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ROUNDTABLE ON COMPETITION AND PAYMENT SYSTEMS

-- Note by the Delegation of Lithuania --

This note is submitted by the delegation of Lithuania to the Competition Committee FOR DISCUSSION under Item VI at its forthcoming meeting to be held on 24-25 October 2012.

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ROUNDTABLE ON COMPETITION AND PAYMENT SYSTEMS

-- Note by Lithuania --

1. Since 2011 the Competition Council of the Republic of Lithuania ('the CC') has carried out an investigation on payment cards charges in Lithuania. In the process of investigation we are collaborating with banks and merchants that provide us with valuable information on the payment systems. A part of received non-confidential information shall be used to prepare this paper.

2. Due to the fact that current investigation is not finished yet, the answers provided below should be treated as provisional and should not be considered as the final opinion of the CC.

3. Before submitting answers to the OECD questionnaire on Competition issues in payment systems, the CC intends to give a brief overview of a current situation in this sector in the Republic of Lithuania.

4. In 2011 in total, 20 banks (including 12 foreign bank branches) and 75 credit unions operate in Lithuania. At the end of 2011, AB bank SNORAS activity was suspended and the bank was later liquidated. According to the Bank of Lithuania, the concentration in the Lithuanian banking sector is high: the market share of the three largest banks by assets made up 69.1 per cent in the first quarter of 2012[1], a year-on-year increase of 9.0 percentage points. Rather high concentration is also indicated by HHI, which is 1,966 points (400 points more than in 2011). However, in some market segments, the concentration is even higher: for example, two main banks issue around 80% of all payments cards. Among market players, in 2011, five banks and five foreign bank branches reported profit, while other three banks and five foreign bank branches suffered losses. Foreign branches are required to follow a lower number of prudential requirements (in accordance with the EU common market requirements); therefore, they are considered to have a competitive advantage over the local banks in the domestic Lithuanian market. An entry of e-money systems or other payment systems could enhance the competition in the market.

5. The number of payment cards in Lithuania was around 4 million by the end of 2011, what is down by 8.8 per cent, compared to 2010[2]. This was largely determined by the suspension of activity (and further liquidation) of AB bank SNORAS. The number of credit cards declined considerably more than the number of debit cards. 3.5 million debit cards were used in 2011. Cards issued under Visa scheme dominated both debit and credit cards markets. Over the years, the volume and the value of payments made by debit and credit cards have grown steadily. In 2011, over 100 million payments were made by cards with the value of nearly 7 billion LT. Compared to 2010, the total volume of cards payments increased by 9 per cent, while the value of cards payments rose by 16 per cent. However, many Lithuanian citizens use their payment cards primary to withdraw cash from ATM instead of paying for services or purchases, e.g. in 2011 the value of ATM transactions was 3 times higher than the value of point-of-sale ("POS") transactions. In general, Lithuanian cashless payment system can be considered less developed than in many other European Union countries, for instance, Scandinavian countries. Among other factors, the

1 http://www.lb.lt/information_on_credit_and_payment_institutions_activity_and_their_supervision_in_2011

2 http://lb.lt/review_of_cashless_payments_2011

reason for payment cards market underperformance could be the lack of financial literacy of consumers, as consumers could be better acknowledged how to use progressive payment technologies and what advantages such payment systems can bring to them.

1. Structural conditions

6. The CC has not carried out an analysis of social costs and benefits of different payment systems as well as new technologies, permitting consumers to make payments without a card platform. However, recently the Bank of Lithuania prepared the analysis of the costs of different payment platforms including costs of cash and cashless payment systems. Under the analysis two types of costs were defined: direct costs, resulted from the activities directly associated with a payment service, and indirect costs, associated with bank's overall business. Calculating cash payment system costs, a number of factors were taken into consideration, including ATM maintenance and its depreciation, cash collection and transportation, cash management and storage, fraud control, losses due to robberies and proceedings of customer complaints. For payment cards costs calculations, payment cards authorization, identification, security, marketing, and risk analysis costs were evaluated among other costs. The results of their analysis suggest that in Lithuania cash payments are the most costly and, therefore, the most unprofitable method of payments for banks among all payment systems. Payment cards[3] are cheaper to serve compared to cash, but still they are more expensive than direct debit transactions. Direct debit transactions are considered to be the most effective payment mechanism as their costs are very low. However, consumers use them listlessly.

7. Retail payment systems in Lithuania operate and develop under the Law on Payments in the Republic of Lithuania[4]. It states that payment services in Lithuania may be provided by banks, foreign banks branches, credit unions, e-money undertaking and payments undertakings. In 2011, ten banks (including foreign bank branches) as well as one credit union issued payment cards. Meanwhile, 6 banks offered POS services to merchants with 38 thousand POS being in use. Currently, new payment technologies such as e-money services or contactless payment cards have not reached the large group of consumers. Moreover, national payment cards were never issued in Lithuania. Until 2007, banks, operating in Lithuania, offered only Visa and MasterCard cards. Though, in 2007 Parex Bank (from 2010 onward AB Citadele bank) began issuing and accepting American Express cards in Lithuania[5]. Under an exclusive cooperation agreement between American Express and AB Parex Bank, AB Parex Bank became the sole official representative of the financial services corporation and the sole American Express cards issuer in Lithuania. Among others, AB Citadele bank is responsible for establishing POS serving American Express. As a result, even though at the end of 2011 AB Citadele bank issued only around 18 thousand American Express cards, according to the Lithuanian bank association[6] the bank took rather significant share of the POS market (around 30 per cent). However, the higher competition in POS market has not led to the significant reduction of merchant fees as the service of American Express card remains to be the most expensive among all payment card networks.

8. Considering, the new payment technologies development in Lithuania, the Law on E-money and payment institutions licensing [7] sets requirements for institutions willing to serve e-money in Lithuania.

3 On average, in general tems Lithuanian banks experienced more costs serving debit card than credit cards. However, per transaction one debit cards transacion is seven times cheaper than a credit card transaction.

4 http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=416620

5 The most recent entry in the payment cards area.

6 http://www.lba.lt/go.php/eng/Payment_cards/431

7 http://www3.lrs.lt/pls/inter3/dokpaieska.rezult_l?p_nr=&p_nuo=&p_iki=&p_org=&p_drus=1&p_kalb_id=1&p_title=elektronini%F8%20pinig%F8%20%E1staig%F8&p_text=&p_pub=&p_met=&p_lnr=&p_denr=&p_es=0&p_tid=&p_tkid=&p_t=0&p_tr1=2&p_tr2=2&p_gal=&p_rus=1

Under the law, to get a license to run e-money business the minimum capital (350 thousand Euros) and minimum equity in the venture are required. Owners and managers should be of fine reputation and have the necessary competence. Applying for the license, the undertaking must provide evidences that e-money holders' funds will be protected. E-money should be issued and operated exceptionally in Lithuania as well as the undertaking headquarters should be located in Lithuania. Among others, credit institutions, post offices, allowed transferring money (i.e. giro), and e-money companies are allowed to issue e-money in Lithuania. Recently in 2012, the first company, an e-money company, got permission to issue e-money in Lithuania. The company is currently launching its services.

2. Fees and charges

9. The main charges paid in payment cards system are cardholders charges, paid to a card issuing bank, merchant fees, paid to a card acquiring bank, and interchange fee, paid by card acquiring bank to a card issuing bank. Besides these charges, card networks also charge their own fees both card issuing and card acquiring banks. All mentioned charges are set to ensure efficient market activities. They aim also at balancing the payment cards demand.

10. Since 2008 the overall level of merchant fees has decreased but marginally. In some cases, the merchant fees can be over 2 per cent per transaction, but we suppose that the average fee is around 1.5 per cent in 2011. According to the Bank of Lithuania 17 per cent of total debit cards costs incurred by banks results from transactions processing (authorization and clearing). However, in general, banks do not differentiate merchant fees according to payment cards: debit card charges are equal to credit card charges. In most cases, according to banks, the merchant charges depend on the merchant size (e.g. smallest merchants tend to pay the most), economic sector, POS ownership, and on the intensity of bank-merchant cooperation in other areas. Even so, merchants consider cashless payments more expensive than cash payments, due to merchant fees and POS maintenance expenditures. Faced with the high fees, some small merchants have refused to accept payments cards, i.e. coffee shops. However, it is rather an exemption than the rule. In general, merchants (especially petrol station networks and retailers) feel oblige to accept cards even though they consider the charges as loss making. The reason is that a part of consumers finds more convenient to pay by cards than by cash. Deciding whether to buy a certain product or service, a customer considers not only the product or service itself, but also a number of additional factors such as an ease of payment. If the customer prefers to pay by card, then the merchant refusing to accept the card payment would lose its customer. By loosing its customers, a merchant will suffer losses.

11. Considering interbank charges, on average in Lithuania interchange fee ("IF") is around 1 per cent. Mainly, banks charge 0.94 per cent of transaction value for debit card transactions and 1.07 per cent of transaction value for credit cards transactions. Compared with neighboring countries the level of interchange fees is higher in Lithuania. For instance, on average IF in Lithuania is higher by [0.3-0.6] percentage point compared to IF applied to debit and credit payment cards transactions in Estonia and it is higher by [0.2-0.5] percentage point for credit cards transactions and by [0.3-0.6] for debit cards transactions in Latvia. However, the interchange fees set in Poland are higher than in Lithuania as Polish IF exceeds 1 per cent per transaction.

12. Banks in Lithuania insist that IF is a necessary incomes source for them. They insist that as payment cards issue remains unprofitable[8], abolishment of IF charges would result in higher price for consumers and less investment in new technologies. In 2011, debit cards issuers got 21.7 million LT revenues from IF and credit cards issuers received 2.4 million LT revenues from IF[9]. Even so, small banks

8 In 2011 revenues from payment cards do not cover all direct and indirect costs associated with payment cards circulation. Debit cards incomes covered 75 per cent of costs associated with debit card circulation and 99 per cent of credit cards costs were restored.

9 This also means that in 2011 banks, accepting payment cards, incurred 24.1 million LT losses due to IF.

stress that they do not get profits from IF and operate at a loss. As a result, one small bank in Lithuania does not issue payment cards, as it is too costly for it. Therefore, without carrying out an in-depth cards payments analysis, it is impossible to say whether constrained or limited interchange fees would be beneficial for the Lithuanian payment systems development and the economy.

13. The increase in consumer use of cards had little impact on interchange fees. Initially, until 2000-2002 the DIF (“domestic interchange fee”), set by Visa and MasterCard, was used to reckon among banks. Later, banks started to set IF bilaterally. In Lithuania IF level remained unchanged for almost 7 years until 2011, when banks started to revise their agreements. The supervision and regulation of payment systems is the responsibility of the Bank of Lithuania. The Economics and Financial Stability Service of the Bank of Lithuania[10] is responsible for financial stability policy, monitoring and forecasting of economic processes and a smooth development of financial market infrastructure and payment instruments in Lithuania. However, currently IF, merchant charges and payment cards fees to consumers are not regulated and they are set independently by banks under bilateral agreements.

14. According to the recent study of the costs of different payment systems[11] conducted by the bank of Lithuania, in 2011 banks incurred 45.3 million LT costs in total serving payment cards. POS management accounted for 24 per cent of them (i.e. 10.92 million LT), while payment authorization and clearing took up 20 per cent (i.e. 9.06 million LT) of payment cards service costs. Meanwhile, actually merchants paid 77.9 million LT to banks for payment cards services. Comparing the numbers, we see that merchants pay more to banks than actual costs are (they pay 77.9 million LT, while actual POS management and payment authorization and clearing cost 19.98 million LT). Therefore, we could expect that cost-based fees would result in fewer profits for banks than it is now. However, as it was noticed before even applying higher current merchant and IF charges banks already issue payment cards in loss. Therefore, the introduction of cost-based fees or a complete elimination of interchange fees might slow down payment cards system development in Lithuania. Further analysis of the charges costs would be necessary.

3. Tying

15. In addition to merchant fees, the banks also apply payment card acceptance rules to merchants. The rules are set by merchant-bank agreements. Some of the rules indicate what payment cards a merchant should accept and what additional charges a merchant may apply for card transactions. In Lithuania, a merchant cannot charge a customer using a card additional amount, even though merchant may experience some additional costs accepting cards. “No-surcharge” rule is set under agreement between merchants and banks. However, the agreements generally do not indicate whether a merchant may offer additional discount for cash payments (“no-discount rule”). The CC do not have information that “no-discount” rule is used in our country (although, there is no information either that merchants offer customers using cash an extra discount). In addition to “no-surcharge” rule, merchants are not allowed to set minimum and maximum amount possible to be paid by cards. Another rule (“honour all cards“rule) is that, banks require merchants to accept all payment cards, valid and properly submitted, regardless it is either a debit or a credit card. Moreover, the banks ask for a lower merchant fee if cards issued by them are used (“on-us” rule).

16. As no-discount rule and no-surcharge rule are applied in Lithuania, non-card users are likely to cross-subsidise card users. It happens because merchants ask all consumers to pay the same amount for products. In general, merchant fees may account for 9-40 per cent of product mark-up. In some cases, merchants even sell at a loss. It happens when banks set a fix charge for the transactions that are smaller

10 http://www.lb.lt/economics_and_financial_stability_service_established_at_the_bank_of_lithuania

11 The study has been conducted using the methodology of the European Central Bank.

than a certain amount (for instance, a payment for a candy). As merchants cannot ask for a “surcharge” for card transactions, they cover the cashless transactions costs and restore profits by asking identical prices for all consumers.

17. Even though the payment cards acceptance rules as well as the cross-subsidies might raise competition concerns, currently under its investigation of IF the payment cards the CC mentions in passing acceptance rules and the distributional effects of merchant fees on non-cardholders.

4. Information limits

18. In general, merchants should follow confidentiality clauses provided for in agreements with banks that restrict sharing of any confidential information that was learned from the agreement, this would likely also including information on card transaction costs, with consumers or any other third party. The only exceptions for this rule are situations when another party of the agreement allows disclosing confidential information or disclosure is necessary due to the requirements of laws.

19. Though, some merchants and banks disclose some information on charges through media channels, but it is done in an aggregate and non-confidential manner. For instance, there were several announcements in the mass media that retailers must pay, for example, 10 cents from the price of one liter of petroleum for banks, as well as one of the major banks advertised merchant charges for new clients on the bank’s internet site.

20. Under the payment cards charges investigation, we have asked merchants to assess and compare costs of cashless and cash payments. The participated merchants did not face difficulties in presenting costs for both payment systems. They identified that for them because of high merchant fees and POS maintenance costs cash payments are cheaper to process than cashless payments. Moreover, when companies are active in other countries than Lithuania, generally they can compare costs across countries. However, consumers usually are not aware of the card payments costs for merchants, therefore they cannot compare the impact of paying by cash and payments cards, especially across countries.

5. Membership in joint ventures: Exclusivity and duality

21. In general, currently in Lithuania exclusivity arrangements between different card platforms do not exist. Any bank operating in Lithuania decides what cards it intends to issue itself. Most of the banks operating in Lithuania issue both MasterCard and Visa cards. Some smaller banks choose to issue cards of only one type, but according to them it is due to financial issues (for example, expensive licenses from card platforms), and not influenced by exclusivity clauses. The CC does not possess any information that could disclose if exclusivity agreements existed before.

22. As to joint ventures, in Lithuania banks cooperate to jointly provide ATM services to their clients. The two joint activities were formed to reduce ATM maintenance costs and to attract more clients. The first joint venture was formed in 2003 and until now it includes two banks. Another joint venture was formed in 2006 when two rather small banks formed a joint venture to also provide ATM services to their clients (later three more small banks joined the joint venture). Under such cooperation by using an ATM of cooperating banks consumers pay the same fee for withdrawal of money as the ATM would belong to their bank. Clients of other banks (beyond the cooperation) can withdraw money too, but different rates of charges are applied in these situations. We do not dispose information whether exclusivity agreements were used.

23. Regarding duality issues, MasterCard Lietuva governance, being a part of MasterCard Worldwide, does not include members from card-issuing banks, because in 2006 MasterCard Worldwide launched a new corporate governance and ownership structure. Menawhile VisaEurope and, consequently,

VisaEurope Lietuva, is a membership organization. VisaEurope board of directors includes, for instance, senior vice president and head of acquiring of Nordea Bank Norge ASA (Nordea bank also operates in Lithuania). Currently we do not dispose further information on VisaEurope Lietuva governance. Moreover, in Lithuania interchange fees, set by Visa Europe and MasterCard Worldwide do not differ significantly for different kinds of operations.

6. Competition law

24. Since 2011 the CC has been conducting an investigation concerning interchange fees, agreed bilaterally between banks that operate in Lithuania. The investigation falls under cartels enforcement. The CC investigates IF for the transactions transacted with Visa and MasterCard payment cards. We do not consider American Express payments cards as they belong to the three-party payment cards scheme and therefore do not apply explicit IF. We investigate *inter alia* the ATM interchange fees and other related fees too. However, our investigation does not concern interchange fees set by Visa and/or MasterCard directly to the banks. Moreover, the investigation does not aim at assessing the competition aspects of payment card schemes.

25. The Visa and MasterCard payment cards operate in two sided markets as payments cards are used by card holders and merchants. The two users' groups provide each other with network benefits. Banks, issuing cards, serve card holders, while banks, providing POS services to merchants, satisfy merchants' demand. It might be considered that card issuers and card acquirers operate jointly by serving a joint demand for payment cards. However, another approach would be to divide the market into several relevant markets. The first market is a card issuers' market, where card issuers compete with each other for card holders. The second market would be the card acquirers, who compete with each other to serve merchants. Due to the fact, that under current investigation the CC has its primary interest in assessing interchange fees and other charges that one party (card issuers) apply to another party (card acquirers), we have preliminary divided the payment card market into two related markets: the market for issuing of payment cards and the market for acquiring of card payment services. Currently, we focus mainly on the platform and merchants' benefits, paying less attention on cardholders. However, as the investigation is still in progress, we cannot discuss ultimate findings.

26. Regarding joint ventures by merchants, generally, broad merchant participation in a new payment system is welcome; however, the formation of a merchants' joint venture for the development of a new retail payment instrument might raise some competition law problems (for example, sharing sensitive information between competitors, creating barriers to enter the market for those merchants that are not members of joint venture, etc.). Such issues would be treated by the Competition Council subject to all the relevant circumstances of the case. For example, if such joint venture (its activities) could be regarded as a hard-core infringement of competition law, it would be treated as a cartel. Whereas if it did not fall within the scope of hard-core infringement, it could be assessed in the light of Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union ('TFEU') to horizontal co-operation agreements[12].

27. Moreover, if such a joint venture by merchants would infringe the requirements of competition law, but at the same time fulfilled conditions for exemption under Art. 6 of the Law on Competition (they are essentially identical to Art. 101 (3) of TFEU), it may not be viewed as a competition law problem.

12 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52011XC0114(04):EN:NOT