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COMMUNICATION FROM THE COMMISSION

Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report)

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1. On 13 June 2005 the Commission initiated an inquiry into retail banking. The instrument of sector inquiries has its legal basis in Article 17 (1) of Regulation (EC) No 1/2003. According to this provision the Commission may decide to conduct an inquiry into a particular sector of the economy or into particular types of agreements across various sectors, where the trend of trade between Member States, the rigidity of prices or other circumstances suggest that competition may be restricted or distorted within the common market. This document is the final report of the retail banking inquiry¹.

1. INTRODUCTION

2. The European banking sector has undergone significant growth and diversification over the last two decades. Today it directly provides over three million jobs in the EU. Retail banking – defined as services to consumers and small and medium enterprises (SMEs) – remains the most important sub-sector of banking, representing over 50% of total EU activity in terms of gross income. The Commission estimates that in 2004 retail banking activity in the European Union generated gross income of 250-275 €billion, equivalent to approximately 2% of total EU GDP².
3. The European retail banking sector provides vital services including saving, borrowing and payments to consumers and small and medium enterprises (SMEs). However, a number of indicators such as market fragmentation, price rigidity and customer immobility suggest that competition in the EU retail banking market may not be working effectively. Based on Regulation (EC) No 1/2003³, the Commission therefore decided to open an inquiry into the retail banking⁴ sector, in particular in relation to cross-border competition.
4. The sector inquiry forms part of the wider political context of the Lisbon Agenda and will help to deliver the objectives set out in the White Paper *Financial services policy 2005-2010*⁵, where the Commission stressed the importance of the close interaction of internal market policy and competition policy. Likewise the creation of a more competitive environment between service providers, especially those active in retail markets, was identified as a priority. Delivering these goals will enable European consumers to reap the full benefits of the internal market. The sector inquiry into retail banking contributes to this agenda by shedding light on the operation of the market; highlighting possible market failures; and identifying where

1 Interim reports were published on 12 April 2006 (payment cards) and 17 July 2006 (current accounts and related services).

2 Figures taken from Interim Report II of the sector inquiry into retail banking.

3 See: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_001/l_00120030104en00010025.pdf.

4 See:

http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/decision_retailbanking_en.pdf

5 See: http://ec.europa.eu/internal_market/finances/policy/index_en.htm

market failures can be tackled through competition law and, where appropriate, other measures.

5. To underpin the development of a single market for financial services and harness the full potential benefits of the euro, the European banking industry is creating a Single Euro Payment Area (SEPA). The SEPA project aims at creating an integrated market for payment services which is subject to effective competition and where there will be no distinction between cross-border and national payments within the euro area. The Commission and the European Central Bank strongly support and are working closely with industry on the development of SEPA.

2. MAIN FINDINGS OF THE SECTOR INQUIRY INTO RETAIL BANKING

6. The sector inquiry has identified a number of symptoms suggesting that competition may not function properly in certain areas of retail banking. The inquiry has confirmed that markets remain fragmented along national lines, including in retail banking infrastructures such as payment systems and credit registers.
7. Different market structures can explain different conduct and performance of the banking sector between Member States. As the inquiry shows, this is reflected, for instance, in a wide variety of profit margins, prices and selling patterns between the Member States. By contrast, the inquiry has found evidence of convergence of banks' prices and policies within individual Member States. High profitability could signal a supportive business cycle and favourable macro-financial conditions or a number of other factors, including increased efficiency in banks' operations. However in some Member States, the conjunction of sustained high profitability, high market concentration and evidence of entry barriers raises concerns about banks' ability to exploit market power over consumers and small firms.
8. The sector inquiries identified a number of factors which might suggest that the symptoms discussed above reflect a problem of competition. First, the banking industry is characterised by a variety of possible entry barriers. These barriers may consist of network and standardisation requirements for certain infrastructures, or be of a regulatory or behavioural nature. From the view point of competition policy behavioural entry barriers are of particular concern, for example access barriers to payment systems, which may result from abuse of a dominant position – e.g. by a dominant network – or by co-ordinated behaviour of incumbents to exclude newcomers.
9. Secondly, the nature of retail banking activity creates scope for formal co-operation among market players. Certain types of co-operation (e.g. creating and operating common standards and platforms) may be necessary to generate efficiencies. However, co-operation extending to banks' strategies, pricing or selling policies could lead to collusion and limit competition and/or exclude third parties.
10. During the inquiry's market survey and following public consultation, banks had the opportunity to highlight, in confidence, any entry barriers and competition problems they faced. Very few banks chose to provide information though a handful pointed to significant behavioural barriers they faced as foreign entrants.

11. The sector inquiry has identified competition concerns in the following areas: (1) payment systems, including card payment systems; (2) credit registers; (3) cooperation between banks; and (4) setting of prices and policies. Therefore action by competition authorities could be needed, in close cooperation with regulators and supervisors, to strengthen competition in several Member States.

2.1. Payment systems

2.1.1. Payment card systems

12. The European payment cards industry provides the means for a significant part of sales in Europe. Total sales volumes with card transactions in the EU in 2005 were more than €1350 billion⁶.

13. The sector inquiry has identified several significant competition issues in the European payment cards market⁷ that confirm the need for strong competition law enforcement in close cooperation with national competition authorities. The Commission has already taken action in several cases, including MasterCard⁸ and Groupement des Cartes Bancaires⁹.

2.1.1.1. High variation in card fees across the EU

14. The substantial *discrepancy in merchant, cardholder and inter-bank fees* (multilateral interchange fees) across the Member States highlights market fragmentation. In 2004, inter-bank fees on credit cards in Visa and MasterCard networks in Portugal were more than twice the level of those in Slovakia. Meanwhile merchant fees for the same type of cards in Portugal and the Czech Republic were more than three times the level of fees in Finland and Italy. Although the Member States tend to have quite different historical backgrounds, differences of such magnitude could be explained by the presence of competition barriers.

15. The identified *multilateral interchange fees* raise competition concerns, particularly in some countries. Card payment networks argue that, given the typical set-up of card payment mechanisms¹⁰, the card issuers typically bear the main costs of the payment system, while most of the revenues are collected on the acquiring side as merchant fees. Therefore, the card payment networks claim that there is a need to redressing cost imbalances by an interchange fee mechanism, i.e. a fee paid by the acquirers to the issuers. However, the evidence shows that most domestic debit card networks set significantly lower (or even zero) interchange fees than international networks on debit card transactions, resulting in generally lower merchant fees.

6 This estimate refers solely to point of sale transactions. Automatic teller machine (ATM) transactions are not included.

7 The current analysis did not extend to ATM transactions.

8 Case COMP/34579.

9 Case COMP/38606.

10 A typical card payment mechanism is described in Interim Report I on payment cards

16. Analysis of the inquiry's market data suggests that card issuing alone (i.e. without interchange fee) generates positive profits in twenty Member States.¹¹ There is an ongoing debate on how far multilateral interchange fee mechanisms are indispensable in practice to enable the efficient operation of payment card networks; and, if such multilateral interchange fees were indispensable, on the necessary conditions for their admission.

2.1.1.2. Structural barriers in payment card networks

17. In several Member States, acquiring of Visa and/or MasterCard transactions is done by a monopoly player. Such acquirers act as *joint ventures* of incumbent banks that at the same time issue cards on that market. This situation may enable issuers to exercise significant market power and thus lead to uncompetitive merchant fees.

2.1.1.3. Access and governance arrangements

18. In international networks (Visa and MasterCard), as well as in national card payment systems in Belgium, Denmark, Finland, France, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain, *membership rules* reserve the right of issuing and acquiring to *credit and/or financial institutions*, or to an entity under direct control of such institutions. While it could be argued that this pre-condition is justified for supervisory or financial stability reasons, it limits participation of merchants and processors in issuing and acquiring, hence undermining the intra-network competition in these countries. Similar concerns appear with respect to access to infrastructures.¹² In Ireland, the Netherlands and Portugal the national system rules require the *local presence* of a foreign entrant, by means of establishment of a local branch and/or a subsidiary. This requirement increases the costs of foreign entry, which may limit the intra-network competition.
19. According to certain *governance arrangements* within the French and Spanish national card payment systems as well as in Visa and MasterCard networks, associate members are obliged to report business sensitive information to the principal members without reciprocal data sharing. This undermines the competitive position of associate members and reduces the competition pressure of principal members

2.1.1.4. Network rules and membership fees

20. Acquirers apply *blending*¹³ to competing products both in domestic and international card payment systems. Acquirers in France, Belgium, Denmark, Hungary, Ireland and Portugal report full (100%) blending of Visa and MasterCard merchant fees, while in Spain, Sweden and Malta, blending is reported in more than 60% of cases. The results of the inquiry suggest that blending of prices may weaken inter-network price competition, which in turn leads to retailers paying higher fees.

11 Portugal, Latvia, Estonia, the Czech Republic and Italy have the highest estimated levels of issuing profitability (gross profit-to-cost margin of at least 60%) of credit cards business, without accounting for interchange fee revenues.

12 The financial institution requirement may, however, no longer apply when the proposed Payment Services Directive is implemented.

13 'Blending' is acquiring banks' practice of charging businesses a global price for accepting cards of different types and/or issued by different networks, without distinction between interchange fee levels.

21. Some network rules *co-branding*¹⁴ may also impede entry or at least make it more difficult. The prohibition on co-branding with networks which are deemed competitors and with non banks might limit competition between networks and between banks and non-banks respectively.
22. Similarly, the prohibition for merchants to charge customers a usage fee, *surcharging*¹⁵, in many networks may hinder the development of more efficient payment instruments as the true costs are hidden to the consumers via cross-subsidisation.
23. While *joining fees* for banks vary considerably across the EU networks, payment systems in some Member States (e.g. Belgium, Denmark, Finland) impose particularly high joining fees, thus directly dissuading new entrants to join the circle of members. The analysis of the membership fee level showed that the magnitude of joining/membership fee levels may not be solely explained by the size of the country in question.

2.1.1.5. Preferential bilateral fee agreements

24. By concluding and acting on a basis of *preferential interchange agreements*, monopoly players, involved in both issuing and acquiring activities, may indirectly have obstructed new entry by not applying the same favourable conditions to newcomers, thus raising their costs of entry. Preferential bilateral interchange agreements¹⁶ ('on-us' interchange fees) existed at least in Portugal, Belgium, Austria, Spain and UK. Since the publication of the Commission's Interim Report on payment cards in April 2006, banks in most of these countries have started to review their interchange fee arrangements and the Commission sees first developments in these markets.
25. In the UK, Ireland and Finland the existence of *bilateral clearing arrangements* between local banks make market entry more difficult. As a rule, new entrants need to find a sponsoring bank for transaction clearing, which in general is not keen on assisting potential competitors.

2.1.2. *Payment systems other than payment cards*

26. Access to clearing and settlement systems is necessary for any bank considering entering a retail banking market and intending to offer customers core banking services such as current accounts. The operators of the established infrastructures are potentially in a position to create entry barriers which may take a variety of forms:
 - *Different classes of membership and special requirements for direct member:* National clearing systems distinguish to varying degrees between classes of

14 The definition of 'co-branding' may vary across card networks. It generally refers to the presence of the logo of the card network and a second logo (of another network or a non-bank) on the face of the card.

15 'Surcharging' is an option available to merchants to request additional fees for the use of the most expensive payment instruments.

16 Transactions under preferential fee agreements are also known as "on-us" transactions, i.e. transactions where the issuer and the acquirer are the same or belong to the same group. In contrast, "off-us" transactions are transactions where the issuer and the acquirer are different credit institutions.

membership. In some cases these membership arrangements may distort the conditions under which individual member institutions concerned compete with each other, or under which potential new members can compete with incumbents.

- *The ‘need to be a bank’ requirement:* Most clearing systems admit only banks. This scrutiny may help guaranteeing financial stability but could hinder the entry of non-bank players in payment systems, in particular if there were other efficient ways to ensure the financial reliability.
- *Membership fees and fees structure:* In some Member States, the fee structure of payment systems – e.g. the level of joining fees and per transaction fees – could act as a barrier to competition for new or small players in the retail banking market.
- *Need to adapt to different national standards.* Payment providers have to observe different technical specifications to enter different national payment systems, as well as a testing and certification procedure. In some systems this can take as long as twelve months and lead to high costs.
- *Interchange fees for credit transfer and direct debit:* In Member States where interchange fees are agreed upon, such fees may distort competition between different means of payment and competition to provide payment services to customers. Competition between means of payment may be distorted where banks have an incentive to promote the use of payment means with high interchange fees.

2.2. Credit registers

27. Open and affordable access to good quality credit data is an important prerequisite for banks wishing to provide core retail banking products such as mortgages, consumer loans and credit cards. However, widespread credit data are not available in several Member States, whether because of regulation or the limited development of credit data markets.¹⁷
28. Moreover, evidence gathered during the sector inquiry suggests that aspects of the operation of credit registers in some Member States may be incompatible with competition law. In at least two Member States, credit registers owned and run as joint ventures among domestic banks appear to offer access to data on discriminatory terms, thereby discouraging potential entrants to the banking market.

2.3. Cooperation between banks

29. Retail banks co-operate in a variety of areas such as the setting of standards and infrastructures or the operation of payment systems. Savings and cooperative banks traditionally have even closer co-operative ties. These specific types of banks cover a significant proportion of the retail banking activities in Europe and play an important role in several Member States such as Germany, France, Austria, Italy and Spain. However, ownership and company structures, the level of co-operation and specific

¹⁷ Clearly the establishment and operation of credit registers must fully comply with Member States' data protection legislation. However, a full assessment of compliance is beyond the scope of the inquiry.

regulatory and prudential provisions vary enormously between Member States¹⁸. A uniform assessment is therefore impossible.

30. Insofar as savings and co-operative banks remain legally independent, they tend to co-operate in a variety of fields, i.e. running their own payment infrastructures, having a joint risk management and protection scheme for deposits or even having a common business and marketing strategy including a common brand. Some savings banks and/or co-operative banks apply the regional or territorial principle, reserving a defined geographic area for the activities of an individual retail bank.
31. Co-operation between banks can result in economic and consumer benefits. It usually does so where the banks involved are SMEs and jointly do not possess a significant market share. Where independent banks with a significant combined market position enter into cooperation with the object or effect of limiting competition among themselves or excluding new entrants, however, effective competition can be impeded. In such cases, the Commission could consider a more in-depth analysis to address the potential competition problems caused by coordination that goes beyond the strictly necessary to achieve any pro-competitive benefits.
32. In case of competition problems, the Commission, therefore, has to analyse whether indicated anticompetitive behaviour is induced or maintained by legislation or other state measures.

2.4. Setting of prices and policies

33. The decisions of retail banking customers are also constrained by information asymmetry and high switching costs. Information asymmetry will vary according to the complexity of products being sold and the transparency of prices. Clear and transparent information for consumers may help to reduce information problems. In addition, authorities in several Member States are working to improve consumers' financial awareness.
34. High switching costs also limit the mobility of customers. Some level of non-financial switching costs appears unavoidable for products such as current accounts, where the administrative burden of switching – and consumers' perception of it – can discourage consumers from changing supplier. However, the inquiry has found that some banks create artificial barriers (e.g. tying¹⁹ banking products or imposing high closing charges) which raise switching costs for consumers and thus reduce the intensity of competition.
35. The inquiry's data show that customer mobility in current account markets is generally low. High customer satisfaction may partly explain low levels of mobility.

18 For instance, savings banks are still publicly owned and/or managed in some Member States such as Germany, Luxembourg and, to a substantial extent, Spain. They are totally privatised in others, mainly in the new Member States, restructured into a co-operative group form (France) or consist of hybrid structures with private and publicly owned savings banks alongside (Austria, Italy). Co-operative banks, on the other hand, are in general based on the principle to provide banking services to their owners, who are not permitted to own (or sell) a controlling number of shares.

19 Tying occurs when a bank makes the purchase of one product (e.g. a mortgage) conditional on the acceptance of another separate product (e.g. a current account).

However, the inquiry's analysis also suggests that banks may have greater scope to exercise market power where customers are less mobile.

36. Prices for retail banking products vary substantially across Member States. However, the inquiry has found that at national level there is evidence of convergent behaviour in pricing and policies for core retail banking products. In current accounts such convergent behaviour can be seen in relation to the setting of several parameters including account management fees, closing charges, ATM fees and default charges.
37. Product tying is an additional aspect where banks in the majority of Member States demonstrate convergent behaviour. Tying can weaken retail banking competition by raising switching costs, reducing price transparency and discouraging the entry of new players (especially mono-line suppliers). The inquiry's market survey suggests that in most Member States the majority²⁰ of banks tie a current account to mortgages, personal loans and SME loans. Moreover, where the largest bank in a Member State ties its products, the inquiry's data suggests that the majority of its competitors choose to follow suit.

3. POSSIBLE NEXT STEPS

38. Based on the evidence gathered in the sector inquiry, the Commission recommends a range of measures to strengthen competition in retail banking, including in the market for payment cards.

3.1. Competition law enforcement

39. Antitrust enforcement may be able to address several of the competition issues identified in the sector inquiry. Areas for potential action include firstly access barriers, discriminatory rules, fee structures and governance arrangements in some payment card networks and clearing and settlement systems.
40. Secondly, enforcement action might also be appropriate in relation to high interchange fees and merchant fees in some payment card networks.
41. Thirdly, the Commission may gather further information in order to assess whether cooperation between savings and/or co-operative banks that have significant market positions appreciably restrict competition either between themselves or in relation to other actual or potential competitors.
42. Fourthly, some forms of product tying by some banks may be inconsistent with competition law, for example where tying constitutes an abuse of dominance in the relevant product markets.
43. Finally, antitrust enforcement may also be appropriate to address access barriers and discriminatory rules in relation to credit registers.
44. Any possible enforcement procedures would require a full examination of the specifics of each case in consultation with the national competition authorities.

20 The 'majority' of banks refers to banks in the Commission's market survey holding a combined market share of more than 50 per cent.

3.2. Regulatory and self-regulatory measures to address competition concerns

3.2.1. Payment systems

3.2.1.1. Single Euro Payments Area (SEPA)

45. Several of the competition barriers that the sector inquiry has highlighted may be remedied through the establishment of a pro-competitive SEPA. For payment card networks SEPA offers the potential to remove many restrictive rules. The Commission will pay particular attention to ensure that co-branding restrictions are not used to compartmentalise markets.²¹
46. The SEPA framework for payment cards should provide retailers with greater choice of supplier for acquiring services, opening up greater competition in this highly concentrated market.²²
47. To ensure the proper functioning of the internal market, the European Commission has the right to propose legislative measures. The Commission's proposed Directive on payment services²³ will prohibit access restrictions to payment systems and infrastructures based on institutional status. This Directive is now in discussion in the Council and the European Parliament. Its implementation will enable citizens to benefit from more competitive and efficient payment services. Within SEPA, payment card networks and clearing and settlement systems should not be able to distort competition by imposing discriminatory rules and governance arrangements.
48. The Commission, together with the national competition authorities, will continue to monitor the compatibility of the SEPA framework with competition law, as requested by the Ecofin Council.²⁴

3.2.2. Credit registers

49. The sector inquiry has found that the principle of non-discriminatory reciprocal access to credit registers is not yet fully applied. Significant barriers also remain to cross-border data sharing. The proposal for a Directive on Consumer Credit requires Member States to ensure cross-border access to credit registers on a non-discriminatory basis²⁵. The Commission is examining these issues in relation to the European mortgage market²⁶. A future examination may also be warranted to assess compatibility with an open and competitive European credit market.

21 This could for example be the case if an international cards scheme deems another scheme a competitor simply because it decides to operate outside its home Member State.

22 It should be remembered that in some Member States retailers currently face only one 'offer' from a monopoly provider of acquiring services (see paragraph [17] for details).

23 See: http://ec.europa.eu/internal_market/payments/framework/index_en.htm

24 See Council Conclusions on SEPA, 10 October 2006:
http://www.consilium.europa.eu/ueDocs/COUNCIL-LIVE/20061010_14209_6.PDF

25 See: http://ec.europa.eu/consumers/cons_int/fin_serv/cons_directive/2ndproposal_en.pdf. The relevant provisions are contained in Article 8.

26 The Commission's Green Paper on mortgages, published in July 2005, is available at: http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm#greenpaper

50. Authorities that wish to enhance competition and efficiency in credit markets may wish to consider regulatory reforms concerning credit data sharing, notably to enable wider coverage of credit registers. However, the frameworks for data protection and credit data sharing are sensitive matters and require careful scrutiny by Member State governments. In a small number of Member States the inquiry has identified concerns that credit registers may not be fully observing data protection rules.

3.2.3. *Setting of prices and policies*

51. There may be a case for examining the effects of tying on competition in specific banking product markets. Authorities in a small number of Member States have introduced regulations to limit or prohibit product tying in retail banking.

52. The Commission has launched an expert group²⁷ to examine customer mobility in relation to bank accounts. The group is considering measures to facilitate the opening and switching of bank accounts on a domestic and cross-border basis, by examining best practices in the Member States. The expert group will present its recommendations in the first half of 2007.

4. CONCLUSION

53. This sector inquiry identified four key issues that will need to be followed up by the Commission and national competition authorities:

- the design and operation of payment systems, including card payment systems;
- credit registers;
- cooperation between banks; and
- the setting of banks' prices and policies, including product tying.

54. The European Commission will not hesitate to exercise its powers of enforcement under Articles 81, 82 and 86 EC, to ensure that the competition rules are respected in retail banking; and with respect to the various payment markets and the SEPA project in particular. The European Commission will also continue its efforts in fields other than competition law to further increase the benefits of the internal market in retail banking to its citizens.

27 See: http://ec.europa.eu/internal_market/finservices-retail/baeg_en.htm