

D2 MERCHANT ACQUIRING

D2.1 The main credit and debit card schemes in the UK are arranged as four-party systems. Merchant acquirers, as one of the parties involved in a four party card system, perform a number of functions. They:

- recruit retailers to card schemes;
- process transaction information to send to issuers (via scheme clearing);
- pay retailers and obtain money from issuers;
- are liable to issuers for outstanding payments, if a retailer goes out of business.

Merchant acquirers play an important role as the interface between retailers and the card scheme. This Annex discusses competition in the market for merchant acquiring.

Market definition and market structure

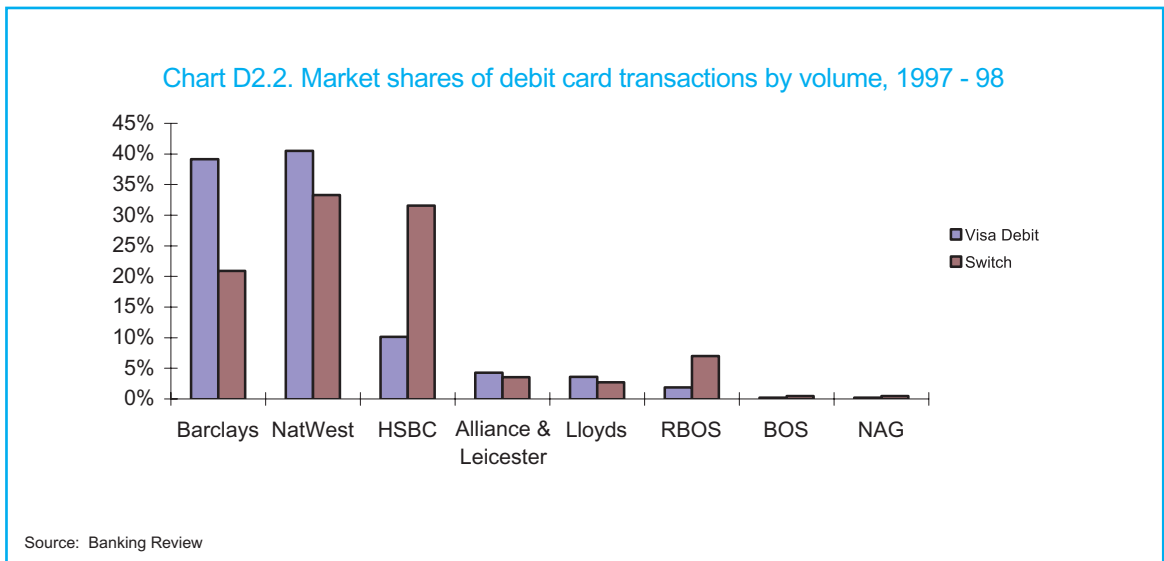
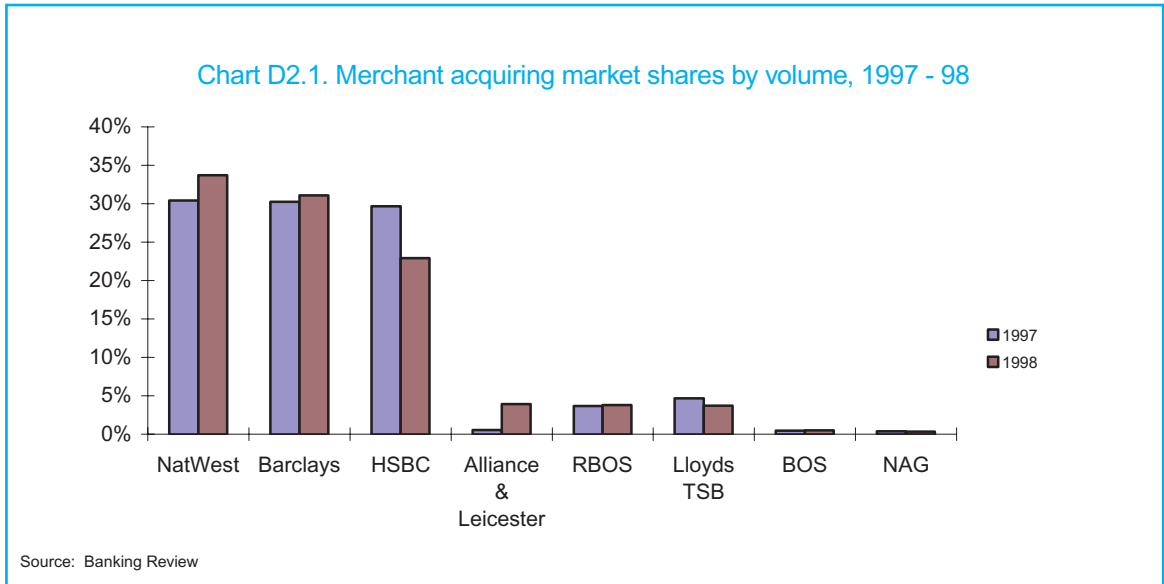
D2.2 On the demand side, acquisition for each individual scheme is potentially a separate market. Once a payment scheme is well established with customers, retailers are unlikely to be sensitive to small changes in the price of accepting that means of payment relative to other schemes. This is because the loss of revenue to the retailer from cardholders going elsewhere is likely to outweigh any savings from no longer accepting a particular card. On the supply side, however, acquirers of one four party scheme can and do acquire the others. This suggests that it is sensible to look at market shares for merchant acquiring for four party schemes as a whole .

D2.3 There are eight merchant acquirers in the UK. Chart D2.1 shows their market shares in 1997 and 1998 by volume of transactions acquired. Three merchant acquirers dominate the market: NatWest, Barclays and HSBC, who together acquire over 85 per cent of credit and debit card transactions in the UK. No other acquirers has more than 5 per cent of the market.

D2.4 One significant recent development in the structure of the merchant acquiring market has been the entry of Alliance and Leicester (A&L) in 1996. A&L have improved their market share, from 0.5 per cent in 1997 to overtake Lloyds TSB and RBOS with a 4 per cent market share in 1998. A&L's share of the market is still dwarfed however by those of the top three acquirers.

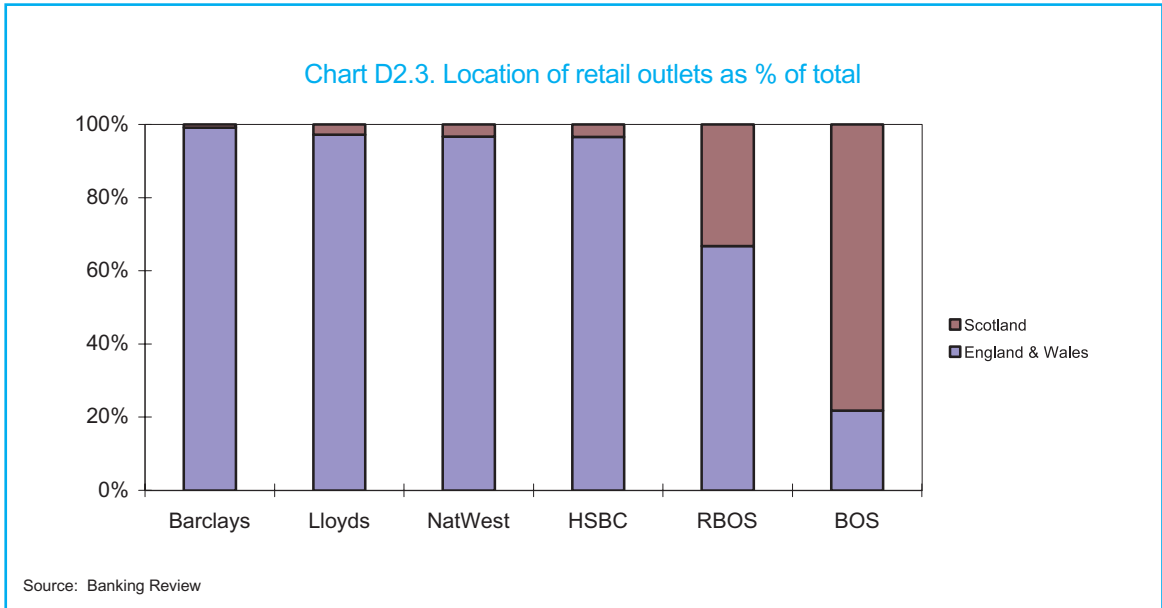
D2.5 There is some notable variation between the merchant acquiring market shares of the two major debit card schemes, as illustrated in Chart D2.2 below. Historically, Switch transactions could be acquired only by banks which issued Switch cards. Issuers included NatWest and HSBC but not Barclays. The scheme's rules were changed in 1990 to allow issuers of other debit cards to acquire Switch transactions, and other acquirers such

as Barclays are now beginning to gain market share. However, the market structure has been slow to change and still reflects the historical arrangements, with NatWest and HSBC together acquiring over two thirds of Switch transactions. This contrasts with Visa Debit, where the market shares are more reflective of the overall merchant acquiring market.

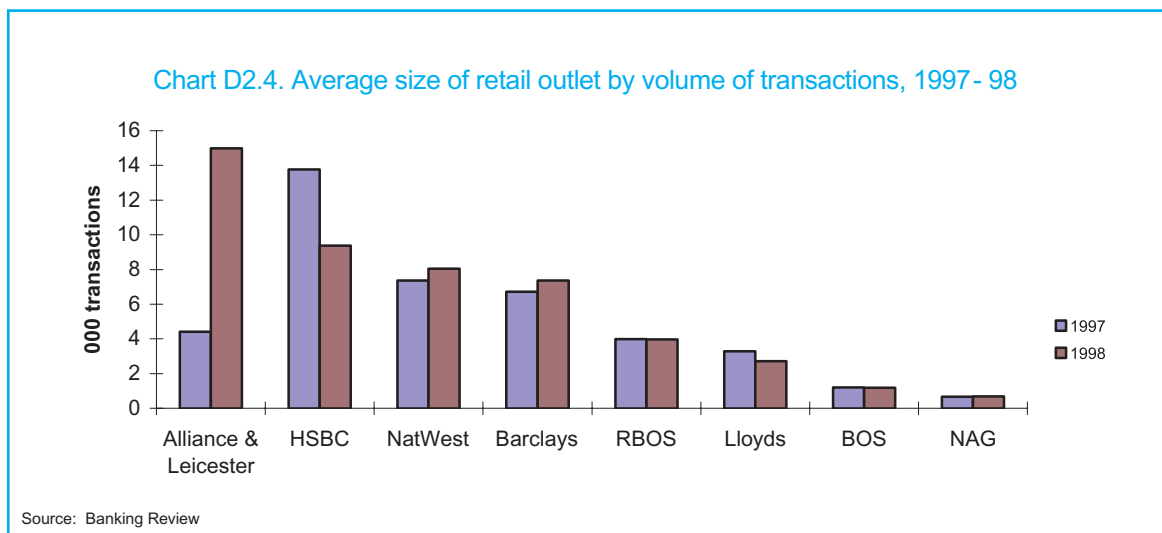


D2.6 The market for merchant acquiring is more concentrated when considered geographically, because the acquiring operations of the two Scottish banks are confined mostly to Scotland. The market in England and Wales is dominated by the English clearing banks, with BOS and RBOS together acquiring only 6 per cent of retail outlets in England and Wales. 60 per cent of the retail outlets in Scotland are acquired by the two Scottish acquirers.

D2.7 In fact, as Chart D2.3 below shows, over 90 per cent of the retail outlets acquired by the English clearing banks are located in England and Wales. By contrast, a third of RBOS retailers are located in Scotland, while over three quarters of BOS acquired retailers are in Scotland.



D2.8 The average size of the retailers acquired differs across the merchant acquirers, and fluctuates from year to year. Data provided by the acquirers on average retailer size was incomplete, so chart D2.4 proxies this using the average volume of transactions to pass annually through a retail outlet, eg a single store. On this measure, the average size of retail outlet acquired by A&L has almost tripled between 1997 and 1998, from 4,000 transactions p.a. to just under 15,000 transactions pa. Over the same period, the average size of retailer acquired by HSBC fell from 13,800 to 9,400 transactions pa. This reflects churn in the market as retailers switch between acquirers, and suggests sensitivity for small acquirers to a few large contracts. The chart also shows that RBOS, Lloyds, BOS and Clydesdale onwards are not focussed on the larger end of the market.



D2.9 The transaction processing function of merchant acquirers is contracted out by several of the acquirers. For example, FDR provides transactions processing services to Lloyds TSB, HSBC, RBOS and the UK and Ireland members of NAG; whereas NatWest and Barclays do their own processing. Other aspects of merchant acquiring are also carried out by third parties - for example, companies such as WorldPay recruit internet retailers to

the card schemes and accept liability in some cases if the retailer becomes bankrupt, acting as a bureau or middleman between the merchant acquirer and retailer.

Entry

D2.10 At the time of the last MMC report¹ on this industry, each scheme had its own merchant acquirer: Barclays for Visa and JCCC - a private company wholly owned by Lloyds, Natwest and RBOS - for Access (now Mastercard). Following that report, the market was liberalised, so that acquirers could acquire for more than one scheme, and acquirers need not be the retailer’s normal bank. So most of the market players have entered since 1990. The most recent new entrant is Alliance and Leicester, who entered in October 1996 and now have 4 per cent of the merchant acquiring market by volume of transactions.

D2.11 There are barriers to entry to the merchant acquiring market. These entry barriers can be broken into two categories. Some arise naturally as a result of the functions involved in the industry; for example, entrants must establish a sound reputation for competence and solvency before retailers will trust them to perform this key function. Entrants must also develop the skills necessary to assess the risks associated with merchant acquiring, obtain processing capacity, and build relationships with potential customers. This category of barriers to entry are created by the nature of the industry, eg the large sums of money involved or the transaction processing, which require sound financial management and data processing capacity. Such requirements do not prevent entry to the merchant acquiring market by competent institutions. As mentioned above, transaction processing can also be contracted out to specialist third parties such as FDR or EDS, an option which A&L adopted on entering this market.

D2.12 However, there are some barriers which are not inherent in the nature of the industry, and which do preclude entry by competent institutions. The main such barrier arises from the card schemes’ rules. Table D2.1 summarises the membership criteria which apply to acquirers.

Table D2.1. Card scheme membership criteria

Scheme	Issuers	Acquirers
Visa credit & debit	Firms organised under commercial banking laws of their own country and licensed to accept demand deposits and organisations they own or control. Exceptions can be made (eg to enter new markets or comply with laws)	Same as issuers; plus In EU must issue cards in the same country that they acquire Exception for countries with no principal members - can have acquiring only members
Switch	Regulated financial institutions who offer current accounts in UK:	As issuers; plus Must either issue Switch cards or since 1990 debit cards under another scheme which can be acquired by Switch issuers
Europay (MasterCard)	Authorised and regulated credit institutions established in Europe. Entities they control and own for 90%	As issuers; plus Must also issue cards in countries where they acquire Exception for ‘international customers’

Source: Banking Review

¹ Monopolies and Mergers Commission *Credit Card Services: A report on the supply of credit card services in the UK*, 1997.

D2.13 Briefly, in order to acquire for each of the main schemes, the entrant must also issue the scheme's cards (in the case of Switch the acquirer must issue any debit card, not necessarily Switch). It is not enough to issue a token number of cards; the entrant must convince the card scheme that it will issue cards in enough numbers to add value to the scheme. This has a number of implications for any potential entrant to merchant acquiring.

D2.14 The most immediate is that the potential acquirer must also meet the card scheme's requirements for issuers, which are shown in Table D2.1. In essence, they must be banks or building societies. Furthermore, the entrant's share of the personal banking market must be large enough to support card issuing in significant numbers, in order to convince each of the card schemes that the entrant is 'serious' about issuing the scheme's cards. Therefore, by extension, acquirers must be banks or building societies with a relatively substantial market share of UK personal banking. This prevents entry not only by non banks, but by small banks and building societies as well.

D2.15 The entrant will incur some sunk costs in the process of meeting the card scheme rules. These costs include legal fees, investment in infrastructure, and membership fees. The application process itself is lengthy, and the pace and eventual decision on acceptance is dictated by the incumbent members of the card schemes, who will also be the entrant's direct competitors. In other words, the entrant must notify the market incumbents of its intention to enter the market. The timing of its entry is then at the mercy of the incumbents, which naturally precludes hit and run entry, and allows the incumbents time to prepare their competitive response to the entry of a new player.

D2.16 These barriers to entry erected by the card schemes are exacerbated by the understandable requirement of most retailers that their merchant acquirer be able to acquire for all of the major card schemes. Fewer than 10 per cent of retailers contract with their merchant acquirer for just one scheme. Thus, an entrant to merchant acquiring must meet the membership criteria for all of the major card schemes, which multiplies the barriers to entry posed by the card schemes' rules.

D2.17 For this reason, following A&L's entry to merchant acquiring, there are no more potential entrants under the current card schemes' rules. Removing the restrictions on who can be an acquirer would open the market to new groups of potential competitors, such as non UK merchant acquirers, niche players or third party data processors, telecoms companies or individual large retailer owned acquirers.

D2.18 The card schemes justify the requirement that acquirers also issue cards using a number of arguments.

D2.19 The schemes argue as follows. Firstly, that acquirers who did not issue cards would face a conflict of interest and would not have any 'sense of commitment to the maintenance of the scheme'. Secondly, that the restrictions are necessary to ensure 'balanced development of the system': in order to grow the payment system it is necessary for members to invest in issuance. Thirdly, that it would not be 'fair' on issuers who also act as merchant acquirers if non issuers were also allowed to acquire transactions.

D2.20 None of these arguments is convincing.

D2.21 It is difficult to see why an acquirer who only performed that role would have a 'conflict of interest', since their interest would lie solely in serving their retailer customers

in competition with other acquirers. They would be committed to maintaining the payment schemes for which they act as acquirers. This is because their customers are likely to continue to demand to use those schemes and they will have invested in developing the capability to work with existing payment schemes. A conflict of interest is more likely to exist where the same company is both an issuer and an acquirer. For this reason the more successful UK acquirers have developed independent merchant acquiring arms, such as NatWest Streamline and Barclays Merchant Services.

D2.22 The arguments about balanced development of the systems may have had some merit when the card payment schemes were in their infancy and the primary need was to get cards in wallets. Today, credit, debit and ATM cards are widely owned and used: in 1998, over 80 per cent of the adult population of Great Britain possessed a plastic card. If anything, it could be argued that balanced growth of the debit and credit card system might be better served through increasing the number of retail outlets who accept these cards. In any case, it is not clear how restricting the supply of merchant acquirers would serve to increase the number of cards in circulation.

D2.23 Similarly, there is nothing inherently ‘unfair’ about allowing non issuers to compete with issuers in the acquiring market. Card issuing is a profitable activity, not a social obligation. Issuers are paid for their issuing activities, through account charges on their customers and also through interchange fees. Again, there may have been some merit in this argument when the schemes were in their infancy, but not in the context of cards of widely held schemes.

D2.24 These arguments are not strong enough to justify the current restrictions on who can be a merchant acquirer.

Market performance

D2.25 At first glance, the merchant acquiring market has performed well on price. The average price charged by acquirers (known as Merchant Service Charge, or MSC), shown in Chart D2.5 below, has fallen over the past five years.

D2.26 One of the main drivers behind this downward trend has been the decrease in processing costs as ever more transactions have been processed electronically and as IT costs have fallen across the economy. There is little reliable public data available on costs, and the major acquirers were able to provide very little data on operating profits and profitability. It is therefore not possible to conclude that average prices are aligned with costs or that they are being kept at competitive levels.

D2.27 The prices charged to retailers vary considerably. Chart D2.6 shows the distribution of retailers and value of transactions in each MSC band. Simple averages were taken across all merchant acquirers to ensure confidentiality of the larger suppliers’s data.

D2.28 The distribution of retailers across the MSC bands shows that the majority of retailers pay MSCs in the higher bands. Over 60 per cent of retailers pay more than 2 per cent per credit card transaction and/or 15p per debit card transaction. By contrast, the majority of transactions (by value) attract MSCs in the lower bands: over a third of the value of debit card transaction attract charges of less than 10p, while over two thirds of credit card transactions incur charges of less than 1.5 per cent.

Chart D2.5. MSC over time, 1993 - 98

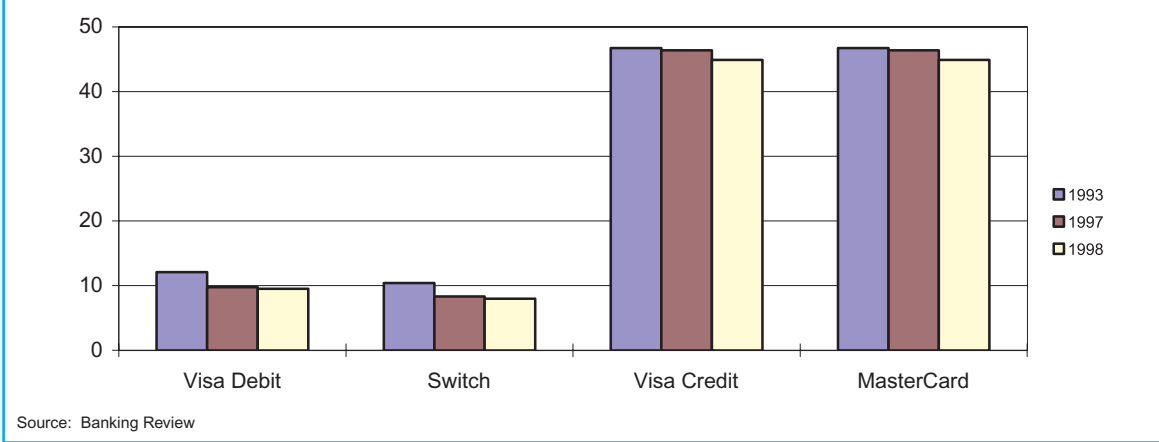
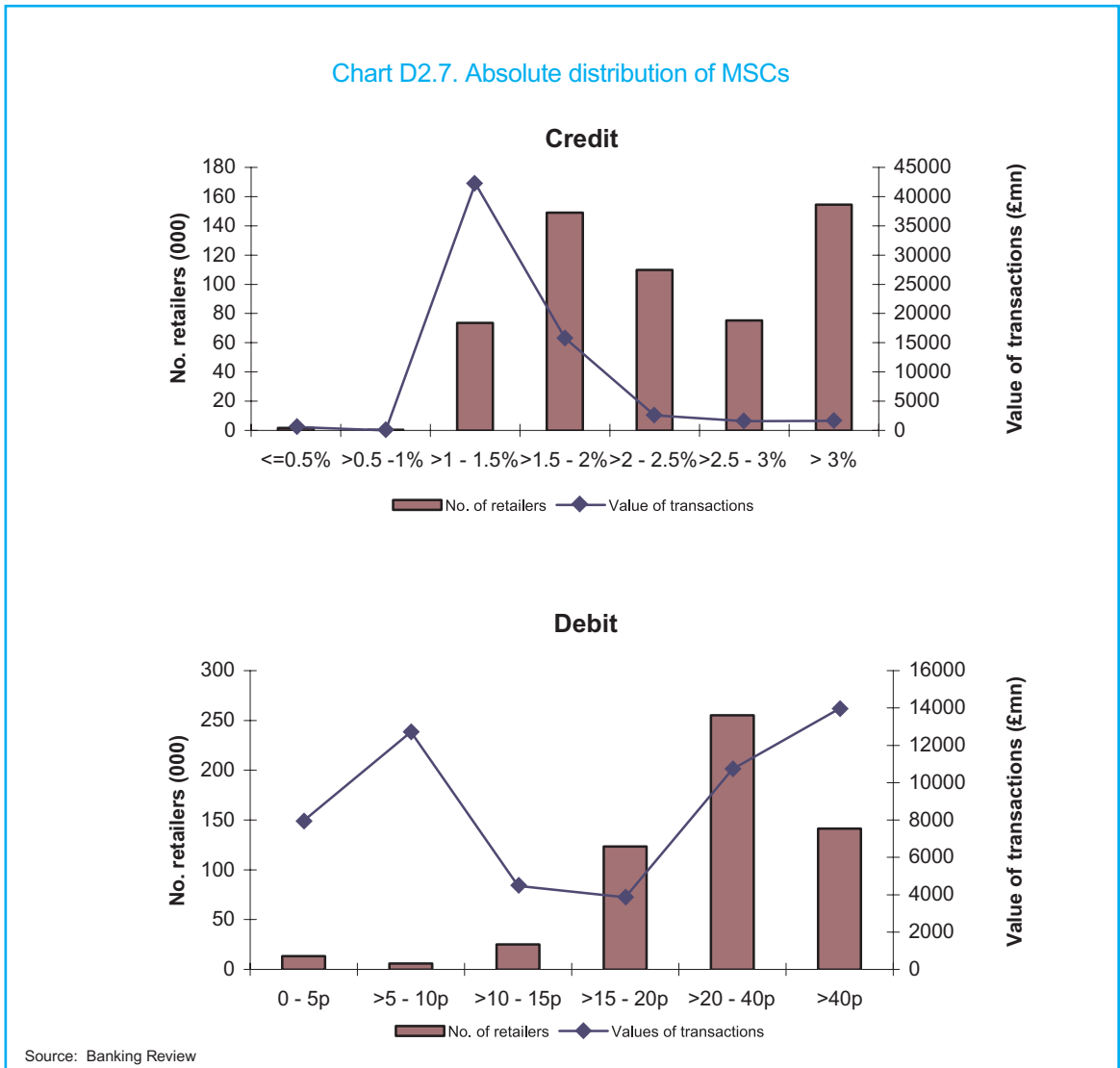


Chart D2.6. Distribution of MSCs



D2.29 Chart D2.7 translates this into absolute numbers. In 1998, there were 546,000 outlets accepting plastic cards, and £64 billion of credit card transactions. Of these,

around 75,000 retailers pay less than 1.5 per cent on credit card transactions, accounting for £43bn of transactions. Similarly, there were £54bn in debit card transactions. Just over 44,000 retailers pay less than 15p per transaction, yet these account for £25bn or almost half of all debit card transactions.



D2.30 These distributions point to the conclusion that only a small number of the large retailers pay MSCs in the bottom of the range. The largest group of retailers, ie small retailers processing few transactions, are paying significantly higher MSCs.

D2.31 There are a number of cost factors which contribute to these price variations. For example, there is an element of fixed cost involved in maintaining an ‘account’ for each merchant, eg statementing, which would result in retailers which generate a lower volume of business paying more per transaction. Some merchant acquirers however charge for this cost separately, in which case it should not impact on the MSC.

D2.32 Other cost based explanations arise from the different demands which large and small retailers make of acquirers. These include the possibility that smaller users are more likely to be paper based, requiring the acquirer to carry out more data processing and thus

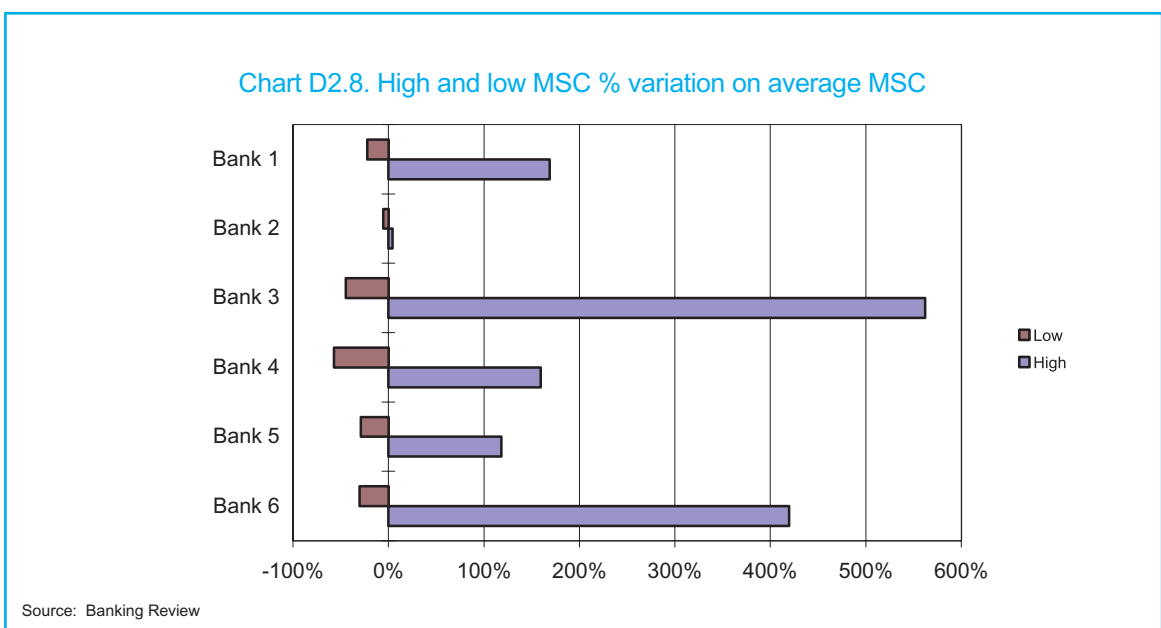
more costly customers. They may require infrastructure such as terminals to be put in place, in contrast to larger retailers which are likely to have electronic point of sale terminals already in place. Smaller retailers may also require more active support from the acquirer eg using start up packs, needing staff training, or heavy use of customer helplines. On a per transaction basis, it is also likely that marketing costs are higher for small customers.

D2.33 Another argument put forward to explain price variations has been that there are economies of scale in merchant acquiring, thus producing an apparent reduction in cost for large versus small customers. No data has been produced to support this argument, but even if this were the case this would result in large acquirers having lower costs, not large retailers. Therefore, this on its own should not result in different prices being charged to large and small retailers.

D2.34 Ideally the former cost based arguments, which may validly explain some price variation, could be tested by quantifying the cost differences and identifying the extent to which they underpin price variations. It has not been possible to undertake this process.

D2.35 Other data however has already shown that this is a concentrated market, with no potential entrants. In these circumstances the unequal bargaining power of small retailers compared to large merchant acquirers would be expected to lead to non cost based price discrimination. In the absence of any data to the contrary, this is the most likely explanation of the wide price variation. It is likely that large contracts are very competitively priced, possibly below cost, while there is a lack of effective competition for small businesses, leading to substantially higher prices for small retailers.

D2.36 This conclusion is supported by data from seven of the eight merchant acquirers on the range of MSCs that they charge (Royal Bank of Scotland did not provide data) . Chart D2.8 below illustrates just how much higher the MSC for debit card transactions are for small retailers. Small retailers are paying much higher average MSCs than large retailers. High MSC refers to the average MSC charged to retailers with a turnover through the merchant acquirer of less than £1m. Low MSC refers to that charged to retailers with a turnover through the merchant acquirer of more than £100m.



D2.37 The picture varies across the acquirers. Bank 3 exhibits the widest variation in price, charging small retailers a MSC which is 500 per cent larger than the average, while charging large retailers a MSC only half the average. Bank 2 is at the other end of the scale, with very little variation. The overall picture is clear however: the lower than average prices offered to larger retailers are more than offset by the higher prices charged to small retailers. The charges for acquiring credit cards are less extreme, yet tell roughly the same story.

Conclusion

D2.38 The evidence above shows that the market for merchant acquiring is concentrated, with the top three acquirers by volume, Nat West, Barclays and HSBC, between them acquiring over 85 per cent of the credit and debit card transactions in the UK in 1998. There are high barriers to entry, the most significant of which is the need to meet the card schemes' membership criteria. There are no potential entrants to the merchant acquiring market under the current card scheme rules. This creates both static and dynamic costs to retailers. Prices can be set higher than would otherwise be the case, and firms are protected from entry by more efficient suppliers, thus weakening the incentives to cut costs and innovate.

D2.39 Although prices have fallen over recent years, it is unclear what proportion of the lower processing costs have been passed on to retailers. Merchant acquirers discriminate between retailers on the basis of size: while larger retailers are able to bring buyer power to bear in securing low merchant service charges, smaller retailers are being charged far higher fees by almost all merchant acquirers. As a result of this lack of actual and potential competition, the market has been slow to adapt to changing conditions such as the development of e-commerce.

D2.40 Taking the high prices and lack of innovation together, smaller retailers are not served well by this market. This reflects a lack of competition in the merchant acquiring market.