



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

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Working Party No. 2 on Competition and Regulation

ROUNDTABLE ON COMPETITION AND EFFICIENCY USAGE OF PAYMENT CARDS

-- Lithuania --

6 June 2006

The attached document is submitted by the delegation of Lithuania 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. Social costs and benefits of the payment systems

1. The payment system in Lithuania is based mainly on cash and payment card settlements. Check payments are used very rarely. Till now no domestic estimates have been produced of the relative costs of cash and payment cards.

2. Payment card system: exit and entry conditions

2. There are 2 international payment card systems operating in Lithuania – VISA and MasterCard. Also there are some domestic payment card systems that operate only on a very limited scale. It should be noted that only 2 out of 8 banks provide domestic cards¹. Domestic cards are being receded from the market. In order to join an international payment card system or to start producing new payment product, the bank must become a licensed member of the said international card payment system. The licence fee differs depending on the system and type of the licence. The fee for the joining of the MasterCard system is EUR 50,000-150,000, and that for the VISA – up to EUR 545,000. In addition banks pay fees for licenses to issue the relevant individual products. Such admission fee policy has played a role in the decision making of smaller banks many of which have chosen to join only one payment card system.

3. During the 3 years' period under review 2 new smaller banks entered the market. That did not have any more tangible impact to the situation in the market, because each of them have joined only 1 system, besides having a very limited number of customers.

3. Merchant charges

4. The scale of the card usage has expanded considerably in the course of the 3 years' period under consideration. This conclusion is confirmed by the data supplied by the banks participants of the survey (table 1).

Table 1

	2003	2004	2005
Credit cards (units)	2,414,879	2,826,000	3,163,356
Growth		17%	12%

5. The number of credit cards in the Table 1 represents the total number of VISA, MasterCard and domestic payment cards. The increasing number of transactions, made by banks as issuers or acquirers also demonstrates the expansion of the payment cards market.

Table 2

	2003	2004	2005
Transactions, 000	26,993.48	38,783.75	57,850.29
Growth		43%	49%
Value, m LTL	2,395.58	3,538.05	6,700.07
Growth of value		47%	89%

¹ The data included in this contribution were collected by having sent a questionnaire to 8 commercial banks operating in the Lithuanian payment card market, to the Bank of Lithuania and to some trading community entities. The inquiry covers a 3 years' period (2003-2005).

6. Table 2 presents the data on the number of transactions performed by the banks as issuers (the number of transactions performed in the role as acquirers being very similar). All banks taking part in the survey act as issuers.

7. The comparison of the growth of the market with merchant charges can contribute to drawing the conclusions about the existing (or absent) market power in this specific field.

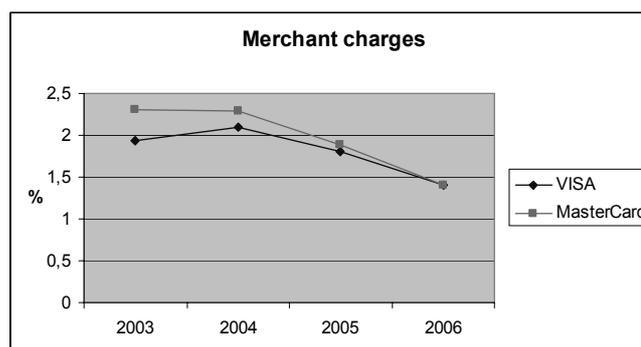
8. There is an observable increase in the number of the payment cards which is a normal phenomenon in emerging markets. Merchant charges have been gradually decreasing which is clearly illustrated by the data presented in the Table below:

Table 3

		2003	2004	2005	2006
VISA	merchant charge	1,93%	2.09%	1.81%	1.4%
	cards (units)	1,387,249	1,703,010	2,052,705	
MC	merchant charge	2.3%	2.29%	1.88%	1,4%
	cards (units)	704,746	785,265	825,793	

9. Obviously the increase in the merchant charge of VISA payment cards in 2004 was just negligible, although any conclusions on the reasons for such an increase are difficult to arrive at since exhaustive data of 2003 have been collected.

10. The data show the existence of the inverse relation of payment card number and merchant charges. It could be treated as an indication of no evident market power of acquirers which facilitates competition between banks over the merchants exists. Five commercial banks acting as acquirers operate in the Lithuanian market.



11. The increasing number of the card holders means the cardholders' demand for the POS services. Thus the increasing demand of POS services stimulates the growth in the number of transactions at acquiring banks. The examination of the merchant charge trend could possibly testify to the increasing competition between the acquirers for the merchants. This situation could hardly lead to the emergence of any disproportional development of the merchant charges.

12. This assumption could be confirmed (or denied) by further analysis of the interchange fee. Competition between acquiring banks for the merchants is possible when the merchant charge is higher than interchange fees (i.e. banks have a possibility to earn through maintaining merchants). The analysis of interchange fees is presented below.

4. Interchange fee

13. As has been indicated by the banks participating in the survey the interchange fee is determined by the payment card systems (VISA, MasterCard) and does not differ to any more significant extent from

bank to bank. It means that in the interchange payments' level the banks have only very limited possibilities (or virtually none) to negotiate with each other in terms of the interchange payments rates and other terms. The margins of interchange fees in Table 4 cover both domestic and international interchange fees (domestic fees are slightly lower than the international charges).

Table 4

	VISA		MC		domestic card systems	
	debit	Credit	debit	credit	debit	credit
Margins of Interchange fee, %	1-1.5	1-1.5	1-1.5	1-1.5	0.6-1	0.6-1

14. The data presented in Table 3 (merchant charges) and Table 4 (interchange fees) shows, that merchant charges are higher than the interchange fees. It means, that by paying merchant charges merchants redeem interchange costs, paid by acquirer to issuer. The positive difference between merchant charge and interchange fee allows the acquirer to earn some profit. On the one hand, issuer can gain increasing market share of cardholders due a considerable number of interchange transactions. On the other hand, for a bank it is a reasonable choice to hold a larger number of merchants as their transactions cover the interchange fees.

15. In the merchants' opinion the merchant charge is still excessive and should be reduced below 1%. On the other hand, merchants recognise that merchant charges are partly determined by the stable interchange fee (1-1.5%) that limits acquirers' possibility to compete in service prices.

5. Regulation of fees

16. Under the Lithuanian legal system Central Bank of Lithuania acts in due to all functions set by Law on Lithuanian Central Bank², including supervision over payment systems. The operations of credit institutions and payment systems are regulated by the Law on Payments of the Republic of Lithuania³. The Law also regulates the usage of the electronic payment instruments. The relationship between banks and the institutions are based on contractual terms in the same manner as joining the international payment cards networks. The Law does not contain any provisions authorising the Bank of Lithuania to influence the payment card system, based on contractual basis. The relations between banks and the banks' strategy regarding the cardholders and merchants are based on competition and partly influenced by international payment card systems (VISA, MasterCard). Payment card systems determine interchange fee of participants, licensing and other conditions of membership.

6. No-surcharge and no-discount rule

17. The merchants that provided responses to the questionnaires noted, that merchant charges are not transferred to buyers (this is restricted by the terms of the agreements with the acquirer). It means, that merchant cannot charge neither customers using a card nor customers using cash.

7. Cost-based fees

18. To the opinion of the Bank of Lithuanian the interchange fee should be computed following the principles of cost-basing and transparency. The Bank of Lithuania, however, noted that it has no authority to intervene into payment card market.

² Law on Lithuanian Bank, 1994.12.23, No. 99 (VŽ, 2001, No.: 890)

³ Law on Payment, 1999.10.08, No. VIII 1370 (VŽ, 1999, No.: 97).

19. Costs of issuing and acquiring activity are difficult to identify and to estimate. For instance, the costs structure of acquiring activity differs from bank to bank. Interchange fee consist a major part of total acquiring business costs, i.e. 54-87% of total acquiring costs, while the other two indicated other costs (for example, transaction processing costs, terminal renting costs): 50-77% of total costs. Very similar situation occurs calculating the issuing business costs. No evident cost-scheme can be identified – issuing cost (or revenue) structure differs from bank to bank. This could be possibly treated as an indication of an undetermined cost account system of this service.

8. Distribution effects

20. As mentioned before, merchant charges are not transferred to buyers (this is restricted by the agreement with acquirer). That means, merchant fees did not lead merchants to set higher prices for their goods in order to redeem merchant charge. Therefore, non-card users do not pay for their goods more than cardholders.

9. Competition law application and joint activity by merchants

21. Lithuanian retail banking market remains a very new area for Lithuanian Competition Council. Up until now the Competition Council of Lithuania has not had a case of any legal proceedings related to any infringement of the regulations related to the payment card system.

22. Joint venture of the merchants for developing of a new retail payment should not directly or indirectly fix purchase or selling prices, limit production markets and technical development, effect the prevention, distortion or restriction of competition. The joint venture activity would be assessed whether it contributes to improving the production or distribution of services or to promote technical or economic progress.

10. Other comments

23. Survey shows, that most of the issuers only recently (since 2005) started operating on a profitable basis while many, from the activities in question, incur losses. The major part of the income naturally is generated from the card holders payments and interchange fee. The issuers having the largest numbers of cardholders number gain mostly from cardholder fees, while others – from interchange fees.

24. The banks compete also in the cardholders' market side. The rates of cardholders fees are different in all banks, subject to the payment system operated, type and the term of validity of the payment card. Nevertheless, certain trends are becoming clearly discernable. A group of smaller banks indicated that the payment card purchasing fee has been decreasing (up to 250% of decrease), while the major banks maintain prices almost stable although offering for the same charge a much wider range of services. The latter now includes is the free travel insurance when leaving abroad, modern chip technologies, etc. The fact indicates that the emerging market and the increase of payment cards demand leads to reduction of payment card purchasing price.

25. The growing income from the cardholders fee clearly demonstrates the attractiveness of the issuing activity. Most of the banks that participated in the survey indicated that cardholder fee constitute the main share of all card issuing revenue. Besides some banks indicated that income from cardholder fees during three years' period has increased more than 4 times. The fact that the number of the issued payment cards grows slower than the rate of the revenue from the issuance of the payment cards, could be treated as an indicator, that the high demand of payment cards makes it possible for the issuers to maintain high costs of cards for consumers and they are unlikely to decrease within the foreseeable period of time in proportion to the to increase in the number of the issued payment cards.