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COMPETITION COMMITTEE**

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Working Party No. 2 on Competition and Regulation

ROUNDTABLE ON COMPETITION AND EFFICIENT USAGE OF PAYMENT CARDS

-- Hungary --

6 June 2006

The attached document is submitted by the delegation of Hungary to the Working Party No. 2 of the Competition Committee FOR DISCUSSION under Item III of the agenda at its forthcoming meeting on 6 June 2006.

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1. The most important paperless payment instruments in Hungary are payment cards. Cheques are of limited usage, and alternative technologies are slow in gaining acceptance. Therefore our submission will focus on the payment card industry.

1. The payment card industry in Hungary

1.1 Structural conditions

2. The Hungarian payment card is a market in development. The payment card industry has a significant growth rate, with important industry characteristics showing significant shifts and changes every year.

1.2 Growing and changing market

3. According to 2004 data, the number of cards per capita was 0.65, while the average in the European Union exceeds one. However, the growth rate of the cards in circulation is in double digits on a yearly average: last year's growth rate was 13%. In addition to the overall growing trend, the increasing role of credit cards can be observed as well: the number of credit cards has doubled in 2005, and their share increased from 8% to 14%. Although that means that 86% of all cards are still debit cards, an increasing development of credit cards is expected in the coming years.¹

4. The card transaction volume is also increasing: In 2005, 209 million transactions were conducted in Hungary, with domestic and foreign issued cards, in the value of HUF 5,249 billion. The transaction number rose by 8%, the value increased by 10%, in comparison to the previous year. Hungarian cardholders used their cards on 203 million occasions inside and outside of the country, in the value of HUF 5,220 billion. The number rose by 11%, the value grew by 9%.

5. The share of cash withdrawal transactions continued to fall; of every one hundred transactions 55 transactions were cash withdrawals (as oppose to 58 in the previous year). In respect of purchase transactions, of every one hundred transactions, there were 41 payments through POS terminals at retail outlets, with 4 mobile phone loading at ATMs.

1.3 Card issuance and acceptance

6. There are 22 banks and one financial enterprise issuing payment cards in Hungary, The market is dominated by a large commercial bank, having a very strong position on the retail banking market: more than half of the cards are issued by this undertaking, whereas the ratio of the 8 largest banks in payment card turnover is around 90%.

7. Merchant acquiring is a very concentrated market in Hungary, with six credit institutions and one financial enterprise offering contracts for the acceptance of MasterCard, and five of them also for Visa cards.² However, the market is dominated by two large players, which perform acquiring for more than 95% of the transactions.

¹ Data for the industry structure is based on a publication by the National Bank of Hungary: 'The payment card business in Hungary (2005)'

² JCB, Diners and Amex is also accepted in Hungary, but their share is very limited: more than 90% of the payment card transactions are completed with a card bearing a Visa, or a Mastercard logo.

2. Fees and charges in the card payment industry

8. Merchant service charges are negotiated by the acquirer and the merchant. The merchant service charge consists of the acquirer's fee and the interchange fee. The acquirer's fee is expected to cover the acquirer's costs, while the interchange fee is the sum paid by the acquirer to the card issuer bank.

9. The ratio of the interchange fee is determined by an agreement between the banks. The level of the fee has been fixed in the middle of the 1990s, and has not been altered since then. The banks had set up a 'Payment Card Forum' that time, which elaborated the default interchange rates. This system is characterised by no differentiation between credit and debit cards, and special rates for a certain sector (petrol stations). The two large card systems, Visa and Mastercard have the same partner banks, and the interchange fees are the same in both large payment platforms, based on the above-mentioned agreement.

10. The interchange fee is regarded as too high compared to costs, especially in the case of debit cards. Both Visa and Mastercard are engaged into cost studies, the results of the latter are expected to be published in June 2006.

2.1 Price discrimination and 'on-us transactions'

11. The high concentration of the acquiring market has its effects on the price structure of the industry as well. In transactions where the issuer and the acquirer is the same bank (so called on-us transactions), the interchange fee plays no role, and the whole merchant service charge stays at the acquirer. Since the larger of the two significant acquirers is also the largest player on the card issuing market, and the other large acquirer is also an active player on the card issuing market, there is room for considering the increased use of on-us transactions.

12. The reason for the on-us transactions is that certain merchants, mostly large hypermarket chains have considerably larger bargaining power against the potential acquirers than smaller merchants. This results in a very significant price discrimination: acquirers claim a considerably lower merchant service charge from these stores, sometimes setting the price of the 'on-us transactions' below the interchange fee.

2.2 Consequences of too high interchange fees and price discrimination

13. This kind of price discrimination may have very adverse effects on competition. With the reduction of the price of 'on-us transactions' merchants will be willing to accept cheaper cards, i.e. cards issued by the acquirer. This may lead to a situation where some stores decide to accept only the acquirer's cards, thereby effecting competition on the card issuing market, since consumers may be willing to choose the bank that offers cards with a wider acceptance.

14. Not only price discrimination, but also the high level of interchange fees can have a negative effect on competition. A high interchange fee level leads to higher merchant service charges, thereby making the installation of a POS terminal more costly and less desirable for certain merchants. Although there have been no studies confirming that it is in fact the high interchange fee that prevents the more widespread use of POS terminals, a 2004 survey showed that the number of POS terminals per thousand inhabitants is quite low in Hungary (3,3)³. As a result of this, the high interchange fees may impede the widespread use of a potentially more effective payment method.

³ The same data value is 3,6 in Slovakia, 4,3 in the Czech Republic, 10,3 in Belgium and 13,1 in Portugal.

3. Competition law

15. There has been no recent competition supervision proceeding in Hungary in this topic, but the Gazdasági Versenyhivatal – the competition authority of Hungary (GVH) is closely monitoring this field. Mastercard was offered a possibility to present their views at the GVH, where experts from the National Bank of Hungary and the Hungarian Financial Supervisory Authority were also present.

16. There are several issues supporting a GVH intervention in this market, which is currently under consideration. The high level of interchange fees may hurt the interest of consumers, since as a result of the agreement, they are paying supra-competitive price for this service. The presence of price discrimination is also a signal for some possible market problems in the pricing pattern of the industry.

17. In addition to this, as it has already been mentioned, the high interchange fees may also prevent the widespread use of cards, and thus a cheaper and more efficient payment method. This could result in significant social costs.

18. The reasons against competition policy intervention are based mainly on two grounds. First is the limited ‘pass-through’, and second is the developing nature of the Hungarian payment card market.

19. Competition policy is targeting long-term consumer welfare, and lower prices paid by the consumers are an indication of an effective competition policy intervention. A reduction in the interchange fees, however, would not necessarily be reflected in consumer prices, as due to limited pass-through, this reduction may only result in a re-allocation of profits between the issuing banks and other members of the payment cards industry. The pass-through of cost reduction may appear on two levels.

20. First, there is a question of pass-through by the merchants. It can be doubted, that merchants will pass through this cost reduction on their consumers in the form of reduced prices. However, on the long run competition in the retail sector is expected to solve this problem.

21. A second difficulty in pass-through results from the very concentrated nature of the acquiring market. A reduction in the interchange fee may not necessarily affect the contracts between merchants and acquirers – it may very well be the case that merchant service charges remain unchanged, and a reduced interchange fee only results in an increasing profit in the acquiring market. However increasing profitability in the acquiring market is expected to induce further entry to this market, and increased competition is expected to drive prices down.

22. The limited maturity of the Hungarian card industry is also a factor to be considered for a competition policy intervention. Given the high concentration in the issuing market, with a reduced interchange fee, some smaller banks would necessarily find the card issuance unprofitable. This would surely result in high costs for banks that are currently shaving off some market share from the dominant market player, and thus are expected to offer a positive contribution to competition in the retail banking sector. These costs, however, may most likely be seen as temporary, and should not prevent the GVH from acting for the reduction of interchange fees.