

## **APACS RESPONSE TO THE EUROPEAN COMMISSION INTERIM REPORT ON PAYMENT CARDS**

### **1. Introduction**

APACS is the UK payments association, a trade association for those institutions delivering payment services to end customers. It provides the forum for the UK's financial institutions to come together on non-competitive issues, to develop banking systems for the future and to provide innovation and developments in payments. It is also the banking industry voice on payments issues such as plastic cards, card fraud, cheques, electronic payments and cash. APACS supplies scheme and project management, business consultancy and secretariat services to the UK payments industry. It is on behalf of UK card issuers and acquirers that this response is made.

We do not believe that the twenty-five questions in the report are appropriate for response from an industry trade association such as APACS dealing as they do with many competitive, pricing and profitability aspects of the industry. Many of these questions are more appropriate for consideration by individual banks. Nevertheless, being fundamental to the interests of our members, we believe that it is legitimate for APACS to comment upon the report in more general terms.

### **2. Competition in the UK Market**

We believe that the UK card payments market - issuing and acquiring – is demonstrably an extremely competitive market:

- an estimated 50 credit card issuers (15 with more than one million cards in circulation);
- an estimated 29 debit card issuers (10 with more than one million cards in circulation);
- over 1,600 credit card products in the market place;
- 8 acquirers;
- 7 international payment card schemes in the UK market (Visa (both debit and credit), MasterCard, Maestro, American Express, Diners Club and JCB);
- 1 national ATM scheme in the UK (LINK).

The UK card payment market has developed through a market driven approach that has led to the relative success of the four-party card payment model compared to the three-party model.

We welcome the SEPA Cards Framework published by the European Payments Council as a valuable assistance in the creation of a competitive, market-driven customer-oriented approach within the European cards market.

### **3. General Observations**

We have a number of concerns regarding the approach of the report and doubt that some of the conclusions reached can be justified on the basis of the information presented. Our response is not intended to be a definitive critique of the report – there are likely to be many other reservations that we have not yet identified – but by way of general observations we make the following comments:

#### **3.1 *Plastic Cards Are More Than Payments Alone***

The report looks at credit and debit cards as isolated payment instruments without reference to the broader product context. For example:

- credit cards are both a payment instrument and a lending product but the influence of the lending element on pricing and profitability is barely mentioned in the report. This is vitally important given the different cultural attitudes to borrowing across Europe and historic preferences in different markets for different types of credit facility.
- likewise, debit cards are a payment and (usually) cash acquisition instrument normally linked to a current account or savings account, often also offering a range of other payment and cash acquisition options. The offering of debit cards as a stand-alone product like credit cards is not a feature of the UK market (although pre-paid cards are emerging as a new product). It is essential that debit cards are placed in the wider context of personal account banking.

Examination of credit cards and debit cards from the point of view of their payment functionality alone is therefore over-simplistic.

Also, cards branded under the Visa and MasterCard schemes need to be considered in the light of their global interoperability, rather than just European or individual country acceptance. Any reduction or limitation in interoperability within, say, a European geographic area (however it is defined) would surely be a retrograde step for consumers, merchants and banks alike.

### **4. Anonymity In The Report**

The report itself is impossible to comment upon in many respects due to the anonymity of countries referred to as country A, B, C...to W (beginning on page 25). This generally makes it impossible to identify any factual inaccuracies on which the report's conclusions might have been based.

In one example where countries have been identified (graph 77) there is a clear and basic misunderstanding and misinterpretation of the data that has been provided that suggests that the interest free period on UK issued credit cards is commonly around two days. In fact, for UK issued credit cards the interest free period can be as much as 56 days if the balance is paid off in full and on time.

Because of the anonymity we have no way of telling which other information relates specifically to the UK market and if it is subject to the same degree of misinterpretation and error.

## **5. Context**

As mentioned above the competitive nature of the UK market has evolved through open competition. However, for open competition to work to optimum levels across Europe there must be a level playing field. There are a number of barriers to competition that have been created by legislators and regulators that are problematic and actively discourage competition that need to be addressed. These underlying issues are probably the major causes behind the differences in e.g. pricing between the various countries. There needs to be a higher degree of harmonisation or commonality of these factors for open competition to work properly.

### **5.1 Local Laws**

Local laws can create additional costs for card providers. For example, the diversity of laws across Europe has been evident in the discussions and debates around the proposed Consumer Credit Directive (of relevance given the importance of lending aspects to product design and pricing) where it is proving extremely challenging to develop a legislative framework with a high degree of harmonisation due to the myriad of different local legal requirements. The Directive fails to address the range of different debt recovery regimes across Europe that can result in different costs on the providers of credit and credit cards when recovering bad debt and which discourages cross-border issuance. In the original draft Directive proposals such as the creation of a duty to advise would actually work against cross-border trade and true competition.

More specifically in the UK, Section 75 of the Consumer Credit Act, known as connected lender liability, creates statutory obligations on credit card issuers by which they are held as equally responsible to the consumer for faulty or non-delivery of goods as the merchant. Recent court cases have established (for the time being at least) that this obligation extends to overseas transactions as well as to domestic transactions, essentially making the UK credit card issuer the insurer of last resort for all transactions made by UK credit card holders anywhere in the world. This is a cost burden that differentiates UK credit cards from UK debit cards, and from credit and debit cards issued almost anywhere else in Europe.

Talking to our colleagues across Europe it is also evident that there are major differences in the way in which initiatives such as the Data Protection Directive have been implemented and interpreted, making it considerably harder in some markets for the industry to combat fraud, or for cross-border co-operation in fraud prevention to work to full effect. With fraudsters having no respect for national boundaries and operating on a global basis it is unsatisfactory that legislation can inhibit fraud prevention activity, which as a cost to the industry inevitably feeds through into pricing.

Although not strictly a legal issue but strongly related to the above, the absence of comprehensive shared credit reference data in many European card markets means lending decisions are made on less robust information, creating a real barrier to competition in terms of cross-border card issuing. In the UK all credit card issuers share information on all credit card accounts to the extent allowed by law. Although shared data is subject to strict controls on how it may be used the ability to see a comprehensive credit record on each potential customer enhances responsible lending and helps reduce costs to credit card issuers arising from bad debt.

## **5.2    *Local Taxes***

Local taxes can create different cost bases for card providers that will inevitably be reflected in their pricing.

For example, in Ireland both credit and debit cards are subject to local stamp duty. The Irish Government has imposed a stamp duty of €10 on debit cards and on ATM cards. Where these cards are combined there is a €20 stamp duty charge. Banks collect this money from their customers on behalf of the government. Stamp duty per credit card account (rather than per card) is €40 per year. This will have a fundamental influence on Irish card issuers' product designs and pricing strategies yet seems to be completely overlooked in the analysis.

## **5.3    *Local Regulatory Interventions***

Product design, particularly relating to elements of the product formulation that generate revenue for the card issuer, is often subject to regulatory intervention within individual countries that will influence the price to the end consumer(s).

For example, in the UK the credit card industry is currently engaged in enforcement action with the Office of Fair Trading regarding default fees on credit cards. The outcome of this intervention, which has seen a general reduction in fees charged to cardholders in breach of their agreement, could result in fundamental changes to products and pricing. Similarly the UK credit card market is subject to a long running investigation of MasterCard's interchange arrangements, which could have equally far-reaching effects. We are aware of other regulator activity on interchange both at European and individual country level.

We have also recently seen intervention relating to the interpretation of Section 75 of the Consumer Credit Act (resulting in an extension to the geographical scope of Section 75, albeit subject to further appeal), the provision of store cards (a product type that the report completely overlooks) and the initiation of an OFT market study into Payment Protection Insurance (PPI).

Similar interventions and impacts can be observed elsewhere. In Ireland, for example, the Irish Financial Services Regulatory Authority will shortly implement a statutory Consumer Protection Code. This is due to be published in July and is expected to include a ban on unsolicited increases in credit card credit limits. As this Code is statutory, this will obviously impact on credit card businesses and their management of credit facilities, creating subtle differences in product design within Europe that will ultimately lead to differences in prices charged to the end consumer(s).

#### **5.4 Local Fraud Experience**

Card payment fraud, often instigated by organised criminal gangs, represents a significant cost to the industry. Unfortunately the UK has for many years been a target for such organised crime. In 2005 fraud losses to UK card issuers amounted to £439m (€606m). The cost of fraud and of fraud prevention activities (such as the one-off development costs for chip & PIN) will be a fundamental component of card issuers' and acquirers' costs and pricing strategies.

Other European markets will have a radically different fraud experience, albeit that it will change over time, the cost of which will be reflected in local market prices to a greater or lesser extent.

We have already mentioned the way in which local implementation and interpretation of data protection legislation inhibits the ability of industry to counter the fraud threat both nationally and internationally.

#### **5.5 Local Infrastructure**

To counter payment card fraud the UK has recently implemented the chip & PIN programme, costing card issuers, card acquirers and retailers in excess of £1.1billion (€1.5billion). Again, the cost of implementing and running the new chip & PIN system and the impact on fraud levels will be a fundamental component of card issuers' and acquirers' costs and pricing strategies in recent and coming years.

Other European markets moving to chip & PIN will be faced with consequent impacts on local costs and pricing strategies.

## **5.6 Local Market Norms and Expectations**

In the UK, and as a result of competitiveness within the industry, pressure from the political establishment and from the media, the typical UK consumer pays no annual fee on credit cards and among the lowest fees (whether annual or transaction based) among comparable banking markets (in fact, most current account banking in the UK is free). It is also the case that virtually all ATM withdrawals through bank-owned cash machines in the UK are free. There is a marked contrast with most other European markets that seem to accept the charging of consumers for banking services much more readily than the UK.

Recent research by APACS and the British Bankers' Association<sup>1</sup> showed annual credit card fees for cardholders in comparable markets to range from 8 to 45 euros. The UK is in the top three in terms of offering the longest interest free period on credit cards and of those four countries that offer a better APR on credit cards than the UK, only one of them does not charge an annual fee of between 16 and 45 euros per year.

Unlike much of the rest of Europe "free if in-credit" banking is the norm and now an established consumer expectation in the UK. Whilst external regulation and commercial pressures might eventually pose a threat to this status quo, this consumer expectation remains a key differential and influence on the pricing of card payments to UK consumers and merchants.

## **5.7 Maturity of Local Payment Markets**

Each domestic payment market across Europe exhibits its own characteristics and profile depending on cultural and historic factors and will be at different stages of maturity, albeit that we see a common move towards a preference for plastic cards at the expense of cash and cheques.

## **5.8 Local Retailer Preferences**

In some countries it appears to be relatively common for merchants to have more than one terminal for accepting card payments, and for the merchant to select a different terminal for a given transaction. From our intimate understanding of UK merchants we believe that they would find such a situation wholly unacceptable. Although only the merchant community can speak for its preferences and requirements we are confident that UK retailers find transaction speed and customer throughput critical considerations, particularly in high volume merchants such as supermarkets.

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<sup>1</sup> A study which compared retail banking costs across a range of countries including the UK, Ireland, France, Italy, Finland, Germany, Sweden, Netherlands, Australia, USA and Canada.

## 6. Governance Issues

The UK trade association model, where APACS co-exists with the international card schemes, allows for active co-operation on non-competitive issues, and is seen as having been a key enabler in the move to a chip & PIN infrastructure. Whilst this industry structure works well in the UK we recognise that it may not be an applicable model across the whole of Europe where other models for the management of fraud and other non-competitive issues have evolved over time.

With regards to SEPA and the development of the SEPA Cards Framework, it is the UK's belief that a market driven approach based on competition is the best way to create SEPA for cards. The UK recognises that there is no future for mainstream credit and debit card schemes that operate exclusively in a single country or, indeed, only in Europe.

## 7. Specific Questions

Notwithstanding the above, there are some specific questions asked among the issues for consultation where APACS is able to provide direct answers, as follows:

*Q7. Do currently existing pricing practices have a substantial negative effect on cross-border card usage by consumers*

The best evidence we have is that card payments are progressively becoming the most popular method of payment for UK citizens travelling overseas, replacing alternatives such as local currency, traveller's cheques etc. There is no evidence that we are aware of to suggest that pricing practices have had a substantial negative effect on cross-border card usage by UK consumers.

*Q16. What are the anticipated impacts on the industry of innovation and technological change?*

No innovation or technological change in a payment system that pervades the whole of society can be undertaken lightly or at little expense. We have just experienced a shift in the UK from signature transactions to chip & PIN at a cost of over £1.1billion. We anticipate that in the near term we could reasonably expect to see the following:

- (i) greater uptake of 3D secure payment technologies such as Verified by Visa and MasterCard SecureCode;
- (ii) deployment of a contactless card payment infrastructure offering benefits of speed and convenience, perhaps for low value payments initially;
- (iii) a token-based remote card authentication infrastructure, offering fraud prevention advantages in the card-not-present arena; and
- (iv) increased take-up of pre-paid cards in specific market segments.

The price that the market will bear for such innovation and the acceptability of such propositions to consumers remains to be determined and will be a matter for individual banks. However, these decisions will be within the context of the already-mentioned convenient and largely "free if in credit" UK banking system.

Longer term we expect to see developments such as mobile-commerce, multi-application payment cards and, perhaps, biometrics.

*Q19. 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?*

Harmonisation of technical standards is only desirable where it enhances competition and enables interoperability. If it fails to do so then it simply represents an additional cost at no benefit and risks possible consumer detriment. We welcome the migration across Europe to the global EMVCo standards for chip cards. We accept that migration to a single terminal-acquirer standard will assist competition and are participating in the discussions on convergence under the auspices of the European Payments Council.

With regard to standards there is a factual inaccuracy on page 116 of the report where it states that the UK's APACS protocols have been developed without any reference to international standards. The latest APACS standards are in fact based upon ISO8583. Earlier versions of the APACS standards pre-dated international standards and therefore had no such point of reference.

Further harmonisation is expected in the light of SEPA.

*Q20. What lessons (best practice) for the design of SEPA schemes can be learnt from existing national and international payment systems?*

Active and intense competition between issuers, between acquirers, between schemes and between processors is central to the future development and health of the European payment cards industry. The design of card schemes is therefore a matter that should be driven by the market, and any regulatory/legislative intervention that impedes competition between schemes will be detrimental to the cardholder and merchant communities.

Even without the industry's drive to create a SEPA for cards via the EPC's SEPA Cards Framework, purely national schemes would not survive competition in the modern Europe – they cannot meet the long term needs of the cardholder and merchants – and regulators/legislators should resist any call to artificially prop them up. The experience of the UK in migrating away from purely national schemes is widely regarded as having brought considerable benefits to all stakeholders.



Of course, if a new pan-European scheme emerges from the joining up of existing national schemes, then the competition it would bring within the market is to be welcomed. But regulators/legislators should avoid any temptation to favour such a scheme against others competing in the market place. Categorising Visa, MasterCard and Maestro as non-European, and somehow as a 'problem', is a fundamental error. These schemes, as well as having an international dimension, are of course the national schemes for a number of European markets – including the UK – and the competition between them in these markets has brought significant benefits to those stakeholders making use of them. Based on the UK's experience of these schemes, we question the often-repeated statement that they are less efficient and more expensive than national schemes.

A modern card payment system will require global reach in order to satisfy the requirements of cardholders, retailers and banks. This is an issue yet to be tackled by those promoting a new scheme or schemes within Europe.

*Q21. How could competition between schemes in SEPA be strengthened?*

Inefficient domestic schemes have survived in some European markets by using rules, technical standards and cross-subsidies in a defensive way (e.g. to make it difficult for foreign acquirers to bring competition into the domestic markets). But this results in a sub-optimal service to cardholders and merchants, who in today's Europe do not want to be artificially limited in their ability to transact by national/regional borders. The EPC's SEPA Cards Framework, with its emphasis on removing such protectionism, is already starting to cause major upheavals. Regulators or legislators should resist the temptation to interfere, but allow competition in the market, aided by the SEPA Card Framework, to drive the process forward.

In this context, debit card schemes should be regarded in exactly the same light as credit card ones; that is, as schemes operating in a competitive marketplace. The competition in the UK between two debit card schemes has been good for all stakeholders and has promoted innovation.

*Q22. Which structural and behavioural barriers to effective competition between banks and payment service providers should be removed to achieve SEPA?*

The SEPA Cards Framework outlines the major areas in which barriers need tackling. This document is well known to the Commission, so we will not attempt to repeat its contents in any detail here. We are comfortable that the Framework defines the major issues which need tackling, and that the EPC is working to provide more detail on some of the high-level statements made within it (e.g. by developing a detailed plan for convergence of technical standards in those areas where such convergence will enable competition.)

*Q23. What governance requirements should SEPA schemes meet?*

The longest section of the SEPA Cards Framework is devoted to a description of the obligations that card schemes must meet if they are to claim to be compliant with it. We believe the Framework correctly describes the governance requirements that SEPA card schemes should meet. The Commission should not fall into the trap of wanting to make one scheme look exactly like another; and should be wary of a loss of diversity being an unintended consequence of over-regulation. The cards industry is not, and should not become, a utility. Difference between schemes is to be welcomed; it promotes innovation and competition.

*Q24. By what means can interoperable communication protocols, security and other technical standards be achieved and certification procedures be limited to the minimum necessary?*

The EPC intends to act as a catalyst for convergence of technical standards in those areas where such convergence is necessary to enable competition. Equally, the EPC (and regulators) must avoid convergence for convergence's sake; this will simply add cost to the detriment of cardholders and merchants. Any new standards created will be handed over to the appropriate standards body for maintenance (e.g. to ISO, CEN etc) and the competing card schemes in Europe will embody the requirement to use such standards in their rulebooks. To see a fundamentally important example of how the process of convergence can work, one has to look no further than the EMV standards.

*Q25. Do the removal of barriers to competition, the observance of pro-competitive governance and the creation of interoperable standards require (further) regulation?*

We do not believe so. However, we would point the Commission to the earlier remarks in our response (section 5 above), where we note that different national characteristics (national laws, taxes etc) are affecting free competition in the European market.

## **8. Conclusion**

APACS is conscious that card schemes and individual banks will be able to provide a more detailed response to the report. Overall, we agree that greater harmonisation and competition in the EU is desirable and have identified above some of the fundamental differences that need to be overcome. Legislators and regulators need to recognise and address those features of regulation that in many instances inhibit competition in the card market.

We would be happy to answer any questions you may have on our response or to visit you to discuss any of the issues raised further.

Yours sincerely

Paul Rodford  
Head of Card Payments  
APACS Cards and Fraud Control Division

## FEEDBACK FORM

Name of undertaking: APACS (the Association for Payment Clearing Services)

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): Trade Association

Address: APACS, Mercury House, Triton Court, 14 Finsbury Square, London, United Kingdom, EC2A 1LQ

Country: United Kingdom

Name of contact person: Paul Rodford, Head of Card Payments

Phone of contact person: 020 7711 6238

Email of contact person: paul.rodford@apacs.org.uk

Participated in the questionnaire:

☒ ~~Yes~~

☐ No

Specific questions from Executive Summary:

### **A. Financial analysis of the industry**

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

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

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3. In view of the apparent profitability of card issuing, is there a generally applicable justification for substantial revenue transfers through interchange fees in card payment systems?

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

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5. What pricing practices, rules and legal provisions distort price signals to consumers and the choice of the most efficient payment instrument?
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6. Would cost-based pricing promote the use of efficient payment instruments and how could such pricing be implemented?
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7. Do currently existing pricing practices have a substantial negative effect on cross-border card usage by consumers?

PLEASE SEE ACCOMPANYING PAPER

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## **B. Market structures, governance and behaviour**

8. What market structures work well in payment cards?
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9. What market structures do not appear to work well / deliver efficient outcomes?
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10. What governance arrangements can facilitate competition within and between card payment systems?
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11. What governance arrangements can incentivise card payment schemes to respond to the needs and demands of users (consumers and merchants)?
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12. What governance arrangements can allow minority participants or minority members to receive appropriate information and participate appropriately in decision-making?
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13. What access conditions and fees are indispensable?

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

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### **C. Future market developments**

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

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

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### **D. Potential solutions to market barriers**

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

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

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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?

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### **E. Lessons for SEPA**

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

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

PLEASE SEE ACCOMPANYING PAPER

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

PLEASE SEE ACCOMPANYING PAPER

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23. What governance requirements should SEPA schemes meet?

PLEASE SEE ACCOMPANYING PAPER

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

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

PLEASE SEE ACCOMPANYING PAPER

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General comments:

PLEASE SEE ACCOMPANYING PAPER

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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.~~

SEEMED INCOMPLETE IN MANY RESPECTS

5. Did the report raised the right policy issues;

~~• yes, covered most of the key issues;~~

• no, there were some significant issues left out.

**Thank you for your contribution!**