NON-CONFIDENTIAL VERSION

BARCLAYS BANK PLC RESPONSE TO

THE INTERIM REPORT ON PAYMENT CARDS OF 12 APRIL 2006

1. EXECUTIVE SUMMARY

Barclays fully supports the ambition of the European Commission to remove barriers to competition in the EU retail banking sector. The development of a Single European Payments Area will encourage more competition in financial services, as well as enabling consumers and businesses to obtain more benefits from the advantages of a Single Market.

Barclays views the European Commission's Interim Report as a useful first step in identifying obstacles to competition at domestic and cross-border levels. Barclays agrees with the European Commission that the following issues require concerted, co-ordinated action by all stakeholders:

- Open and harmonised technical standards need to be developed to make it easier for merchants to accept cards from multiple schemes; and
- Country-specific rules, regulations or practices that make it difficult for new entrants to compete need to be addressed.

In addition Barclays believes the following issues must be addressed:

- The lack of availability of common credit data in some Member States makes it difficult for new entrants to assess the creditworthiness of new customers; and
- The encouragement of the development of those aspects of the Single European Payments Area which are market-driven and customer-oriented.

However, Barclays is concerned that the European Commission has not undertaken sufficiently robust analysis to assess the profitability of debit cards, credit cards and merchant acquiring. The European Commission has not defined the market and has used an inappropriate methodology to assess the impact of interchange fees and profitability. In particular:

- Debit cards were examined without an adequate consideration of their role as part of the current account offering;
- Credit cards were examined without sufficient consideration of their significantly different function to debit cards, in particular the lending aspect of the card, the higher costs, and the enhanced benefits to merchants;
- There is insufficient analysis of the effect of alternative forms of payments available (e.g. cash, cheques, store cards and automated payments); and
- The European Commission used a spurious measure of profits that does not reflect how businesses, or other competition authorities, assess

profitability. It also exaggerated profitability by completely ignoring the cost of financing investments in a payment card business.

Credit cards have been a UK success story, with its consumer credit market being one of the most competitive in the world and also an engine for economic growth. Consumers, businesses and the UK economy as a whole have benefited. The challenge for the European Commission is to remove the unnecessary barriers to competition found in some Member States without inadvertently undermining this success story.

2. BACKGROUND

The European Commission ("**EC**") published its interim report on payment cards on 12 April 2006 ("**Interim Report**").[1] The deadline for responses to the Interim Report is 21 June 2006.

Barclays Bank plc ("**Barclays**") responded to the EC's 18 July and 9 August 2005 "Payment Cards Request for Information", on 6 and 16 September 2005. Barclays also answered follow-up questions from the EC on 22 September and 11 October 2005.

3. STRUCTURE OF RESPONSE

Barclays sets out its response to the Interim Report below, which is structured as follows:

- An introduction setting out general remarks relating to Barclays activities in the sector and sector developments;
- Areas of agreement;
- General feedback; and
- Feedback on financial and economic analysis.

In the interests of keeping this response as short as possible, Barclays has not commented on all the points raised in the Interim Report. Any silence on a particular point should therefore not be interpreted as any indication that Barclays agrees with any statements or analysis set out in the report.

4. INTRODUCTION

Barclays is a UK-based international financial services group engaged primarily in banking, investment banking and investment management. In terms of assets employed, Barclays is one of the largest financial services groups in the EU. Barclays has been involved in banking for over 300 years and operates in over 60 countries with more than 110,500 permanent employees. For more information about Barclays, please visit www.barclays.com.

Barclays believes strongly that measures that enable banks to operate as easily in their home Member State as in other Member States will benefit not only consumers, but also businesses and the EU economy as whole. Such measures must enable, rather than prevent, the market to find the optimum solution. Regulation, which may bring unintended consequences, should only be considered as a last resort and after careful impact assessments.

[1] The Interim Report is published pursuant to the EC's sector inquiry on retail banking, under Article 17 of Council Regulation (EC) No 1/2003.

The payment cards sector is an area of retail banking which has developed in very different ways across the EU, particularly on the debit card side. However, the EC should note that the most widely accepted, most technologically advanced, and most convenient form of consumer payment, is the payment card (in particular, the credit card). Many of the developments including, most recently, the introduction of EMV Chip + PIN, have occurred without the intervention of central banks and regulators.

Barclays welcomes the EC's decision to look into payment cards in more detail. It is, however, a monumental task to look at acquiring, debit card issuing and credit card issuing, across 25 different countries. Barclays urges the EC to focus on those areas, geographic or otherwise, where competition could be improved for the benefit of all parties.

5. AREAS OF AGREEMENT

5.1 Market Fragmentation

Barclays agrees that market fragmentation should be addressed, in particular, by:

5.1.1 *Barriers to entry*

Amending or removing national payment scheme rules which may restrict new entrants from competing, such as local establishment requirements. Barclays notes that the UK banking sector has welcomed new entrants, with payment systems allowing access to participants where reasonable payment system risk criteria are met.

5.1.2 *Harmonisation of technical standards*

The European Payments Council ("**EPC**") is in the process of setting up working groups to deal with the harmonisation of technical standards as prescribed by the Single Euro Payments Area ("**SEPA**") Cards Framework.

Barclays has remained fully involved in the SEPA Cards Framework project, which may offer opportunities for increased competition across the whole EU (even though it only covers EUR denominated transactions). SEPA's goal in respect of payment cards is to provide EU citizens with better card propositions, and EU businesses with access to more consumers.

The EPC needs to be allowed to develop technical standards in such a way that all stakeholders, including domestic, European and international schemes, are fairly represented, to ensure that the new standards do not lead to a "preferred" scheme favouring a minority of stakeholders, but rather encourage competition between schemes. Regulatory intervention in setting technical standards should not be required.

5.1.3 *Delivering SEPA*

Barclays believes that self-regulation and market forces are the best approach to delivering the SEPA for cards in the EU. Barclays agrees that technical standards are a significant barrier to cross-border acquiring, and that this has knock-on effects on cross-border credit card issuing (as it inhibits acceptance of all cards). Beyond this, the issues encountered by new entrants are different in each Member State. Further analysis may be needed to identify the real "hotspots" with a view to understanding what, if any, action needs to be taken.

5.2 Acquiring joint ventures

The EC notes that acquiring joint ventures between domestic banks offer merchants a single proposition, in lieu of offering competing propositions.[2]

This finding is consistent with Barclays experience of entering (or attempting to enter) payment card acquiring markets in Member States, other than in the UK.

5.3 Excessive joining fees

The EC finds that the joining fees for certain payment schemes across the EU are set at an excessive level, which may hinder intra-scheme competition by dissuading entrants or raising their costs significantly.[3]

Barclays has encountered one domestic scheme (**[CONFIDENTIAL]**), where the costs of joining (both monetary and technical) outweighed the potential benefits of entering that Member State (in this case, **[CONFIDENTIAL]**).

6. GENERAL FEEDBACK

6.1 Methodology

Generally, the EC's methodology does not fit Barclays business model, in particular:

6.1.1 *Examination of debit cards*

The EC examines the provision of debit cards services without considering the wider retail banking market.[4] Barclays views debit cards as an integral part of its current account service offering. Barclays would expect this view to be shared by other banks across the EU25. As a result, reviewing debit cards in isolation from other current account services may be misleading. Specifically, calculating the profitability of debit card issuing in isolation from the rest of the current account product is inappropriate, because banks do not

[2] See page 92 of the Interim Report.

[3] See page 106 of the Interim Report.

[4] See page 74 of the Interim Report.

generally view the card as an individual product, but as a feature of the current account offering (See paragraph 7.1.4 below).

6.1.2 ***Assessment of profitability***

Barclays assesses its profitability using its return on economic capital, as opposed to the EC's weighted average profit-to-cost ratio methodology (see paragraph 7.1.2 below).

6.2 **Income and profits**

In assessing the income and profits of card issuers, the EC has mainly focussed on interchange and merchant fees in isolation, without considering all other sources of income and underlying costs.

6.3 **Other barriers to entry**

Information asymmetries between new entrants and incumbents represent significant barriers to entry to the issuing of credit cards. These barriers have not been examined in the Interim Report. For example, the biggest single difficulty for a new lender is the lack of data for credit scoring purposes.[5] Whilst this is referenced within the draft Consumer Credit Directive[6] and the EC's Mortgage Credit Green Paper[7], Barclays believes that this is an area worthy of specific attention by the EC. New entrants wishing to set up lending businesses need to be able to assess the creditworthiness of applicants. Lack of common data means that new entrants are significantly disadvantaged.

In addition, the lack of a pan-European fraud database leads to additional costs for new entrants. Barclays notes that card schemes are committed to providing aggregate statistics on fraud to a pan-European anti-fraud database, pursuant to the SEPA Cards Framework.

6.4 **Specific issues to the UK**

Barclays sets out comments on the EC's specific UK observations below.

6.4.1 ***High fees for MasterCard credit cards***

The EC notes that the fees which merchants pay in the UK for accepting MasterCard credit cards, are five times higher than the fees paid for accepting MasterCard debit cards.[8]

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[5] See 'Accentuating the positive: sharing financial data between banks', OXERA paper, December 2005, previously provided to the EC on 3 February 2006 (see e-mail from Alan Ainsworth to Paul McGhee).

[6] Modified proposal for a Directive of the European Parliament and of the Council on credit agreements for consumers amending Council Directive 93/13/EC (COM(2005) 483 final).

[7] 'The Integration of the EU Mortgage Credit Markets', Report by the Forum Group on Mortgage Credit.

[8] See page v of the Interim Report.

Barclays notes that credit and debit cards by their very nature are different products and therefore the costs associated with them differ.

There are also additional benefits to merchants of accepting credit cards (for example, the consumer can make purchases without having the necessary funds in his/her current account at the time of purchase).

6.4.2 ***Barriers to entry for new entrants***

According to the EC, a central acquirer has encountered difficulties entering the UK acquiring market due to the peer-to-peer clearing arrangements of Switch. However, the EC will be aware that the Switch scheme decided to contract out processing and clearing services to MasterCard and rebrand the scheme as Maestro, with effect from 2003. Barclays understanding is that this barrier therefore no longer exists.

Barclays understands that card schemes operating in the UK (Visa, MasterCard and Maestro UK) have membership criteria which are non-discriminatory and are transparent.

6.4.3 ***Blending***

According to the EC, there are instances of partial and full blending of merchant service charge ("**MSC**") rates in the UK (i.e. where the same MSC rate is offered to merchants accepting cards issued in two or more schemes).[9]

Barclays sets out its comments in relation to blending below (see paragraph 7.3.4).

6.4.4 ***Concentration in UK acquiring market***

The EC notes that the level of concentration for acquiring in the UK is quite high despite the presence of a large number of acquirers.[10]

Barclays considers that the market for the provision of acquiring services in the UK is very competitive. Competition is very intense and an increasing number of accounts regularly retender their acquiring contracts.

6.5 General findings on EU Payment Card Sector

Barclays sets out comments on the EC's general findings below.

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[9] See page 44 of the Interim Report.

[10] See page 80 of the Interim Report.

6.5.1 ***Preferential interchange fees***

The Interim Report states that domestic issuing banks may agree a preferential ("**on us**") interchange fee with the incumbent acquiring joint venture, and charge foreign acquirers higher multilateral interchange fees.[11] Such interchange fees and other factors which the EC has listed prevent cross-border acquirers from offering merchants the level and quality of services which merchants require. As a result, merchants cannot serve their customers as they would like to.

However, as the EC acknowledges, this is not a feature of certain Member States, such as the UK, where there is an open market in merchant acquiring.[12]

6.5.2 ***Domestic vs international schemes***

The EC suggests that domestic schemes provide a better value proposition to users than international schemes, by charging lower fees to cardholders and business.[13]

Barclays does not accept this conclusion, as international schemes do not set cardholder or merchant fees. It is Barclays experience that international schemes may offer a better service to their customers than domestic schemes. For example, it was for this reason that Switch members agreed to use the services of MasterCard, rather than a domestic system, to undertake the processing of its transactions.

The operation of typically international "hub-and-spoke" systems, whereby all transactions are routed via a central scheme, will incur a higher scheme cost than the costs of individual bilateral linkages (like the old Switch system). This is because the scheme is doing the work that the individual members would have previously had to undertake. However, the individual members' costs as a proportion of the total cost of an international system, will be significantly lower than the costs of individual bilateral links.

These considerations were part of the analysis undertaken by Barclays when agreeing to the Switch proposals. In addition, in a hub-and-spoke system, technological developments are easier to incorporate and new members are more easily accommodated. The EC appears to have ignored these factors.

In any event, Barclays notes that the work undertaken by the EPC will facilitate competition between domestic and international schemes, as

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[11] See pages 31 and 92 of the Interim Report.

[12] See pages 90-92 of the Interim Report.

[13] See page iii of the Interim Report.

all schemes will operate on an equal footing as "SCF-compliant" schemes.

6.5.3 *Exclusive contracts*

The EC notes that one particular international scheme relies on a seven year exclusivity arrangement with member banks regarding its clearing services for domestic debit card transactions.[14] Although it has not undertaken a detailed examination, the EC implies that such arrangements have an adverse impact on competition, as it is only after seven years that members will be free again to use third party providers for processing services. This analysis ignores that competition authorities generally accept that certain exclusivity terms may be necessary in order to provide schemes with the opportunity to recoup the costs of significant investments, which schemes might otherwise not make.

In the UK, Switch members have benefited from such exclusive arrangements. As part of a competitive process, Switch members chose to use MasterCard as their processing platform, based on the proposed level of investment MasterCard was committing to the platform. Without any exclusivity periods, it is unlikely that MasterCard would have made the appropriate level of investment necessary to facilitate the move away from the old Switch system. However, in any event, Barclays notes that new entrants seeking to use the MasterCard platform are not subject to long term exclusivity arrangements.

6.6 Market definition

The EC findings and conclusions regarding market power are not based upon a rigorous market definition. It is widely accepted that a competitive assessment must be based on a correctly defined relevant market.[15] Pursuant to the conclusions it appears that the EC implicitly assumes that credit and debit cards compete in separate markets. However, the EC does not provide any analysis to substantiate this assumption.[16]

For instance, market definition in this sector must take into account the interaction of different types of payment cards with the use of other cash and non-cash payments. In particular, Barclays concurs with the finding of Guibourg and Segendorf that current tariff structures of payment instruments, in

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[14] See page 93 of the Interim Report.

[15] See Commission Notice on the definition of relevant markets for purposes of Community competition law, Official Journal C 372, 09/12/1997.

[16] The EC has previously left open whether individual types of payment cards form separate markets (for example, see paragraph 52 of the Visa Decision, OJ 318/17).

particular cash, may not provide sufficient incentives to stimulate use of the most efficient payment instrument.[17]

For example, in the UK, the retail banking sector has been subject to significant on-going scrutiny by not only regulatory and competition authorities, but also consumer groups. In particular, pursuant to the review of the interchange fee arrangements for LINK[18] by the UK Office of Fair Trading ("**OFT**"), the interchange fee for ATM withdrawals has been set as cost-based. In addition, as a result of consumer pressure, UK consumers are usually not charged for cash ATM withdrawals[19] and cash transactions. This results in UK consumers not receiving price signals reflecting the actual cost of using cash, which makes it difficult to move to cheaper card-based instruments.[20]

7. FEEDBACK ON FINANCIAL AND ECONOMIC ANALYSIS

The EC concludes that it is likely that the lack of competition and market integration, and in particular barriers to entry, contribute to high prices and to a skewed pricing structure.[21] Barclays believes that these conclusions are flawed as they incorrectly infer a lack of competition from the evidence cited, and uses inappropriate methodologies for assessing competition.

7.1 Profitability analysis

7.1.1 *General*

The EC reaches a number of conclusions regarding the existence of market power in the provision of payment card services, solely from its analysis of profitability.[22]

In particular the EC concludes that:

(1) Payment card services profitability is high and persistent over time, suggesting that this might be a result of the existence and exercise of market power;[23]

(2) Profitability is higher for issuing than for acquiring;[24] and

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[17] See page 11 of the Interim Report.

[18] Case CP/0642/00/S LINK, Decision 16 October 2001.

[19] The LINK ATM network allows both free and charging ATMs. 96% of all cash withdrawals are free and at the majority of ATMs in the UK there is no charge for cash withdrawals when using a debit card or ATM card (see www.link.co.uk).

[20] For example, cash spending still accounts for 33.75% of all retail spending (high street and online) in the UK (Plastic Card News, APACS, May 2006).

[21] See pages iv-vi of the Interim Report.

[22] See page 68 of the Interim Report.

[23] See pages 68 and 77 of the Interim Report.

[24] See page iv of the Interim Report.

(3) The finding on the profitability of payment card issuing casts doubt on the assumption that, in the absence of a positive interchange fee, issuers could not recoup their costs.[25]

It is generally recognised in competition policy that conclusions on the state of competition in a market should not be drawn from such evidence in isolation. In addition, the EC's conclusions are flawed for the reasons set out below.

7.1.2 ***Average profit-to-cost ratio vs. return on economic capital***

The EC's methodology is not sound as it assesses profitability using a profit-to-cost ratio before taxes ("**profit ratio**").[26] This measure does not reflect Barclays business practice (Barclays assesses its profitability using its return on economic capital), and is not normally used in competition law practice. For example, as set out in its report 'Assessing profitability in competition policy analysis' ("**OFT Report**"), the OFT prescribes that the return on economic capital should be used.[27]

Economic activities typically have a pattern of an initial investment followed by a stream of revenues in subsequent periods. In this context, a profitability assessment should involve calculating the rate of return obtained on investments in an economic activity over a time period and comparing it to an appropriate benchmark.[28]

In this regard, economic and financial literature suggests that Internal Rate of Return ("**IRR**") and Net Present Value ("**NPV**") are the conceptually correct measures of profitability of an economic activity.[29] The IRR is a discounting mechanism, which discounts the future cash-flows of a project by an amount equal to the initial outflow (i.e. the investment). Implementation of the IRR (or NPV) concept requires high-quality information on cash flows and the value of assets. However, when the quality and the structure of the data does not allow estimation of the IRR, under specific conditions, accounting rates of profitability (e.g. return on sales ("**ROS**"), gross margins, return on capital employed ("**ROCE**"), return on equity ("**ROE**")) or market valuations can be used as proxies for the IRR.[30]

[25] See page 77 of the Interim Report.

[26] See page 63 of the Interim Report.

[27] See 'Assessing profitability in competition policy analysis', Economic Discussion Paper 6, July 2003, a report prepared for the Office of Fair Trading by OXERA.

[28] See paragraph 1.12 of the OFT Report.

[29] See paragraph 1.4 of the OFT Report. For competition policy purposes, IRR is more convenient because it returns a measure which can be easily compared to the cost of capital which is also expressed as a percentage.

[30] See chapters 3 and 4 of the OFT Report.

For example, the OFT and the UK Competition Commission ("**CC**") have used return on capital as a measure of profitability when assessing the state of competition in a relevant market. In effect, without necessarily accepting this particular application, the CC has applied a return on employed capital IRR proxy for assessing profitability.[31]

The profit ratio used by the EC is not an accounting rate of profitability usually used by competition authorities to assess profitability. Furthermore, the EC does not offer a justification for using this profit ratio as a proxy for IRR in the context of the payment card services.

Given the central role of the profit ratio in its analysis and conclusions, the EC must show a well-established theoretical link between the IRR economic concept and the proposed (accounting) profit ratio in order for its conclusions to have economic significance.[32]

7.1.3 ***Errors due to divergent cost allocation***

The EC appears to have made errors and omissions in the implementation of its proposed profit ratio. It is likely that the EC's profit ratio produces biased profitability estimates due to the absence of a uniform cost-allocation methodology. The EC considered the respondents' allocation of costs and revenues as reliable on the basis that such respondents know their businesses.[33]

This approach is flawed because the EC ignores the potential effect of respondents making different assumptions on their cost allocation, which may lead to (a) inaccurate estimated returns, and (b) a significant variation in returns across countries, schemes and institutions.

7.1.4 ***Product offerings***

The EC has failed to take account of the way in which payment cards are offered to customers. For example, debit cards are offered as part of a package of current account services. The EC ignores the fact that debit cards are just one aspect of current account services. This artificial allocation of costs and revenues does not reflect actual business strategies, and the resulting measures of profitability have no economic relevance.

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[31] See Chapter 2 (Conclusions, page 64) of Competition Commission Report on 'The supply of banking services by clearing banks to small and medium-sized enterprises'.

[32] See page 41 of the Interim Report. The financial literature shows that it is possible to establish a theoretical link between the IRR economic concept and accounting rates of profitability such as ROCE.

[33] See page 41 of the Interim Report.

7.1.5 *Ratios and returns*

Even if the EC had rigorously implemented an adequate methodology, the analysis of profitability would still be flawed and incomplete as it would not compare the observed profit ratio with an appropriate benchmark.[34]

In general, a complete profitability analysis requires the comparison of the estimated IRR with the relevant costs of capital and the IRR of appropriate comparator activities.[35]

In the case of payment cards, the estimated profit ratio has to be compared to the opportunity cost incurred in investing the required capital for the provision of payment cards, and to the profitability observed in similar competitive industries.

Therefore, given that the EC does not compare the proposed profit ratio against such comparators, there is no basis for concluding that observed rates are "high" or "low".

It seems, though, that the EC implicitly might be comparing the profit ratios to weighted averages and/or medians of this ratio across countries and schemes.[36] Specifically, in comparing interchange fees across Member States the EC finds that (a) credit card acquiring businesses are relatively profitable and issuing business are very profitable at the EU-25 level,[37] and (b) acquiring and issuing of credit cards are more profitable than issuing and acquiring of debit cards.[38]

In relation to the comparison between acquiring and issuing, it is clear that issuing and acquiring are very different activities. There is no reason to expect that the acquiring activity's profit ratio is an appropriate benchmark for assigning the issuing profitability. Equally, there is no reason to expect that the profit ratio used by the EC would be the same for both activities.

In the same way, the comparison of credit card profitability to debit card profitability is meaningless. Further, as noted above, measuring the profitability of debit cards in isolation is meaningless.

[34] See paragraphs 1.40-1.43 of the OFT Report.

[35] In similar way, a proxy measure such as accounting rates of return should be compared to observed results for comparator activities.

[36] See pages 64, 66, 72 and 74 (graphs 44 and 47) of the Interim Report.

[37] See pages 64, 67 and 68 of the Interim Report.

[38] See pages 71 and 73-74 of the Interim Report.

7.1.6 *Failure to consider relevant business cycle*

The EC concludes that the high profits allegedly identified are "persistent", without considering the relevant business cycle. The EC should have assessed the extent to which profitability can be attributed to the stage of the macroeconomic business cycle as opposed to other factors, such as a lack of competition in the market.

Although the EC is aware of the relevance of economic cycles,[39] it has not (a) considered the full business cycle and (b) "controlled-for" the impact of the business cycle on profitability. Specifically, the EC calculates profit ratios only for a short period that necessarily does not coincide with the relevant businesses cycle.

7.1.7 *Sole reliance on profitability analysis*

Conclusions on the state of competition in a market should not be drawn from profitability evidence in isolation from other significant factors and market conditions. Profitability should always be assessed in conjunction with other competition indicators, such as structural and behavioural market conditions. The EC profitability assessment does not include such analysis.

Furthermore, where the assessment indicates that profits are in excess of the appropriate benchmark(s), it is necessary to verify whether this profitability is due to a lack of competition, or whether it reflects other factors such as superior efficiency or temporary profits in a dynamic market. The EC does not analyse any of those aspects.

In addition, the EC concludes that the differences observed in the profit ratios of some top issuing institutions in the same country appear mainly to reflect a different level of efficiency and not a fierce competition in price.[40] However, the EC should not draw conclusions about the state of competition simply from a correlation between cost structure and profitability.

7.2 Necessity of an interchange fee

The EC finds that issuers in the majority of Member States would, on average, *ceteris paribus,* enjoy positive profits if interchange fees were reduced to zero.[41] In light of this, the EC concludes that income from cardholder fees and interest rates would make issuing profitable in the absence of a positive

[39] See pages 65, 66, 68 and 76 of the Interim Report.

[40] See page 68 of the Interim Report.

[41] See page 70 of the Interim Report.

interchange fee.[42] However the analysis is flawed for the reasons described below.

7.2.1 ***Wider impact of reduction in interchange fees***

The EC analyses the impact of a change in interchange fees, with an assumption that all other variables would remain constant. This ignores the fact that a reduction in interchange fees would have wider impacts, leading to changes in issuers' costs and other sources of revenues. For example, a zero interchange fee might lead to a necessary increase in cardholder charges and thus to a decrease in demand for and usage of credit cards, cardholders revenues and total profits. This could have the unintended consequences of:

- A reduction in retail sales following a reduction in credit availability;
- Increased costs of credit, as less flexible forms of credit may be used as alternatives;
- Increased fraud, as less secure forms of payment, such as cheques and cash, will be favoured;
- An increase in the use of three party (closed loop) schemes, including but not limited to American Express and Diners Club. This has already been seen in Australia, where interchange fees have been subject to regulation;
- A reduction in acceptance of international and European schemes (due to a fall in cardholder numbers);
- Reduced choice, flexibility and convenience for consumers; and
- Reduced innovation and investment in card payment infrastructure. The continued development of EMV Chip + PIN and secure e-commerce technology, which are both important ingredients in SEPA, are dependent on the continuation of the current, successful, payment card business models.

7.2.2 ***Reduction of competition***

Even if the underlying methodology was correct, the EC's analysis would imply that a large number of issuers would exit the market. Specifically, the EC finds that if interchange fees were zero, 62 out of 100 institutions would remain profitable.[43] However the EC ignores the impact on the 38 institutions that would not be profitable. Following the EC's reasoning, those institutions would have to exit the market,

[42] See page 70 of the Interim Report.

[43] See page 70 of the Interim Report.

which would in turn reduce competition and, therefore, consumer choice.

7.2.3 ***Lack of benchmark***

As explained above, the EC's profit ratio needs to be compared with an appropriate benchmark to reflect the cost of investments in the relevant activity. The EC is implicitly using a benchmark of zero. In other words, it is suggesting that card issuers should receive no return on their significant investments in their business. Barclays only invests in areas where it can make a return on economic capital.

7.2.4 ***Inconsistency with Visa decision***

In addition to the methodological and analytical flaws of this exercise, the EC analysis contradicts its own understanding of the market. In its 2002 Decision, the EC held that the interchange fee should pay for services supplied by issuers to merchants.[44] The EC's suggestion now that cardholders should fund these costs, is inconsistent with its previous analysis.

7.3 **Price levels and structure: Comparison of interchange fees and merchant fees and across schemes**

The EC concludes that price levels and structures indicate that the market for payment cards services is not working effectively in some Member States.[45]

However, as in the case of the profitability analysis, the EC methodologically and analytically ignores the likely contribution of different market conditions (i.e. supply, demand, institutional and regulatory conditions) that might impact prices and their structures. In particular, an appropriate analysis of the impact of the state of competition on price levels and structures should take into account (i.e. "control-for") other significant factors.

It seems that the EC's inferences about the relationship between price levels (and structure) and the state of competition are not based on this type of analysis. The absence of this analysis is particularly evident in the following findings.

7.3.1 ***Divergences in interchange fees***

The EC suggests that strong country divergences in interchange fees and between merchant segments may provide indications that interchange fee levels could reflect the existence of market power in certain Member States.[46]

[44] See paragraph 98 of the Visa Decision.

[45] See pages iv-v of the Interim Report.

[46] See pages 32 of the Interim Report.

Specifically, the EC applies a cross-country comparison and finds that differences between countries in the prices charged to businesses for card acceptance and to consumers for card issuing are significant. The EC thus concludes that (a) the differences in prices might result from a lack of competition, and (b) that the size of these differences indicates the potential for a price reduction in certain Member States.

The above conclusions about the state of competition have a common flaw. Namely, the EC's economic analysis ignores the impact of country-specific and scheme-specific factors on price levels in each of the Member States. These factors can distort the current tariff structure of payment instruments (including payment cards). The example of UK consumers not facing the costs of cash withdrawals and transactions is set out above (see paragraph 6.6). Therefore without any analysis of the impact of national factors on prices, the EC might not be in a position to identify a causal link between prices and the state of competition.

7.3.2 ***MasterCard vs. Visa***

The EC finds that Visa's cross-border interchange fees have been falling and have been lower than MasterCard fees. The EC suggests that one of the most likely explanations for the above pattern is the adoption of the Visa Decision, which set an annual ceiling on the interchange fee for each subsequent year up to 2007.

However this comparison does not provide any insight regarding the competitive constraint imposed by the Visa regulated interchange fees on MasterCard's interchange fee. The EC cannot assume a priori that the regulated market "mimics" a competitive market. For example, if MasterCard believes that the Visa fee was set at a sub-optimal level it would be rational for MasterCard to create a differential between its interchange fee and Visa's, in order to encourage more card usage. MasterCard would have to balance this against the competitive pressure from acquirers whose merchants may be, or may be threatening to be, disincentivising MasterCard usage.

Specifically, the EC should put forward evidence that shows that the economic welfare before the 2002 Decision was statistically significantly lower than the economic welfare after that Decision and that the increase in welfare resulted from that Decision. The EC has not conducted such analysis.

7.3.3 ***Differentials between large and small merchants***

The EC finds that there are differences across schemes in the price differential between large and small merchants. It suggests that small merchants may be paying a "premium" for accepting MasterCard and Visa cards and that this provides evidence of market power.[47]

The EC, however, reaches the above conclusion without fully analysing the economic reasons for such a price differential. In fact the EC ignores the possibility that "large" and "small" merchants categories might be highly non-uniform across schemes in terms of turnover (e.g. large merchants in international schemes might be significantly larger, on average, than large merchants in other schemes) and volume. Therefore, if the costs of servicing merchants vary with turnover, and if large and small merchants vary in size across schemes, a non-uniform price differential between these categories across schemes would be expected.

7.3.4 *Blending*

The EC indicates that the blending of acquiring prices is a frequent phenomenon across the EU-25.[48] The EC suggests that blending may weaken inter-network price competition, which in turn may lead to businesses paying higher MSCs.[49] However, the EC should analyse the extent to which price blending is not efficiency and cost oriented. This might be the case, given that the acquiring business is a commodity-type service and merchants can switch relatively easily between acquirers.

In addition the EC does not consider the possibility that merchants might prefer blended prices. If merchants did object to blended prices it is not clear why they have not switched to acquirers that do not blend fees, or why acquirers have not offered "unblended" fees to attract those merchants.

7.3.5 *Analysis of high interchange fees*

The EC alleges that, in countries with higher interchange fees, issuers enjoy higher levels of profitability. The EC concludes that this suggests that a higher interchange fee does not necessarily reflect higher costs of issuing.[50]

However this rudimentary statistical analysis does not necessarily indicate that higher interchange fees are the main *cause* of higher profitability.

For example, one of the causes of high penetration of credit cards in the UK is due to the wide offering of products available as well as the

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[47] See pages 50-51 of the Interim Report.

[48] See page 43 of the Interim Report.

[49] See page v of the Interim Report.

[50] See page 141 of the Interim Report.

fact that UK consumers have traditionally been less cautious about using credit cards. **[CONFIDENTIAL]**. **[CONFIDENTIAL]**.

7.4 Price structure: Imperfect pass-through between interchange fees and cardholder fees

The EC carries out an econometric analysis to assess the pass-through of (a) interchange fees to card holder fees (i.e. the extent of a negative relationship),[51] and (b) interchange fees to MSC (i.e. the extent of a positive relationship).[52]

In the first exercise the EC finds that that there is no compelling evidence indicating that lower (higher) interchange fees lead to higher (lower) cardholder fees. Specifically, the EC claims that the analysis provides no strong negative relationship between the levels of the two fees at a country level. According to the EC, these results confirm the findings on profitability and may cast doubt on the relevance of the arguments advanced by the industry regarding the role played by the interchange fee.[53]

In the second exercise the EC finds that the level of the interchange fee determines the level of the merchant service fee.[54]

As the EC's econometric analysis fails to include standard robustness checks, the validity of its results must be queried. There are six significant flaws in the analysis which can be summarised as follows.

7.4.1 *Unconventional preferred model specifications*

The EC's preferred model specifications are unconventional because some variables appear with a linear effect and whilst others appear with a non-linear effect on MSCs and cardholder fees. For example, in Tables 10, 11, 12 and 14 of the Interim Report, the interchange fee is included in the model but the *logarithm* of the number of transactions is also included in the model. This means that a change in the interchange fee changes the MSC with a constant number (for example, with -0.31 according to the fourth column in Table 14, i.e. 0.1% increase in the interchange fee causes a 0.31% decrease in the MSC). This is a linear relationship. In contrast, the change in the number of transactions causes a non-linear change in the MSC.

Standard econometric practice requires reporting model specification tests to justify the choice of certain model specifications, which the EC do not appear to have done.

[51] See page 61 and Annex 5 (pages 12 and 14) of the Interim Report.

[52] See page 141 of the Interim Report.

[53] See page 56 of the Interim Report.

[54] See Annex 5 (pages 6 and 12) of the Interim Report.

In general, as a matter of econometric theory and practice, an econometric analysis should be based on the model that best fits the underlying data. The reason is that the chosen model affects the results (i.e. the estimated parameters of the *true* pass-through).

The EC, however, does not explain why this unusual mixed model best fits the data at hand and does not provide the results of testing the proposed model against more obvious specifications (i.e. "pure" linear model and "pure" non-linear models). Consequently, the EC's model specification might not reflect the true relationship between the dependent variable (i.e. MSC or cardholder fee) and the interchange fee.

7.4.2 *Potential measurement error*

Whilst the EC is aware of potential measurement error in important variables used in its econometric analysis, it does not take this into account in the analysis, nor does it mention or discuss this important issue in the analysis

The EC states that it cannot be excluded that there may be errors in the calculated interchange fee for some of the observations included in the data set used for the econometric analysis.[55] If the interchange fee is wrongly measured, this error carries over to the estimated coefficient of this variable and also to estimated coefficients of other variables of the model.

As a result of this potential measurement error, the EC's model might result in a biased estimated coefficient (i.e. the estimated coefficient might overstate or understate the true relationship). Therefore, it cannot be excluded that given measurement errors the pass-trough between, the interchange fee and cardholder fee, is in fact higher than the EC's estimate.

7.4.3 *Range of factors determining cardholder fees and MSCs*

The choice of other factors determining cardholder fees and MSCs is not explained, nor is the exclusion of other factors explained. For example, in the fourth column of Table 16, the only variable that is included in the analysis (in addition to the bank-specific effects) that accounts for unobserved differences between banks, is the interchange fee. This means that the obtained result of -e.g. 0.25 does not take into account the effects of, e.g. marketing costs of promoting credit cards, distribution costs of credit cards, or costs of credit provision born by the issuer. The exclusion of these factors is not explained and not supported by evidence of statistical tests supporting this particular model.

[55] See Annex 1 of the Interim Report.

7.4.4 ***Representativeness of sample***

The study uses only a sample of merchants, rather than the whole population. The sample of the merchant population is constructed by assembling "top" and "bottom" merchants. This sampling raises questions regarding the extent to which the sample is representative of the true population.

However, the implication and interpretation of the results obtained by putting together only "top" and "bottom" merchants in the analysis is not discussed. For example, in Table 11, different estimated interchange fee effects are presented for the "top" merchants and the "bottom" merchants. No explanation is provided as to why these two groups are a representative sample.

7.4.5 ***Exclusion of turnover***

Turnover appears as an equally important factor for MSC in Figure 2 of the Econometric Analysis but it is not included in the econometric analysis. Figure 2 of Annex 5 shows that merchant annual card turnover (the second column) appears as an equally or more important factor affecting the MSC as the interchange fee value (the first column) for five out of six considered networks. In the econometric analysis, no result is reported with merchant annual card turnover as a variable included in the model, explaining MSCs. Its exclusion from all presented models is not discussed and not supported by statistical test results.

7.4.6 ***Significance of the estimated coefficients***

While the EC reports precision tests (statistical significance) of the estimated coefficients, it is not clear whether the standard econometric tests are passed or not. It is widely accepted practice, especially in a competition assessment, that analysis reports should determine the significance of the estimated coefficients. Such reporting would explain whether the estimated coefficients are statistically significant (i.e. statistically precise). In particular it cannot be verified from Annex 5 how the precision of the estimated coefficients is calculated. For example, there is no discussion regarding the possible presence of heteroskedasticity and autocorrelation in the residuals of the estimated models. Autocorrelation is a particularly relevant issue for the dynamic models that have been estimated.

8. CONCLUSION

Barclays accepts that there are competition issues that need to be addressed in order to improve payment card propositions for businesses and consumers. The EC has identified some of these in its report.

However, Barclays disagrees with many of the EC's conclusions, in particular, those concerning the profitability of issuing and acquiring, and the level of interchange fees. Barclays believes that the EC's analysis is significantly flawed in the key area of profitability.

Barclays remains of the view that the EC should refocus on specific areas in which it can influence change that will encourage or enable competition. This may include referring concerns to national competition authorities where it is clear that practices in a particular Member State prevent competition. The EC should also include a more detailed consideration of the availability of credit data for assessing customer risk, which is, in Barclays opinion, the most significant barrier to entry into credit card issuing (and consumer credit in general).

Barclays would be pleased to provide further information on any of its feedback contained in this submission.

Barclays Bank PLC
21 June 2006

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