-97, which stated that "there is no way in which one can look at accounting rates of return and infer anything about economic profitability". See also the subsequent discussion in AER 1984 pp492-517; Oxera: *Assessing profitability in competition analysis*, OFT working paper 2003; and Grout & Zalewska: *Profitability measures and competition law*, forthcoming.)

Some of the difficulties inherent in profitability analysis are apparent in the Interim Report. As a result, RBSG does not believe that the profitability analysis is sufficiently robust to support some of the hypotheses advanced, including the assertions that:

1. Issuing is more profitable than acquiring;
2. Issuing profitability is persistently high; and
3. Issuing would still be profitable without any interchange.

1. Issuing is more profitable than acquiring

The Interim Report measures profitability in terms of a mark-up (income minus costs divided by costs). RBS does not believe that this kind of measure is appropriate for gauging the profitability of capital-intensive industries such as card issuing and acquiring, or for comparing the relative profitability of these two segments, whose capital intensity and risk profiles differ.

For the purposes of illustration, RBSG has derived the following ratios for First Data, the largest US merchant acquirer, and Capital One, a large US card issuer, using their 2005 Annual Reports. Although not pure monolines, their businesses appear to make them reasonably representative of, respectively, acquiring and issuing businesses.

	EC profitability ratio	Return on assets	Return on equity
First Data (acquirer)	26%	4.7%	18%
Capital One (issuer)	39%	2.9%	17%

This illustrates how an acquiring business might have a lower profitability ratio than an issuing business, as measured in the Interim Report, and yet have a significantly higher return on assets and a slightly higher return on equity. It seems likely that in most instances issuers would require more capital than acquirers, notably because they bear the risk of consumer default, so an analysis that does not take capital into account will not present a full picture of the relative profitability of issuing and acquiring.

2. Issuing profitability is persistently high

The analysis of profitability in this section does not establish any relevant benchmark, such as a cost of capital. The Commission's original questionnaire contained (spreadsheets 1.06 and 2.6) an item headed "other costs". We understand that the Commission believed that respondents might add a cost of capital under this heading, but it does not appear to us that this would have been obvious from the questionnaire. RBSG did not include any such cost and would be very surprised if other respondents had interpreted the question in this way. As a result, the existence of a positive mark-up ratio on the measure used in the Interim Report does not on its own convey any information about whether or not profitability is high.

Even if respondents had included a cost of capital under "Other", the measurement of cost of capital is by no means without difficulty, and it is unlikely that data would have been submitted on a sufficiently uniform basis to enable sensible comparisons to be made. The timeframe for the analysis performed (2000-2004) also appears to be too short to establish that profitability is not related to the business cycle.

RBSG notes also in this regard that it does not allocate shared costs to business units, still less to individual product lines, and has no means for doing so. There are significant conceptual and practical difficulties in establishing an appropriate basis for allocating such shared costs to individual services or businesses. Any such allocations made in respect of RBSG's various businesses would be subjective and dependent upon the various assumptions made. RBSG's response, as was made clear at the time, did not include such data.

3. Issuing would still be profitable without any interchange

Given the absence of an appropriate benchmark, the positive mark-up ratios calculated in the Interim Report do not in themselves convey meaningful information about the level of profitability. Positive accounting profits could very easily be insufficient to cover the cost of capital of the issuer, resulting in negative economic profits.

Finally, RBSG notes that any profitability analysis is unlikely to provide useful information if it is not fully linked to the broader competition analysis. The Interim Report's findings on the relative profitability of issuing and acquiring appear, however, to be at odds with, for example, its findings on market structure. In relation to the UK market, the Commission found that both issuing and acquiring were very competitive.

D.1.2. Economic justification for interchange fees

RBSG considers that the Commission has reached a number of contentious and unsupported conclusions in relation to interchange fees. RBSG has considered those conclusions under the following headings:

1. the role of interchange fees;
2. the effects of interchange fees; and
3. miscellaneous observations.

1. The role of interchange fees

RBSG considers that there is a generally applicable justification for revenue transfers through interchange fees in card payment systems. RBSG agrees with the cited economic approach of Rochet and Tirole et al[1], i.e. the effect of interchange fees is neutral and interchange fees provide efficient incentives for card issuers to expand output. Four party payment schemes involve joint (two-sided) demand by merchants and cardholders, and joint supply by acquirers and issuers. There is a cost-revenue imbalance between issuers and acquirers, as issuers bear the bulk of the costs of operating a card payment scheme, while acquirers have access to potential revenue from merchants, in excess of the direct costs that acquirers bear. Interchange fees are a balancing mechanism, ensuring optimal usage of the scheme.

In this context, the Commission concludes, based on an observation that not all domestic debit card payment systems have interchange fees (page 26), "that interchange fees are not intrinsic to the operation of card payment systems" (page 32). In response, RBSG would observe that:

- the fact that some domestic debit card schemes may appear to operate without an interchange fee does not mean that this is in fact the case. By way of example, RBSG understands that the Netherlands system referred to by the Commission does have a mechanism that operates in an analogous fashion to an interchange fee;
- the fact that some domestic debit card schemes operate without an interchange fee does not mean that they operate efficiently. By way of example, in Denmark, the lack of an interchange fee is a direct result of regulatory intervention and the absence of an interchange fee is correlated with limited functionality;
- only very few debit card systems do not have an interchange fee and the vast majority of debit card schemes consider it necessary to operate with an interchange fee;

[1] Interim Report, page 5.

RBSG is not aware of any four party credit card scheme anywhere in the world that operates without an interchange fee. Given that credit and debit card payment schemes are inherently different products, even if it were true that a debit card scheme can operate (albeit inefficiently) without an interchange fee, this does not imply that a credit card scheme could.

2. The effect of interchange fees

The Commission notes that interchange fees "have an effect similar to a tax on each payment" and may be used as a tool to extract rents from merchants[2]. Related to this point, the Commission concludes that interchange fees are high (see page 33). In this context, RBSG would observe that:

- the only basis for the Commission's conclusion that interchange fees have an effect similar to a tax appears to be the observation that interchange fees lead to a transfer of revenues from acquirers to issuers. As indicated above, interchange fees are an essential, and indeed the primary, component in the balancing exercise between issuers and acquirers in order to ensure that credit card payment systems operate at an optimal level and are, therefore, efficient. By ensuring an economically optimal scheme, this balancing exercise is pro-competitive and not anti-competitive;
- given the two-sided demand for card payment systems, the level of interchange fees cannot be considered independently of the services offered to merchants and cardholders and the impact on output of the scheme as a whole.
- there appears to be an insufficient basis for the Commission's conclusion that interchange fees are high. It would be expected that in order to conclude that interchange fees were indeed "high", some form of comparison, as against the costs of comparative services, would need to be undertaken. No such analysis appears to have been undertaken by the Commission. Accordingly, RBSG can see no basis for claiming that interchange fees are generally high across the

[2] Interim Report, page 32.

EU. Further, even if the Commission were to find that interchange fees were indeed on average high across the EU, as its analysis shows wide discrepancies in the interchange fees in individual countries, this finding has no generalised applicability when considering individual countries, including the United Kingdom.

At page 17, the Commission notes that high interchange fees may have the effect of transferring profits to the side of the scheme where they are least likely to be competed away. As interchange fees represent a transfer from acquirers to issuers, this comment implies that the Commission considers that issuing is the less competitive side of a payment card scheme. In fact, card issuing in general is very competitive, as recognised by the Commission at page 86 where it observes that card issuing is not concentrated and indeed is characterised "by a high number of market players of varying size". RBSG reiterates that in the United Kingdom in particular, there is robust, and in fact fierce, competition between a large number of market participants.

3. Miscellaneous observations

The Interim Report (page 61) concludes that there is no negative relationship between interchange fees and cardholder fees (i.e. when interchange fees increase, cardholder fees do not necessarily decrease). The Commission supports this conclusion by calculating that: for each €1 increase in interchange fee revenue, only €0.25 is passed on to cardholders through lower fees (page 56). Further the Commission analysed cardholder fees and interchange fees over time and found there was no negative correlation coefficient (page 56). This view, as stated in the body of the Interim Report, is not consistent with the Commission's econometric analysis section of the report, which states that the "interchange fee also has a significant impact on the cardholder fee, albeit the elasticity is (in absolute terms) much smaller than –1 which indicates a non-perfect "pass-on" by the issuing banks" (Annex 5, page 14).

In this context, RBSG notes that it charges credit cardholder fees in respect of less than 1 per cent of its customers in the UK and that cardholder fees in general are very uncommon in the UK market. Given that this is the case, a straight comparison between cardholder fees and interchange fees in the UK would provide no meaningful information. Further, even if cardholder fees were a feature of the UK market, the Commission's approach would still not provide a meaningful insight into the impact of changes in interchange fees as it fails to take into account the full range of services and benefits offered to cardholders. By way of example, a lower interchange fee might result in a variety of outcomes other than an increase in cardholder fees. These outcomes might include higher interest charges on credit card borrowing or a reduction in cardholder benefits (such as a reduction in the interest free period, the removal of loyalty programmes etc). A reduction in cardholder benefits might have a similar impact as an increase in cardholder fees, yet would not be reflected in the Commission's high-level analysis.

For these reasons RBSG does not consider that any meaningful conclusions can be drawn from a simple comparison of interchange fees and cardholder fees in the UK. Whilst the experience of RBSG outside the UK on this issue is more limited, RBSG would expect similar difficulties to arise in other jurisdictions.

The Commission has also made a number of other findings that, although they may hold true for some jurisdictions in the EU, are not applicable to the United Kingdom. Examples of such other findings include:

- Some large merchants in specific sectors may benefit from special interchange fee rebates (page 24).
- Merchant-specific interchange fees are common for Visa and MasterCard schemes (page 23): RBSG notes there are no merchant-specific multilateral interchange fees in the United Kingdom.
- Co-existence of preferential ("on us") interchange fees and general fallback interchange fees create market entry barriers for foreign banks (page 31): RBSG confirms it does not participate in such arrangements.

In addition, RBSG has some specific comments in relations to more discrete Commission observations, analysis and conclusions.

In footnote 46 at page 26, the Commission defines a joint MasterCard/Visa issuing market that does not include three-party schemes such as Diners Club, American Express and JCB. RBSG is of the firm view that, via its participation in the MasterCard and Visa schemes, it competes directly with the services provided to cardholders by Diners Club, American Express and JCB. There is established and fierce competition between the three-party and four-party schemes in the United Kingdom and RBSG sees no sound basis in the Interim Report for departing from this commercial reality and concluding that these schemes do not compete with one another.

The Interim Report refers to the Office of Fair Trading ("OFT") decision that interchange fee arrangements infringe competition law, but that they might be allowed if the fees were set on the basis of costs incurred by issuing banks for providing card-related services (page 32). RBSG notes that this decision has been set aside by Competition Appeal Tribunal.

Summary of response to Question 3

In summary, RBSG believes that the Commission's approach to calculating profitability is too simplistic and, for the reasons stated above, the Commission could not have reached a meaningful analysis of RBSG's profitability based on the information provided. In any event, RBSG firmly considers that interchange fees are an essential component of card payment systems in the UK and they ensure an economically efficient scheme to the benefit of merchants and cardholders. This is inherently pro-competitive.

Question 4:

Are the high profits observed due to innovation or do they arise from some kind of market power in a two-sided industry?

As indicated above, RBSG considers that the Commission's profitability analysis is not sufficiently robust to support the assertion that profits are, in fact, high. Even if this were not the case, RBSG considers that both card issuing and card acquiring in the UK are characterised by development and innovation and steadily lowering costs to both cardholders and merchants.

Question 5:

What pricing practices, rules and legal provisions distort price signals to consumers and the choice of the most efficient payment instrument?

RBSG considers that four party payment schemes are very efficient arrangements that benefit cardholders, merchants and social welfare in general. In this regard, the price at which services are offered to merchants and acquirers reflects their respective demand characteristics and reflects the value each attributes to participating in the scheme. This maximises output and ensures that card schemes are efficient. RBSG is not aware of any empirical studies that consider the marginal social costs and benefits for both merchants and cardholders. It doubts the economic validity of comparisons between actual and optimal use of alternative payment mechanisms that fail to consider these costs and benefits in full. In short, RBSG considers pricing to both cardholders and merchants to be transparent and that there is no distortion of price signals on either side.

Question 6:

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

At a practical level, RBSG does not allocate central costs [see our response to question 3 at D.1.1. (2) above] and would therefore not be in a position to set pricing by reference to its actual cost levels. At a theoretical level, RBSG is a commercial undertaking and must therefore make an adequate return on capital. Accordingly, if RBSG's payment instrument activities were required to be priced solely by reference to costs, with no prospect of an adequate return (either in absolute terms or relative to other business areas), RBSG would need to withdraw from such activities and use its capital in more productive ways. In addition, a purely cost-based approach to setting pricing would not be in the interests of consumers or merchants because it would ignore the market signals affecting demand. Such signals serve as a key factor affecting the price of payment instruments and RBSG believes that, as outlined in our response to Question 5, these price signals operate efficiently without distortion. This view is also consistent with the findings of Rochet.[3]

Question 7:

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

Without further specification of the pricing practices to which the Commission refers, RBSG is unable to comment in relation to this issue.

D.2. Market Structures, Governance and Behaviour

Question 8:

What market structures work well in payment cards?

In our experience, there are advantages of four party schemes (that are characterised as having a number of issuers and acquirers competing for business) over three party schemes. Four party schemes offer a better product for cardholders than do three party schemes because:

- they have widespread acceptance (both domestically and internationally) and allow open entry to both issuing and acquiring activities resulting in greater choice for the cardholder;
- the community of purpose between four party schemes fosters innovation, often based on technological developments;
- they are a better product for merchants due to the consistently high service levels and lower MSCs;
- they create more competition as they allow small banks and other institutions to participate; and
- they encourage participants to develop interoperable standards thus enhancing efficiency.

[3] Rochet, "The Interchange Fee Mysteries", p. 142.

Question 9:

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

See our response to question 8.

Question 10:

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

In general, we believe that the attributes of accessibility and transparency facilitate competition within and between card payment systems.

Question 11:

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

Issuers and acquirers deal directly with users and are therefore best placed to know their needs and demands. The best governance arrangements to incentivise payment card schemes to respond to the needs of users are those arrangements which give issuers and acquirers the opportunity to influence the card payment schemes to ensure that the services provided by the schemes evolve in ways that continue to meet these user needs.

Question 12:

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

One arrangement employed effectively in the past to allow minority members greater participation and access, has been the practice of smaller members grouping together and electing a representative to sit on the board and represent their common interests.

Question 13:

What access conditions and fees are indispensable?

RBSG believes that it is critical that the schemes retain the ability to set proportionate risk-based membership criteria. A number of operational and financial risks need to be successfully managed by both the payments scheme itself and all of its members. Because risks are transferable, and members of schemes operate interdependently, the imprudent actions of one member could adversely affect all other members of the scheme. This risk of contagion requires the adherence of all scheme members to the same high standards. If even one party in the payment system network is unable to meet its financial obligations (for example because of lack of capital or ineffective operational procedures) then this can lead to serious shortfalls in liquidity for the other participants, provoking a domino effect and potentially causing the collapse of the whole system. Payments systems are crucial to maintaining financial stability and the impact on the economy as a whole if a system were to fail could be devastating. In order to maintain public confidence in payment systems the existence of risk based criteria for entry to the system is essential. The types of risk-based criteria that the schemes need to be able to maintain are e.g. ones relating to financial solidity (solvency and liquidity), operational and security controls and general risk management. At the same time, adherence to these criteria must be supervised by an appropriate regulator. RBSG strongly considers that consumers and merchants alike would not benefit from any relaxation of these necessary safeguards.

Question 14:

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

There are several models that facilitate competition/efficiency which can be equally effective. The potential benefits usually identified with the separation between scheme, infrastructure and financial activities are the ability to attract investment into infrastructure from sources other than the owners and scheme members, removal of conflict and more choice. However, where there is competition that already drives efficiency and innovation, as in the existing four party schemes, there is no obvious case to press for separation. As can be seen from the outcome to date of the UK's Payment System Task Force Working Group for LiNK, a clearer division of roles and responsibilities will suffice to resolve these perceptual issues. This solution will still allow the systems to benefit from the greater communication and efficiencies which are derived from keeping the entities linked.

In our opinion therefore, the most effective way for the Commission to address specific instances of possible anti-competitive behaviour would be to raise the issue directly with the relevant schemes. This route would be preferable to the Commission attempting to harmonise scheme structures across the whole EU, which would stifle competition in markets whose schemes are not comparable by either size or type of participant.

D.3. Future Market Developments

Question 15:

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

Yes. A major example of this is MasterCard's recent IPO (Initial Public Offering) where MasterCard International moved from being a private company to a Public company. MasterCard International's shares were floated on the New York Stock Exchange on 25 May 2006.

Question 16:

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

Two initiatives currently being progressed are prepaid cards and contactless cards and both these innovations are designed to replace cash transactions. Prepaid cards are ones where the value is loaded on the card before it is issued to consumers. Examples of such products are money-transfer cards, gift cards and cards used as payment for services.

Contactless cards and the related technology are expected to revolutionise the way transactions are conducted/expedited at the point of sale. Rather than the need for a card to be swiped/inserted into a terminal, the related radio frequency technology means that the card only has to be touched onto a point on the terminal for the authorisation/data capture processes to be effected.

As new technology continues to be introduced, the industry will need to maintain high standards over issues such as data security and account verification. The business control environments of banks will respond accordingly. For example, contactless cards represent a shift away from the traditional cardholder verification process at point of sale terminals, so the industry will need to consider limiting the value per transaction to contain the risk of fraudulent losses.

D.4. Potential Solutions to Market Barriers

Question 17:

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

RBSG observes that open markets facilitate competition. The UK market is open to any bank that wishes to issue or acquire credit or debit cards, with entry eased by the ability to outsource a range of operations. Since the advent of duality and banks commencing acquiring in their own right in 1989, both competition and innovation have increased dramatically. We use the term "duality" in relation to when the banks became able to be members of both MasterCard and Visa. Both cardholders and merchants have reaped significant benefits since the advent of duality, with benefits for the latter including reduced MSCs and improved customer service.

Given the advantages of an open market, RBSG would welcome further action by the Commission to remove significant structural barriers where these exist within EU payments markets. We would wish to see a similar open regime to that in the UK adopted across all of Europe: a level playing field is a pre-requisite to effective competition.

In respect of other European markets, RBSG first observes that the structure in many cases appears to be a legacy from when the schemes were first established. Although we accept that these structures may have been necessary when the card markets were in their infancy, and indeed have been in place previously in the UK, they become less and less appropriate as the markets mature. As such, we believe that it is now appropriate for many of the legacy structural barriers to be removed.

In our view the existence of sole/joint venture acquirers (which were indeed in place in the UK until 1989) fosters neither competition nor innovation. The practice highlighted in the report of shareholder banks conceding low interchange rates to "their" acquirer is obviously a barrier to new entrants, which makes it extremely difficult for new entrants to make an economic return. It appears that some other countries are finding that the sole/joint venture acquiring model is not an effective one and are making structural changes and we would welcome efforts by the Commission to encourage such moves in all EU countries.

Further, the Interim Report criticises legacy peer-to-peer clearing arrangements, such as those used in the former Switch national debit scheme. However, this barrier to new members' entry has been eliminated in the UK following the migration of Switch to Maestro, which also ended the use of proprietary data standards. Since this migration, a number of new members have joined Maestro in the UK, including an acquiring-only member. Related to this, the fact that UK debit cards are now almost exclusively one or other of the global debit card brands (Maestro or Visa debit) is in line with the SEPA initiative, of which RBSG is very supportive. The fact that there are many issuers and acquirers in these schemes leads to high levels of competition and good services for cardholders and merchants.

Question 18:

Are there compelling justifications for the identified possible behavioural barriers to competition?

Clearly, we agree with the Commission that behavioural barriers restrict competition and should be discouraged. Imposing conditions such as higher interchange fees for non-domestic operators, prohibitive membership requirements and excessive joining fees reduces the ability of members to join schemes and compete in providing payment card services.

In our opinion, the most effective way for the Commission to address specific instances of possible anti-competitive behaviour would be to raise the issue directly with the offending scheme(s). This route would be preferable than the Commission attempting to harmonise scheme rules across the whole EU, which would stifle competition in markets whose schemes are not comparable by either size or type of participant.

Question 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?

The existence of national standards need not in itself be a barrier to entry to a market. The key issue is how freely the standards are available and how any related certification process is enforced. Certification should not be used as a means to prevent new entrants from joining the market, so needs to be carried out by a truly independent body rather than an organisation controlled by the incumbent players. Any costs should be reasonable and applied evenly.

By way of example, the UK APACS communication protocols - which are mentioned in the report - are available for a nominal fee (which is no doubt the reason why the protocols have been adopted in other countries). Even so, the protocols themselves are not mandatory. Indeed, some larger merchants require their acquirers to use bespoke protocols instead.

In this light, it can be seen that the creation of a new independent standards body is neither required nor necessary.

We would also like to refer to the APACS response to this question.

D.5. Lessons for SEPA

For clarity, RBSG's responses to Questions 20 to 25 are made specifically in relation to the payment cards sector.

Question 20:

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

The experience in the UK has been that the cost of operating a national system is high and is not commensurate with the benefits. Increasingly, consumers are demanding the ability to use their card globally so the card issued under the national scheme badge needs to be co-badged with an international scheme badge anyway. This leads to high costs, as the card needs to meet both national and international technical standards. In the UK, we have taken the consequence and migrated from the domestic Switch debit card brand to Maestro. As a former Switch issuer, we believe that this move has been a success and has been well received by our customers. We understand that the decision has similarly been taken in Belgium to move away from their domestic debit card brand and believe this trend is a natural evolution.

We would also like to refer to the APACS response to this question.

Question 21:

How could competition between schemes in SEPA be strengthened?

The movement to SEPA should enable the current vigorous competition between the international card schemes in relation to credit cards to be extended to debit cards in all European markets.

We would also like to refer to the APACS response to this question.

Question 22:

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

We refer to our response to questions 17 and 18 and would also like to refer to the APACS response to this question.

Question 23:

What governance requirements should SEPA schemes meet?

Both issuers and acquirers should be able to influence the SEPA card schemes given that they are the entities that deal with the users, i.e. consumers and merchants. This reduces the risk of scheme rules being skewed in favour of issuers (who tend to be the greatest in number). Concerns that the needs of smaller members are not taken into account are best addressed via the existing practice of allowing smaller members to elect a collective representative to sit on relevant scheme/industry boards and committees and to represent their common interests.

It should also be recognised that common membership of competing schemes produces positive results. As natural competitors, MasterCard/Maestro and Visa have an interest in developing bespoke standards in order to gain commercial advantage over their rivals. However, the fact that the schemes have common membership ensures that the schemes do co-operate on non-competitive issues, e.g. common technical standards and fraud prevention. The establishment of the EMVCo standard - a pre-requisite to the successful roll out of chip card technology - and 3D Secure (MasterCard Securecode and Verified by Visa) are prime examples of the latter. Any move to prohibit common membership of competing schemes should therefore be resisted.

We would also like to refer to the APACS response to this question.

Question 24:

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

We refer to our response to question 19 and would also like to refer to the APACS response to this question.

Question 25:

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

We believe that current competition laws should be sufficient to deal with any competition issues. As regards scheme governance, we believe that this already operates in a pro-competitive fashion and therefore additional regulation is not required. Finally, interoperable standards have been successfully implemented by the schemes as a result of market pressure exerted on them via issuers and acquirers. We do not believe that regulation would enhance this process; indeed, regulation is more likely to slow the process and make it more inflexible than it currently is.

We would also like to refer to the APACS response to this question.

E. ADDITIONAL ISSUES RAISED IN THE REPORT

This section addresses a number of additional issues raised in the Interim Report that were not specifically covered by the questions in Section D, namely:

E.1. Merchant charges

E.2. Cardholder fees

E.3. Cross-border competition

E.4. Interest free periods and float in POS card transactions

E.1. Merchant Charges (Chapter 5)

RBSG has responded to the Commission's observations on merchant charges under the following headings:

1. differential merchant charges; and
2. blended merchant charges.

E.1.1. Differential merchant charges

The Commission observes that there may be differential MSC pricing for smaller merchants as compared to larger merchants (see, for example, page 35)[4]. In this regard, the Commission observes that its analysis has certain limitations as "It does not take into account other merchant-specific characteristics such as, for example, the better risk rating associated typically with larger merchants, which, where of relevance for the analysis, may lead to somewhat biased results." (page 35). In practice, RBSG considers there are sound justifications for any differentials in the level of MSCs it agrees with its merchant customers and that, in this context, the limitations in the Commission's analysis are of fundamental importance.

RBSG's practice is to individually negotiate MSCs with each merchant, reflecting a wide range of different factors and risks. These include, but are not limited to, the type and size of the business, the trading history and the profile of card transactions accepted, all of which vary greatly. Examples of the latter include:

- average transaction value;
- mix of credit and debit cards;
- mix of consumer and commercial transactions;
- mix of domestic and international transactions;
- mix of face-to-face and card-not-present transactions; and
- card scheme mix.

These factors can, and do, result in RBSG charging small and large businesses different MSCs. In simple terms, larger merchants tend to be charged lower MSC rates because, for example they process far greater card volumes, which in turn deliver economies of scale to both the merchants themselves and the acquirer. Larger merchants also tend to have a very different risk profile. Further, it is quite common for different businesses within the same retail sector to be charged different MSCs, thereby reflecting the actual business of

[4] On this point, RBSG observes that the Commission states (at page 37) that the main international networks appear to give larger merchants similar relative discounts on MSCs as compared to smaller merchants. The Commission has also observed, at page 38, that "smaller merchants on average receive much less favourable treatment form the main international networks (MasterCard and Visa) in terms of fee rates." In this regard, RBSG would emphasise that it is the individual banks (i.e. acquirers), and not the networks, that set MSCs.

each individual customer. For instance, the acquirer of an up-market city restaurant would expect to see high average transaction values (ATVs) and a high proportion of corporate cards. In contrast, the acquirer of a suburban restaurant would expect lower ATVs and a mixture of consumer credit cards and debit cards. These two restaurants will have very different risk and transaction profiles and accordingly it is unsurprising that they would be charged different MSCs, despite both businesses being classified as restaurants.

For these reasons, any attempt to draw conclusions from average MSCs charged across Europe, as the Commission seeks to do, is fraught with difficulty. The Commission's analysis of average MSCs by merchant sector grossly oversimplifies the complex internal decision-making process undertaken by banks, such as RBSG, and cannot accurately or meaningfully reflect the position in individual Member States. In summary, as merchant-specific characteristics are central to the negotiated level of MSCs, the inability of the Commission to have regard to those characteristics in its analysis fundamentally undermines the validity of any observations drawn by the Commission from that analysis.

E.1.2. Blended merchant charges

The Commission has observed that the practice of blending MSCs is common across the EU-25 (pages 43-44). RBSG would observe that although it does engage in blending, a large proportion of the transactions in relation to which RBSG provides acquiring services are not subject to a blended MSC.

Where RBSG does blend MSCs, it does so based on sound commercial and economic justifications. In the experience of RBSG, the UK's largest acquirer, simplicity of offer is often key for smaller merchants. In this context, the main factor in determining whether MSCs will be blended is the volume of card transactions processed from an individual merchant. Where the volume is low, as is typically the case with smaller merchants, any limited potential costs savings for the customer are usually insufficient for the merchant to justify the increased complexity (in terms of negotiations and contracts) of moving from a blended MSC.

In this connection, the Commission notes at page 44 that whether a multi-national bank blends MSCs varies according to each jurisdiction it is active in. In this regard, the different behaviour in different countries is likely to be a direct result of the banks adjusting to the competitive conditions in the specific jurisdictions and, in particular, merchant demand. Where merchants demand blended rates, RBSG will offer blended rates. Where merchants demand separate rates, RBSG will offer separate rates. This is normal competitive behaviour.

E.2. Cardholder Fees (Chapter 6)

The UK credit card market is the most dynamic in Europe and is fiercely competitive. This is reflected by the fact that the four types of fee identified by the Commission (fee per card, card issuance fee, fee per transaction and account statement and billing information fee) are rarely if ever applied to normal consumer cards - credit or debit.

Payment cards for businesses (as well as super premium cards for the very high net worth consumer that offer a host of other value-added services) is a niche market and has completely different characteristics to the mass market for consumer cards. Fees for business cards can and do vary, reflecting the different product characteristics. Business and normal consumer appetites to pay for services are completely different. The former are much more willing to pay a fee to benefit from the value-added services that payment cards bring to their businesses (including, of course, a willingness to pay an MSC for accepting card payments).

E.3. Cross-Border Competition (Chapter 12)

The UK banking community in general and National Westminster Bank (which became part of RBSG in 2000) in particular were the prime movers behind the creation of the Visa and MasterCard cross-border and central acquiring licensing regimes. The initial demand for the service came from a leading international airline. Other airlines followed suit and continued lobbying saw the rules expanded to include other parts of the travel and entertainment sector (e.g. car hire and hotels), leading to today's focus on e-commerce in general.

Whilst cross border/central acquiring can satisfy the needs of larger merchants and the e-commerce sector - where payment is largely made by MasterCard and Visa cards - it does not allow acquirers to offer a full service to other merchants. The key to doing so is the ability to acquire national debit card transactions, as merchants - particularly smaller businesses - are unlikely to have relationships with more than one acquirer. Given that these merchants only want to have one acquirer, unless RBSG is able to acquire transactions for domestic debit schemes on a commercial basis, it is not able to acquire transactions for the international card schemes either. As the Interim Report finds, this presents a number of significant challenges.

E.4. Interest Free Periods and Float in POS Card Transactions (Chapter 15)

As the Interim Report recognises, the UK has the most developed credit card sector in Europe. Given this, it is surprising to see in the Interim Report that the Commission considers that the answer to the question "Do the majority of banks surveyed distinguish between MC/Maestro, Visa/V Electron for free funding period" (Table 10) is "not clear".

The Interim Report defines free funding period as "The time delay … between… a POS transaction … and the time the issuing bank debits the cardholder's bank current account" (page 130). However, the Request for Information itself did not ask for this information. Issuers were in fact asked to provide the average delay (number of days) between the day of POS transaction and the day when:

1. the funds are transferred to acquirers; and

2. the day when the cardholder's account is debited [split into (a) top 10%, (b) bottom 10% and (c) total client base].

With a few exceptions (Graph 77, page 137), UK issuers have provided the Commission with the delay between the transaction date and posting to the cardholder's **credit card account** rather than the cardholder's **bank current account**. The great majority of credit card products do have an interest free period and the majority of cardholders pay their bills in full every month. The conclusions in this chapter - and any other conclusions that have been drawn from them - are therefore invalid, at least as far as the UK is concerned.