MEMO/07/40

Brussels, 31st January 2007

Competition: Final report on retail banking inquiry – frequently asked questions

(see also IP/07/114)

General

What will be the follow-up to the inquiry?

Following the publication of the interim report, several market players have taken voluntary action to address the most serious problems identified.

Where barriers remain, the Commission's follow-up actions will focus on competition law enforcement. The inquiry identifies competition concerns in several areas of retail banking, including:

- barriers and discriminatory rules in payment cards and payment systems markets;
- high payment card fees, including interchange fees and merchant fees;
- cooperation among banks which may restrict competition; and
- product tying by banks which may hold dominant market positions.

On each issue the Commission – together with the national competition authorities (NCAs) – will identify potential infringements and, where appropriate, open an investigation. All such investigations will be entirely separate from the sector inquiry process and only use evidence gathered on each individual case.

What was the result of the public consultations?

Two interim reports were published during the sector inquiry, both of which received extensive and detailed feedback. The Commission is grateful to all respondents for their contributions. The first report, on payment cards and payment systems, was published on 12 April 2006 for a ten week public consultation. This received around 90 responses, mainly from banks and payment card networks. These respondents tended to be critical of the inquiry's methodology and findings on industry profitability and the role and effects of interchange fees. However, many respondents from consumer groups and retailers endorsed the inquiry's analysis in these areas. Public versions of all consultation responses are available at:
http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/rep_report_1.html

The second interim report, on current accounts and related services, was published on 17 July 2006 for a twelve week public consultation. This report received over 60 responses, of which the vast majority were from banks and bank associations. Several respondents criticised the Commission's methodology concerning market concentration and industry profitability and refuted the inquiry's findings of low customer mobility. Public versions of all consultation responses responses will be published shortly.

The Commission has prepared a summary of all consultation responses to the inquiry, which is available at:
http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/

What is the evidence base for the Commission's sector inquiry?

The sector inquiry's findings are derived from extensive pan-European surveys of retail banking markets. The findings on payment cards are based on a survey of around 250 banks providing payment card services; and on a detailed survey of payment card networks throughout the EU. The findings on current accounts and related services are primarily based on a survey of around 240 retail banks, covering well over half of the European market. Additional surveys were made of bank associations, payment infrastructures, credit registers, banking regulators and national central banks.

Although the Commission's findings are based on a sample of the market – with the limitations that implies – the inquiry has gathered a large and rich database which is unprecedented in the EU retail banking sector.

How does this sector inquiry fit with the ongoing work to build an Internal Market for financial services?

The inquiry makes an important contribution to building an Internal Market for retail banking services. Firstly, it provides valuable data on the extent of market integration and fragmentation. Secondly, it highlights a wide range of competition barriers – including entry barriers – that hinder the Internal Market. Thirdly the inquiry has enabled the Commission and Member States' competition authorities to set priorities for antitrust enforcement in order to open markets and strengthen competition. Fourthly, the inquiry's findings on payment cards and payment systems highlight obstacles to the creation of the Single Euro Payments Area (SEPA), which can now be addressed.

Does the inquiry recommend new EU regulation in the banking sector?

The sector inquiry has examined competition in the retail banking sector and considered where the application of competition law can improve the operation of markets. In some cases the inquiry recommends that industry take measures to address the competition problems identified. The inquiry has not considered whether additional regulation is necessary in the retail banking sector.

Current accounts and related services

Which are the main competition problems identified in the inquiry?

Some characteristics of retail banking markets such as economies of scale, the importance of a local branch network, customer immobility and the standardisation and network requirements can function as entry barriers.

From the viewpoint of competition, barriers only raise concerns if they are artificially created through companies' behaviour or regulatory and legislative measures. The inquiry has identified several barriers of the latter category, mainly:

- discriminatory rules, fee structures and governance arrangements that impede access to some payment card networks
- discriminatory rules, fee structures and governance rules hindering access to certain clearing and settlement systems
- discriminatory rules that impede access to credit registers
- product tying practices by incumbent banks in some Member States
- high costs to switch to another bank in some Member States
- supervisory, regulatory and other legislative measures that hinder entry (e.g. takeovers, mergers or entry by foreign banks or takeover of certain types of banks).

Why are retail banking prices and profitability so different across Europe?

Large variations in price levels (e.g. interest rates) and financial performance across the Member States indicate that retail banking markets remain fragmented, largely along national lines. This fragmentation is partly explained by obvious differences at country level, including legal, regulatory and tax systems and language. In addition, the inquiry has shown that key banking market infrastructures such as payment systems and credit registers operate along national lines. Various entry barriers also prevent foreign banks and payment card providers from penetrating new markets. Taken together, these factors explain why retail banking markets are fragmented, and thus why large divergences can persist in banks' prices and profitability across the EU.

Are European banks too profitable?

The inquiry does not take a view on whether the profitability of European banks is too high or low. The evidence suggests that within the long-term trend of rising bank profitability, performance varies considerably across the Member States and returns appear low in some Member States. However, the inquiry has expressed concerns about Member States where there appears to be a conjunction of high market concentration, high profitability and evidence of entry barriers erected by incumbents.

Why is it so difficult for consumers and small businesses to change bank?

The sector inquiry has examined customer mobility only in relation to current accounts. The data suggest that between 5% and 7% of EU consumers changed their current account in 2005. Levels of mobility are generally higher for small businesses. The inquiry has found that several widespread bank practices can reduce customer mobility; for example, forcing customer to purchase extra products (tying), low price transparency and high fees for operating and closing current accounts. The Commission has established an Expert Group on Bank Accounts which is looking further into these issues.

Is the Commission attacking specific business models in retail banking, e.g. the role of savings and co-operative banks in certain Member States?

The Commission is completely neutral regarding business models, company structures and ownership. What matters is that banks - as other companies - comply with the competition rules and do not engage in anticompetitive behaviour and that Member States do not require or reinforce anticompetitive behaviour. The Commission does not promote any particular market structures - as long as markets are characterised by effective competition.

What is product tying and does it weaken banking competition?

Product tying occurs when a bank forces a customer to buy additional products (e.g. a current account or insurance) as a condition of acceptance for another product (e.g. a loan or mortgage). The inquiry has found that such practices are widespread. The inquiry's data suggest that most banks (measured by market share) in most Member States tie current accounts to mortgages and loans to consumers and small businesses. Product tying can weaken competition by making it harder for customers to switch bank. Moreover, tying reduces customer choice: the evidence suggests that where the largest bank ties it products, smaller banks also follow suit. It is possible that product tying by banks holding a dominant market position may infringe competition law. The Commission and NCAs will examine this further.

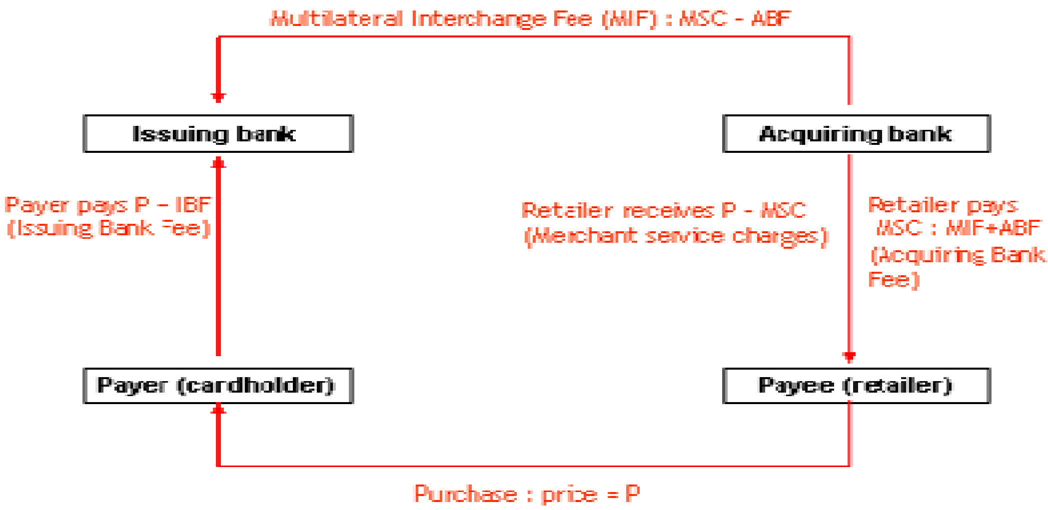
What are credit registers and why can they affect banking competition?

Credit registers collect various kinds of financial data on individuals. Clients of the registers can (subject to data protection rules) access this data for commercial purposes such as bank lending. Banks require access to good quality credit data in order to set lending rates for new borrowers. The inquiry has found that banking competition can be impaired where credit registers set discriminatory access rules and provide inaccurate or incomplete information to the register.

Payments

How does a four-party card payment system work?

Here is a graphical presentation of a card transaction and associated payments:



When a cardholder uses his/her card to pay at a merchant outlet, the merchant receives from the acquirer the retail price less the merchant service charge (MSC). The issuer pays the acquirer the retail price minus an interchange fee (MIF). In addition, the issuer receives cardholder fees, interest payments on any debt outstanding and fees for late payment or other reasons. However, the issuer may offer customers rebates, loyalty rewards or other incentives.

Why a sector inquiry into the payment cards business?

The sector inquiry's aim is to provide stakeholders (customers, financial institutions, regulators and policy makers) with concrete information about possible market failures. It should help to identify issues that require investigation and possibly remedy under the EU competition rules (Articles 81 and 82).

It should set a framework for coordination among National Competition Authorities and the Commission, to ensure coherence between operations at the different levels.

Finally, it constitutes valuable input for the creation of the Single Euro Payments Area.

What is competition in payment cards market?

There are various levels of competition in the payment card markets. First, there is competition between payment networks (such as Visa, MasterCard, Amex, national debit schemes, etc.). Then, there is competition between acquiring banks (who provide the service of card acceptance to the merchants); and between issuing banks (who issue cards to the cardholders). Finally, there is competition between other payment services providers, including providers of processing services and producers of terminals (devices used at a shop to make a card payment).

Is there effective competition in the payment card markets?

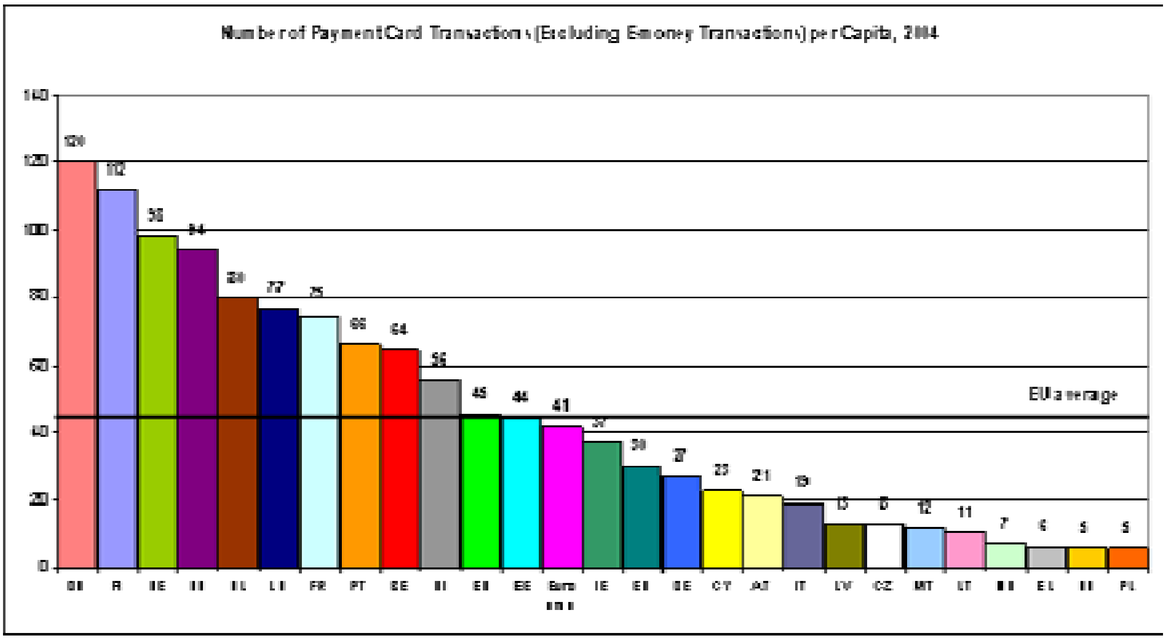
The report emphasizes that the European payment system markets are still mostly fragmented, with little competition at the EU level. Market players mostly compete domestically, with the rare exception of a few international network players, such as Visa, MasterCard and AMEX, who compete at the European level. In some Member States, these international networks face strong competition from national debit networks, which sometimes account for up to 90% of all card transactions. At bank level, the picture is very different, depending on the Member State. Typically in all Member States competition remains strong among issuing banks, while acquiring often remains a monopolistic or nearly monopolistic activity. This effectively limits competition at the level of cards acceptance and results in uncompetitive market conditions, particularly with respect to the level of fees charged by acquiring banks to merchants.

Has the sector inquiry had any impact on competition?

Yes. Some market players have already taken steps to modify the structures and the rules and remove entry barriers. For example, Austrian banks have agreed to review arrangements for setting interchange fees and announced that a reduction can be expected. They will also take steps to foster genuine competition in acquiring between Europay Austria and Visa Austria. In Portugal issuers and acquirers have met some of the Commission's concerns by reducing domestic interchange fees somewhat and removing preferential bilateral domestic interchange fees. These initiatives in Austria and Portugal are welcome first steps. However, the Commission will continue to screen these markets. The possibility cannot be ruled that after careful analysis, antitrust enforcement might still be necessary in these and other Member States.

What is the evidence to support the statement that markets are fragmented?

There are many indications that suggest market fragmentation in the EU. The graph below provides an illustrative example: there are, for example, huge differences in terms of card usage per capita across the EU.

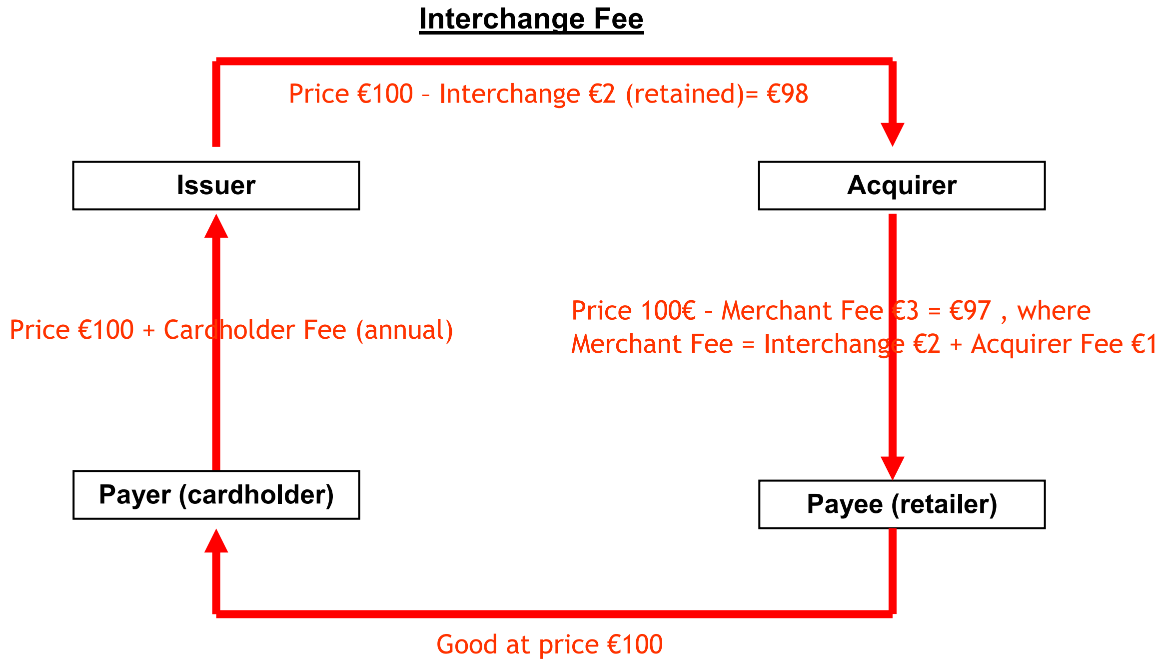


The graph shows that in some countries there are 24 times more card transactions per inhabitant than in others (Denmark versus Poland). Denmark, Finland, Sweden are the countries with the most frequent usage of cards, while in Greece, Slovakia and Poland card usage is still very low. This suggests that card payment markets are not equally developed across all Member States.

What is an interchange fee?

The interchange fee is the fee paid by an acquiring institution (also known as acquiring bank or acquirer) to an issuing institution (also known as issuing bank or issuer) for each payment card transaction at a merchant's point of sale. Acquirers then recoup this fee (as well as other costs plus some profit) by charging a fee to the merchant, called merchant service charge. Thus, the interchange fee becomes the floor to the merchant fee, which is then passed on to consumers in the form of higher retail prices, paid not only by card users but also by customers paying in cash.

Here is a hypothetical example of a card transaction indicating the direction of monetary flows (price of a good is €100, interchange fee is 2%; merchant fee is 3%):



How does interchange affect competition?

The cost of interchange fees ultimately forms part of the retail price paid by consumers. This cost is non-transparent and therefore cannot serve the purpose of a signal to select the most efficient means of payment. Furthermore, all consumers, including those who do not use cards, pay the cost of the interchange fee when it is passed on in the retail price. As a result, we face the problem of so-called 'cross-subsidisation': consumers that use other means of payments indirectly subsidise consumers who use costly payment cards.

Are you proposing to abolish interchange fees?

No, we do not propose to abolish the interchange fee. We are trying to make sure that the interchange fee is set at a fair level as a result of a competitive outcome and the cost of this fee is sufficiently transparent for market participants.

Some networks claim that decreasing the interchange fee would lead to a commensurate increase in cardholder fees and thus make consumers worse off?

There is no economic evidence for such a claim. Firstly, the inquiry's data suggests that in most cases card issuers would remain profitable with very low levels of interchange fees or even without any interchange fees at all. Secondly, the international card networks have failed to substantiate the argument that lower interchange fee would have to be compensated with higher cardholder fees The evidence gathered during the inquiry rather suggests that the pass-through of higher interchange fees to lower cardholder fees is small.

Consumers already pay the cost of the interchange fee without knowing it. This cost is now hidden in the final retail price and is therefore non-transparent. Our objective is to improve transparency, so that consumers know how much and when they are paying for a card.

How does competition work at the retailer level?

Several rules and practices imposed by the card networks neutralise competition at the retailer level. When retailers are obliged to accept all cards of the same brand, when retailers have to pay the same charges even if the usage costs are different, when retailers cannot choose their acquirer, when retailers cannot request a surcharge for the more expensive cards, then cardholders have no incentive to use the most efficient payment instrument. This lack of competition at the retailer level explains also why it is possible to maintain such high fees.

Why does the inquiry criticise networks' practice of blending?

By applying a flat merchant fee to retailers for accepting various brands of cards with variable interchange fees, blending distorts price signals to retailers and discourages price competition between networks. Where merchant fees for Visa and MasterCard are blended to a single fee, price pressure on both networks is reduced.

Are you looking at 'three-party' card networks such as AMEX and Diners Club?

The analysis also covered three-party payment card networks, such as AMEX, Diners Club and JCB. However, given the limited market share of these networks and their specificities, the analysis was not as detailed as that conducted on four-party networks (e.g. Visa and MasterCard). Nevertheless many findings of the inquiry apply equally to three and four parties systems.

What is SEPA?

SEPA stands for Single Euro Payments Area. It is a project of the banking industry, supported by the Commission, and is coordinated by the European Payment Council (EPC), a body created in May 2002 by the European banking industry. SEPA aims to create a single market for payments throughout the euro area by integrating national payments systems. This should permit greater economies of scale and enable cross-border competition. The advent of SEPA will significantly change the landscape for card/non-card payments and related infrastructures in the EU.

The Commission's proposal of 1 December 2005 for a Payment Services Directive (see IP/05/1514) would establish the regulatory framework needed for the creation of SEPA by the industry.

Is the sector inquiry looking into SEPA?

The final report of the Sector Inquiry presents an assessment of the state of competition as resulting from the Commission investigation into existing systems. The competition problems highlighted in the inquiry will provide stakeholders with useful information for a pro-competitive implementation of the SEPA.

Will SEPA improve competition?

SEPA is clearly pro-competitive at the conceptual level. However, stakeholders need to remain vigilant that SEPA is implemented in a way that supports more effective competition and innovation, thus enabling the cost savings to be passed on to businesses and consumers.

Would reducing or abolishing interchange fees jeopardise SEPA?

There are several examples of efficient card networks operating without interchange fees, so they are not indispensable. Together with the European Central Bank, we share the concern that interchange fees of MasterCard and Visa jeopardise the achievement of SEPA. In countries where local banks decide to replace domestic debit cards with MasterCard or Visa debit cards, interchange fees of the international schemes may raise costs for businesses and consumers. The Commission will investigate any situation where the SEPA project is said to price increases. If such developments are due to concerted practices of banks and payment systems, the Commission will use its tool under EU competition law to stop such practices and impose fines.

Why is access to payment infrastructures so important?

Access to infrastructures is important because it enables new payment schemes (providers of payment card services to market participants) to enter markets and provide retail banking services such as current accounts. The creation of alternative payment infrastructures would require substantial investments from new entrants and so discourage them from entering the market altogether.

What is the link between the Sector Inquiry and the Commission's case work?

Prior to the opening of the sector inquiry, the Commission had done substantial case work in the field of payment cards systems. Some of these cases, such as those addressing interchange fee (inter-bank fee paid by acquiring banks to issuing banks) in the MasterCard network and other types of fee arrangement, such as the 'MERFA' in the French card network 'Groupement de Cartes Bancaires', are still open. Experience and knowledge gained by the Commission in these and other cases has enabled more effective scrutiny of specific aspects of the payment card markets. However, it needs to be noted that no evidence collected in the framework of these cases, was ever used for the purpose of the sector inquiry and, of course, vice versa.

What about suggestions that the data gathered in the market investigation into payment cards are inaccurate and unreliable

The market investigation surveyed more than 200 banks and 26 networks in the EU25 over the period 2000-2004. Thanks to the co-operation of each bank and network involved in this exhaustive survey, the Commission has a unique database, coming from the banking and payment industry themselves. For the first time there is solid evidence on an issue that was previously discussed only in theory. As for the size of the sample, increasing the size of the sample from hundreds to thousands would create a disproportionate burden on the industry without significant altering the competition analysis.

Some have suggested that the methodology used to assess profitability in the card payments industry is flawed (e.g. it fails to include costs of capital), so your estimates are unreliable. Is this true?

Data for the calculations of profitability were provided by banks, which know their own business best. And the same measure of profits – which is appropriate for this analysis – was consistently applied across all respondents. The variation in profitability across the Member States is unmistakable. The results show that issuing profitability is more than 10 times higher in some countries than in others. We generally found fairly low profits in acquiring; we therefore doubt that our findings overestimate the real situation. And we find higher profits in issuing, partly thanks to the interchange fee.

How do you react to allegations that the report ignores the effect of different market conditions on prices, e.g. the maturity of the card networks

We accept that different maturity levels of the market may partially explain differences in fees across countries and merchant sectors. But the results also show that other factors are also important; particularly the level of competition. For example in some Member States we see monopoly acquiring joint ventures alongside high interchange and merchant fees.