

# STORE CARDS MARKET INQUIRY

## The CC's 'emerging thinking'

### Introduction

In the Issues Statement published on 21 September 2004,<sup>1</sup> the Competition Commission (CC) described briefly the methodological approach it intended to adopt in its investigation (paragraphs 7 and 8) and the business model that appeared to support the provision of store card services to retailers and their customers (paragraphs 9 to 11). It then identified a broad range of issues, on which it invited comment.

The CC has considered carefully the further written and oral evidence from parties that was submitted in response to the Issues Statement. In the light of this and other evidence submitted throughout the investigation, it has begun to focus its thinking on the central issues that appear to merit consideration under the provisions of the Enterprise Act 2002 (the Act). Its current thinking is set out below, together with summaries of supporting evidence in the form of a number of annexes that address aspects of the store card sector.<sup>2</sup> These summaries do not purport to be comprehensive or definitive, and will be supplemented as the inquiry progresses. They omit confidential information provided to the CC.

The CC is required to answer the questions set out in section 134 of the Act. The first question is whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK. The Act states<sup>3</sup> that, for the purpose of a market investigation reference, a feature of a market in the UK shall be construed as:

- (a) the structure of the market concerned or any aspect of that structure;
- (b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or
- (c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

The CC is also required to consider<sup>4</sup> whether any feature or combination of features it may identify has brought about, or may be expected to bring about, a detrimental effect on consumers in the shape of higher prices, lower quality or less choice of goods or services in any market, or less innovation in relation to such goods or services.

The CC is continuing to consider whether Articles 81 or 82 of the EC Treaty are applicable to any agreements or conduct in the relevant markets such that Article 3 of the Modernisation Regulation needs to be taken into account.

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<sup>1</sup>Published on the CC's web site.

<sup>2</sup>The annexes consist of the following summary papers: overview of store cards in the UK; upstream market; an assessment of recent tenders; store branded credit cards; card-related insurance; downstream market; pricing; a model of store card economics; financial performance of store card providers and cost of capital of store card providers. Surveys referred to in the annexes are published separately on the CC's web site.

<sup>3</sup>Section 134(2).

<sup>4</sup>Section 134(4) and (5).

During the next stage of the inquiry, the CC wishes to explore its thinking with parties involved in its investigation, and invites their views on the matters raised in the document and its annexes, including views on whether any matters might or might not amount to market features that prevent, restrict or distort competition, or whether any significant issues pertinent to competition have been omitted. The CC expects to hold further private hearings to explore the issues raised in this document, probably during February 2005.

## **The emerging thinking**

1. In relation to the supply of store cards and ancillary services, we have identified two interdependent markets:
  - an **upstream** market involving the provision of store card credit services, and related services, to retailers by store card credit providers; and
  - a **downstream** market involving the provision of store cards, and related services, to customers by credit providers and retailers jointly.

### ***Upstream market***

2. The upstream market consists of the provision by credit providers of store card services to retailers. These services involve the administration of the store cards that retailers offer their retail customers, together with the provision of marketing information and support; and the provision of store card credit and related insurance services on behalf of those retailers. Contracts for the provision of store card services to retailers are (except for the very few retailers who run these services in-house) now increasingly put out to formal or informal tender. Hence the upstream market has many of the characteristics of a 'bidding' market.
3. The upstream market has evolved significantly over time and is in a period of change. In two particular respects this market appears to have become more competitive: first, there has been some entry and second, some retailers have assumed a more active management both of the bidding process and the operation of their store cards. So far as entry is concerned, new providers have come into the sector by offering store cards in conjunction with store branded credit cards<sup>5</sup> and other types of credit services to retailers, and have begun to compete against the more established players. As regards the behaviour and attitude of retailers, some retailers, particularly the larger ones, have been able to secure a general improvement in terms from store card credit providers. Examples of such improved terms include up-front payments, specified supplier performance targets, break clauses, more clearly specified provisions governing matters such as the ownership of data and termination arrangements, and the stipulation of joint decision-making across some or all aspects of the store card operation (often through contractual or corporate joint ventures, with some resultant profit sharing).
4. But although these developments seem likely to continue, it is not clear what effects they will have or how widespread they might be across retailing as a whole. New credit providers that have entered the traditional store card sector appear not to be seeking contracts with retailers solely, or primarily, for store cards but to be interested in offering those retailers a range of financial products, in particular store-

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<sup>5</sup>Store-branded credit cards are general usage credit cards issued jointly by a credit provider and a retail organization; the cards are embossed with the retailer's name and logo and are marketed by the retailer; they usually entitle the holder to retailer-specific benefits such as discounts.

branded credit cards that operate alongside their store card. Much recent entry has been by acquisition of in-house card programmes; only one large retailer and very few other retailers now maintain store card operations in-house, and this limits future opportunities for new entry through outsourcing. It is also as yet unclear to what extent the ability of some retailers to extract more favourable terms from credit providers can or will extend in due course across the retail sector, especially to smaller retailers. In addition, a few store card credit providers have exited, although these had small-scale store card operations.

### *Possible 'features' in the upstream market*

5. In relation to the upstream market, the CC is now focusing on the matters set out in subparagraphs (a) to (e) of this paragraph. The CC is concerned that one or more of these may amount to 'features' of the relevant markets that prevent, restrict or distort competition in connection with the supply of any goods or services in the UK or a part of the UK:

(a) *Market structure.* The store card sector consists of six credit providers,<sup>6</sup> of which the largest has a significantly greater market share (on any measure) than any of the others. In 2003, the four largest credit providers together accounted for more than 90 per cent of the sector. And although contracts are won following a tendering process, they typically last for between five and ten years, and this makes market shares relatively stable over time.

(b) *Barriers to entry.* Established players may enjoy incumbency advantages, for example in terms of reputation or capacity. The preference of some potential entrants to tender only for contracts that offer them the opportunity to provide both store cards and store-branded credit cards (as opposed to store cards alone) may reduce competition with respect to tenders which concern store cards alone, and reinforce such incumbency advantages.

(c) *Switching costs.* Information asymmetries and uncertainties associated with the transfer of the portfolio of receivables from one card supplier to another may deter some retailers from switching between credit providers when their contracts come to an end.

(d) *Price matching.* Most, though not all, *retailers* cede the right to set APRs<sup>7</sup> and other charges<sup>8</sup> to their credit provider. Many retailers appear to be concerned primarily that the APRs and other charges on their store cards are in line with those of their retail competitors;<sup>9</sup> and it may be that the smaller credit providers offering store cards to retailers have little incentive to set lower APRs than those set by the market leaders on their cards. At the same time, leading store card credit providers have a large number of store card contracts, each with a different retailer. These providers have little incentive to cut their APRs and other charges for fear of a 'domino' effect, and tend to set similar levels of APR across all their

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<sup>6</sup>Or eight, if providers of both store and budget cards are included. Budget cards are a source of instalment credit offered by retailers. Although the CC regards budget cards as another type of store card, it has concentrated during its inquiry on the general store card, as this is quantitatively the more important of the two categories. See Annex A for a fuller description of budget cards.

<sup>7</sup>Annual Percentage Rate. See Annex G.

<sup>8</sup>These other charges may include annual fees, late payment charges and charges for exceeding the credit limit on the card.

<sup>9</sup>Some retailers, however, have always been concerned about the level of APR on their store cards; moreover, there is some evidence that recent adverse publicity has made certain retailers more sensitive to the absolute level of their store card APR than had previously been the case.

retail customers. Taken together, these factors may tend to discourage price reductions, and encourage price matching, across store cards as a whole.

- (e) *Insurance.* The provision of insurance services by store card credit providers to cardholders, via retailers, appears to be subject to little, if any, competitive pressure (regardless of how competitive the provision of insurance services to store card credit providers by insurance underwriters might be). The terms on which store card credit providers propose to offer store card insurance to cardholders are generally included as one of the provisions of the contracts between store card credit providers and retailers who do not, typically, undertake a separate negotiation in respect of these insurance provisions. Indeed, retailers tend to accept the terms—usually a package that includes payment protection, purchase protection and (in a number of cases) price protection insurance—proposed by the credit provider, even in circumstances where retailers have in other respects taken a more active role in the negotiations for the store card. In almost all cases, the store card credit provider assumes exclusive rights in respect of such insurance products, and charges the same price on most or all of its retailers' store cards.

Subject to further evidence in relation to the matters raised in this paragraph, the CC is currently most concerned about the features set out in subparagraphs (d) and (e) above. These are also features of the downstream market and are considered further below.

### ***The downstream market***

6. Store cards have the following set of characteristics which, taken together, are exhibited by no other payment card (including store-branded credit cards, which we consider in paragraphs 9 and 10):
- (a) *Marketing tools for retailers.* Retailers view store cards as only one element of their marketing strategy. Store cards are designed to encourage loyalty on the part of customers, provide retailers with customer information for marketing purposes, and thereby increase sales. Very few retailers appear to view the credit facility provided through store cards as an important element leading to increased sales.
- (b) *Distribution channel and usage.* Store cards are supplied mainly through the retailer in store, and their usage is limited to a single retailer or a group of retailers.
- (c) *Customer benefits.* Customer services and benefits are provided by the retailer in order to induce loyalty. Typically, they include an initial discount or other benefits on taking out the card, privileged access to facilities and events, and other loyalty benefits and programmes. The survey evidence suggests that, for a large proportion of store cardholders, the primary value of the card is the initial discount (where offered) and the continuing benefits that holding the store card gives them, rather than the credit facility that it offers.
- (d) *Immediate credit.* Immediate credit is made available to those customers who are judged creditworthy by the store card credit provider, for use only in the particular retailer's stores.
- (e) *Affinity value.* Store cards have some affinity value for customers, associated with their preference for the particular retailer or its brand.

(f) *Acceptance rates.* Retailers want as many of their customers as possible to take out their store card. The acceptance rate (generally well over 65 per cent) is therefore typically higher for store cards than for store-branded credit cards or general credit cards. With these higher acceptance rates typically come lower credit limits.

7. Market definition at the downstream level—that is, the provision of store cards and ancillary services to customers—is complex because store cards are hybrid products having elements of loyalty, payment and credit. Furthermore, there are three different stages at which customers of a particular retailer make decisions in respect of store cards:

- *Take up.* At the stage when customers are offered or apply for a store card, their choices may be based solely or predominantly on the discount or other benefits offered on the goods or services purchased, rather than the credit offer; as a consequence, many customers may be unaware of, or uninterested in, the APR on the store card at this stage.
- *Use as a means of payment.* On subsequent occasions when goods or services are being purchased from the same retailer, customers can choose whether or not to use the store card as the means of payment; this choice is also influenced by the offer of any discounts or benefits.
- *Taking credit or not.* When customers receive the store card statement for the first time, and on each subsequent occasion when they have used it to pay for goods or services, store card holders can choose whether to take credit and pay interest or pay off the outstanding balance.

Substitutes for the store card are different at each of these three decision stages. In particular, it is not clear that there are as many substitutes at the first and second of these stages as there are at the third stage.

8. The CC's current thinking is that, while the downstream market may be a relatively wide one that includes many forms of plastic card that can be used for payment or credit, store cards represent a distinct and identifiable segment of that wider market because of their particular characteristics, described in paragraph 6 above. In this wider payment market within which each store card programme is located, the cards appearing to be most similar to store cards are store-branded credit cards, as these share a number of the particular characteristics noted above. However, store-branded credit cards also share the characteristics of general credit cards—most notably their significantly wider acceptance.

9. Store-branded credit cards are relatively new products and the extent and speed of their development are not yet clear. The following points in particular are relevant to an understanding of the role that they may play for card providers and retailers who offer both types of card to customers:

- (a) Not many retailers yet have store-branded credit cards and not all plan to introduce them; and there may be limits on the ability of some retailers to offer store branded credit cards.
- (b) Any differences in customer attitudes between store cards and store-branded credit cards, in respect of the usage, benefits and credit offer associated with each, and the relative importance of these factors, are not yet clear.

- (c) Some customers with a store card of a particular retailer who would be eligible for a store-branded credit card have not switched to that type of card when the same retailer has offered it.
10. The CC has not yet formed a view on what role store-branded credit cards play in the wider market, how many retailers may be expected to introduce them, to what extent they represent substitutes for store cards and to what extent they complement store cards. A key question for the CC is whether the generally lower APRs on store-branded credit cards have constrained, or may be expected to constrain, the pricing of associated store cards. In this context, the CC is considering whether a particular retailer's store-branded credit card offered alongside that retailer's store card, where the same credit provider is involved, would have the effect of segmenting the population of cardholders by offering different terms and conditions to different groups. In these circumstances, even if the store-branded credit card were considered the nearest substitute for the store card, it is not yet clear whether or not they would compete with each other and hence to what extent, if any, the store branded credit card would operate as a competitive constraint on the store card.

### *Possible 'features' in the downstream market*

11. In relation to the downstream market, the CC is now focusing on the matters set out in (a) to (d) below. One or more of these may amount to 'features' of the relevant markets that prevent, restrict or distort competition in connection with the supply of any goods or services in the UK or a part of the UK:
- (a) *Retailer link and the customer benefits.* Store cards are marketed on the basis of the retailer link and the customer benefits which the retailer offers, in particular the discount or other benefits which are widely available as an initial (and continuing) incentive. They are, typically, not offered on the basis of their APRs (as credit cards typically are). This feature of the offer of store cards may contribute to a lack of knowledge of, or an indifference to, the APRs on these cards on the part of customers, which may allow store cards to be priced independently of any potential competitive constraints provided by other kinds of payment card, such as store-branded credit cards.
- (b) *Low price sensitivity and transparency.* In taking up store cards and in using them for payment or for credit, a proportion of customers appear insensitive to APR levels and other charges. Moreover, the setting in which some cards are offered—in store, at the same time as the 'primary' transaction for goods and services—is likely to make it difficult for customers to focus on the details of the store card contract, particularly the credit and insurance terms and conditions.
- (c) *Limited competitive pressure on APRs and other charges.* In their negotiations with store card credit providers, retailers appear to have little incentive to drive down APRs or other charges, for some or all of the following reasons:
- (i) high APRs do not significantly limit take-up rates;
  - (ii) retailers receive very few complaints about APR levels;
  - (iii) in many cases, APRs do not appear to be part of the 'value proposition' offered to customers by retailers; that is, retailers compete with each other on the basis of the elements of their offer other than the charge for credit; and

(iv) most retailers benefit financially from high APRs.

(d) *The offer of insurance to customers.* Most customers signing up for a store card are offered a package of insurance products at the same time. Customers who have chosen to purchase store card insurance cover have, hitherto, usually agreed to do so in store, and signed for this on the same form as that for the store card (though in a separate signature box). Only one insurance package has typically been on offer to customers, at an all-in price. As a result, customers have had limited choice in respect of which types or combinations of insurance to take out with their store card. New regulations governing the sale of insurance products,<sup>10</sup> including store card insurance, will come into force early in 2005. It is not clear whether these provisions will change the way in which store card insurance is sold; neither is it clear whether, if insurance continues to be sold in store, cardholders will have any greater choice of products.

12. The CC is also considering to what extent any recent increase in competition in the upstream market has had an effect on any aspect of the store card offer made jointly to consumers by credit providers and retailers in the downstream market, and if it has had no such effect, why that might be.

### **Market outcomes as possible indicators of the extent of competition**

13. The CC is considering possible indicators of the extent of competition in the markets it has identified and in particular:

- (a) whether the profits of one or more store card credit providers are excessive; and if so, whether this can be explained by high efficiency, transitory factors, the age profile of the portfolio of contracts held, an unexpectedly benign economic environment for consumer lending in recent years, or other causes;
- (b) APRs and insurance rates that are very similar across the store cards of many different (but, interestingly, not all) retailers and for almost all customers of a given retailer;
- (c) store card APRs that have shown little responsiveness to changes in the base rate and have not fallen in line with credit card APRs; and
- (d) the pricing model for store cards which is such that those who pay interest on their balances, and other charges, bear most of the costs of the store card operation.

### **Detrimental effects on consumers**

14. The various features of the upstream and downstream markets discussed above could bring about one or more of the following detrimental effects on consumers:

- (a) higher prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or

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<sup>10</sup>A rule entitled *Insurance Mediation and Mortgage Mediation, Lending And Administration (Prudential Provisions) Instrument 2004*, made under *The Financial Services and Markets Act 2000*, will come into effect for the sale of insurance products on 14 January 2005. Insurance intermediaries will have to be registered with the Financial Services Authority (FSA). Companies selling credit insurance will have three options: to become authorized by the FSA; to become an appointed representative of an authorized firm; or to operate under an exemption.

(b) less innovation in relation to such goods or services

than would be the case in a more competitive market. We propose to examine whether any of these effects has been brought about or is attributable to any of the features of the upstream or downstream markets discussed earlier in this paper, or to other features of these markets which may emerge as the inquiry progresses.

[10] January 2005