FEEDBACK FORM

Public Consultation of the European Commission on the Interim Report I Payment Cards June, 2006

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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): Academic Research

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Participated in the questionnaire:

- Yes
- No

A. Motivation and General Comments

0. Economic history provides a lot of examples for processes moving in incremental steps but sometimes changes occur in a significant jump. This is true for technological developments as well. Very often it turns out that inventions offer dramatic increases in the set of opportunities for economy and society. The monetary sector too has been dramatically transformed by techznical progress. The strategic dimensions of such developments especially the evolvement of the monetary sector are of great interest for us, as for many years we have been working in this field.[1]

[1] There is a monograph forthcoming Hanns Abele, Ulrich Berger, Guido Schaefer, on payment technology in the Euro-area; recently published is Guido Schaefer, “Money, Trust, and Banking”, Palgrave Macmillan, Houndmills, Basingstoke and New York, 2005; a research programme was formulated in “Towards a neo-Austrian Theory of Exchange”. In G. Schwödiauer (ed.), Equlibrium and Disequilibrium in Economic Theory. Dordrecht 1977.

Although we support the goals of the European Commission as stated in the “Interim Report I Payment Cards” we are convinced that the effort of the Interim Report and the theoretical and empirical information collected is not sufficient to support the conclusions stated in the Report and even more the policy ideas put forward may even be counterproductive with respect to the stated goals. Because of the importance of the redesign of the European payments sector we feel urged to take part in the discussion process the European Commission has initiated and therefore submit the following comments.

1. Consent has been established about the importance of settlement technologies for trade and exchange in economies with division of labour. In general the European Commission expects a great cost saving potential in these activities and argues that lowering of costs especially Interchange Fees and abolishing competitive barriers is the policy response necessary.

2. In accordance with the theoretical literature the Interim Report views the payment cards industry as an example of a complex system of interactions. It represents a network industry whose structure is summarized under the heading of a “two-sided market” model. Consequently quantitative information about the interaction of all participants is needed for a comprehensive analysis and evaluation of all aspects. Especially benefits and economic welfare cannot be judged correctly from the standpoint of one interested party alone. Without such an informational basis even the best intended policy measures by regulators may lead to unwanted results failing to reach improvements.

3. The Interim Report reviews empirical work indicating that payments using cards is comparatively cost efficient. The existence of different forms of payment side by side indicates that the choice of a specific technology by the trading partners is not governed exclusively by cost deliberations. Thus considerable doubts are induced by relying on a unifying cost oriented approach. Further difficulties in evaluating differences in prices are fostered by the huge differences in the economic and social situation in the enlarged EU of 25 members. In important areas integration has just begun and the variations to be found are still huge. However, experience has shown that market pressure can lead to speedy adjustment.

B. Financial analysis of the industry

Issuers and Interchange Fees

4. In a payment card network costs and benefits are unevenly distributed among cardholders, merchants, issuers, and acquirers. To make networks viable and more efficient interchange fees have the essential function of restoring the economic balance between the participants. By collecting

interchange fees from merchants through acquirers the substantial cost burden arising from issuing cards can be spread more evenly among cardholders and merchants. Economic research has clarified this essential role of interchange fees in payment cards networks. However, the research also shows that an exact determination of the appropriate rate hinges upon a large number of parameters whose values are virtually impossible to determine empirically. Still, in the Interim Report the European Commission expresses concern about possible anti-competitive uses of interchange fees, arguing that the rates may be too high. The fees are considered as a possible means to transfer revenue from price insensitive merchants via acquirers to the issuing banks that collectively set the fee and face only limited competition from other card systems or other means of payment. The Commission provides several pieces of evidence to support its view. We think that major problems exist in this analysis such that one cannot draw any definite conclusions about competitive effects of interchange fees based upon the evidence provided in the Interim Report.

Economic factors other than competitive restraints can explain fee differentials between countries.

5. The Interim Report interprets the variation in the level of interchange fees among EU countries as a possible indication for the lack of competition in some card systems. However, the Commission does not take into account any differences between countries in terms of taxes, productivity, wage levels, market size, network size, quality of services, maturity of networks, payment habits etc. Clearly, all those factors cause a substantial variation in the level of interchange fees across countries. As long as they are omitted in the analysis one cannot conclude that competition related factors play a major role for explaining fee differentials between countries.

Higher interchange fees and cardholder fees may be required to cover higher issuing costs rather than yielding extra profits.

6. According to the Commission issuing banks might not pass on the benefits of higher interchange fees to cardholders but earn excessive profits. This conclusion is mainly derived from the supposedly weak negative correlation between interchange fees and cardholder fees across EU countries. However, the same national factors causing fee differentials will also tend to move interchange fees and cardholder fees in tandem, thus creating a positive rather than a negative correlation between the two fees. E.g., higher taxes, higher wage costs, higher quality of service, smaller, less mature networks and markets will all tend to raise the overall cost of the card scheme in a given country. Hence they will tend to increase both interchange fees and cardholder fees, thus creating a positive correlation between the two fees from a cross-country perspective. Because the Interim Report does not take into account these factors, one cannot conclude that banks do not pass on higher interchange fees to cardholders.

The data on profits appear unreliable and are inadequate to simulate the abolition of interchange fees.
7. Comparing profits across countries requires a unified method of collecting data. Otherwise differences in measurement will get confounded with true differences in profits. In the Interim Report the data on profits were collected by relying upon country-specific accounting data and by letting firms themselves decide about the allocation of revenues and costs. Hence there is no common basis for calculating profits, e.g. how depreciations are accounted for, how common costs are allocated in multiproduct firms, or how taxes are treated. The profit data may also contain systematic biases as issuers are likely to be more affected by the problem of allocating common costs. Taxes seem to have been neglected completely, such that profits get overstated. All in all the quality of data on profits is doubtful and one should be careful to base conclusions upon such evidence. This point gets confirmed by the apparent lack of any relationship between profits and the organization of the industry in section C of the Interim Report. In addition to these data problems a one-year perspective is insufficient to gauge the profitability of long-term investments in the payment cards industry.

8. It is impossible to assess the impact of an abolition of interchange fees on issuers' profits by subtracting current interchange income from current profits as is done in the Interim Report. An interchange rate of zero would lead to a major restructuring of the payment cards industry. Complex simulations would be necessary to assess the changes in prices and quantities at the various levels of a payment card network. Hence one cannot conclude from the analysis of the Interim Report that an abolition of interchange fees would leave most issuers profitable.

Merchants and Merchant Service Charges

9. In the Interim Report the European Commission expresses concern about higher merchant service charges for smaller merchants as compared to larger merchants because such differences may be due to the anticompetitive behavior of acquirers.

Economic factors other than competitive restraints can explain fee differentials between small and large merchants.
10. Differential terms for large customers versus small customers are a standard feature in many markets widely regarded as being competitive. Differences in cost, risk etc. can explain such differential treatment. Also in the payment cards industry the relative importance of such factors has to be assessed before any conclusions can be drawn about the role of competition for explaining differences in merchant service charges.

A coherent policy approach requires showing that lower merchant service charges lead to a reduction in consumer prices.

11. Any policy proposal envisaging a decrease in interchange fees and merchant service charges beyond the market-driven rate reductions during the last decades also has to demonstrate convincingly that merchants will reduce consumer prices in response. Otherwise such a policy initiative might result in a mere increase in merchants' rents at the expense of consumers which contradicts the basic principles of EU competition policy. The analysis in the Interim Report does not touch upon this fundamental point although methodologically a cross-country comparison of the relationship between merchant service charges and consumer prices as in other parts of the report would be analogous. From such an analysis one would have to expect, however, that differences in productivity, taxes, country size, openness, market structure etc. are far more important determinants for explaining national price levels in EU countries than differences in merchant service charges.

C. Market structures, governance and behaviour

Organisation of the Industry

12. In the Interim Report the European Commission is concerned about several features concerning the organisation of the payment cards industry in various countries which might promote the restriction of competition.

The organization of the payment cards industry appears largely unrelated to its profitability.

13. The Interim Report fails to identify a relationship between profits and various structural features of the payment card industry in the EU countries. Even basic factors such as industry concentration appear largely unrelated to profits. E.g., the banking industry is regarded as being most competitive although issuers' profits are the highest according to the Interim Report. Hence either organizational features are irrelevant in the payment cards industry or the analysis of profits as performed in the Interim Report is insufficient. In particular, a multiproduct perspective on the pricing of banking services may be necessary to understand better the payment card industry. If transaction accounts and cards serve as a means for attracting customers in order to cross-sell other more profitable products, banks may even be willing to make losses on transaction accounts and cards such that the organization of the card industry becomes relatively unimportant for explaining pricing. This view also weakens the case for regulatory action in payment card networks.

The conclusions about "sole acquirers" owned by issuing banks are not supported by the analysis in the main text.

14. In the final conclusions of the Interim Report the European Commission hypothesizes that high profits of issuers due to high interchange fees are related to the existence of "sole acquirers" owned by issuing banks. However, the role of sole acquirers is not systematically analyzed anywhere in the Interim Report. Hence such a conclusion cannot be supported by the evidence.

D. Future market developments and lessons for SEPA

15. Due to their specific economic nature efficient networks will always exhibit some features which are coordinated by forces other than competition. However, pockets of competition in a network retain an essential role to ensure overall economic discipline and to promote efficiency and innovation. The fundamental design challenge is to find the right mix between competitive and collectively coordinated elements. From this perspective four-party payment cards systems contain more competitive elements than alternatives. It is not surprising that they have gained much wider market acceptance than alternative systems, creating a world-wide settlement technology which today is supposed to be more efficient than cash. Commonly determined legal and technical standards as well as collectively set interchange fees were an essential part of this development, driving rather than inhibiting progress.

16. Still, public authorities have become concerned about the substantial gain of market acceptance of payment cards, fearing possible abuses of market power. Calls for rate reductions beyond the market-driven reductions which have taken place during the last decades have sometimes resulted in direct regulatory intervention cutting rates below the existing levels. We have doubts about the wisdom of such policy initiatives. The case for an abuse of market power has not yet been made in a convincing manner. Also in the Interim Report analytical problems abound as we have pointed out in our comments on the consultation. One important step to obtain more solid results would be to take better account of the many differences currently existing between EU countries such that the variation of systems is not interpreted from a one-eyed competition perspective.[2]

17. Furthermore, payment cards systems are so complex that an outside regulator is unlikely to possess the knowledge necessary for efficient direct intervention such as rate setting. This regulatory approach faces major obstacles to achieving its goals. Rather it makes sense to ensure that the pockets of competition in payment cards networks remain effective by developing further a market framework

[2] Technically speaking, to avoid the currently existing omitted variables problem in the econometric analyses of the European Commission, additional control variables better capturing the national differences unrelated to competition should be introduced.

fostering competition and efficiency. As issuing banks coordinate interchange fees, they have a pivotal role in a card system. Hence competition in the banking sector is key. Even though the Interim Report concludes that concentration in the banking industry is currently no matter of concern, EU wide initiatives to deepen further the integration of national financial sectors and of payment systems in particular remain important. The SEPA project can play a constructive role in this context.

18. SEPA is viewed by the EU as a companion step to and of similar importance as the introduction of the euro. Under the guidance of the Eurosystem an integration of the separated national markets and solutions are attempted relying predominantly on self-regulation and market driven processes. SEPA has a much broader scope than card payment including credit transfer and direct debt transactions as well. The Eurosystem is involved in the process of designing the systems and products to be used with the start of SEPA relying, however, on the European Payments Council (EPC) for the essential design work. This represents a more market driven approach than it seems to be the position of the Interim Report which may lead to conflict. While the European Commission states overall support for EPC's effort it raises doubts about the competitive effects of standards be they national or international. These controversies underline the need for sound analysis to understand better the economics of payment cards networks. It is our conviction that only by such an approach policy can achieve progress for society.

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!