Payment Systems Regulator

Market review of card scheme and processing fees

Stakeholder input to the competitive constraints call for evidence and profitability working paper

September 2023

MR22/1.7

Contents

1 Introduction

1.1 On 23 February 2023, we published two papers as part of our market review of scheme and processing fees. Our terms of reference explain the scope of this market review.[1] These working papers covered:

- a summary of what we have heard so far about the competitive constraints that Mastercard and Visa face when setting scheme and processing fees (the 'call for evidence')[2]
- our proposed approach to assessing Mastercard and Visa's profitability (the 'profitability working paper')[3]

1.2 The working papers asked stakeholders for feedback on our thinking and understanding so far. In particular, we asked for feedback and any supporting documents and information on:

- the factors that influence and constrain the card schemes in setting their fees, and the impact of those factors
- the approach to assessing Visa and Mastercard's profitability

1.3 We received six responses to the profitability working paper and 14 responses to the competitive constraints call for evidence, from a variety of stakeholders. In this paper, we summarise and respond to the key points that they made. We have also published the non-confidential versions of their responses.[4]

1.4 The remainder of this document is structured as follows:

- **Chapter 2** summarises the responses to the call for evidence
- **Chapter 3** summarises the responses to the profitability working paper
- **Annex 1** lists the stakeholders who responded to each paper

1 MR22/1.2: Final terms of reference (October 2022)

2 MR22/1.4: Competitive constraints in card payment systems call for evidence (February 2023)

3 MR22/1.5: Approach to profitability analysis working paper (February 2023)

4 Stakeholder submissions to competitive constraints call for evidence (MR22/1.4) and approach to profitability analysis working paper (MR22/1.5) (September 2023)

2 Competitive constraints

2.1 We are looking at how the competitive constraints on card schemes work in practice, to understand and assess whether or not competition is working well.

2.2 In the call for evidence we:

- provided background on four-party card payment systems and the economics of setting scheme and processing fees
- summarised stakeholder views on the competitive constraints that Mastercard and Visa face when setting scheme and processing fees
- invited responses to questions posed in the paper, divided into four themes

2.3 The four themes are:

1. the intensity of competition and innovation in the payments ecosystem
2. differences in the competitive dynamics on the issuing and acquiring sides
3. the impact of transparency on competitive pressure at all levels of the value chain
4. the 'must-take' status of Mastercard and Visa-branded cards (in many retail environments)

2.4 Fourteen stakeholders responded to this working paper, including Mastercard, Visa, two acquirers, three issuers, two merchants and four associations. Annex 1 lists the respondents.

Respondents' views

Theme 1: The intensity of competition and innovation in the payments ecosystem

Competitive constraints faced by Mastercard and Visa

2.5 Mastercard and Visa made the following points about the competitive constraints they face:

a. Mastercard and Visa both stated that the characterisation of competition set out in **the call for evidence understates the degree of competitive constraint exerted on them**. They noted that card payments comprise only a small proportion of overall UK payments and must compete with the full range of payment options active in the UK.

b. Mastercard stated that the call for evidence considers an 'artificially narrow segment of the market' and that the popularity of different payment methods varies for different types of payments.

c. Mastercard noted that direct debit remains the most popular method of payment for utilities, while card payment is not commonly used for this purpose. Mastercard explained that cash accounts for around 15% of transactions and is more popular in certain payment segments (such as peer-to-peer and trades profession payments). Mastercard stated that it is not possible to adjust a card payment's product offering across these segments. Mastercard stated that for many payment methods and card schemes in the UK, the product offering will be largely the same across different sectors. Given this, Mastercard stated that card scheme providers must ensure that their offering is competitive across all payment segments.

d. Mastercard and Visa identified a number of competitors to their card scheme services in the UK, including other card schemes, with Mastercard noting American Express and JCB. Visa referenced open banking-enabled payments, account-to-account, digital wallets, buy now pay later (BNPL) services, payment facilitators, payment orchestration platforms and other alternative payment service providers.

e. Mastercard and Visa stated that **the call for evidence failed to account for the role played by alternative payment methods** in the UK. Visa considered it incorrect to view alternative payment methods as at an early stage of their development. Visa noted that non-card-based payment methods play a significantly increased role, such that they are even overtaking the role currently played by cards for specific payment types. Visa cited PayPal, Apple Pay, Revolut and Monzo as examples of developed alternative payment methods, as well as other established payment infrastructures such as Faster Payments and open banking.

f. Mastercard and Visa also noted that **merchants can steer consumers** towards the merchant's preferred payment method or away from using certain payment methods that are not favourable to the merchant. Visa outlined how this could be done in various ways, including presenting payment options to consumers in a particular order to influence consumers' choices. Visa also noted that merchants can (and do) opt to not accept certain payment types.

g. Mastercard emphasised that **payment systems compete to be used at the transaction level**, rather than just to be accepted more generally. Mastercard explained that both merchants and consumers use both Mastercard and Visa, as well as various other payment methods (known as 'multi-homing'). Mastercard stated that this, combined with merchants' ability to influence consumers, gives merchants the ability to steer and creates competitive pressure at the transaction level.

h. Mastercard also noted that **alternative payment methods which are currently card-based, such as digital wallets, involve two separate 'funding' and 'payment' stages**. Mastercard explained that given the separation between these stages, relevant alternative payment services could feasibly add a different funding source instead of card payments.

2.6 Most respondents said Mastercard and Visa are not strongly constrained by competition. The following points were made by merchants, merchant associations or acquirers:

a. Two respondents noted that **people use different payment methods for different things**. While a variety of payment methods are available for low-risk payments, such as where the payee and payer know each other, there were few or no alternatives to Mastercard and Visa for high-risk payments where they do not know each other. This is the case in most consumer-to-business and business-to-business transactions.

b. One respondent said that **the range of available payment types** has not increased: consumers do not decide which payment method to use but instead use the card their issuing bank gives them, and merchants cannot steer consumer choice of method. Another respondent said cardholders normally choose the most convenient payment method, while merchants cannot choose to accept only Mastercard or only Visa. This respondent added that, for some payments, high payment friction or slower payment speeds do not lead people to abandon transactions. For these types of payments there are likely to be more non-card options.

c. Another respondent said **non-card payment methods offer a competitive alternative** to Visa and Mastercard in some circumstances, because changes to the payments landscape, such as open banking, have created opportunities for new entry and competition.

d. Five respondents commented on **whether other card schemes, such as American Express, impose competitive constraints on Visa and Mastercard**. One cited other card schemes, such as American Express, as established payment systems. Another said these alternatives may have strong positions with certain types of merchants. This respondent said that in specific merchant categories, such as travel and lifestyle, three-party systems could provide limited competition to Visa and Mastercard. Three respondents raised that alternative card schemes, such as American Express, are not a strong constraint, with significantly less UK penetration than Mastercard and Visa. Three respondents said that the alternative schemes cannot compete with the high levels of merchant acceptance that Mastercard and Visa offer to consumers.

e. Several respondents noted that many **alternative payment methods rely on card schemes** for their payment infrastructure – for example, BNPL and digital wallets. This means they are not substitutes to Mastercard and Visa and do not competitively constrain them. Two respondents said this reliance further entrenches Mastercard and Visa. One said that by improving consumers' 'front-end experience' – which was the 'USP [unique selling point] of open banking' – wallets limit how far open banking can compete with cards. One respondent said that such alternative payment methods also create opportunities for Mastercard and Visa to charge additional fees. Another respondent said that alternative payment providers have positioned their businesses to benefit from the existing card payment model, so – despite having a separate funding stage – they won't be switching away from card payments as a funding method anytime soon. The same respondent said that the funding stage of alternative payment methods should not be relevant to our investigation.

f. Two respondents suggested that **payment methods that do not rely on card payment infrastructure**, such as those using open banking, are not mature enough to compete effectively with Mastercard and Visa. One respondent showed that payment initiation service (PIS) payments are not performing well enough in terms of conversion rates and payment speeds to compete with card payments.

2.7 Some respondents commented on **competition Mastercard and Visa face for their value-added services**:

a. Mastercard stated that there is variation in the take-up and use of optional services by different customers, in different years. **Mastercard explained that optional services offered by card schemes promote competition** by supporting diversity and choice of product, service, and by allowing service providers to compete in new areas of the market, facilitated by open standards.

b. Other respondents maintained that **competition for optional services is more limited** than the card schemes suggest. One said that although there are alternatives to Mastercard and Visa for fraud detection, there are none for authentication. Another said that Visa or Mastercard is the only choice of provider for some new services. The importance of the schemes' core services makes it difficult to avoid using their optional services, so some fees are not 'genuinely optional', this respondent said. Some features of Mastercard and Visa's optional services limit the ability to choose services that alternative providers offer, the respondent said, adding the following points:

- A lack of cooperation from the schemes makes it difficult for customers to unsubscribe. Understanding fees presents a large operational burden and schemes take 'severely long' to respond to queries and clarification requests. Card scheme providers often respond to requests for clarification with an 'unhelpful general-purpose explanation'.
- Lack of transparency means that acquirers struggle to distinguish between essential, non-essential and optional fees. This means the respondent lacks the information it would need to optimise costs by opting out of certain optional services. Schemes use this lack of transparency to cross-sell optional services – for example, the acquirer Transaction Processing Excellence Fee. Visa's fees are so complicated that in order to comply with Article 12 of the Interchange Fee Regulation (IFR), it is essential to use the scheme's own acquiring interchange reporting service.
- Schemes may charge non-compliance fees when customers do not use so-called optional services. Such fees (for example, the 3DS and tokenisation non-compliance fees) limit customers' ability to find alternative providers as they must incur the cost while disputing the fee. The schemes can use their market power to compel users to use the schemes' own optional services, rather than allowing users to buy these services from another provider. Another respondent expressed a similar concern regarding these fees.

Barriers to entry and expansion for other payment systems

2.8 Mastercard and Visa both commented that the call for evidence understated the extent of entry and expansion of alternative payments that has occurred in the UK in recent years, and the constraint exerted on them by entry and expansion:

a. Visa noted that recent entry and expansion has included: new entrants such as BNPL and online banks; existing payment sector firms expanding into new parts of the payments value chain; large firms leveraging existing consumer relationships to expand into the payments ecosystem; and established payments firms active in other jurisdictions entering into the UK. Visa noted that further entry is expected to occur in the future and provided examples from other countries where a range of non-card payment services have entered and were able to become significant players in those markets.

b. Mastercard noted that there are strong network effects but new entrants have shown that these barriers to entry can be overcome. Mastercard explained that competition is driven by the high prevalence of using Mastercard, Visa and other payment systems among payers and merchants, which facilitates rapid switching if one payment system offers advantages to customers. Similarly, Mastercard considered that the credible threat of merchant steering, in addition to any actual merchant steering that may be taking place, imposes a constraint on incumbent payment system operators.

c. Mastercard disagreed that it is in a position to discourage the development of alternative payment types, stating that there has been a significant amount of innovation and entry in recent years. Mastercard considers that it must continually innovate and that its innovations facilitate entry by alternative payment methods, including BNPL and digital wallets.

2.9 Other respondents disagreed, **saying it is difficult for alternative payment types to develop**:

a. Five respondents said there are significant barriers to entry and expansion, and three of these respondents gave the example of network effects.

b. Two respondents referred to regulatory barriers.

c. Another respondent said that would-be alternatives need high levels of investment and marketing. There is an 'increasing pattern of Mastercard and Visa buying out potential challengers entering the market', this respondent added.

2.10 Some respondents said **Mastercard and Visa's conduct helps raise barriers** to entry and expansion in the payments landscape:

a. One respondent said these card scheme providers have an interest in the development of alternative payment types such as open banking and bank-based payments. This dilutes competition, the respondent said.

b. A respondent merchant association pointed to public sources to state that there is 'evidence to suggest' Mastercard and Visa have secured agreement from digital wallets to only accept cards or not to steer users to cheaper non-card payment methods.[5]

Future developments

2.11 Visa considered that **the call for evidence omits the impact of existing and planned regulation** relating to open banking and the New Payments Architecture (NPA). Visa explained that regulation has already boosted competition by facilitating entry and expansion by new operators. Visa also stated that these interventions would intensify competition in the UK payments ecosystem in the future. In addition, Visa noted other UK policy developments. Firstly, the Treasury publications for plans to recognise stablecoins as forms of payment, and secondly, the Bank of England publications which explore the introduction of a digital pound for everyday payments. Given these policy publications and the planned regulation, Visa explained that existing and planned interventions are important factors in understanding forward-looking competitive dynamics.

2.12 Mastercard explained that the choice of payment options for merchants and consumer has been increasing due to BNPL, digital wallets, open banking and new players competing for transactions. Mastercard stated that multi-homing is very common (and increasing) among both consumers and merchants.

5 The sources are: (i) the US Department of Justice complaint petitioning to block Visa's 2020 acquisition of Plaid, see paras 47-49, and (ii) RPGC – Payment Insecurity: How Visa and Mastercard Use Standard-Setting to Restrict Competition and Thwart Payment Innovation (December 2019).

2.13 Mastercard noted there are options for building the necessary customer base to enter the payments industry and highlighted two: (i) by introducing a new value proposition to differentiate from current offerings in the market, as BNPL and digital banking companies have done; and (ii) companies with large user bases can leverage users into payments, as mobile wallets have done.

2.14 There was **disagreement with Visa's characterisation of payment innovation**, both existing and planned:

a. Four respondents considered that no one has yet introduced or adequately developed a credible competitor to Mastercard and Visa's card payment systems. Open banking and account-to-account payments show potential as competition, but open banking solutions must still mature and evolve.

b. One respondent cited changes that could introduce competition by making payment systems interoperable and establishing 'dynamic end-user choice':

   - Surcharging could give consumers the incentive to use the payment method with the lowest surcharge. But on its own, surcharging is not enough to introduce competition.
   - Creating a UK domestic card scheme that would enable co-badging for card schemes and multi-homing for issuers, allowing merchants to route a payment through their preferred payment system. This would allow the payee side of the market to exert 'direct competitive pressure on the schemes'.

Fees and fee increases

2.15 Mastercard stated that the 'average fee per euro transacted paid to Mastercard has not increased significantly since 2017'. Mastercard explained that the average mandatory acquirer fees have increased 3.1% per year because of specific fee changes which reflect improved value and service quality. Mastercard also explained that it would only be able to increase its fees 'when there is a solid rationale rooted in the customer value proposition and where competitive conditions permit'.

2.16 Other respondents expressed **diverse views on fees and fee increases**:

a. The majority said Mastercard and Visa fees have increased in recent years.

b. Without commenting on fees specifically, some respondents said the card schemes generate considerable value for their end users. One highlighted the benefits of the two schemes' high acceptance and broad coverage, high security and resilience, and consistent standards.

c. One respondent said that some fees do not fully reflect the value of Visa and Mastercard to issuers, acquirers and end users.

d. Others felt the schemes' fees do not represent value for money or that the fees have increased without service quality significantly improving. One respondent said that since merchants must accept Mastercard and Visa cards and acquirers must offer them, these stakeholders will continue to pay fees that do not reflect 'value for money'. It is therefore wrong to consider 'value for money' in relation to these fees, the respondent said.

e. A few respondents also noted that when either Mastercard or Visa made fee changes, the other scheme often copied them.

Theme 2: Differences in the competitive dynamics on the issuing and acquiring sides

Competition on the issuing side

2.17 **Visa considered that card schemes' payment ecosystems cannot be analysed by considering the acquiring and issuing sides separately**. Instead, the ecosystem should be analysed 'holistically'.

2.18 Mastercard commented that competition between Mastercard and Visa **for issuers and cardholders** is intense. Mastercard considered that they compete on price, innovation and quality.

2.19 Other respondents commented on **various aspects of competition on the issuing side**:

a. Two said it is important to analyse the competitive conditions on issuing and acquiring sides separately. One said that on each side, particular competitive constraints determine prices.

b. Among those who commented on competitive conditions on the issuing side, the majority considered that Mastercard and Visa compete to win contracts with issuers.

c. Other respondents said Mastercard and Visa compete in terms of the prices offered to issuers. Some of these respondents said the rivals' offerings to issuers are so alike that they compete on price but not innovation.

d. Some respondents noted that compared with acquirers, issuers have far greater bargaining power with the schemes. Two linked this greater power to the tendency of issuers to use either Mastercard or Visa, not both.

e. Two respondents noted that competition will be more intense for issuers whose cardholders make more valuable transaction types (for example, those associated with higher interchange fees or high cross-border spending). One of these respondents also felt that the larger the issuer, the greater the bargaining power.

f. Respondents commenting on the extent to which Mastercard and Visa compete for cardholders agreed that the schemes do not directly compete for cardholders. Respondents noted that consumers have a relationship with the issuing bank rather than the schemes and do not consider their banks' choice of card scheme when choosing their bank.

Competition on the acquiring side

2.20 Visa considered that the **competitive dynamics** of the issuing and acquiring side cannot be assessed in isolation from one another.

2.21 Mastercard noted the following points regarding **competition for acquirers and merchants**:

a. Competition between payment systems happens at the transaction level, and that card schemes must therefore offer a proposition that encourages both the acceptance and use of its cards.

b. If propositions were not attractive enough, merchants would have an incentive to steer transactions away to another card scheme, as well as to alternative payment methods.

2.22 In general, other respondents saw **no meaningful competition between Mastercard and Visa for acquirers**.

a. These respondents said that merchants must accept both Mastercard and Visa cards, as cardholders hold one or the other depending on the choice of their issuing bank (but probably not both). This means acquirers must enable merchants to accept both cards, and offering only one card would not be a viable business proposition.

b. One of these respondents considered that competition between Mastercard and Visa for acquirers is so low that no acquirers switch, despite fee differences between the schemes. Another respondent said that only the largest acquirers, or those who also have a large issuing business, are in a position to negotiate with Mastercard and Visa.

c. Several respondents also said there is a lack of competition between Mastercard and Visa for merchants. One of these respondents said the very largest merchants may be able to negotiate with Mastercard and Visa (for example, Amazon), but the vast majority cannot. Some respondents argued that merchants have little ability to steer between payment methods.

Cross-subsidisation

2.23 Three respondents said **competition for issuers rather than acquirers** leads to cross-subsidising by Mastercard and Visa. That is, they use fee revenue generated on the acquirer side to facilitate low or negative fees on the issuer side.

2.24 Mastercard noted that it gives acquirers **incentive payments** 'from time to time', and that 'each incentive is unique and individually agreed, typically as a joint investment between Mastercard and an acquirer in order to incentivise and meet the costs of the acquirer in adopting or promoting a particular product or service or to cover the costs of a specific project'.

2.25 Other respondents commented on **imbalances between acquiring and issuing sides**:

a. Fee increases fall disproportionately on the acquiring side, and that fees on this side are higher because Mastercard and Visa are competing more and more on the issuing side.

b. Two respondents said that the schemes transfer fee revenue from the acquiring side to the issuing side by offering rebates to issuers.

c. Respondents said that, by contrast, it is uncommon for the schemes to offer rebates to acquirers.

d. One respondent said it is uncommon for merchants to get rebates. One merchant felt that where the schemes offer incentives to merchants, it is to reduce any competitive threat from a domestic scheme. Another merchant said one of the two major card schemes had offered bespoke incentive deals to some merchants, but could be shifting to a 'funding model' to encourage them to adopt the scheme's other products. The rival scheme already uses this 'funding model', the respondent said.

e. One respondent said the schemes charge negative fees to issuers and argued that this practice should be considered exclusionary, as more efficient or innovative competitors will be unable to compete with such prices.

2.26 The call for evidence noted that some stakeholders considered that 'increases in scheme and processing fees (combined with rebates and incentives for issuers) could effectively amount to a circumvention of the Interchange Fee Regulation (IFR) (paragraph 3.28). Visa questioned the inclusion of these comments, stating that there is no evidence that such conduct is taking place.[6] Two respondents considered that the schemes' pricing behaviour could be considered an infringement of the IFR but did not provide any further evidence to support these statements.

Theme 3: The impact of transparency on competitive pressure at all levels of the value chain

Transparency and complexity of fees

2.27 Mastercard and Visa made the following comments regarding the complexity and transparency of fees:

a. Visa stated that fees are presented clearly and transparently.

b. Mastercard and Visa both said that customers – that are sophisticated businesses – are capable of understanding and engaging with the schemes' pricing structure. Mastercard said that one reason used to support this is that different customers choose to take different optional services. Visa explained that issuers and acquirers actively engage with the schemes on fee information and negotiate on fees as evidence of this understanding an engagement.

c. Mastercard noted that fees are appropriately complex since different services must be priced differently. Mastercard considered that varying uptakes of optional services is a sign that its customers understand the fees that are being charged.

d. However, Mastercard did note that 'in summary, the complexity of the fee schedule is a result of Mastercard's value-based pricing approach combined with Mastercard's continuous efforts to innovate to enhance its product proposition and introduce new services (which in turn is a result of being subject to competitive pressure) rather than it being "a symptom of competition not working well"'.

2.28 All others who commented on complexity on the acquirer side agreed that **fees are complex and lack transparency**:

a. Respondents considered that the fees' complexity can make it difficult for merchants to understand what a particular fee is for and the value they get from a service.

b. All these stakeholders also agreed that Mastercard and Visa lack transparency over their fees.

c. Merchants (including those on contracts with acquirers who pass scheme fees directly to them) considered that fees are not transparent and so it is hard for merchants to understand or query them.

6 See further, page 7 of Visa's response.

d. One stakeholder said the lack of transparency around new fees makes it difficult to plan for rising scheme and processing fees. The respondent noted that this disproportionately disadvantages small acquirers who do not have the resources to forecast internal costs and the fees they charge merchants for each transaction type. This is particularly true for increasingly popular blended contracts.

e. One respondent said fee complexity leads acquirers to spread the cost of obscure fees across all merchants because they cannot allocate them more accurately.

2.29 One stakeholder said that if the PSR is concerned about fee complexity, we should not encourage payment systems to provide additional information as this would further increase the complexity.

Impact on competition/arising from degree of competition

2.30 Some respondents said **complexity comes from lack of competition** in the market:

a. One said that the number of fees has increased between 2019 and 2022. Others agreed that schemes introduce new fees frequently and for existing product types.

b. Since a lack of transparency could be a symptom of a lack of competition, some respondents said we should focus on other market issues that are more important to competition, such as whether or not fees are optional.

c. Many respondents said that complex fees and a lack of transparency cause issues that inhibit competition in card payments.

d. Some said that lack of fee transparency hinders competition by making it difficult to evaluate the costs and benefits of a card brand or by preventing merchants from challenging fees.

e. These respondents felt that simpler fees would enable acquirers to negotiate better, could lead to lower fees, and would make it harder for schemes to introduce fees that merchants consider unwarranted.

2.31 Some respondents said that fees could be more transparent and less complex, but that there are **bigger issues for competition**:

a. They said that fee optionality is more important because customers may not be able to reject a service or fee or may be punished with another fee for doing so.

b. These respondents said that users must buy some services that schemes say are optional.

c. One respondent said a lack of transparency of financial flows between schemes and issuers is an important pro-competitive aspect of the relationship between schemes and issuers.

Theme 4: The 'must-take' status of Mastercard- and Visa-branded cards (in many retail environments)

2.32 Mastercard and Visa both highlighted that merchants do not necessarily have to accept Mastercard and Visa payments:

a. Visa noted that merchants are under no obligation to accept card payments and that merchants have chosen not to in the past.

b. Visa highlighted the wider competitive constraints from other payment systems which offer alternative payment options to merchants.

c. Visa stated that merchants have an ability to reject cards and steer cardholders. One way Visa said merchants can do this is by ordering payment options in a way to encourage cardholders to pay with a certain payment method.

d. Countering the view from other stakeholders quoted in the call for evidence, Visa stated that it cannot 'effectively act as [a monopolist]' as merchants would choose to encourage cardholders to pay another way if the quality and pricing of Visa's products were not able to support downstream services that are competitive and compelling.

e. Mastercard noted that merchants can influence consumer behaviour through many ways (such as non-acceptance of payment methods, steering, and incentives). Mastercard disputed claims that cards must be accepted by merchants, stating that this presents an overly narrow segment of the market. Mastercard explained that its pricing is constrained by the credible threat of merchants steering cardholders away from Mastercard, and merchants do not have to accept Mastercard in the medium-term.

2.33 However, the majority who responded to this point believe **merchants must accept, and acquirers must offer, Mastercard and Visa**:

a. Three respondents said that retailers generally have no choice but to accept Mastercard and Visa.

b. One said merchants must accept both cards because cardholders will generally only hold one of the two.

c. One respondent said merchants could lose a significant proportion of their customers if they stopped accepting Mastercard and Visa.

d. These respondents said that this situation causes problems in the card market because schemes can charge higher fees to acquirers, who can generally pass them on to merchants.

e. Two respondents noted that merchants in the UK are more likely to need to accept Mastercard and Visa than in some other countries. This is because there is no domestic card scheme or domestic alternative payment scheme here.

f. Five respondents said that acquirers must offer Mastercard and Visa payment options to merchants who wish to accept card payments.

2.34 One respondent said **American Express** is well established and operates effectively to a similar extent that Mastercard and Visa do. One said American Express can be strong in certain merchant categories. However, another respondent said American Express's lower market share (in volume and value) means it is not a competitive constraint on Visa and Mastercard.

2.35 Two respondents noted that **issuers can issue either Mastercard or Visa cards**. But one also said that the growth of digital wallets means issuers must also offer these to cardholders.

Our response

2.36 As part of our scheme and processing fees market review, we are looking at how the competitive constraints on card schemes work in practice, to understand and assess whether or not competition is working well. The points raised by stakeholders and noted above will form part of our evidence base. So will the information and evidence we have gathered through other methods, such as questionnaires and bilateral engagements.

2.37 We continue to review and analyse this information and will present our emerging findings in our interim report.

3 Profitability analysis

3.1 We are looking at the profitability of Mastercard and Visa's UK card businesses to understand whether their profit levels are what would be expected in a competitive market, or are too high.

3.2 In our profitability working paper, we set out our proposed approach to analysing the profitability of Mastercard and Visa's UK businesses and provided some initial analysis of their European and global profits.

3.3 We made several points about our approach:

- We plan to carry out a **margin-based assessment** of their operating profits.
- For now, we do not plan to undertake an **asset-based approach (return on capital employed (ROCE))**. That's because this might be an unreliable metric for the card schemes due to their low asset bases, the number of assumptions needed on intangibles and cash, and the sensitivity of the results to those assumptions. In addition, we were not confident we could obtain robust UK asset information for Mastercard.
- A margin-based approach still presents **challenges**, primarily in identifying comparators so we can assess the level of profitability objectively.

3.4 We asked **two questions**:

- **Question 1:** Whether respondents agreed that a margin-based approach to calculating profitability is the appropriate approach for this market review.
- **Question 2:** Details of any comparator companies that we should use as benchmarks for Mastercard and Visa, including the characteristics that make them suitable candidates, particularly the business risks they face.

3.5 We received six responses to the working paper. Mastercard and Visa submitted detailed responses; a full list of respondents is set out at Annex 1.

Respondents' views

Question 1: Appropriateness of the margin-based approach for the profitability analysis

3.6 Mastercard said that it had previously raised similar concerns as those expressed in our working paper in respect of the challenges with the application of a ROCE approach. Mastercard said that it had therefore prepared and shared a fully loaded profit and loss for its card business in the UK, noting that care needs to be taken when assessing operating margins and when selecting benchmarks as 'operating margins do not account for past investments and provide only snapshots of a company's performance at particular points in time'.

3.7 Visa said that there are a number of complexities that need to be taken into account in a margin analysis, including that:

a. Margins calculated by reference to financial statements are based on accounting and not economic profits.

b. Accounting standards, policies and assumptions can differ between companies and there are differences in accounting treatment of organic growth and acquisitions, making comparisons between companies challenging.

c. The choice of comparators is subjective – for example, due to different business models and stages of growth.

d. The profitability analysis is comparing margins for Mastercard and Visa that were calculated on the basis of UK-specific allocation assumptions, with comparators' financial data that is based on publicly available information.

e. Consideration of the complexity of the payment sector, how different payment services or groups of payment services could have different levels of profitability and the reasons for any such differences needs to be understood and considered.

3.8 Another two respondents noted **challenges for the margin analysis**, as follows:

a. It is not an objective measure of profitability.

b. Identifying meaningful comparators is challenging because there are none with the same features as Mastercard and Visa.

c. Comparators in similar markets are often characterised by a lack of competition and the companies most comparable to Mastercard and Visa are themselves earning above competitive margins.

3.9 These two respondents also said we should undertake a **ROCE analysis** because that is the standard approach when assessing profitability, and because the ROCE can be estimated within a range to account for uncertainty. It was also highlighted that the value of the asset base needed for the ROCE analysis can be robustly estimated when making cost allocation assumptions for its key components (for example, asset allocation to UK operations).

3.10 Two respondents provided views on **estimating UK margins**:

a. Allocations of costs should be based on transaction value rather than revenues, to account for different fee levels in different countries.

b. Incentive payments should be added to earnings before interest and taxes (EBIT) as these are effectively profits paid to issuers.

c. Mastercard and Visa's exposure to financial risk (as guarantors) is significantly mitigated by collateral requirements on users.

Question 2: Suitable comparators for the margin analysis

3.11 Mastercard noted that comparators should have considerable similarity with Mastercard and Visa, such as a similar risk profile, capital intensity, and stage in the business life cycle – for example, large upfront investments with low initial returns and higher returns over time.

3.12 Visa noted the difficulties and significant subjectivity in identifying comparators due to different business models and stages of growth. Visa also noted that the PSR did not explain how it would address comparability issues between Visa and Mastercard and companies listed on the New York Stock Exchange (NYSE) in the IT and credit services sectors.

3.13 Mastercard said that:

a. Comparators should not be restricted to companies listed on the NYSE.

b. The PSR's approach to selecting comparators did not seem to capture an appropriate group of comparators, querying in particular the inclusion of those that construct and sell physical goods and those that provide credit to consumers.

c. When including comparators that operate in a number of markets, then the EBIT margins comparable to payment systems need to be separately estimated (rather than use the whole business financial information).

3.14 **No suitable comparators for margin analysis emerged** in comments from any of the six respondents.

3.15 **The best comparators would be strongly similar to the two card schemes**, one respondent said. That meant having the same four-party business model as well as the same cost structures and business risks in a fully competitive environment. Jurisdictions where Mastercard and Visa compete with strong domestic card schemes might provide such an environment, the respondent said.

3.16 Another respondent said **IT companies are the most appropriate benchmark comparators**, and that more comparable companies would include:

a. tech companies such as Apple, Amazon and Microsoft

b. companies that harness and monetise their customers' data to develop value added services

c. companies that invest in brand recognition and reputation, and those that require high levels of trust by consumers

d. companies that have large/global networks

The respondent observed that the companies most comparable to Mastercard and Visa, and which fulfil the above criteria, may not be representative of a competitive market.

It also said companies in hardware manufacturing and distribution would be less comparable.

Recommended interventions

3.17 Visa indicated that the UK payments sector is undergoing a period of great dynamism, with significant competition between card schemes, increased sophistication of end users of payment solutions, and growing competition from existing and potential alternative payment networks and methods, as well as from other providers of payment solutions present within the card payments value chain. Visa suggested that the PSR establishes a forward-looking view of competitive dynamics in UK payments.

3.18 One respondent said **Mastercard and Visa's margins** have been high for a long time and even higher than those of Big Tech companies with market power. Margins are also higher than for credit services, which are comparator businesses but take more risk. There is a seesaw effect where incentives to issuers are ever increasing, and fees paid by acquirers are then increased in turn.

Our response

3.19 As part of our market review, we seek to understand whether Mastercard and Visa's profit levels are to be expected in a competitive market or too high. Our profitability working paper gathered stakeholder views on our proposals to use margin analysis to assess the schemes' profitability and on the comparators to use in our margin analysis.

3.20 Mastercard, Visa and three out of the other four respondents highlighted challenges with using margin analysis.

3.21 Mastercard said it had concerns with a ROCE approach; Visa did not comment on such an approach. Two other respondents said our profitability analysis would be more robust if it included a ROCE calculation. The other respondents suggested that the challenges of making a ROCE analysis can be overcome by using assumptions and estimates and by applying a range of estimated ROCEs rather than a spot estimate. They also said that in tandem with the margin analysis, the ROCE analysis could provide valuable information on the profitability level of Mastercard and Visa.

3.22 We are therefore considering whether to supplement our margin analysis with a ROCE analysis based on a number of assumptions.

3.23 We note that none of the six respondents suggested specific suitable comparators. However, we are considering their comments as we select our criteria for identifying relevant comparators for the margin analysis.

Annex 1
Respondents

Respondents to the call for evidence – competitive constraints

AIB Merchant Services

Association of Convenience Stores

American Express

British Retail Consortium

HSBC UK Bank Plc

Ingka Group

Innovate Finance

John Lewis Partnership

Mastercard

NatWest Group

Revolut

Teya (formerly SaltPay)

The Startup Coalition (formerly Coadec)

Visa

Respondents to the working paper – profitability analysis

American Express

Innovate Finance

Mastercard

Teya (formerly SaltPay)

The Startup Coalition (formerly Coadec)

Visa

PUB REF: MR22/1.7

12 Endeavour Square
London E20 1JN
Telephone: 0300 456 3677
Website: www.psr.org.uk