PSR Market Review into the supply of card-acquiring services: Consultation on the approach to the profitability analysis

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Address: UK Finance, 5th Floor, 1 Angel Court, London, EC2R 7HJ

Sent to: cards@psr.org.uk

UK Finance is the collective voice for the banking and finance industry.

Representing more than 250 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

General comments

UK Finance welcomes the opportunity to engage with the latest stage of the PSR Market Review into the supply of card-acquiring services by inputting on the general approach of this working paper; *Consultation on the approach to the profitability analysis.*

Due to the commercial sensitivities involved and when considering a profitability/ economic analysis of this sort UK Finance's response has purposefully been kept at a high-level. Our general comments are as follows:

- UK Finance welcomes the PSR's acknowledgement in recognising the associated difficulties and challenges of conducting a profitability analysis, and the fact that it needs to be considered alongside other evidence gathered during the course of this market review[1].
- In this context, UK Finance would remind the PSR that a general assessment of *'how profitable'* the supply of card-acquiring services is, using the proposed *ROCE vs. WACC* approach is likely to be very heavily driven by accounting and economic adjustments, many of which are open to considerable subjectivity. The PSR should, if it commences this analysis, be prepared to discard it, if it is not sufficiently robust, as many authorities have done so in the recent past.
- UK Finance would respectfully point out the PSR's working paper offers little of any substantive guidance in how the industry should engage with the complexities of the profitability analysis given the nature of the industry. UK Finance would reiterate that more guidance is needed above and beyond the high-level principles as being referenced to (at Annex A).
- UK Finance would point to three key concerns based on what is set out at Section 3 (Adjusting Accounting Data):
    - That the proposed methodology will impose disproportionate costs and lead to an undue regulatory burden being place on each of the individual acquiring companies concerned. We further consider that the overall exercise is disproportionate to the potential insight into how competition works, given the inherent difficulties and uncertainty of the analysis.
    - UK Finance would reiterate the reasonableness and proportionality of any such request should be being considered in the wider context of many acquirers *business-as-usual* statutory reporting requirements, other *'live'* regulatory programmes (e.g. *Brexit, PSD 2 (including SCA)),* normal operating business responsibilities, and investor relations reporting obligations.

[1] As highlighted at paragraph 1.17

  - Given the complex nature of the acquiring industry and subjectivity that is normally involved in asset/ cost valuation and allocation, the *ROCE vs. WACC* analysis may not be sufficiently robust to draw any conclusions, even if considerable effort is expended by both the PSR and industry over the coming months.

- UK Finance would encourage a working group; or some other more harmonized and agreed methodology (including a wider sub-set of interested stakeholders reflective of the wider payment ecosystem), rather than what is being suggested (i.e. having the five companies themselves proceed independently with a complete analysis that is then submitted to the PSR for assessment).

Our more specific observations, and subsequent comments are more thematic in tone, rather than a comprehensive set of individual responses to each of the questions as are posed in the proposed consultation paper[2].

Our response is focussed on three distinct subject headings and as are reflected in the main body of the text – these include:

  - Consideration of the principles of the analysis;
  - Challenges to implementation/ calculation of profitability measures; and,
  - Issues around interpretation and future conclusions.

Consideration of the principles of the analysis

UK Finance appreciates that the proposed measure of profitability (i.e. return on capital employed (ROCE), weighted average cost of capital (WACC), and gross profit margin (GPM) have all been used in UK market review/ investigation precedent.

However, we note that the ROCE vs. WACC approach has in practice mostly not been used by UK regulators; to our knowledge it has only been applied fully in two of the last twenty market studies by the PSR, FCA or CMA.

Geographic and product scope issues will be very complex, due to the global nature of the acquiring market and the way individual acquirers sell multiple products. When looking at recent reviews/ studies undertaken by the PSR, FCA and CMA it is our understanding that none have successfully completed both a geographic and scope allocation; and, as the PSR is now intending.

A further issue that compounds the uncertainty and 'comparability' of the results of the analysis, is both the geographic and product scope cost and revenue allocations that will need to be made to focus on the PSR's reference market.

The economic value of assets will be very difficult to determine.

This is particularly challenging in any industry where much of the value is generated from a range of intangibles (*e.g. software development, research and development, IT security, network resilience, reputation/ goodwill, brand value, relationship management (including data security/compliance)*). All are difficult to identify, and are not recognised as classic 'fixed assets', making it hard to 'value' the asset base with any degree of accuracy.

This differs markedly when compared to other industries that possess a more readily and identifiable tangible capital base (e.g. utilities/ energy sectors).

Even for those sectors, which have been subject to market reviews/ investigations in recent years, the use of such measures (i.e. ROCE vs. WACC) to assess profitability have seldom been pursued, because of the inherent difficulties of being able to draw any significant conclusions as a comparison measure (for example, the CMA's audit, retail banking or investment consultants market investigations).

[2] As stipulated at paragraph 4.2.

The FCA also decided not to conduct a detailed profitability analysis in the cash savings market study, noting that the data requests would have been overly burdensome and that, due to the complexities in that market, it was unlikely that the conclusions would have significantly enhanced the evidence base.

The PSR should therefore be under no illusion, nor underestimate, how complex a task this has proven to be.

We would therefore suggest that though useful in *'theory'* such measures are often *'problematic'*, particularly in industries that do not depend on the existence of a range of tangible assets such as card acquiring.

With regard to the use of Gross Profit Margin (GPM) as a *'tool'* in the profitability analysis, we would express concerns that this cannot be meaningfully used when comparing different merchant groups, because there are likely to be significant differences in their indirect costs, which would not be reflected in this kind of measure making it difficult to interpret in practice.

Challenges to implementation / calculation of profitability measures

UK Finance would reiterate its concern that because of the complexities of the acquiring market any analysis of this kind is fraught with complexity with considerable scope for subjectivity.

Acquirers generally operate through large global platforms, purposefully designed to maximize the efficiencies in running enterprises of this sort, and whose role represents an integral element in supporting a global payment network.

Many larger acquirer organisations have global R&D operations/ network capacity that are designed to facilitate a range of cross-border payments across multiple jurisdictions to help serve their merchants' needs. Those merchants, in turn, may have differing service requirements based on their presence, maturity and commercial ambitions at a local market-level.

This means it is very complex to then attribute and separate out any future allocation of assets, costs or revenue for one individual jurisdiction by identifying 'UK business' as a distinct revenue stream from other parts of the same business, which can often be further complicated by regional differences reflective of previous legacy acquisitions and systems operating at a regional and/or country level.

Furthermore, acquiring may not be the only service being offered to an individual merchant customer.

Acquiring may be a distinct service offered in conjunction to a host of other value-added elements (e.g. financing/ small business lending) which might be inclusive as an additional service; or, where a singular function *(e.g. PoS device/ gateway service*) is provided in isolation, as a bespoke element to satisfy the requirements of an individual merchant.

This raises practical problems in how you separate out; or, begin to identify, the 'value' of the assets on offer.

There is the further challenge of implementing these measures, on a consistent basis, across five acquiring businesses that operate under very different business models.

Not least in that there exists a full range, and separate categorisation of issues, that could be raised based on any future individual request for information (RFI) that might significantly impact on how that profitability calculation is made. These issues could include:

- valuing intangible assets;
- revaluing tangible assets to estimate their replacement (rather than historical) cost;
- applying an economic rather than standard accounting approach to depreciation;
- the five-year time period does not capture a full business and investment cycle.

All are considerations, that challenge the implementation and appropriate calculation of any benchmarked profitability measure.

Issues in relation to interpreting findings and drawing conclusions

The issues that UK Finance can foresee at this early stage are threefold.

Firstly, because of the inherent nature of acquiring it is extremely difficult to robustly quantify the 'capital employed'[3], as part of any ROCE assessment. The ROCE calculations will be subject to a very wide margin of error and therefore the results will be difficult to interpret and will not be comparable between acquirers. The estimation of WACC is also potentially complex, given the global nature of the businesses. This means that any conclusions (even tentative/draft) on *'excess profitability'* need to be treated with great care.

Secondly, any analysis purporting to track the impact of the IFR caps on profitability needs to be considered alongside the changing market conditions that have also occurred during the same timeframe. UK Finance would reiterate that any focus around one particular aspect is too blunt a measure, when attempting to *'pin down';* or, account for the levels of profitability that may have accrued over the chosen timeframe, which has coincided with seismic changes that the acquiring industry has had to respond to, and, further adapt.

Thirdly, a recognition as to what those changing market conditions have been and which should be being reflected and identified in conjunction (e.g. increased card payment penetration at the SME level, significant M&A activity in recent years, seismic and changing customer behavioural trends, massive growth in ecommerce, the exponential growth of online markets / contactless payments, the emergence of a recognised fintech scene characterised by competitive new entrants and international entities now operating at scale in the UK market etc),

Based on the various complexities we have identified we would hope that the PSR takes a flexible approach and is prepared to adapt its analysis should this be required.

Similarly, as has been commonplace with other regulatory investigations, should the methodology prove insufficiently robust, we would respectfully ask that the PSR is responsible enough to disregard and/or discard it as an approach, and, as it chooses to see fit.

[3] When so much of the value of acquirer's asset bases derives from a variety of intangible assets which are subjective and difficult to quantify.