

Market review into the supply of card-acquiring services

Draft Terms of Reference

July 2018

We welcome views on these draft Terms of Reference.

If you would like to provide comments, please send these to us by 5pm on 14 September 2018. You can email them to cards@psr.org.uk or write to us at the following address:

Card-acquiring market review team
Payment Systems Regulator
12 Endeavour Square
London E20 1JN

We will consider your comments on these draft terms of reference when preparing the final Terms of Reference for the market review.

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1 Introduction

- 1.1** We plan to carry out a market review into the supply of card-acquiring services in the UK to ensure that the supply of these services is competitive and works in the interests of merchants, and ultimately consumers.
- 1.2** This document sets out our draft Terms of Reference (ToR). We are looking for feedback on this document and, in particular, our proposed approach to the market review.

Why card acquiring matters

- 1.3** Card payments are critical to the smooth running of the UK economy. In 2017, there were 13.2 billion debit card payments totalling £523 billion. Credit card payments in the same year numbered 3.1 billion and amounted to £168 billion.¹
- 1.4** Card use is high and has been growing strongly in recent years. Between 2007 and 2016, the number of card payments in the UK more than doubled² and in 2017, debit cards overtook cash as the most frequently used payment method for the first time.³ There are several reasons for this, including higher online spending and a significant increase in contactless payments.
- 1.5** The number of merchants (retailers or service providers) accepting card payments has also grown. In 2017, 1.38 million outlets accepted card payments⁴ while over the last five years the number of point-of-sale terminals has increased by half.⁵
- 1.6** Card payment systems enable people to make payments using debit and credit cards. These systems are administered by card scheme operators. To accept card payments, merchants need to buy card-acquiring services.
- 1.7** Card-acquiring services are services to accept and process card payments on behalf of a merchant resulting in a transfer of funds to the merchant. Merchants can contract with acquirers or payment facilitators to obtain these services. Unless otherwise stated, when we refer to card-acquiring services we mean card-acquiring services provided by acquirers and payment facilitators.
- 1.8** The costs merchants incur for such services may ultimately be reflected in the prices they charge or the services they provide to their customers.
- 1.9** Similarly, the service merchants receive from an acquirer or payment facilitator may affect the experience they can offer to customers paying for goods and services by card.

1 UK Finance, *UK Payment Statistics 2018* (2018), Tables 6.2 and 6.3.

2 PSR analysis based on UK Finance, *UK Payment Statistics 2018* (2018), Table 6.2.

3 UK Finance, *UK Payment Markets Summary 2018* (2018), page 3.

4 UK Finance, *UK Payment Statistics 2018* (2018), Table 15.1.

5 PSR analysis based on UK Finance, *UK Payment Statistics 2018* (2018), Table 15.1.

Why we are carrying out this market review

- 1.10** Various stakeholders have raised concerns with us about card payments.
- 1.11** A number of these concerns indicate that the supply of card-acquiring services may not be working well for merchants and ultimately consumers. This includes concerns that:
- acquirers have not passed on to smaller merchants the savings they made from the interchange fee caps introduced by the Interchange Fee Regulation (IFR)
 - there is a lack of transparency around the fees merchants pay to accept card payments
 - there are barriers making it hard for merchants to compare and switch acquirers, and they tend not to shop around
 - there are barriers to offering services that would help merchants to compare and switch between acquirers
 - the fees that card scheme operators charge to acquirers (called 'scheme fees'), and the rules they set, favour larger acquirers
 - the scheme fee portion of the fees that merchants pay to acquirers is increasing significantly
- 1.12** Given these concerns, we plan to carry out a market review into the supply of card-acquiring services in the UK.
- 1.13** We recognise that, in addition to the concerns identified in paragraph 1.11, some stakeholders have raised concerns about the costs of card payments for merchants that may point to problems beyond the supply of card-acquiring services. However, we consider that focusing first on the supply of these services is appropriate for two reasons.
- 1.14** First, the concerns raised with us that acquirers are holding on to the savings they made from the IFR interchange fee caps could indicate that some merchants – especially smaller merchants – are suffering significant harm because competition in the supply of card-acquiring services is not working well.
- 1.15** The IFR is an EU regulation that aims to reduce the costs of card payments for merchants and consumers, and strengthen competition. It caps interchange fees⁶ on certain consumer debit and credit card transactions and sets out several business rules. The IFR did not cap the fees that merchants pay to acquirers. It relied on effective competition between acquirers to ensure the benefits of the interchange fee caps flowed through to merchants and ultimately consumers. Interchange fees typically make up the largest portion of the fees that merchants pay to acquirers. So, the harm to smaller merchants from acquirers holding on to the benefits of the IFR interchange fee caps could be significant.

⁶ An acquirer pays an interchange fee to a card user's payment service provider (called an issuer) for most transactions when a card payment is made. Interchange fees usually form part of the fees that merchants pay to acquirers.

- 1.16** Second, we would expect any problems relating to card payment systems that affect merchants to materialise largely through the charges and services they receive from acquirers and payment facilitators. Therefore, focusing on card-acquiring services is an appropriate first step in examining stakeholders' concerns. As described in paragraph 2.17, our work will include understanding how the fees merchants pay to acquirers have changed in recent years in the light of changes to key input costs (including interchange and scheme fees) that acquirers pay. We will also consider what factors determine the overall level of fees that merchants pay.
- 1.17** We may find evidence of potential harm that does not relate to the supply of card-acquiring services. If so, we will consider undertaking further work to investigate such harm separate to this market review.
- 1.18** Our intention to carry out a market review has been informed by engagement with a variety of stakeholders and desk-based research. For example, we have discussed card-related issues with the PSR Panel (our independent advisory body), and chaired a discussion on the future of card payments at the launch event for our 2018/19 annual plan. Concerns about card payments were also raised with us through our work to monitor compliance with the IFR.
- 1.19** We plan to conduct the market review using our general powers under the Financial Services (Banking Reform) Act 2013 (FSBRA). Market reviews are one of our tools for investigating how well the market for payment systems, or the markets for services provided by payment systems, are working for service-users (i.e. the people and organisations who use, or are likely to use, services provided by payment systems) in line with our statutory competition, innovation and service-user objectives.
- 1.20** The remainder of this document is set out as follows:
- In **Chapter 2** we explain our proposed approach to the market review including our proposed scope and possible outcomes.
 - In **Chapter 3** we set out our consultation questions and next steps.

2 Our proposed approach to the market review

- 2.1** We plan to examine whether the supply of card-acquiring services is working well for UK merchants and, therefore, ultimately consumers. This includes examining the competitive conditions in the supply of these services and identifying any detriment to merchants and consumers if the supply of card-acquiring services is not working well. We will also take account of other issues that might be relevant to our other objectives of promoting innovation and the interests of service-users.

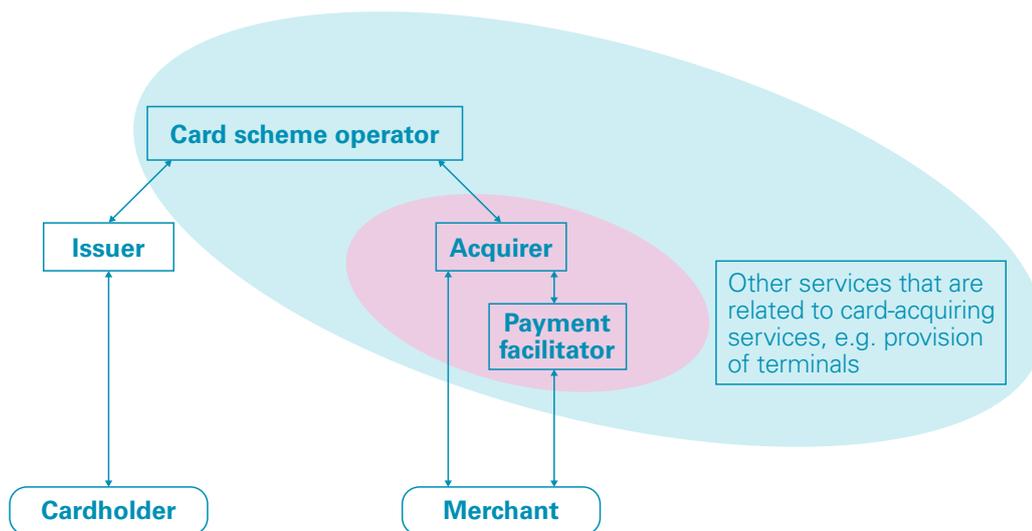
Background

- 2.2** Customers commonly use credit and debit cards to pay for goods and services online, over the phone, by mail order or in store. There are six card payment systems operating in the UK: American Express, Diners Club International, JCB International, Mastercard, UnionPay International and Visa.
- 2.3** To accept card payments, merchants need to buy card-acquiring services. One option is to contract with an acquirer. The acquirer allows a merchant to access a card payment system and processes transactions on its behalf. The acquirer is also responsible for making sure the merchant complies with the rules set by the card scheme operator. These rules govern how card payments are made.
- 2.4** Acquirers use a variety of channels to gain customers, including face-to-face sales, their own websites and call centres. An acquirer may also engage third parties such as independent sales organisations (ISOs) to sell their services and procure new merchant relationships.
- 2.5** Rather than contract with an acquirer, merchants – typically smaller merchants – can buy card-acquiring services from a payment facilitator. The payment facilitator contracts with an acquirer who retains responsibility for allowing merchants to access the card payment systems.
- 2.6** Annex 1 provides more information on the roles of acquirers and payment facilitators.

Proposed scope of the market review

- 2.7** We propose to cover the supply of card-acquiring services (as described in paragraph 1.7) in our market review. Figure 1 shows the proposed scope of our work.

Figure 1: Proposed scope of the market review



↔ Contractual link ■ In scope ■ In scope if affect supply of card-acquiring services

Diagram shows a simplified representation of a four-party card payment system

- 2.8** We do not intend to limit our scope of work to any particular types of merchant. It is possible that conditions of supply may differ between categories of merchant, which means our findings may differ between categories of merchant.
- 2.9** We propose to examine the supply of card-acquiring services by acquirers and payment facilitators. This is because merchants – typically smaller merchants – can access these services by contracting with acquirers or payment facilitators. We’ll also consider the role that ISOs play as a channel for acquirers to sell their services.
- 2.10** Supply of products and services that are related to card-acquiring services, including ancillary services, are not in scope except insofar as they may affect the supply of card-acquiring services. Services provided by card scheme operators would be an example of a service that could affect the supply of card-acquiring services. Another example would be the supply of point-of-sale terminals.
- 2.11** In assessing card-acquiring services, we propose to focus on the supply of these services in relation to Mastercard and Visa. This is a non-exclusive focus. We will also consider card-acquiring services for other card payment systems operating in the UK.

- 2.12** We propose to focus our analysis on the supply of card-acquiring services for Mastercard and Visa for the following reasons:
- Mastercard-branded cards and Visa-branded cards accounted for over 98% of all UK debit and credit card payments in 2017, both by volume and value.⁷
 - The concerns that stakeholders have raised with us about card-acquiring services largely relate to Mastercard and Visa.
 - Our current understanding is that most merchants are unlikely to see card-acquiring services for other card payment systems as alternatives to card-acquiring services for Mastercard and Visa. This is because it is the customer who decides which payment instrument to use, and 98% of cards in issue in the UK in 2017 were Mastercard-branded or Visa-branded cards.⁸
- 2.13** Merchants may buy acquiring services for digital (i.e. non-cash) payment methods other than card payments – for example, for payment methods that enable them to be paid using the interbank payment systems. However, we propose to limit our scope of work to card-acquiring services. It appears likely that, for many merchants, accepting other types of digital payments is not currently a good alternative to accepting card payments. Testing whether merchants have credible alternatives to card-acquiring services will be part of the market review.

Our proposed approach

- 2.14** We want to understand whether the supply of card-acquiring services is working well for UK merchants and, therefore, ultimately consumers.
- 2.15** To do this, we propose to examine how competition in the supply of card-acquiring services operates. This includes examining:
- the nature and characteristics of card-acquiring services
 - whether there are credible alternatives to card-acquiring services for some or all merchants (i.e. what are merchants' demand side and supply side substitutes for these services?)
 - who provides card-acquiring services and how their market shares have developed historically
 - how providers of card-acquiring services compete for merchants, and how this process affects merchants
 - how merchants buy card-acquiring services
 - the regulatory and legal framework that applies to the supply of card-acquiring services
 - the scope for differentiation and innovation
- 2.16** We also propose to examine the outcomes of the competitive process. This includes looking at the fees merchants pay and the quality of service they receive.

7 PSR analysis based on UK Finance, *UK Payment Statistics 2018* (2018), Tables 10.1 and 10.2.

8 Excluding ATM-only cards. PSR analysis based on UK Finance, *UK Payment Statistics 2018* (2018), Table 7.1.

- 2.17** We propose to analyse how the level of fees merchants pay have responded to changes in the fees acquirers pay to card scheme operators and card issuers (the payment service providers that issue cards to cardholders). This includes collecting detailed data on scheme fees and interchange fees – including on how they have changed. We will also explore the factors that determine the level of scheme fees. Given our focus on card-acquiring services, we will not look in this market review at whether scheme fees are excessive. If we find evidence of potential harm that does not relate to the supply of card-acquiring services, we will consider undertaking further work to investigate such harm separate to this market review.
- 2.18** We propose to examine the quality of card-acquiring services merchants receive. This includes understanding what support they receive from their acquirer or payment facilitator to comply with the rules set by the card scheme operators.
- 2.19** Within the proposed scope of our work, we propose to examine the three specific issues of interest outlined below. These issues were identified based on stakeholders' concerns, and desk-based research and analysis. We do not yet have a view on what impact, if any, these issues might have on the supply of card-acquiring services.

Specific issues of interest

Barriers to entry or expansion in card-acquiring services

- 2.20** We want to understand if there are any barriers to entry or expansion for providers of card-acquiring services. These could include technical, contractual, legal or regulatory barriers, economies of scale, or something else. For example, we will consider whether scheme fees and the rules set by card scheme operators create or exacerbate barriers to entry or expansion.
- 2.21** Barriers to entry or expansion can make it difficult to offer card-acquiring services or grow as a supplier of these services. Such barriers could therefore result in less competitive pressure on established suppliers. Barriers could also make it difficult for a new supplier to launch innovative products.

Barriers to switching or searching that merchants face

- 2.22** We would like to find out how merchants choose between providers of card-acquiring services so that we can better understand the barriers merchants face in the process. For example, merchants could face barriers:
- when they gather information about card-acquiring services
 - when they compare card-acquiring services (for example, if fees are not transparent)
 - when they switch between card-acquiring services, including technical and contractual barriers to switching
- 2.23** We are interested in whether market participants behave in ways that exacerbate any such barriers.
- 2.24** Barriers to searching or switching can make merchants less responsive to price increases or reduced quality of service. As a result, prices may be higher, or quality of service lower, than would have been the case if searching and switching had been easier.

Availability of services that facilitate merchant decision-making

- 2.25** Outcomes for merchants might be better if there were services available to help them make better choices about card-acquiring services. This would particularly be the case if merchants face barriers to searching.
- 2.26** We want to consider if there are factors that prevent such services from emerging or growing. This includes any restrictions on ISOs or others that could prevent them from helping merchants make better choices.
- 2.27** Services that help merchants make better choices about card-acquiring services could promote competition, for example by reducing the barriers to searching that they face.

Possible outcomes

- 2.28** We will consider what actions, if any, to take should we identify detriments to service-users. For example:
- making new, or amending existing, general directions
 - making new specific directions
 - requiring the operator of a regulated payment system to establish or change their operating rules, to notify us of rule changes or to seek our approval before making rule changes
 - making recommendations for industry initiatives or enhanced industry self-regulation
 - making proposals to the Financial Conduct Authority (FCA), which regulates payment service providers including those providing card-acquiring services, where appropriate
 - publishing guidance
 - carrying out an investigation into a potential breach of the Competition Act 1998
 - making a market investigation reference to the Competition and Markets Authority (CMA) to investigate a market or a feature of several markets
- 2.29** Where we have reasonable grounds to suspect that any feature, or combination of features, of a market or markets are adversely affecting competition, we can refer a market or a feature of several markets to the CMA for an in-depth investigation, or accept undertakings in lieu of making a reference.
- 2.30** We aim to ensure that any action we take is effective and proportionate to any detriments we identify. The following three principles will generally be relevant when considering intervention:
- **The efficiency principle:** This is an expectation that resources are used in the most efficient and economical way.
 - **The proportionality principle:** This is where a burden or restriction that is imposed on a person, or on the carrying on of an activity, should be proportionate to any benefits that are expected to result from the imposition of that burden or restriction.
 - **The transparency principle:** This requires regulators to exercise their functions as transparently as possible.
- 2.31** In the absence of any detriments to service-users, we would not act.

3 Consultation questions and next steps

- 3.1** We welcome feedback on these draft ToR. We set out a list of consultation questions below.
- 3.2** You can provide your comments in writing until 5pm on 14 September 2018. We have extended the time we would typically give to respond to a draft ToR as we are consulting over the summer.
- 3.3** Our scoping of the market review will continue following the publication of these draft ToR. We will also continue to liaise with other authorities. These include the FCA, which regulates payment service providers including those providing card-acquiring services, and the Bank of England, which supervises Visa.
- 3.4** After reviewing the comments on these draft ToR, we plan to publish the final ToR for the market review before the end of 2018. We will set out our timetable for the market review in that document.

Consultation questions

- 3.5** You are welcome to provide whatever comments you see fit, but it will be helpful if you can structure your responses in line with the following questions.

Card-acquiring services

- 3.6** We describe what we mean by card-acquiring services in Chapter 1, paragraph 1.7.

Question 1

Do you agree with our description of card-acquiring services?

If not, please explain:

- a. how our description should be altered
- b. why you think the description should be altered in this way

Please include any evidence you think is relevant to your response.

Scope

- 3.7** We set out in Chapter 2, paragraphs 2.7 to 2.13, the proposed scope of the market review.

Question 2

Do you agree with the proposed scope of the market review?

If not, please explain:

- a. how the proposed scope should be altered
- b. why you think the proposed scope should be altered in this way

Please include any evidence you think is relevant to your response.

- 3.8** We explained in Chapter 2, paragraphs 2.11 and 2.12, that we propose to focus on card-acquiring services for Mastercard and Visa.

Question 3

Do you agree with our proposal to focus on card-acquiring services for Mastercard and Visa?

If not, please explain:

- a. how the focus should be altered
- b. why you think the focus should be altered in this way

Please include any evidence you think is relevant to your response.

Our proposed approach

- 3.9** We set out in Chapter 2, paragraphs 2.14 to 2.27, our proposed approach to understanding whether the supply of card-acquiring services is working well for UK merchants and, therefore, ultimately consumers.

Question 4

Do you agree with our proposed approach?

If not, please explain:

- a. how proposed approach should be altered
- b. why you think the proposed approach should be altered in this way

Please include any evidence you think is relevant to your response.

- 3.10** We also set out in Chapter 2, paragraphs 2.20 to 2.27, a list of specific issues of interest.

Question 5

Do you have any comments on the specific issues of interest, including whether there are additional issues we should consider and whether the issues identified have the potential to be relevant to the market review?

If not, please explain:

- a. what, if any, additional issues should be included (i.e. factors that affect how the supply of card-acquiring services functions)
- b. why you think these additional issues have the potential to be relevant to the market review
- c. which, if any, of the issues of interest in Chapter 2 do not have the potential to be relevant to our market review
- d. why you think those issues do not have the potential to be relevant to the market review

Please include any evidence you think is relevant to your response.

How to provide comments

- 3.11** Please send your comments by 5pm on 14 September 2018. You can email them to cards@psr.org.uk or write to us at the following address:

Card-acquiring market review team
Payment Systems Regulator
12 Endeavour Square
London
E20 1JN

- 3.12** We will consider your comments on these draft ToR when preparing the final ToR for the market review.

Disclosure of information

- 3.13** Generally, we will seek to publish views or submissions in full or in part. This reflects our duty to have regard to our regulatory principles, which include those in relation to:

- publication in appropriate cases
- exercising our functions as transparently as possible

- 3.14** As such, we would ask respondents to minimise those elements of their submission that they wish to be treated as confidential. If respondents include extensive tracts of confidential information in their submissions, we would ask that they submit nonconfidential versions that they consent for us to publish. We will also not accept blanket claims of confidentiality, and will require respondents to identify specific information over which confidentiality is claimed, and to explain the basis on which confidentiality is sought. Despite this we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request.
- 3.15** Respondents should note that we will not disclose confidential information that relates to the business or affairs of any person, that we receive for the purposes of our functions under FSBRA, unless:
- The information is already lawfully publicly available.
 - We have the consent of the person who provided the information and, if different, the person to whom it relates.
 - The information is published in such a way that it is not possible to ascertain from it information relating to a particular person (for example, if it is anonymised or aggregated), or there is a 'gateway' permitting this disclosure. Among the gateways is the 'self-help' gateway whereby the PSR will be able to disclose confidential information to certain third parties to enable or help it (or the third-party recipient) to perform its public functions. Those receiving information disclosed under the gateway are still bound by the confidentiality regime.
- 3.16** Our data privacy notice applies to our handling of personal information and is available to view on our website: www.psr.org.uk/privacy-notice

Annex 1:

Roles of acquirers and payment facilitators

Role of acquirers

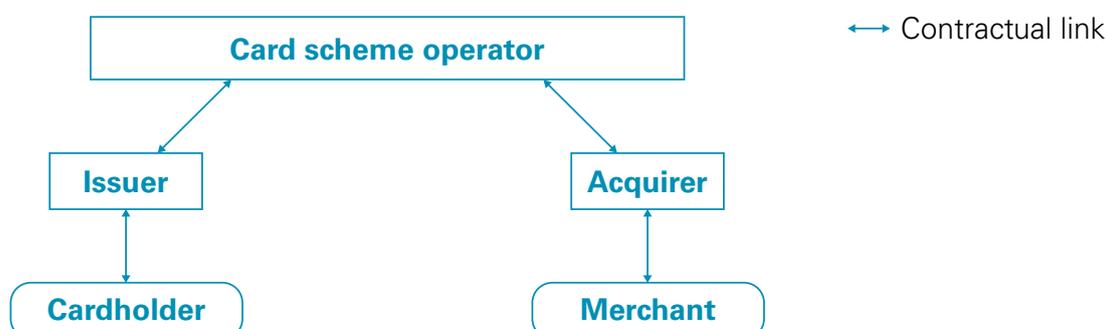
1.1 Acquirers generally perform three core functions:

- recruiting merchants to accept card payments and underwriting them
- facilitating the authorisation, clearing and settlement of transactions through the card payment system
- ensuring merchants comply with the rules set by the card scheme operator that govern how card payments are made

1.2 When a card is presented to pay for goods or services, the merchant sends an authorisation request to the acquirer who forwards this to the issuer via the card scheme operator.⁹ The issuer decides whether to approve or decline the transaction including by checking that the cardholder has enough money in their account to make the payment and that the card has not been reported lost or stolen. If the transaction is authorised and once the merchant has received the issuer's response, the sale can proceed. Later, the acquirer receives the funds from the issuer and credits the merchant's account through the clearing and settlement processes. The merchant receives the value of the transaction less the fees that the acquirer charges for its services. The issuer debits the cardholder's account.

1.3 In a four-party card payment system, the card scheme operator has no direct contractual relationship with the merchant. It licenses acquirers to manage these relationships. Similarly, the card scheme operator has no direct contractual relationship with cardholders. It licences issuers (often banks) to issue cards to customers and to manage those relationships. Figure 1 shows a simplified structure of a four-party card payment system.

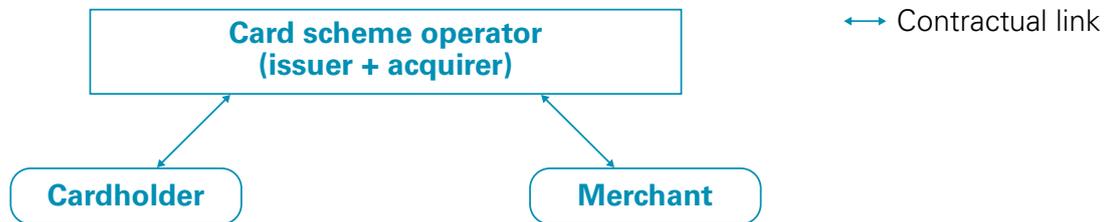
Figure 1: Simplified structure of a four-party card payment system



⁹ In some cases, the transaction does not need to be authorised.

- 1.4** In a three-party card payment system, the card scheme operator generally performs the issuing and acquiring functions itself. Figure 2 shows a simplified structure of a three-party card payment system.

Figure 2: Simplified structure of a three-party card payment system



- 1.5** Acquirers may choose to outsource some of their core functions to third parties. Where an acquirer outsources its functions, it retains responsibility for allowing the merchant to access the card payment system and for making sure that third parties perform these functions in accordance with the rules set by the card scheme operator.
- 1.6** Acquirers may offer other services beyond the core functions, such as:
- leasing point-of-sale terminals
 - offering credit facilities
 - providing payment gateways that support card payment processing
- 1.7** Third parties can also provide these services directly to merchants.

Role of payment facilitators

- 1.8** Rather than contract directly with an acquirer, merchants – typically smaller merchants – can contract with a payment facilitator. The payment facilitator contracts with an acquirer who retains responsibility for allowing merchants to access the card payment systems. The acquirer is also liable for the merchant’s and the payment facilitator’s activities relating to acceptance of card payments.

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