



EUROPEAN CENTRAL BANK

EUROSYSTEM

**OCCASIONAL PAPER SERIES**

**NO 131 / SEPTEMBER 2011**

**INTERCHANGE FEES  
IN CARD PAYMENTS**

by Ann Börestam  
and Heiko Schmiedel



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**Address**

Kaiserstrasse 29  
60311 Frankfurt am Main, Germany

**Postal address**

Postfach 16 03 19  
60066 Frankfurt am Main, Germany

**Telephone**

+49 69 1344 0

**Internet**

<http://www.ecb.europa.eu>

**Fax**

+49 69 1344 6000

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## ABSTRACT

The present paper explores issues surrounding multilateral interchange fees (MIFs) in payment card markets from various angles. The Eurosystem's public stance on interchange fees is neutral. However, the Eurosystem takes a keen interest in facilitating a constructive dialogue among the stakeholders involved in this debate. Transparency and clarity with respect to the real costs and benefits of different payment instruments are indispensable for a modern and harmonised European retail payments market. Interchange fees (if any) should be set at a reasonable level so as to promote overall economic efficiency in compliance with competition rules.

**JEL code:** G21, D43, L13.

**Keywords:** Trade credit and debit cards, retail payment systems, two-sided markets, interchange fees.



**NON-TECHNICAL SUMMARY**

The project of creating the Single Euro Payment Area (SEPA) represents a major step forward with respect to closer European integration. Most recently, SEPA credit transfers and direct debits have been successfully introduced. To complete the SEPA project, the third missing piece in the puzzle is SEPA for cards.

Payment cards have become the non-cash payment instrument used most in Europe. Inherently tied to card payments are multilateral interchange fees (MIFs). In this context, the European Central Bank (ECB) takes the view that further clarity in the framework for cards, in particular with respect to interchange fees, is likely to foster the creation of an open market environment for existing and new card schemes and take the euro area forward along the road towards an advanced retail payment market.

The present paper explores issues surrounding MIFs from various angles. The Eurosystem's public stance on interchange fees is neutral. Interchange fees are typically an issue within the field of competence of the European Commission. However, the Eurosystem takes a keen interest in facilitating a constructive dialog among the stakeholders involved in this debate. In addition, the Eurosystem shares the view that it is crucial for the success of SEPA that cards can be used throughout the euro area to make euro payments without any geographical differentiation.

Transparency and clarity with respect to the real costs and benefits of different payment instruments are indispensable for a modern and harmonised European retail payments market. Interchange fees (if any) should be set at a reasonable level and should not prevent the use of efficient payment instruments. A sharp increase in cardholder costs could induce consumers to use less efficient means

of payment, thereby hampering the success of, and the objectives pursued by, the SEPA project. Interchange fees (if any) should be set to promote overall economic efficiency in compliance with competition rules. The future shape of the payment cards landscape in the euro area and the application of interchange fees (if any) would benefit from a fresh and European approach.

## I INTRODUCTION

With the establishment of the Single Euro Payments Area (SEPA), there will be no difference in the euro area between national and cross-border retail payments. SEPA will strengthen European integration and is aimed at fostering competition and innovation, and at improving conditions for customers. With the united efforts of the European banking community, legislators and the central banking community, SEPA made a successful start with the introduction of the SEPA credit transfer in 2008 and the SEPA direct debit in 2009. However, in addition to SEPA credit transfers and direct debits, the focus is now moving to the third pillar of SEPA, namely SEPA for cards.

Without the success of SEPA for cards, the project will not be complete. Given the importance of SEPA for cards, the Eurosystem is acting as a “catalyst” with the aim of developing a framework for a competitive European cards market (European Central Bank (2010)). In this context, the Eurosystem provides guidance and expresses expectations that further clarity in the framework for cards, in particular with respect to interchange fees, is likely to foster the creation of an open market environment for existing and new card schemes and take the euro area further along the road towards an advanced retail payment market.

Cards are the most commonly used non-cash payment instrument in the European Union (EU).<sup>1</sup> The success of payment cards is associated to their convenient, safe and efficient use. In most cases, card payments are linked to multilateral interchange fees (MIFs) that flow from the payee’s bank to the payer’s bank.<sup>2</sup> In Europe, every time a card payment is made, the consumer’s bank usually receives an interchange fee from the merchant’s bank. The issue of interchange fees in card payments is very complex and there can be substantial differences in the ways interchange fees are calculated and how they are interpreted. For many years, interchange fees have been a controversial issue subject to regulatory and antitrust investigations,

and card schemes have cut cross-border and some national MIFs in order to comply with EU antitrust rules.

Against this background, the European Central Bank (ECB) is attempting to enhance the general understanding on the nature of interchange fees and their role in the proper functioning of card payments market. The present paper explores aspects of MIFs charged on card payments from an economic and legal perspective. It highlights the relevance and development of card payments. It reviews the existing economic literature and examines the theoretical justifications for, and economic rationale behind, interchange fees.

The paper looks only at interchange fees for card payment transactions. Interchange fees for other payment instruments, e.g. direct debit payments, are not considered. Moreover, the paper presents existing experiences, options and interpretations of interchange fees in selected European countries. It seeks to identify potential issues that interchange fees may raise in terms of innovation in, and the efficiency of, payment systems. The paper also compares some selected regulatory decisions by EU and national authorities, and assesses the roles that the respective authorities play in setting interchange fees. The study covers the whole European Union, but places an emphasis on the euro area and its member countries.

Numerous theoretical models on interchange fees have been established in the economic literature. However, there is only limited knowledge and evidence on market practices. The present study’s original contribution in this regard is that it comprehensively links important aspects of interchange fees from both an economic and a legal perspective. Where applicable, the study is enriched by fact-finding with respect to different practices and models in selected euro area countries.

1 See Section 2 for recent developments in card payment usage in Europe.

2 However, some card schemes function without MIFs and in other card schemes, the MIF is paid by the payer’s bank to the payee’s bank.

The Eurosystem's public stance on interchange fees is neutral. Interchange fees are an issue by nature that falls within the field of competence of the European Commission and national competition authorities. However, the Eurosystem endeavours to facilitate a constructive dialogue among the stakeholders involved in this debate. In addition, the Eurosystem shares the view that it is crucial for the success of SEPA that cards can be used throughout the euro area to make euro payments without any geographical differentiation.

Transparency and clarity with respect to the real costs and benefits of different payment instruments are indispensable for a modern, competitive and integrated European retail payments market. Interchange fees (if any) should be set at a reasonable level and should not prevent the use of efficient payment instruments. A sharp increase in cardholder costs could induce consumers to use less efficient means of payment, thereby hampering the success of, and the objectives pursued with, the SEPA project. Interchange fees (if any) should be set to promote overall economic efficiency in compliance with competition rules. The Eurosystem recommends a close dialogue between appearing new card schemes and the European Commission on the compatibility with competition law of the MIFs they plan to charge. Guidance in the form of a regulation might even be considered as the *ultima ratio* (European Central Bank, 2010).

The remainder of this study is structured as follows: Section 2 provides stylised facts and figures on the cards market, determining the significance of the card payments industry. Section 3 presents and reviews the underlying economic concepts and Section 4 provides a review of the literature on interchange fees. Section 5 presents the results of a fact-finding exercise on interchange fee arrangements, highlighting recent developments in, and determinants of, interchange fees in the euro area. Section 6 provides a legal assessment and

comparison of some interchange fee decisions by EU and national competition authorities. Section 7 discusses possible policy options and perspectives for future market structures. The final section contains a summary and conclusion.



## 2 SIGNIFICANCE OF CARD PAYMENTS

The evolution of the different payment instruments and, in particular, the use of cards point to the important role card payments play in a well-functioning European payment system. A well-functioning financial system allows an economy to fully exploit its growth potential, as it ensures that the best real investment opportunities receive the necessary funding (European Central Bank (2008)). Similar to other financial innovations, cashless transactions make financial markets more complete, allow transaction costs to be low and, most importantly, facilitate the exchange of goods and services. Against this background, significant changes in the use of cashless payments have taken place in the euro area over time; the number of cashless transactions, e.g. credit transfers, direct debits, card payments and e-money payments, has risen in all countries. Over the last few years, the volume of cashless payments in the euro area has increased by 6% per annum. In the euro area, as is shown in Chart 1, card payments

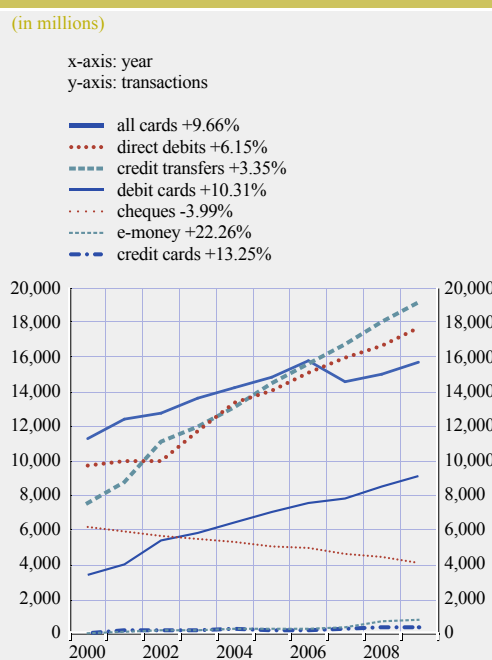
experienced the highest growth in the period from 2000 to 2009, rising by about 10%, and have become the payment instrument used most in the euro area, with over 19 billion payments in 2009.<sup>3,4</sup>

In particular, considering card payments in the euro area, the growth and development of the use of debit card payments over time was far stronger than that of credit card transactions, as shown in Chart 2.

<sup>3</sup> 19,131 billion transactions in the euro area in 2009.

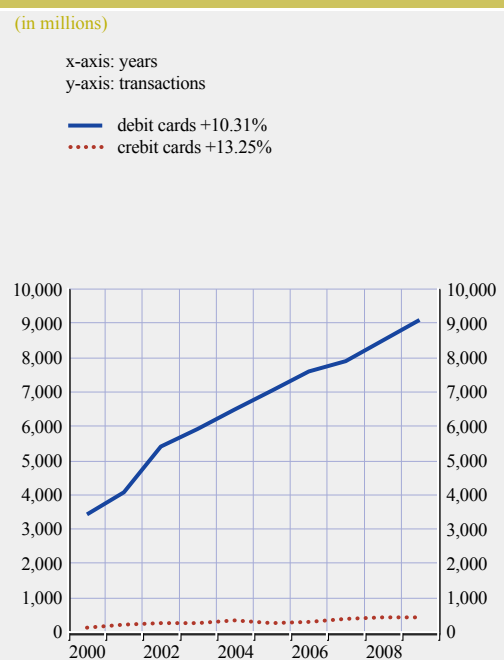
<sup>4</sup> Chart 1 shows a positive difference between the number of card transactions and the sum total of all sub-groups, broken down by the function of card transactions, i.e. credit cards, debit cards, delayed debit, debit/delayed debit, credit/delayed debit. For example, the total of payments made using cards was above 19 billion in 2009, while the total number of payments using the sum of payments broken down by card functions totalled only 12 billion transactions in 2009. In other words, there is difference as the “sum of the components” is not always equal to the “total”. The underlying reason is to be found in the fact that, although all the countries provide data on the totals, they do not all provide data on the sub-groups, so that there is no one-to-one correspondence between the sum of the components and the totals. The relatively large difference is due primarily to data from France, which does not provide any breakdown.

**Chart 1 Use of payment instruments in the euro area (2000-2009)**



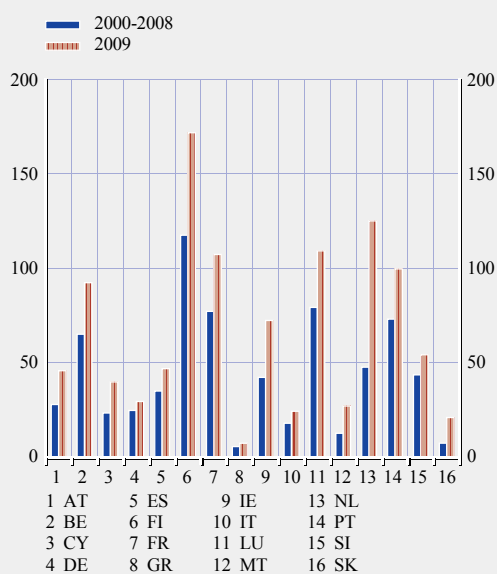
Source: ECB Statistical Data Warehouse.

**Chart 2 Debit versus credit card transactions in the euro area (2000-2009)**



Source: ECB Statistical Data Warehouse.

**Chart 3 Number of card payment transactions per capita in the euro area (2000-2009)**



Source: ECB Statistical Data Warehouse.

Note: The abbreviations AT, BE, CY, DE, ES, FI, GR, IE, IT, LU, MT, NL, PT, SI, SK are country codes for the following countries (listed in the same order): Austria, Belgium, Cyprus, Germany, Spain, France, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia and Slovakia.

Despite a trend towards an increasing use of payment cards, the European retail payments market is still relatively fragmented and national payment habits differ, leading to substantial asymmetries in card payment usage. As shown in Chart 3, within the euro area, card payments were most frequently used in Finland, France, the Netherlands and Luxembourg. In Greece and Italy, card payments are made least frequently. In effect, Greece and Italy have experienced the smallest increases in the number of card payment transactions per capita over the years. The highest growth in the use of cards for payments has been made by Slovakia, closely followed by the Netherlands and Malta. It is worth noting that, apart from the Netherlands, countries that have adopted the euro more recently have recorded relatively high growth rates in payment card usage.

In future, asymmetries in customers' habits when purchasing goods and services are expected to diminish. More competition, more

choice and new business opportunities, for example in the cards market, will influence payment habits and could encourage a greater use of cards. Innovative payment solutions, such as online payments, are also likely to change customers' habits. Overall, recent developments and changes in the payments market reveal great opportunities and potential for non-cash payments, in particular for the cards market. Further replacement of cash by other payment instruments, including cards, is likely to benefit profitability, to entail economies of scale and, thereby, to enhance competition and overall economic efficiency.

### 3 INTERCHANGE FEES IN CARD PAYMENTS

The mechanism of interchange fees is a complex issue and involves many participants in the payment transaction chain. This section provides some stylised facts on the interplay of different actors in the cards market and introduces the economic background of interchange fees.

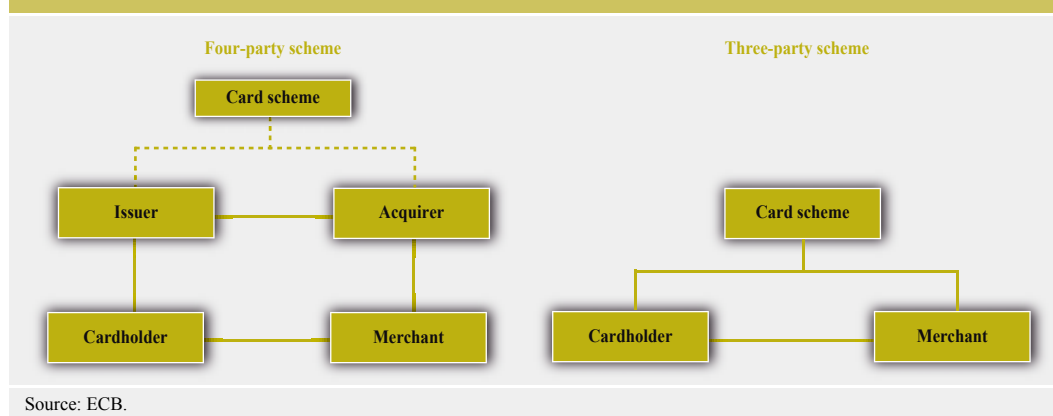
#### 3.1 TWO-SIDED MARKETS AND INTERCHANGE FEES

Two-sided markets typically feature one or several platforms, such as a card scheme, which make interactions between end-users possible and try to bring the two sides “on board” by appropriately charging each side. Markets are two-sided if supply and demand on one side of the market are determined by supply and demand on the other side of that market, so that pricing should take into account both sides of the market. The payment card market is characterised by a two-sided market structure. Payment card schemes sell their services to two types of customers, namely (i) cardholders, who use their card (a) to buy goods and services from merchants that accept the card and/or (b) to withdraw cash from most automated teller machines (ATMs), and (ii) merchants, who offer their customers the possibility of paying with cards.

There are two main business models for the provision of card payments: three and four-party schemes, as illustrated in Chart 4. A three-party scheme is generally a commercial company that directly serves both sides of the market: cardholders and merchants. The scheme itself is responsible for issuing cards and acquiring transactions. A four-party scheme brings together multiple actors (normally banks), each of which may tend to specialise on either one or both sides of the market: as issuer serving the cardholders, or as acquirers serving the merchants. The scheme may be administered by a non-profit organisation or a commercial company. In the EU, for example, three-party schemes are American Express and Diner’s Club, and four-party schemes comprise Visa Europe, MasterCard and Cartes Bancaires. It should be noted that the three-party schemes are primarily credit card schemes. The four-party schemes are debit and credit card schemes, while the debit function is the most dominant. In the following, particular attention is paid to four-party schemes.

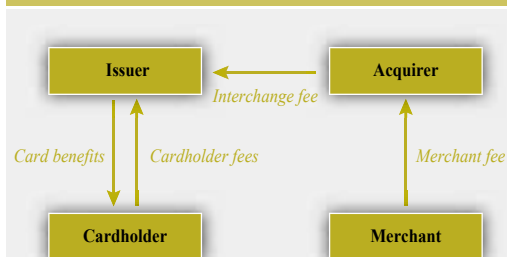
An interchange fee is a transfer of funds from one side of the market to the other, as in Chart 5. It should also be noted that some schemes work without any kind of interchange fee, with each leg of the payment covering its own costs.

Chart 4 Business models for the provision of card payments



Source: ECB.

Chart 5 Multilateral interchange fee structure



Source: ECB.

In four-party schemes, an interchange fee can be, and usually is, explicitly provided for in the scheme rules. Three-party schemes also involve some kind of transfer of funds from the acquiring side to the issuing side, usually an implicit interchange fee. In the classic model, the interchange fee goes from the acquiring side to the issuing side, but it can sometimes also take the opposite direction.

In the dominant model, every time a card payment is made, the issuer (on behalf of the cardholder) is instructed to pay the acquirer (on behalf of the merchant) for the value of the goods or services. The card issuing and the acquiring sides of the business are normally performed by banks. The interchange fee typically flows in the opposite direction: it is paid by the acquirer to the issuer. In other words, interchange fees are basically a balancing mechanism through which some of the costs on the issuing side are covered by the acquiring side.

In 2006 there were at least four national card schemes that operated without an MIF, namely those in Denmark,<sup>5</sup> Finland, Luxemburg<sup>6</sup> and the Netherlands.<sup>7</sup>

Interchange fees are only one component. Besides interchange fees, there are up to four additional fees to be found in a four-party card scheme, namely the merchant fee, the cardholder fee and two scheme fees. The acquirer charges the merchant a fee<sup>8</sup> and can thus recover the

interchange fee paid to the issuer. Interchange fees are usually the main component of the merchant's service commission. Merchants also need to recover the costs paid to acquirers. To this end, they could increase the general level of prices or – if not prevented from doing so by the schemes rules or national legislation – they could charge cardholders more (i.e. impose a “surcharge”) if accepting card payments is more expensive for them than accepting other payment instruments such as cash. The cardholder fee is typically a fixed monthly or annual fee paid by the cardholder to the card issuing bank. In addition to interchange fees, the merchant fee and the cardholder fee, four-party schemes typically have “scheme fees”. These are fees that card schemes charge both to issuers and to acquirers. These fees are related to membership in the scheme and are generally based on the number of cards issued and/or the number of transactions carried out (acquisition).

### 3.2 ECONOMICS OF INTERCHANGE FEES

#### MAXIMISING AGGREGATE PROFIT FOR CARD SCHEME MEMBERS

The cards industry is characterised by two features: the need to serve a two-sided market, i.e. cardholders and merchants, and the network externalities related to both sides of the market, i.e. the benefit accrued by merchants when more people have a card and, similarly, the benefit cardholders have when they can use their cards for payments to more merchants.

- 5 It should be noted that Dankort works without an MIF in the traditional sense. However, Nets, and its predecessor PBS, acts as the only acquirer and all merchants pay a fixed fee that depends on the number of transactions submitted to Nets. Subsequently, Nets pays the issuers, the banks, a fee per Dankort transaction. The size of the merchant fee, and thus the fee from Nets to the issuers, is regulated. If that were not the case, it would be quite similar to an MIF.
- 6 The situation may change in Luxembourg with the upcoming decommissioning of the national debit card scheme Bancomat in early 2012.
- 7 For detailed explanations of MIFs, see European Commission, “Report on the retail banking sector inquiry”, *Commission Staff Working Document*, January 2007, p. 112 (available at: [http://ec.europa.eu/competition/sectors/financial\\_services/inquiries/sec\\_2007\\_106.pdf](http://ec.europa.eu/competition/sectors/financial_services/inquiries/sec_2007_106.pdf)).
- 8 Referred to as the “merchant service charge” (MSC) in European literature, while US literature uses the term “discount fee” (DF).

Card schemes set prices to maximise the aggregate profit for their members. To this end, two decisions need to be taken with respect to the price level and the price structure. The price level refers to the aggregate price charged by the card scheme to the two sides. The price structure relates to the sharing of the total income between the two sides of the market. The price structure in card payments is normally determined such that merchants pay a larger share of the aggregate price than the cardholders. Cardholders may on certain occasions even enjoy a price gain (i.e. a “subsidy”) for having and using their card. This would be the case when they are not charged any annual fee and they obtain benefits from using the card, e.g. airline miles, cash reimbursements, etc.

There are many examples of two-sided markets where the costs are not allocated evenly to both types of clients. Newspapers generally sell to readers at prices that are lower than the production costs, while a large proportion of the revenue is collected from advertisers. A newspaper may even be free of charge for readers and recover its costs entirely from advertisers. But this does not extend to readers being paid for obtaining the newspaper.

The imbalance in the way card schemes allocate costs and obtain their income is caused by the lower price elasticity on the merchants’ side. A low price elasticity means that the merchants’ demand for a given card scheme is affected relatively little by changes in prices. In other words, card schemes can afford to raise the prices they charge to merchants in order to maximise the profit for their members. Low price elasticity is due mainly to the fact that accepting card payments has become a necessity for merchants in many business sectors, e.g. hotels, restaurants, petrol stations, supermarkets.<sup>9</sup>

The price elasticity of merchants in accepting card payments has never been researched. However, the difference in price elasticity of consumers vis-à-vis that of merchants is a key element in explaining and studying interchange fees and assuming that there is a difference in price elasticity is plausible.

Substitutes for a given card scheme certainly exist. The merchant may offer customers the possibility of paying with other payment instruments, including other cards. Customers who cannot pay with their preferred card will normally accept paying with a different payment instrument. However, the merchant might not wish to risk losing a sale, e.g. in cases where the customer does not have alternative means of payment, or losing future sales, e.g. if the customer is annoyed because the merchant will not accept the card.

Therefore, the willingness of the merchant to take the risk of not accepting a well-known and widespread card scheme will depend on two factors. The first is the question as to whether the “cost” is in proportion to the “income”, i.e. whether the cost of the merchant fee is high or low in comparison with the profit margin lost as a result of a foregone sale.<sup>10</sup> The second is determined by the card scheme’s acceptance and overall coverage within the business sector and, consequently, the customers’ expectations with respect to their card.

When setting the prices in a four-party scheme, the card scheme needs to take into account the demand curves of both the merchants and the cardholders at the same time.<sup>11</sup> In such a scheme, the profit-maximising scheme takes into account both the price elasticity of demand on both sides of the market and the externalities caused by the demand on one side of the market to that on the other. In particular, it needs to balance the following considerations:

- An increase (decrease) in merchant fees may, in theory, decrease (increase) the demand for card services by merchants and –

9 Recent studies have shown that consumers are price sensitive. See, for example, Amromin et al. (2005), Ching and Hayashi (2008), Humphrey et al. (2001) and Zinman (2008). Bolt et al. (2010) provide evidence of the price sensitivity of Dutch consumers with respect to debit card services.

10 For this reason, merchants operating with low margins tend not to accept credit cards, while merchants operating with high margins tend to accept them.

11 It should be noted that in a three-party scheme, the scheme sets the prices for the cardholder and the merchant, while in four-party scheme, the card scheme only sets a default interchange fee.



through the network externality – cause a decrease (increase) in cardholders’ demand for card services.

- An increase (decrease) in cardholder fees may, in theory, decrease (increase) the demand for card services by cardholders and – through the network externality – cause a decrease (increase) in merchants’ demand for card services.

The price structure of a card scheme would be optimal if the total profit for the card scheme members is maximised. The price structure depends on the respective price elasticities in that the side of the market with lower price elasticity of demand has higher prices than the side with higher price elasticity of demand. As the elasticity of demand for merchants in card payments is lower than that for cardholders, the prices for merchants are higher than the prices for cardholders. Ensuring that an optimal number of cardholders join a card programme may even necessitate a “negative price”. Another way of reducing the price for cardholders, instead of cash pay-backs, is to bundle other services together on the payment card. This is especially relevant if the perceived value of these services for customers exceeds the issuers’ cost thereof. In addition to payment services, international credit cards also offer insurance, concierge and other value-added services that come to cardholders with the card.

Typically, the interchange fee in a four-party scheme is set by the card association, which is generally owned by the issuers and acquirers,<sup>12</sup> both also being represented in the association’s board. The prices set to maximise total profits may not be the same as those that maximise the profits of the scheme’s individual members, i.e. the issuers and acquirers. In such a case, the bargaining powers of the issuers and acquirers in the scheme’s governance affect the interchange fee that is chosen. Such internal bargaining may thus cause the interchange fee actually charged to differ from the individual optimum.

Moreover, in practice, pricing is also largely determined by the price elasticity of the issuing banks. When setting its interchange fees, the card scheme will not pay much attention to the price elasticity of cardholders, but would rather take into account the price elasticity of issuing banks. Issuers’ decisions on which card to issue depend on the level of the interchange fee. This elasticity can be very marked and may induce issuing banks to switch to another card provider with higher interchange fees. The question as to whether competition between card schemes drives up prices may need to be assessed in terms of the expected interchange fee revenues determined by overall card acceptance and usage.

#### COMPETITION BETWEEN ISSUERS AND ACQUIRERS WITHIN A GIVEN CARD SCHEME

In the event of perfect competition between schemes, the prices offered to cardholders and merchants would be calculated as follows:

*merchants: marginal cost of serving merchants  
± interchange fee;*

*cardholders: marginal cost of serving  
cardholders ± interchange fee.*

The actual prices also depend on the level of competition in the issuing and acquiring markets. A lack of competition between both issuers and acquirers can move the price level away from the efficient level by allocating increased costs to either of the two sides of the market.

Card schemes consist of a group of sellers on the issuing and acquiring side that have agreed on common rules for providing the service and take decisions jointly. Through the interchange fee, they collectively decide on the lower bounds of the prices that acquirers charge merchants and issuers charge cardholders. Although there are similarities in the modus operandi, there are also important differences between card schemes

<sup>12</sup> Typically, all acquirers are issuers, but many issuers are not acquirers.

and cartels.<sup>13</sup> Like a cartel, a successful four-party scheme has the potential to reduce competition between schemes. Network externalities often make it more attractive for a bank to join a four-party scheme than to be issuer and acquirer for its own card brand. However, competition within the scheme exists in the issuing and acquiring markets. Another very important difference is that a cartel often seeks to raise prices by restricting output, while card schemes seek to maximise their output, and interchange fees support this objective. Furthermore, an important difference is also to be found in the fact that a card scheme needs to serve both sides of the payment market, while a “classic” cartel serves only a one-sided market.

Gauging if and to what extent interchange fees affect the degree of competition between issuers, or between acquirers, one needs to take into consideration that the interchange fee acts like an indirect tax that all acquirers are equally bound to impose on their customers, the merchants. At first sight, this does not seem to have an impact on internal competition between acquirers. However, the interchange fee affects the incentives for members to specialise as acquirers or issuers, because it transfers revenue from the former to the latter. In this way, it affects the number of competing issuers/acquirers.

#### **CONTESTABILITY OF THE CARD SCHEME MARKET**

Network externalities substantially limit the contestability of the card scheme market. Once cards of a given card scheme are to be found in many consumers’ wallets and once acceptance of that card scheme has become generalised within a given sector of business, it becomes very difficult to reverse this situation. Given that merchants’ price elasticity is low and that demand for card services is little affected by changes in prices, interchange fees can be set sufficiently high. Under these conditions, issuers may offer cardholders negative prices. Choosing from among several payment instruments, cardholders will use their card to pay for goods in order to benefit from those negative prices.

For example, if a credit card provides for a cash reimbursement of 1%, the effective price for the cardholder of a good costing 100 will be 99 if he/she pays with the credit card, and 100 if he/she pays with cash or debit card. A competing card scheme wishing to enter the market would have to offer lower prices to induce cardholders to switch their preferred payment instrument, for example, a cash reimbursement of 2%. Such a policy would require increasing interchange fees. However, as it has not yet attained widespread acceptance, this new card scheme would be incapable of imposing a price on merchants that provides for the necessary level of interchange fees.

The efficient price structure is likely to change in the course of the lifetime of the scheme, as the elasticities of demand and network externalities change with the usage of the scheme. At the outset, the elasticities of merchants and cardholders may be higher, as neither need the card as much as when the scheme has established itself. In sum, the more widespread a card scheme becomes, the higher it can set interchange fees, the more opportunities it provides issuers to reduce the prices offered to cardholders to negative levels and the more cardholders will make use of the card. Network externalities are a reinforcing mechanism.

#### **MARKET FAILURE AND REGULATORY ASPECTS**

In principle, there are two ways in which markets that provide card payments can fail. First, the price level may be above the socially efficient one. The market power of providers on either or both sides of the market may enable them to extract rents, i.e. charge their customers more

<sup>13</sup> A cartel can be seen as a group of sellers of a product who have joined forces to control the production, sale and price of that product in the hope of obtaining the advantages of a monopoly. Actually, the outcome may not be a monopoly, but rather a situation in which the group has a dominant market power. The more firms enter the market, the more will the price gradually drop from the monopoly level to the welfare-maximising level. In economic theory, cartels are generally considered to be inferior to competition, and there is little material in economic literature to justify them. Whether they are allowed to exist depends on the policies of the relevant competition and antitrust authorities.

than the competitive price. Second, the price structure may differ from the socially optimum one, i.e. merchant and cardholder welfare is not maximised on the basis of the relative prices charged by the card payment provider.

It should be noted that excessive interchange fees may have two negative effects. The first is an allocative effect. When merchants decide whether or not to accept cards, they not only take their own direct benefits from card acceptance into account (e.g. cost savings relative to cash payments), but also consider the benefits of cardholders. This is because card acceptance is a desirable service that attracts customers. This internalisation of cardholder benefits implies that schemes can push interchange fees very high without jeopardising card acceptance.

The economic literature (e.g. Rochet and Tirole (2002, 2011)) has shown that this allows schemes to introduce “hidden costs” into the system. When a payment is made with a high interchange fee card, cardholders impose a negative externality on the merchant and, hence, all other purchasers. Cardholders are tempted to use more expensive payment cards, because their high interchange fee is often reimbursed via low cardholder fees and reward programmes. In doing so, they do not take into account the genuine costs of the payment, which is to a large extent borne by the merchant and other shoppers. Rather than internalising positive externalities for merchants, excessive interchange fees therefore create negative externalities.

The second negative effect that can arise is a distributive effect. It has often been argued that the pass-through of interchange fee income from issuers to cardholders takes place at a lower rate than the pass-through of interchange fee costs from acquirers to merchants. With such an asymmetric pass-through, schemes have an incentive to use the interchange fee to affect the price structure of payment card markets so as to maximise output. In addition, it would be commercially profitable for them to raise the interchange fee to a higher level in order to shift revenues to the side of the market where

the pass-through is low (issuing), while costs are shifted to the side of the market where the pass-through is high (acquiring). In this way, they can increase banks’ joint profit margins across issuing and acquiring, which allows rents to be extracted from consumers. With such an asymmetric pass-through, a reduction of the interchange fee must decrease the price level across issuing and acquiring, because the original interchange fee set by the scheme could otherwise not have been profit-maximising.

Competition laws affect the price structure of four-party schemes, due to their multilateral nature. Antitrust policy is normally the competence of competition authorities. Competition laws restrict the ability of four-party schemes (consisting of competing entities) to set a privately optimal price structure. The goal of competition law is an efficient and competitive market, without restrictive agreements between entities. Their ability to succeed in attaining this goal will depend on the application and interpretation of competition rules.

It is sometimes argued that the reduction of interchange fees due to the application of the competition rules is likely to result in higher prices or a reduction of reward programmes for cardholders. Arguably, this depends on a number of factors, such as the level of the actual fee, the level of competition in the issuing market, the magnitude of the reduction, the current level of fees and rewards, etc., and possible cross-subsidising between banking services. In addition, issuing banks may make the actual use of cards by cardholders subject to certain conditions. Therefore, it is difficult to anticipate the effect that a decrease in interchange fees will have on the issuing banks’ business case with respect to cards.

Another question that arises is that as to whether a decrease in interchange fees also results in lower prices for merchants. This may, but is not necessarily the case. For a reduction of interchange fees to be passed through to merchants, the market for acquiring needs to be competitive. The more competitive the

acquiring market is, the more of the reduced costs (for acquirers) are passed on to merchants. As a consequence, a reduction in interchange fee transfers wealth either from cardholders or issuers to merchants or acquirers – depending on the degree to which issuers and acquirers pass the increase in costs (issuers) or decrease in costs (acquirers) on to the side they serve.

The assessment of the compliance of multilateral interchange fees (MIFs) with EU competition law primarily requires an analysis whether the MIF arrangement violates Article 101 of the Treaty on the Functioning of the European Union (TFEU).

The merchant indifference test (also called the tourist test), as applied by the European Commission in assessing the undertakings offered by MasterCard and the commitments offered by Visa Europe, is described in further detail in Section 4. An assessment of some interchange fee decisions by competition authorities is provided in Section 6.

#### 4 REVIEW OF LITERATURE

Over recent years, economic analysis has brought forth an enormous number of theoretical contributions on issues falling into the field of interchange fees. The interest in modelling interchange fees is related to two prevailing issues in the debate on interchange fees: the question as to whether and how interchange fees really ensure efficiency in the payment market and that as to whether and how interchange fees alter competition.

What is of key interest both in terms of economic modelling and from a regulatory perspective is to determine whether the current interchange fee patterns are socially optimal, i.e. whether the various payment instruments will be overused or underused relative to a socially optimum outcome (Prager et al. (2009)). Both at a policy level and at an academic level, it has been argued that an increase in the use of electronic payment instruments would reduce the social costs of payments. However, the cash will only be replaced by card payments if consumers and merchants have incentives to do so. Thus, MIFs have been designed to provide incentives for the use of electronic payment instruments (Leinonen (2007); and Verdier (2009)).

A number of important findings that have emerged in the theoretical literature deserve mention in the context of policy debate on competition in retail payment systems, in general, and on setting MIFs in the cards business, in particular (Rochet (2007)).

The models that have been developed thus far include the contributions of Baxter (1983), Carlton and Frankel (1995), Schmalensee (2002), Chang and Evans (2000), Wright (2004), Evans (2006), Armstrong and Wright (2007), Rochet and Wright (2008), and Rochet and Tirole (2003, 2006, 2011). Common to these contributions is the concept of two-sided markets. Under certain conditions, one side of the market will pay relatively less than the other side or, in the extreme, will not pay anything for the service. In other words, the pricing distribution is

skewed on account of some positive indirect network externalities in the market (Evans and Schmalensee (2005)). The market for retail payment instruments is a two-sided market. Interchange fees are designed to lead to lower cardholder fees: consumers are given an incentive to move away from the use of cash and cheques to more efficient means of payment. Therefore, the balancing nature of interchange fees is a fundamental prerequisite for the successful functioning of retail payment systems.

Baxter (1983) was the first to justify the existence of interchange fees, claiming that they are needed to deal with market failures caused by the existence of externalities in the market. However, Baxter's model has been challenged because of its too simplistic assumptions on the homogeneity of consumers and merchants. In reality, consumers and merchants differ in terms of their card usage and card acceptance, and there can be strategic interaction among merchants that alters the acceptance of cards (Rochet and Tirole (2006); and Verdier (2009)).

Wright (2004) improved the model by assuming heterogeneity in both sides of the market, so that the volume-maximising interchange fee is chosen such that it brings the demand in the two sides of the market into balance. Here, the classic feature of a two-sided market (Rochet and Tirole (2006)) becomes evident. The model explicitly takes into account the asymmetry between the two sides of the market, considering the differences in the price elasticity of cardholders and merchants.

A variant of these models examines the relationship between the level of the interchange fee and the quality of the payment system services. According to Verdier (2006), the level of quality of the payment system should be a factor to be taken into consideration when choosing the optimal interchange fee. Furthermore, there seems to be evidence that card system operators and bank associations have an interest in inflating interchange fees. This may not be bad from a social welfare point of view, but only to the limited extent that banks need to use those revenues to recover their high fixed



costs for ensuring the safety of, and innovations in, their payment networks. On the other hand, revenues from interchange fees may be used in an excessive and socially not most efficient manner.

Bolt and Schmiedel (2011) conclude that increased competition between card schemes drives down merchant fees and increases card acceptance. Recent data on the development of interchange fee levels support an overall decreasing trend in different European countries. Moreover, from a European perspective, consumers and merchants are likely to benefit from the creation of SEPA when sufficient competition in the card payments market alleviates potentially monopolistic tendencies.

Thus, in sum, there is general academic consensus on why interchange fees exist, irrespective of whether they are agreed bilaterally or multilaterally. The existence of such fees seems to hold even in mature payment card systems that take into account that payment networks are driven by usage, rather than by membership externalities.

Concerns arise with respect to the determination of the socially optimal interchange fee. In fact, part of the literature maintains that the trade-off between a consumers' surplus and a merchants' surplus should be taken into account when dealing with heterogeneous markets (Verdier (2009)). When heterogeneity is considered, there can be an underuse or overuse of card payments from the point of view of the social planner. If that is taken as given, the volume-maximising, the profit-maximising and the welfare-maximising interchange fees are not equal (Schmalensee (2002); Wright (2004); and Rochet and Tirole (2006)).

One of the problems with respect to the setting of interchange fees both for private agents and for regulators is that they cannot rely on empirical studies. Although a large number of theoretical models on interchange fees have been put forward in the literature, these formal models have not been subjected consistently to empirical tests. The empirical studies mostly relate to the

different costs of various payment instruments. However, most of them differ significantly in the approaches and definitions used. One of the main problems in empirical analysis is linked to the core issue in the payments market: the replacement of cash with electronic payment instruments. It is not clear how to define the full costs of all payment instruments, given the difficulty in estimating the cost of cash (Leinonen (2007); and Verdier (2009)).

However, there is one recent empirical work that is worth mentioning. Chakravorti et al. (2009) have looked at the effect of ceilings on multilateral exchange fees in Spain in the period from 1997 to 2007. They argue that consumer and merchant welfare improved when the interchange fees were dropped in Spain, following a private agreement between the parties in conflict. Furthermore, bank revenues increased because the increase in the number of transactions offset the decrease in the revenue per transaction. However, a potential side effect of reducing interchange fees remains unsettled as the issuing banks may demand and charge the final consumer higher card fees to recover foregone revenues from multilateral exchange fees.

This brief review of the literature shows that determining which pattern of fees is socially optimal is a difficult task. There seems to be consensus on why interchange fees exist in the market for debit and credit cards. However, both the issue of the allocation of costs and benefits and potential economic effects of a ceiling on such fees in the market for card payments are key matters that are still under discussion among academics and banks (issuers and acquirers).

However, there is a need for more extensive empirical research. Moreover, it is worthwhile to say some words on new models, the so-called "tourist test" models, that have been developed to take into account some aspects that previous research had failed to consider and that have been followed by market agents and regulatory authorities. In the MasterCard case (Case No Comp/34.579), after more than a year of discussions on the reduction of multilateral

exchange fees on cross-border payments, MasterCard decided to calculate these fees on the basis of this new methodology, which led to a substantial reduction of fees.

One of the main shortcomings of previous models is the strategic interaction among merchants. There is competition among merchants in attracting costumers. They are aware of the fact that the decision to accept cards will have an impact on competition, so that they may be willing to accept higher fees if they have advantages in terms of competition. This is called the “must-take card” concern (Vickers (2005); and Rochet and Tirole (2008)).

Antitrust authorities claim that merchants cannot refuse to accept cards because that would mean losing clients and this pushes up the level of the interchange fees chosen by the payment platform (Verdier (2009)). This can imply ex post market inefficiency, in the sense that merchants may refuse a card payment from a costumer even if they had declared ex ante that they would accept cards.

This can be made clearer on the basis of a simple example: suppose that a non-repeat customer decides to have dinner at a restaurant on the last day of his/her holidays; when he/she gets the bill, he/she hands over his/her card, but the proprietor informs him/her that he does not accept cards, so that the customer either has to have cash or needs to find an ATM.

The main point here is that it may well be that the restaurant did have a properly working card terminal, but the proprietor decided to ask for cash because it was less costly, also given the fact that the costumer was a one-off costumer. If the main component of the merchant fee, i.e. the interchange fee, had been lower, he might have been willing to accept the card payment.

Put differently, the “tourist test” is a measure of the level of the interchange fee that would make merchants indifferent to which payment instrument is used, ensuring that interchange fees are not raised to such a high level that negative

usage externalities are introduced into the system. If interchange fees are too high, merchants may still accept cards to attract customers. However, once the non-repeat customer is inside the shop, the merchant has an incentive to steer the customer to cheaper means of payment. Such customer steering only occurs if cards have been priced too high and above the transactional benefits of merchants. Hence, the tourist test is failed because there are hidden costs in the system.

This is the main idea behind the so-called tourist-test model. Roughly speaking, the main question behind the tourist test is how to make merchants accept a card payment if the costumer is also able to pay in cash or, in other words, the question as to whether and to what extent cards are more expensive than cash.

The first to consistently develop the model were Rochet and Tirole (2006). They constructed a model to create a benchmark for interchange fees. They focus on the merchant’s avoided-cost when a cash payment is replaced by a card payment. The merchant fee will pass the tourist test if accepting the card payment does not raise the merchant’s operating costs (Rochet and Tirole (2006)).

Starting from this basic model, they improved it by considering various, more general assumptions, such as the internalisation by merchants of cardholders’ surpluses and heterogeneity among merchants, to verify under what conditions the test gives unbiased results (Rochet and Tirole (2011)). They compare the maximum interchange fee that passes the tourist test with that which maximises the joint surplus and the overall welfare. They conclude that the tourist test is a reliable tool in the case of constant issuer margins and homogeneous merchants (Rochet and Tirole (2011)). Under different contingencies, the results of the test may be less reliable than in the case mentioned above.

Overall, this new methodology currently seems to be a preferred approach that may help in determining those interchange fees that will promote the use of more efficient payment instruments and prevent abuses in the market.

## 5 PAYMENT CARD INTERCHANGE FEES IN THE EU

This section presents the results of the fact-finding exercise on the structure of, and recent developments in, MIFs for card payments at the EU level. It also presents different interchange fee models and alternative arrangements.

### 5.1 FACT-FINDING ON INTERCHANGE FEE ARRANGEMENTS

Recently, the European System of Central Banks (ESCB) has carried out a fact-finding exercise and collected relevant information on interchange fees for card payments in Europe so as to increase its understanding of national practices, experiences and developments in the field of interchange fees in card payments at the EU level. The survey focused on the interchange fees applied to debit and credit card transactions. Potential interchange fees on cash withdrawals via ATMs were not covered by the exercise. For this exercise, 26 of the 27 EU member countries participated in the survey. All data reported for this exercise refer to the year 2010.

The fact-finding exercise showed that interchange fees are not set and applied in a harmonised way in the EU. The choice, structure, and level of interchange fees applied in the European payment card markets differ in many ways and depend on a number of options and dimensions. At the domestic level in many countries, interchange fees are set bilaterally or multilaterally by domestic card schemes.

In cases where there is no domestic card scheme serving the country's home market, national card markets are generally served by Visa Europe and/or MasterCard. In the card systems operated by Visa Europe and MasterCard, the fees applied to domestic transactions are determined either by national banking associations operating under the scheme's "flag" or by Visa Europe and MasterCard themselves at an EU level. Apart from domestic fees, both Visa Europe and MasterCard also fix cross-border fees. These cross-border fees generally

also apply by "default" in domestic situations if no bilateral or multilateral agreements (in the case of transactions within EU countries) are in place. The level of fees on debit and credit card payments typically differ.

Across European countries, the level of interchange fees varies significantly. The table provides an overview of interchange fees charged for a €10 and a €100 debit card transaction. Overall, it can be seen that the maximum interchange fee for such transactions can be substantial. Typically, interchange fees are reviewed periodically, on an annual or bi-annual basis, by the respective scheme's governance body.

In many countries, interchange fees have been decreasing over time. This holds true of, for example, Belgium, Estonia, France, Italy, Portugal and Spain. Chart 6 reports the development of the effective average MIF for point of sale (POS) transactions in Spain in the period from 2000 to 2009. As a result of successive cross-industry agreements, interchange fees for card payments have gradually been decreasing since 1999. However, this trend accelerated significantly in 2005. Thus, maximum interchange fees dropped by 21% in absolute terms between 1999 and 2002, starting

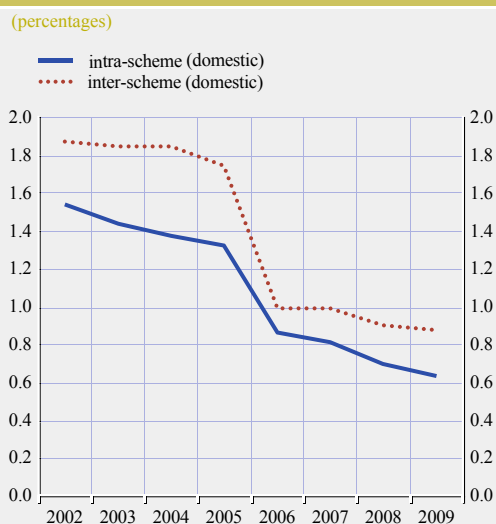
Overview of minimum debit card interchange fees for €10 and €100 transactions in 2010

Interchange fees	Amount debit card transaction	
	€ 10	€ 100
Maximum [EUR]	0.30	1.55
Minimum [EUR]	0.01	0.01
Average [EUR]	0.10	0.47
Standard deviation	0.07	0.47
Number of reporting countries	20.0	20.0

Source: European System of Central Banks.

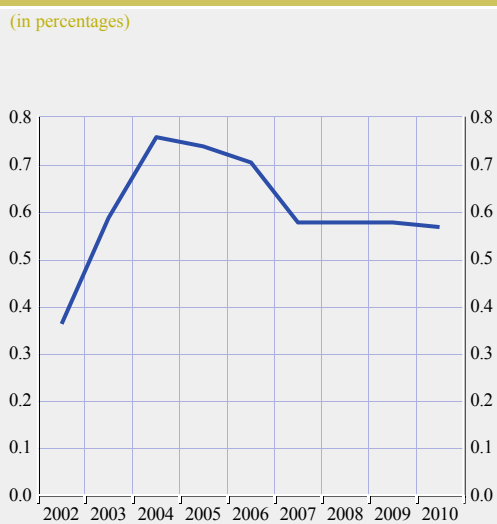
Notes: An attempt was made to calculate and provide an overview of credit card interchange fees for €10 and €100 transactions. However, data unavailability and the incomplete information available on such fees in a number of countries made it impossible for fees on credit card transactions to be reported here. The available results could be biased because of missing or not available data on domestic credit card fees. It should be noted that there is a floor interchange fee for government and utilities transactions in Greece. In this case, the minimum figure overrides the average minimum fee that is used in this table. For further details, please also see Annex 1.

Chart 6 Effective average multilateral interchange fees in Spain (2002-2009)



Source: European System of Central Banks.  
Notes: Since 2006, domestic interchange fees in Spain no longer differentiate between business sectors, but rather between turnover values and card transaction types. As a result, the figures above represent aggregated average fee levels and merely provide an illustrative picture of the actual evolution of interchange fees in the country (see the Banco de España's website for more detailed information).

Chart 7 Effective average multilateral interchange fees in Portugal (2002-2010)



Source: European System of Central Banks.

from a level of about 3.5%. Until the end of 2005, interchange fees continued to decrease, albeit at a slower pace. Finally, following the above-mentioned agreement, an additional adjustment took place, driving average MIFs down further, namely by 43% for inter-scheme operations and by 35% for intra-scheme transactions. Chart 4 presents the evolution of overall yearly weighted average MIF values for intra-scheme and inter-scheme transactions in Spain.

Chart 7 depicts the development of average interchange fees in Portugal over time. The values reflect the calculation of the average MIF charged, considering all purchases at POSs of the Multibanco network. The average MIF applied in transactions on the Multibanco network reached its highest level in 2004, standing at 0.76%. The level of interchange fees then steadily decreased to stabilise at 0.58% between 2007 and 2009. In 2010, the level of interchange fees stood at 0.57%, representing its second lowest level over the past nine years. The overall decrease was due mainly to increased

competition with international card payment schemes and to favourable market developments, i.e. the evolution of card payments in the overall market and in core segments thereof. However, at the aggregate level, this needs also to be seen against the background of positive market growth in terms of card issuance and card usage in general.

In Germany, a standard interchange fee applies to payments using the national card scheme “electronic cash”. Although the fee level has basically remained unchanged since its introduction, negotiations between certain retailers and the banking community recently resulted in a tendency towards lower fees.

In the United Kingdom, interchange fees for credit/charge card purchase transactions have tended to decrease, especially for chip/PIN transactions, while those for immediate debit card purchase transactions have tended to increase, mainly on account of so-called interim payment guarantee charges. Competition between VISA

and MasterCard to attract issuing banks may also have led to an increase in the MIF levels.

In Slovenia, domestic interchange fees were not changed very frequently in recent years and have basically remained stable at the same level for the last 15 years, with the exception of one scheme where the level of interchange fees rose by 16.7% in 2007.

Overall, there has been a trend towards decreasing the fee levels in different countries, which mainly reflects efficiency gains from economies of scale and technological improvements over time, cross-industry arrangements and, in some cases, the involvement of public authorities. At the aggregate level, however, this decrease in MIFs needs to be seen against the background of positive market growth in terms of card issuance and card usage in general.

However, in cases where public authorities have been involved in lowering the interchange fee, some card schemes argue that this is generating losses for member banks and that it may lead to the disappearance of the scheme. Some national schemes have different interchange fees for different economic sectors, types of payment card (e.g. debit card versus credit card) and types of transaction (e.g. paper-based, electronic or combinations of both). For example, the domestic card payment schemes in Denmark, Germany, Malta, Romania, Portugal and Slovenia provide for differentiated interchange fees, depending on the merchant and business sector, and on the type of card and transaction.

Another dimension in the calculation of the interchange fee arises from the question as to whether the fees are set on a fixed basis, ad valorem, or as a combination of both. The choice of the fee structure has an impact on the usage of the card if the value of the transaction is taken into consideration. On the one hand, for example, a fixed interchange fee that has to be paid by merchants has the potential to discourage the acceptance of cards for payments of small amounts. On the other hand, an ad valorem fee for higher transaction values or for highly

taxed purchases such as petrol could result in the perception at the merchant that the merchant service charge to be paid and the service offered are not connected to one another.

## 5.2 ALTERNATIVE APPROACHES

As shown earlier, interchange fees are present with different levels in most European card schemes. In addition to model interchange fees, alternative arrangements can be put in place with the aim of generating similar economic effects as interchange fees. The following three alternative mechanisms can be distinguished.

The first alternative arrangement is the model of a *single acquirer*, where the card scheme provides for a single processor as acquirer. Under this arrangement, banks may only position themselves as card issuers and receive no revenues from interchange fees per transaction. However, as the owners of the scheme, card issuers may, through the realisation of profits, receive an income equivalent to what they would receive through interchange fees. The distribution of the rents received by issuers depends on membership quotas. Therefore, the remuneration of issuers differs from that based on interchange fees in that the issuers' income does not depend directly on the usage of the card.

In the Netherlands, the PIN scheme followed a single-acquirer policy until 2004, using Interpay as processor. However, the Dutch Competition Authority opposed that situation, so that banks also took over the card acquiring activity. Classic interchange fees were then introduced as a result. However, the Dutch interchange fees are based on bilateral agreements that preserve competition both between acquiring banks and between issuing banks. Belgium still has a single-processor model in operation, with most of the transactions being acquired by Atos Worldline.

A second alternative is the approach of a *direct fee* paid by the merchant to the card issuer. This model is used, for example, in the Girocard scheme in Germany. In this scheme, the acquisition of transactions takes place through



network providers and not through the banks of the merchants. The payment guarantee is given to the merchant directly by the issuer. While the merchant's bank is only involved in the final clearing operation, the network operator, the so-called "Netzbetreiber", routes the transaction directly to the issuer. In principle, the economic effect of the direct fee is the same as that of having an interchange fee.

What is known as a system of *balanced participation* of issuing and acquiring banks is a third alternative and means a situation in which the business share of each of the banks participating in the scheme is equal on the issuing side and on the acquiring side. The net effect of interchange fees will thus be zero. This was the case in Finland, within Pankkikortti. At the time of the launch of the scheme, fees were not deemed necessary, given a good balance of issuing and acquiring activities within each bank. This cooperative model is no longer in place. Lately, the growing dominance of international brands has brought competitive pressure to bear on interchange fees.

### 5.3 DETERMINANTS AND CONTRACTUAL ARRANGEMENTS

#### COMPONENTS OF INTERCHANGE FEES

In general, the level of interchange fees is set on the basis of a certain rationale in each country. Traditionally, the minimum common denominator in all cases is the reimbursement of certain costs incurred by the card issuer. Typically, three cost elements are taken into account in the case of debit card transactions, namely:

1. the operating costs, e.g. the cost of processing, clearing and settlement, and accounting;
2. the costs for the payment guarantee for merchants; and
3. the security costs, e.g. fraud prevention costs.

For credit card payments there are additional credit funding costs.

In Europe, there are different national practices for, and experiences in, determining the exact fee level. In France, for example, the French Competition Authority has defined the calculation of the MIF as a mix of cost-based and incentive-based mechanisms. The MIF there comprises an element intended to cover expenses that are inherent in the processing of any transaction carried out, an element intended to cover the cost of collective security measures and an element intended to cover the expenditure-related to the guarantee of payments. The interchange fee is calculated on the basis of this formula for every pair of banks, taking into account the fraud incidents observed between them. In some countries, interchange fees are not only aimed at recovering costs, but also at generating a profit margin.

More recently, a "balancing theory" was put forward in justification of interchange fees. In order to assess multilateral interchange fees under Article 101(3) of the TFEU, the concept of the merchant indifference test was introduced and applied to set the level of interchange fees, in particular for the provision of cross-border payment card transactions. On 1 April 2009, the European Commission announced the results of its discussions with MasterCard. In essence, the Commission took note of MasterCard's decision to apply a new methodology that results in a lower average weighted MIF level than that which had been found to violate EU antitrust rules.

Since July 2009, MasterCard has undertaken the following three commitments:

1. The repeal of the increases in its scheme fees introduced in October 2008.
2. Calculation of the cross-border MIF according to the "tourist-test" methodology, which will lead to a substantially reduced

maximum weighted average MIF level of 0.30% per transaction in the case of credit cards and 0.20% per transaction in that of debit cards.

This compares with, depending on the card, cross-border MIFs ranging from 0.80% to 1.90% in the case of MasterCard's in 2007, while Maestro's cross-border MIFs ranged from more than 0.4% to more than 0.75%.

3. The adoption of some other related measures to enhance the transparency of the scheme.

The proposed methodology for calculating the MIF level is based on the economic concept of the so-called merchant indifference test. According to this test, the appropriate MIF level would be a level at which a merchant would not refuse a card payment by a non-repeat customer even if this non-repeat customer had enough cash on hand to pay for the purchases. According to this avoided-cost test, a balancing fee is set to a level that enhances user benefits. In fact, the fee would pass this test if the merchant is willing to allow the consumer to pay by card. In other words, it would make merchants indifferent to accepting cash or cards as a payment instrument.

In addition, capping the maximum fee on the basis of the merchant's avoided costs would prevent merchants from accepting card payments that they do not want. Moreover, if such MIF could be passed on, in part, to the cardholder, it would ensure that the cardholder's decisions with regard to the choice of payment instrument are based on efficiency considerations.

The level of the revised MIF has been based on the results of central bank studies on the cost of payments in the Netherlands, Belgium and Sweden. The amount is calculated using the difference between the merchant's costs of accepting payments in cash and those of accepting card payments.

Similarly to MasterCard, Visa Europe offered on 26 April 2010 to reduce its maximum weighted average MIF for cross border transactions

within the European Economic Area (EEA) and for national transactions with Visa consumer debit cards such as Visa, Visa Electron or V Pay to 0.20% in a number of Member States (Greece, Hungary, Iceland, Ireland, Italy, Malta, Sweden, Luxembourg and the Netherlands). The commitment was made binding via a Commission Decision of December 2010, which will apply for four years. The reduction of the MIF to 20 basis points for debit card transactions is in line with MasterCard's commitment of April 2009. The MIF of 20 basis points in place for Visa Europe's debit card is in conformity with that set on the basis of the "merchant-indifference" methodology.

#### **MERCHANT SERVICE CHARGES<sup>14</sup>**

The main component of merchant fees, the so-called merchant service charge (MSC), is an interchange fee. For several schemes, this fee is subject to bilateral negotiations between acquiring banks and merchants. Some card schemes report that big merchants have a wider margin to negotiate the level of the merchant fee, especially in case of strong competition on the acquiring side of the market. In some cases, it is also possible that merchant fees are not charged at all. As interchange fees are the main component of merchant fees, merchants are very interested both in knowing their exact level and in transparency on this issue.

In most countries, interchange fees are not known to merchants. Card schemes argue that merchants should not have access to this information because it is an interbank issue. However, there are few exceptions to this policy of non-disclosure, e.g. in Italy, Spain and Ireland. In France, the calculation formula is publicly available, but not the fee level itself, as it varies for every pair of banks.

One of the terms of the EU Commission's exemption for Visa is that, upon request, merchants could be informed of the interchange

<sup>14</sup> For developments in the MSC, see European Commission, "Report on the retail banking sector inquiry", Commission Staff Working Document, January 2007, p. 120 (available on the Commission's website at: [http://ec.europa.eu/competition/sectors/financial\\_services/inquiries/sec\\_2007\\_106.pdf](http://ec.europa.eu/competition/sectors/financial_services/inquiries/sec_2007_106.pdf)).

fee level and its breakdown into the three cost elements mentioned above. Following its undertakings of 2009, MasterCard has made all interchange fees set by MasterCard available on its websites. Visa Europe had started to publish the effective intra-regional MIF rates on its website in May 2004.

#### ISSUER, ACQUIRER AND MERCHANT PERSPECTIVES

Card schemes set certain rules and conditions for their members. Some of these rules and conditions must necessarily be reflected in the contracts that issuers sign with cardholders and acquirers sign with merchants. There are other aspects of the contract that are left to each issuer or acquirer to define, e.g. the level of the merchant fee, thus leaving room for competition. Merchants have often expressed concerns about some of the standard clauses defined by the card schemes. This section reviews selected rules and conditions. These include the “no surcharging” rule, the “no acquiring without issuing” rule and the “honour all cards” rule (i.e. the rule of accepting all card products of a given card scheme).

The “no acquiring without issuing” rule, if applicable, prevents members of schemes from pursuing only acquiring activity, as members are also required to be active in card issuance. This rule can contribute to the initial take-off of a scheme, since card payments take place on a two-sided market, where both issuers and acquirers are needed. The “no acquiring without issuing” rule therefore ensures a certain balance between the issuing and acquiring activities within each bank. Visa Europe used to have this rule, which had been cleared by the EU Commission as not being harmful to competition. However, it was abolished in January 2005. MasterCard, too, used to have this rule for credit cards, but it was likewise abolished in January 2005. No national scheme has a “no acquiring without issuing” rule. In practice, however, despite there being no compulsion, most banks are issuers and acquirers at the same time. In sum, the level of interchange fees cannot be related to the existence of this rule, which has been discontinued.

The “honour all cards” rule is another rule with respect to interchange fees. According to this rule, merchants are obliged to accept all the brands issued within a single card scheme,<sup>15</sup> irrespective of the level of merchant fee and, therefore, the interchange fee. If a merchant accepts a given scheme, the merchant also has to accept all products of that scheme. The merchant may even be forced to accept products that are marketed in the future, i.e. without knowing the exact charges or fees it will face on those products. The honour-all-cards rule has the effect of tying the acceptance of expensive card products to that of low-cost card products. In the case of national schemes, this rule does not exist, or is not applicable where there is only one payment product.<sup>16</sup>

#### SURCHARGING RULES AND PRACTICES

An argument often used in the context of interchange fees is that merchants face a higher cost for card payments, in particular credit card payments, in comparison with other payment instruments, although they charge the same amount to all clients regardless of the payment media. The “no surcharge rule” explicitly prohibits such a different pricing for cards transactions. It is also argued that the effect of a higher interchange fee is that merchants may increase the general level of prices. Consequently, clients without cards cross-subsidise clients with cards.

<sup>15</sup> It must be underlined that the rule applies per scheme; co-branding with other schemes does not make all co-branded schemes eligible. If, for example, a national card scheme applies the rule and its cards are co-branded with an international card scheme, merchants would not be obliged to accept the international brand; they would only be obliged to accept all brands issued under the national card scheme.

<sup>16</sup> MasterCard already has a separate honour-all-cards rule for MasterCard credit cards and Maestro debit cards, i.e. merchants may freely choose to accept either. MasterCard has committed itself not to make any changes to these rules and to require its acquirers to inform merchants that they are permitted to accept MasterCard cards and/or Maestro cards and/or competing schemes' cards. Similarly, Visa Europe already has a separate honour-all-cards rule for VISA, VISA Electron and VPaycards. In its commitments, Visa has undertaken to maintain the honour-all-cards rule as it applies to consumer debit transactions and to inform merchants that they are free to choose to accept VISA branded cards and/or VISA Electron branded cards and/or VPay branded cards.

Surcharging occurs when the merchant charges an additional amount to clients paying with a card, or gives a discount to clients paying with an alternative payment instrument. If surcharging were possible and effectively implemented by merchants, it would be a tool for the merchant to direct their customers towards using of the payment instrument the former prefer.

One reason for merchants not to apply pricing differentials is that it may entail a cost in itself. This is because the merchant has to recalculate the price according to the payment media and this makes the execution of the transaction longer. But this should not be a problem if the cashier services are automated, as in the case of internet commerce, for instance. Another reason for merchants to refrain from surcharging is that it is not generalised and that there are first-mover disadvantages since it is an unpopular measure. It has also to be noted that surcharging is a tool to facilitate choice among cards and not to discriminate among payment instruments. Surcharging entails a risk of moving to cash, which also has a cost for merchants.<sup>17</sup>

Recently, the ESCB has carried out a fact-finding exercise on the transposition of the surcharging option in the Payment Services Directive (PSD). According to the PSD, the “payment service provider shall not prevent the payee from requesting from the payer a charge or from offering him a reduction for the use of a given payment instrument. However, Member States may forbid or limit the right to request charges taking into account the need to encourage competition and promote the use of efficient payment instruments.” Overall, 25 central banks participated in the survey and information on the two remaining countries was obtained from other sources. 14 countries<sup>18</sup> reported to have exercised the option of forbidding surcharging, while 13 countries<sup>19</sup> have not used the option.

The countries that have banned surcharging reported that they had done so mainly to avoid

a distortion between efficient card payments and inefficient cash payments, but also to better protect the interest of consumers, prevent added complexity for merchants and to ensure a level playing field. The ban on surcharging typically applies to all payment cards, except in the case of Denmark where surcharging is allowed only on cards issued by non-Danish banks. It should be noted that the European Commission has formally complained about the surcharging rules in Denmark, which discriminate citizens from other EU countries vis-à-vis Danish citizens. As a result, the rules in Denmark will now be changed. According to the amended rules, which will take effect on 1 October 2011, merchants will be allowed to impose a surcharge on all credit cards, rather than on only foreign cards, as is the case today, while there will be a ban on surcharging debit cards, irrespective of their origin.

Countries in which surcharging is allowed reported that a prohibition thereof was not seen to be necessary as surcharging was very limited, but also that it was allowed in order not to hinder the development of more efficient payment instruments, impair competition among payment cards, hide the cost of various payment cards from the consumer and intervene in a business matter involving relations between retailers and customers. In most countries, surcharging is limited to a few business segments/industries, e.g. small shops and the airline industry. Face-to-face surcharging is still quite rare. In the Netherlands, the tendency to impose a surcharge seems relatively to be a little higher in the case of credit cards than in that of debit cards. In Denmark before 2005, retailers were not allowed to surcharge Dankort POS transactions, but only when the Dankort card was used for online, i.e. internet, transactions.

17 See also Bolt et al. (2010) for supporting evidence with respect to the Dutch market.

18 Austria, Bulgaria, Cyprus, Denmark, France, Greece, Italy, Lithuania, Luxembourg, Latvia, Portugal, Romania, Sweden and Slovakia.

19 Belgium, Germany, Estonia, Spain, Finland, Ireland, Malta, the Netherlands, Slovenia and the United Kingdom.

Surcharging was then allowed on Dankort POS transactions as from 1 January 2005 when the banks were also given the possibility to charge merchants for those transactions, which had not been allowed before that date. However, already with effect from March 2005, the rules were changed yet again, to those currently in force. According to these rules, the merchants pay a regulated fixed fee, which changes stepwise according to the number of transactions, while merchants are not allowed to charge any card fees from consumers at a POS.

Where surcharging takes place, it generally applies to both debit and credit card transactions. In most countries that allow surcharging, there are no legally set limits, but retailers are required to inform consumers of the fact that a surcharge is being levied and of the level thereof. Most countries have not observed any major reactions from the cardholder or merchant side, partly due to the fact that – although now explicitly allowed by law – the surcharge practices in shops have simply not been changed. In addition, merchants are reluctant to impose a surcharge, and consumers do not expect to be surcharged, except for certain types of purchases. Also, merchants are likely to fear the loss of a sale to a competitor in an environment where card acceptance is universal, but card surcharging is not common.

Overall, different practices and experiences on surcharging exist in Europe. The decision to ban or allow surcharging involves a complex trade-off between considerations in the field of efficiency, consumer protection, transparency and competition.<sup>20</sup> In countries where surcharging is forbidden, the rule typically applies with no exceptions, i.e. to all industries/sectors and all payment cards. In countries where surcharging is allowed, it occurs mainly in a few business segments, but for both debit and credit cards and without a legally fixed limit. No major market reactions have been observed; either due to the fact that surcharging was rarely used before, or because the rules are unchanged and surcharging is limited.

<sup>20</sup> For a more theoretical and formal model approach on surcharging, see also Economides and Henriques (2011).

## 6 ANTITRUST POLICY AND REGULATORY PERSPECTIVES

This section provides a brief summary of general competition principles, followed by a comparison of some selected legal assessments and public authorities' involvement in the field of interchange fees.

### 6.1 GENERAL PRINCIPLES

Restrictions of competition regarding interchange fees could occur both between actors within a scheme, e.g. as intra-system competition between acquirers or issuers, or between schemes, e.g. as inter-system competition between Visa and MasterCard. From a legal point of view, the key question is whether or not a centrally set interchange fee restricts competition either (i) as an agreement between undertakings or as decisions taken by associations of undertakings, or (ii) as an abuse of a dominant position. In this paper, the focus is on interchange fees as an agreement between undertakings or a decision taken by associations of undertakings.

In the EU, not only the European Commission, but also national competition authorities such as the Latvian Competition Council (CC), the Italian Antitrust Authority (AGCM), the Hungarian Competition Authority (GVH), the Polish Office of Competition and Consumer Protection (OCCP) and the Spanish Tribunal for the Defence of Competition (TDC) (currently the *Comisión Nacional de la Competencia* (CNC))<sup>21</sup> have assessed the competition aspects of interchange fees in decisions. The UK Office of Fair Trading (OFT) also made an assessment, which was set aside by the Competition Appeal Tribunal (CAT) on account of procedural problems.

Agreements between undertakings or decisions by associations of undertakings which have as their object, or effect, the prevention, restriction or distortion of competition within the internal market are prohibited and automatically null and void. Under certain circumstances, however, the aforementioned provisions could be declared

inapplicable if an agreement contributes to promoting technical or economic progress, while allowing consumers a fair share of the benefits (Article 101 of the TFEU). Abuse by one or more undertakings of a dominant position within the common market, or in a substantial part thereof, is prohibited as incompatible insofar as it may affect trade between Member States (Article 102 of the TFEU). Whereas Article 101 of the TFEU is aimed at various forms of cooperation between entities, which hinder competition, Article 102 relates to abusive conduct by dominant actors that is not primarily characterised by any agreement, decision or concerted practice between undertakings.

When analysing any kind of breach of competition, the relevant market would have to be defined. The relevant market consists of the product market and the geographical market. The product market for cards could be the market for payments, the market for cards, the market for card issuing or card acquiring, or even the market for debit card or credit card acquiring. The geographical market could, for instance, be defined as regional, national, EU or global.

### 6.2 ROLE OF PUBLIC AUTHORITIES

Competition authorities, both at the national and at the EU level, are often involved in questions related to the setting and level of interchange fees, and have frequently taken up investigations regarding these issues. The involvement of national central banks is more the exception than the rule.

For example, from 1998 to 2005, the Banca d'Italia (as the competition authority and overseer) established rules and requirements on the level of fees in Italy, and its approval was required after every revision. Since 2006, such rules are being adopted and updated by

<sup>21</sup> In 2007, the Spanish Tribunal for the Defence of Competition (TDC) was restructured and renamed *Comisión Nacional de la Competencia* (CNC) and has been actively involved in the issue of MIFs ever since.



the general antitrust authority.<sup>22</sup> In France, the French competition authority defined the formula for calculating the level of fees for card payments. Interchange fees for cash withdrawals were left unconsidered, being regarded as a pure interbank issue without any repercussions on merchants. In Germany, the German competition authority (the Bundeskartellamt) approved the merchant fee level in 1990. In Spain, the competition authority objected to the calculation methods of the three Spanish schemes (ServiRed, Sistema 4B and Euro 6000). Since January 2011, Spanish schemes are free to decide individually and independently on the level of the default interchange fees they apply, while still ensuring maximum transparency. Any agreement a scheme may reach has to be reported to the national competition authority, along with a self-assessment that proves its compatibility with the provisions of anti-trust legislation. In the Netherlands, an interchange fee was put in place when central acquiring was replaced by individual banks' acquiring after the decision of the Dutch competition authority on Interpay in 2004. PIN participants decided thereafter to establish bilateral interchange fees.

### 6.3 LEGAL ASSESSMENTS AND DECISIONS ON INTERCHANGE FEES

The following summarises and compares some selected EU regulatory decisions regarding MIFs. A summary of individual cases, together with a table summarising the decisions, is presented in Annex 3. National decisions were largely available only as summaries in English. The references to Articles 81 and 82 of the Treaty establishing the European Community (EC Treaty) are kept in the text below, due to that Treaty having been in force at that time. In the current Treaty on the functioning of the European Union (TFEU), these articles are Articles 101 and 102.

#### RESTRICTION OF COMPETITION

The legal assessments made by the Commission (MasterCard, 2007, and Visa International, 2002), the Latvian CC (Latvian commercial banks, 2011), the Italian AGCM (MasterCard

and eight Italian banks, 2010), the Hungarian GVH (Hungarian financial institutions, Visa and MasterCard, 2009) the Polish OCCP (20 Polish banks in Visa and MasterCard systems, 2007) and the Spanish TDC (ServiRed, Sistema 4B and Euro 6000, 2005)<sup>23</sup> were all related to the question as to whether the cooperation between banks when setting a common interchange fee was restricting competition and, if so, whether the interchange fee fulfilled the conditions for an exemption under the provisions of Article 81(3) of the EC Treaty. This section presents and compares the series of elements taken into account in the reasoning behind the decisions relating to these legal assessments. However, it must be borne in mind that the prerequisites for these cases were different in parts, which only allows general conclusions to be drawn. Some of the decisions related to cross-border activity, while others were restricted to the national level. In some cases, the relevant market is the market for payment cards, while in other cases it is restricted to card issuing and/or acquiring.

#### RELEVANT MARKET

In the Commission's Visa decision of 2002, two kinds of markets were distinguished, namely the inter-system market – competition between different payment systems, e.g. different card schemes and possibly also other means of payment – and the intra-system market – competition between financial institutions with respect to card-related activities, e.g. issuing cards to individuals and acquiring merchants for the acceptance of card payments. The main focus of the Commission's analysis in this decision was on the inter-system market, where the relevant market was considered to be the market for payment cards, as was also the view of the TDC (2005). Later decisions by European and national competition authorities focused mainly on the intra-system market,

22 Since 2006, Banca d'Italia is no longer the Competition Authority for the banking sector, according to L. Decree 262/2005.

23 The reasoning of the UK Office of Fair Trading in its MasterCard decision is also of some interest, despite it having been set aside by the Competition Appeal Tribunal. A summary is therefore attached in Annex 2.

restricting the relevant market to card acquiring or card issuing<sup>24</sup> by arguing that the card services provided to merchants and those provided to cardholders are two distinct services that are provided on the basis of structurally different pricing to two groups of customers, with card acquiring usually being based on a fee paid for each transaction, while cardholders typically pay annual fees. In its 2007 MasterCard decision, the Commission also pointed out that card acquiring services are not sufficiently replaceable by other payment services such as cash, cheques and bank giro or direct debit services.

In the Commission's MasterCard decision (2007), the geographical market was deemed to be a national market, while in its Visa decision (2002), the Commission had found that the market for inter-system competition might be broader than the national markets.

#### **JUSTIFICATION OF MULTILATERAL INTERCHANGE FEES**

Visa defended its MIF as a way of balancing the conflicting interests of merchants and cardholders by distributing the costs of the system between the two user groups in a way that corresponds with the marginal benefit that each user derives from the system, and thus maximising the overall use of the system. The costs were split into three different categories: processing costs, the payment guarantee and the free funding period. MasterCard initially claimed that their MIF was a way of distributing costs between scheme issuers and acquirers, but later argued that it was a tool to balance cardholder and merchant demand without having the function of a "price". Latvian banks claimed that a MIF was necessary in order to ensure the availability of a card payment system and to promote the use of card payments. Polish banks, too, were of the opinion that an interchange fee is an indispensable income source for issuing banks, allowing them both to cover the costs related to their card operations and to avoid charging cardholders. According to the TDC decisions (2005), the Spanish schemes (ServiRed, Sistema 4B and Euro 6000) defended

their interchange fees as being indispensable for the operation of their network, without providing any detailed justification of such fees.

#### **AGREEMENTS BETWEEN UNDERTAKINGS/ DECISIONS BY ASSOCIATIONS OF UNDERTAKINGS**

When assessing whether competition is being restricted, the first issue to consider is whether the interchange fee is the result of an agreement between undertakings, or a decision by an associations of undertakings, or a concerted practice that restricts competition. The MIF in the Visa system were deemed by the Commission in 2002 to amount to an appreciable restriction of competition by limiting the freedom of banks individually to decide their own pricing policies, which distorted the conditions of competition on the Visa issuing and acquiring markets. The Commission found that the Visa rules could be regarded either as decisions of an association of undertakings or as agreements between undertakings. In the case of the MasterCard decision (2007), decisions on the level and structure of the interchange fees and the related network rules adopted by MasterCard were found to be decisions of an association of undertakings within the meaning of Article 81(1) of the EC Treaty. According to the Commission, they remained decisions of an association even after the initial public offering (IPO) of MasterCard Incorporated in 2006 and the related changes to the governance of the payment organisation in Europe with regard to the authority for setting the level of MIFs.

The reasoning of the Spanish TDC in 2005 followed the same line, stating that agreements between banks to set an interchange fee are equivalent to the concerted practice of fixing the price that the issuing banks charge the acquiring banks. The Hungarian GVH found in 2009 that the banks concerned uniformly determined the level of interchange fees for both major international payment card schemes, which

<sup>24</sup> Commission's MasterCard decision of 2007, CC's decision (Latvian commercial banks), AGCM decision (MasterCard and 8 Italian banks) and OCCP's decision regarding Visa and MasterCard (2007).

hindered competition between Visa Europe and MasterCard Europe, and competition between acquiring banks. The Polish OCCP stated in its decision of 2007 that 20 Polish banks had jointly set rates for domestic interchange fees, in violation of both Polish legislation and EC law. MasterCard and eight Italian banks were considered by the Italian AGCM in 2010 to have established agreements restricting competition so as to maintain high interbank fees. In 2011, the Latvian CC found that the multilateral agreement between banks hampered, restricted and distorted competition in the Latvian cards market both by object and by effect.

Overall, the setting of a multilateral interchange fee seems generally to be considered an agreement between competitors, or a decision of an association of competitors, that restricts competition by fixing prices. Bilateral agreements on interchange fees between issuers and acquirers, which are permissible, albeit not frequently used in all Member States, appear not to change this assessment.

#### CONTRIBUTION TO PROMOTING TECHNICAL OR ECONOMIC PROGRESS

The next issue to consider when assessing whether competition is being restricted is that as to whether the agreement at hand fulfils the prerequisites for an exemption. This is done, first, by assessing whether the interchange fee contributes to promoting technical or economic progress.

In its Visa decision of 2002, the Commission initially pointed out that a MIF is not a price charged to a consumer, but a remuneration paid between banks who must deal with each other for the settlement of a card payment transaction, and thus have no choice of partner. The absence of some sort of default rule on the terms of settlement could lead to abuse by the issuing bank, which is in a position of monopsony as regards the acquiring bank for the settlement of an individual payment transaction. Thus, some kind of default arrangement is necessary, but whether it qualifies for exemption or not will depend on the details of the arrangement.

Moreover, the Commission found that it is in theory technically feasible for the Visa scheme to function with arrangements other than an MIF. The modified MIF<sup>25</sup> was, however, considered to contribute to technical and economic progress in the meaning of Article 81(3), namely to the existence of a large-scale international payment system with positive network externalities. In its 2007 MasterCard decision, the Commission took a different position, initially stating that it was not disputed that payment card schemes such as MasterCard may represent, as such, economic and technical progress. The decisive question was, however, whether the MIF specifically contributed to such progress, which MasterCard was not able to show.<sup>26</sup>

The Hungarian GVH did not contest in 2009 that collective multilateral agreements may produce substantial efficiencies, but no evidence had been provided to show that the restriction of competition was limited to the reasonably necessary. In its decision on Sistema 4B in 2005, the Spanish TDC considered an interchange fee as such to be justified, due to the need for a multilateral agreement on compensation for the operation of a payment system which is useful for the consumer and has benefits for the merchant. This was confirmed in the ServiRed decision, in which the court stated that the fixing of interchange fees between the card issuers is capable of contributing to technical and economic progress, provided that it met the conditions set out in the Competition Act (which ServiRed failed to do). The Polish OCCP followed the same line in 2007, concluding that banks had not been able to present any convincing evidence to support their claim that the interchange fee was an instrument for the optimal distribution of costs. This was a position

25 During the proceedings, Visa decided in June 2001 to reduce its intra-regional MIF by introducing a fixed-rate per-transaction MIF for debit cards and a phased reduction of the level of the ad valorem per-transaction MIFs applicable to certain types of credit and deferred debit cards.

26 The claim that an MIF creates efficiencies must be founded, according to the Commission, on a detailed, robust and compelling analysis that relies, in its assumptions and deductions, on empirical data.

also supported by the Latvian CC in 2011 when it pointed out that the CC had repeatedly asked banks to provide evidence that the benefits of the multilateral agreement counterbalanced restrictions to competition, which banks had failed to do.

It was only in the Commission's Visa decision (2002) that the MIF was considered to contribute to promoting technical and economic progress. In later decisions, competition authorities have not accepted the reasoning provided by card schemes, an issue which might to some degree be related to the relevant market determined. If the relevant market is considered to be the market for cards, it might be easier to accept an MIF as a balancing mechanism, contributing to promote efficiency and progress for the whole scheme, than if the market is restricted only to the market for card issuing or acquiring. It seems also to be a matter of proof – in all cases where the competition authorities have not accepted that the MIF contributes to promoting technical or economic progress, they have stated that it was due to the lack of convincing analysis and evidence.

#### **COST CATEGORIES**

Visa International claimed in 2002 that for the assessment of their MIF, costs based on three cost categories, namely (i) the processing costs, (ii) the payment guarantee and (iii) a free funding period, constituted an objective benchmark for supplying Visa payment services. These cost categories were also used by the Spanish card schemes, and by Polish banks together with Visa and MasterCard, to prove that the agreements on MIFs meet the conditions for exemptions set out in Article 81(3) of the EC Treaty.

Issuing banks' *costs for processing* card payments, apart from account maintenance, were considered by the Commission in its 2002 Visa decision as being to the benefit of the merchant, especially in the context of international card transactions. According to the TDC, the authorisation and processing costs for credit and debit cards should be expressed as a fixed amount per transaction. The OCCP found that

payment processing costs varied significantly between card schemes, banks and even within banks. The OCCP therefore pointed out that not every cost that can be linked with an operation of a payment card should be included in the interchange fee, and should thus be borne by merchants. There had to exist a convincing direct relationship between a given activity and the benefits that merchants receive from it.

The *payment guarantee*<sup>27</sup> was considered by the Commission in its 2002 decision to be an insurance against fraud and cardholder default for merchants. The Commission expressed some concern that, if not provided by the issuing bank, such a service might not be widely available for merchants at reasonable cost. There was also a risk, from the Commission's point of view, that, without a payment guarantee, some retailers might consider not to accept Visa cards, which would then be less attractive to cardholders and thereby start a downward spiral in the size and level of usage of the Visa system. The TDC emphasised that financing the free funding period and the payment guarantee created greater costs in credit card transactions than in debit card transactions. In its decision on Sistema 4B of 2005, the TDC found that, in the majority of cases, a default was temporary and not definitive, and that it was only in the event of definitive payment default that the issuing bank faced real costs. Given that banks obtain a considerable profit from charging clients for delayed payments, the TDC considered it to be quite reasonable to assume that this profit amply compensated for any costs resulting from a definitive default. On the one hand, fraud management was to the benefit of merchants, but such services could also, according to the TDC, be offered directly to the merchants by third parties. The OCCP found that the costs of the payment guarantee were being paid twice: first, by cardholders to their bank in the case of a lack of funds and, second, by merchants as part of the MIF. In addition, considering the benefits arising from MIFs, banks

<sup>27</sup> The payment is guaranteed for the merchant, i.e. he/she will be reimbursed even if the cardholder does not pay for the transaction.

might not pay sufficient attention to the “quality” of their customers, which could contribute to increasing MIFs further.

The *free funding period*<sup>28</sup> was considered by the Commission in its 2002 decision to facilitate and encourage cross-border spending as the cardholder did not have to fear taking his account into red. The free funding period could therefore be justified, primarily as it benefited merchants with whom such purchases were made, but also for contributing to promoting cross-border purchases. In its Sistema 4B decision of 2005, the TDC stated that the funding of the interest-free period was a service provided by the issuing bank to the credit card user. The TDC emphasised that there was no evidence, neither theoretical nor empirical, that served to prove that this service led to a permanent increase in sales of the merchant outlets, taken as a whole. The TDC also pointed out that the interest-free period, like the default management, was closely linked to one of the most important sources of income for issuing banks, namely the high interest rates charged for using credit cards outside the interest-free credit periods, and should therefore not be included in the interchange fee. The OCCP took a similar position, stating that financing deferred payments was not one of the payment system services provided to retailers. It was a service provided by card issuers directly to individual holders of cards that allow for late payment.

### BALANCING MECHANISM

Initially, MasterCard argued that its interchange fee was a mechanism for balancing cardholder and merchant demand by distributing the costs of delivering the service between the scheme’s issuers and acquirers. At a later stage, MasterCard focused its justification on the MIF being a mechanism to balance demands of cardholders and merchants, which did not have the function of a “price”. MasterCard advocated that the technical and economic progress of the MasterCard system was a result of its default MIF, since it rendered the system more efficient.

According to MasterCard, an interchange fee was indispensable since issuers and acquirers provided a joint service to cardholders and merchants, and faced joint demand. The common costs for that service should then be distributed between those two user groups, making the interchange fee indispensable for the system’s operation. Furthermore, payment system operators could maximise the overall value of the product on both sides, since neither issuers nor acquirers took into account the effect of the prices they set on the other party. The Commission did not agree with this reasoning in its 2007 decision, claiming that MasterCard’s payment system could not be considered to be a “joint production” venture, since the costs for issuing and acquiring could easily be separated. With respect to maximising the scheme’s output, the Commission found that MasterCard had failed to prove its line of reasoning, since no detailed, robust and compelling analysis and no empirical evidence had been provided. In addition, the Commission stated that an increase in the system’s output only contributed to appreciable objective advantages if parties other than the organisation’s member banks benefited therefrom.

### ALLOWING CONSUMERS A FAIR SHARE

According to the second condition for exemptions under the provisions of Article 81(3) of the EC Treaty, consumers must receive a fair share of the efficiencies generated by the restrictive decision/agreement. The concept of consumers has been further developed in the Commission’s Guidelines on the application of Article 81(3) of the EC Treaty,<sup>29</sup> where it is stated that the concept of consumers should encompass all direct or indirect users of the product covered by the agreement, including producers that use the products as an input, wholesalers, retailers and final consumers. In other words, consumers

<sup>28</sup> The card-holder does not have to pay his/her purchases immediately, but only after a certain time that is agreed with the issuer – this applies to deferred debit and credit cards.

<sup>29</sup> European Commission, “Guidelines on the application of Article 81(3) of the Treaty (2004/C 101/08)”, Communication from the Commission, Notice, 2004.



within the meaning of Article 81(3) are the customers of the parties to the agreement and their subsequent purchasers. The Commission's interpretation of a consumer in this context is considerably wider than what is commonly understood as a consumer, namely a natural person acting for purposes that are outside his/her trade, business or profession. Even if not formally binding, the Commission's guidelines in this context provide a strong message on interpretation.

In its 2002 Visa decision, the three cost categories mentioned earlier were examined and the Commission concluded that the modified MIF provided a fair share of the benefits to each category of user of the Visa system (cardholders and merchants). Where MasterCard was concerned, the Commission focused mainly on the merchant's benefits. The Commission did not dispute that merchants may benefit through enhanced network effects of the issuing side, but this did not necessarily offset their losses from paying inflated merchant fees. The efficiencies of the scheme had to benefit all customers, including those that bear the cost of its MIF (merchants and subsequent purchasers). The Polish OCCP argued along the same line in its 2007 decision, stating that the jointly set interchange fee imposed costs on merchants for services provided by banks to its cardholders, so that merchants did not get a fair share of the benefits (since the fee includes costs that do not benefit merchants).

The Italian AGCM found in 2010 that MasterCard and the eight banks had promoted the scheme's expansion by passing the interchange fee on to merchants and, consequently, to the prices effectively charged of consumers. The Hungarian GVH did not find any evidence to prove that a due share of the benefits had reached cardholders and merchants in its 2009 decision. The Spanish TDC did not go into any detail in 2005, stating only that the system should be useful to final consumers and should benefit merchants.

To what extent consumers are provided with a fair share of the benefits of cards appears to

be difficult to determine. The tourist test (also called the merchant indifference methodology), as introduced by Rochet and Tirole in 2006 (described in more detail in Section 4), has been taken on board by the Commission in what appears to be an attempt to find a reasonable benchmark for benefits generated for merchants and consumers. The intention of the tourist test is to ensure that card fees are set at such a level that merchants are indifferent to whether they receive a payment by card or in cash, with the interchange fee corresponding to the value of the benefit that the card use generates for them. The Commission is advocating that a MIF set along the lines of the tourist test encourages the promotion of efficient payment instruments, while simultaneously preventing abuses to the detriment of the scheme's users (merchants and cardholders).

One of the most important benefits when applying the tourist test for balancing retailer's costs for different means of payments would be that consumers as cash payers are released from the burden of paying for cardholders' transactions. High card fees passed on by merchants to all their customers would not provide the community of consumers with any benefits in general; on the contrary, consumers paying with cash would also have to pay for cardholders' payments and reward programmes.

From a merchant's point of view; card fees capped at a level similar to the costs incurred for cash payments would make the acceptance of cards more appealing. A capped MIF might therefore contribute to a more widespread acceptance of cards among merchants, to the benefit of all cardholders. From a cardholder's point of view, a restriction of MIFs as a result of the application of the tourist test might lead to some reduction of card benefits, e.g. reward programmes. Any such disadvantages may, however, be outweighed by a more widespread card acceptance.

#### **INDISPENSABILITY**

The issue of indispensability relates to whether the applied MIF is proportional to the restriction



of competition in the sense that no less restrictive arrangement is possible. The Commission stated in its Visa decision 2002 that no alternative, less restrictive than the revised Visa MIF, existed at the time, which would achieve the advantages and benefits to consumers, while being practically feasible in the context of the Visa International four-party card payment scheme. In its 2007 MasterCard decision, the Commission found that MasterCard had not proven that its MIF was indispensable to maximise system output and to achieve any related objective efficiencies. In addition, the Commission pointed out that several payment card schemes in the European Economic Area (EEA) had been operating successfully without a MIF for a long time. Since the agreement on the setting of domestic interchange fees did not meet the first and second conditions for an exemption under the provisions of in Article 81(3) of the EC Treaty (contributing to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit), the Polish OCCP did not analyse whether the agreements in question met the other conditions for exemption in 2007.

It is only in the Commission's Visa decision that the MIF is considered to be indispensable. The change of position in the Commission's MasterCard decision may have originated from MasterCard's reasoning that its MIF was a balancing mechanism, instead of a recovery of costs for services provided (as Visa had argued). It could also be related to the change of focus from the inter-system market (the market for cards in the Commission's Visa decision of 2002) to the intra-system market (the market for card acquiring in the Commission's MasterCard decision of 2007). The comparison with national payment schemes without a MIF may have been due to card acquiring being a service mainly provided on a national basis, or it may be an indication that the Commission considered the European payment market to be more integrated, putting cross-border card systems on the same cost level as national card systems. Agreeing on bilateral fees or processing activities might, however, still be more complicated on a cross-

border level than in a national context, which was also mentioned in the Commission's Visa decision, where the Commission stated that it would not be possible, in the absence of a direct contractual relationship between issuers and merchants, for issuers to recover their costs of services from merchants without some kind of multilateral interchange fee arrangement.

#### NON-ELIMINATION OF COMPETITION

The fourth and last criterion for exemption under Article 81(3) states the agreement should not eliminate competition in respect of a substantial part of the products concerned. In its 2002 Visa decision, the Commission stated that the MIF did not eliminate competition between issuers who remained free to set their respective client fees, nor did it eliminate competition between acquirers, since acquiring banks were free to compete on the other components of the merchant fee, apart from the MIF. Nor was the MIF considered to eliminate competition between Visa and its competitors, since the Commission had not found any evidence of concertation between Visa and Europay (now MasterCard).

The Commission did not enter into any assessment regarding the non-elimination of competition in its decisions on MasterCard in 2007. Neither did the national competition authorities, probably because they were already of the opinion that none of the schemes had been able to prove their MIFs' compliance with the other criteria.

#### CONCLUSION, LEGAL ASSESSMENTS

The relevant market seems to have been narrowed down in recent decisions, from focusing on the market for cards in the Commission's Visa decision of 2002 (inter-system market) to the market for card acquiring or card issuing in more recent decisions (intra-system market).

There seems to be a general consensus among competition authorities that interchange fees for cards should be seen as an agreement between undertakings, or a decision of an association of undertakings, which restricts competition (Article 81(1)). Different lines of justification

for an MIF are taken by card schemes, with Visa justifying its MIF on grounds of cost and MasterCard justifying it as a mechanism for balancing demands. Visa's success with its argumentation, however, did not necessarily depend on the line of argumentation, but could also be related to the relevant market at the time, namely the market for cards in Visa's case and the market for card acquiring in the case of MasterCard.

In its Visa decision, the Commission accepted that a multilaterally agreed interchange fee is likely to lead to efficiency gains, due to lower negotiation and transaction costs, especially in a cross-border context. In its MasterCard decision of 2007, the Commission did not enter into any discussion of the benefits of an MIF in a cross-border context, referring only to the fact that several national card schemes were operating without an MIF. This may have been due to the relevant market being defined as the market for card acquiring, and to the fact that cross-border card acquiring was only given to a very limited extent.

Even if interchange fees for cards are generally considered by competition authorities to be an agreement restricting competition, it is not denied that such agreements could bring benefits, which might make them compatible with competition law. In most cases, however, card schemes have not been able to prove these benefits. Until the introduction of the merchant indifference test (tourist test), competition authorities have provided very limited guidance, mainly by stating that card schemes have not provided any convincing analysis and evidence in justification of the existence of their MIF. The Commission's introduction of the merchant indifference methodology may, however, provide some additional guidance on this issue. The pending decision of the European General Court<sup>30</sup> in the MasterCard case will, of course, also bring further clarity on the application of interchange fees.

30 Until 30 November 2009, the European Court of First Instance.

## 7 CONCLUSIONS

The SEPA project represents a major step forward along the road towards closer European integration and the creation of a well-functioning and competitive European retail payments market. SEPA will become reality once there are no differences in the euro area between national and cross-border retail payments. Substantial efforts were undertaken by the European banking community, the legislator and the central banking community to successfully launch SEPA credit transfers in 2008 and SEPA direct debits in 2009. However, the third missing piece in the SEPA puzzle is SEPA for cards.

Payment cards have become a very popular way for people to pay for services and goods. Cards have proven to be a simple, safe and cost-efficient payment instrument. Over recent years, usage of payment cards has grown at an unprecedented rate and has become the non-cash payment instrument most used in Europe. Intrinsicly tied to card payments are multilateral interchange fees for card payments. The ECB, like many other central banks, has studied the issue of interchange fees, given its responsibilities for the smooth functioning of payment systems. In its catalyst role, the ECB closely monitors and assesses developments in the field of SEPA for cards. In this context in particular, the ECB provides guidance and expresses expectations that further clarity in the framework for interchange fees for card payments is needed so as to foster the creation of an open market environment for card schemes and to take the euro area towards an advanced retail payment market.

At present, there is only limited knowledge of, and evidence on, market practices with regard to interchange fees for card payments. With this study, the ECB attempts to enhance the general understanding of the nature of interchange fees and their role for the successful functioning for retail payment systems. This study presents a comprehensive fact-finding exercise with respect to the functioning and the underlying concept of interchange fees from an economic and a legal

perspective. It reviews most recent experiences, practices and interpretations of interchange fees in European countries. Moreover, it presents additional insights into the role and initiatives of public authorities in this domain.

From the present study, it can be concluded that under certain assumptions, the existence of interchange fees in four-party card schemes can be explained from an economic point of view. Network externalities have the potential to substantially limit the contestability of the card scheme market. A card brand that is widely held could easily set fees and other conditions for participation without jeopardising its market share.

In recent decisions of competition authorities, multilateral interchange fees for cards have generally been considered to be decisions of associations of undertakings, or as agreements between undertakings, which restrict competition. It is, however, not denied by competition authorities that such agreements could bring benefits, which might make them compatible with competition law, but in most competition cases, card schemes and/or financial institutions have not been able to prove these benefits. In the absence of convincing analysis and evidence justifying the existence and the applied level of MIFs set by card schemes, competition authorities have only been able to provide limited guidance in recent decisions. The Commission's introduction of the merchant indifference methodology might, however, bring some additional guidance with respect to this issue. Further guidance is also expected to be given in the pending decision by the European General Court in the MasterCard case.

The Eurosystem recognises that clarity on the applicability, methodology and the level of MIFs is crucial for banks and other payment service providers to decide on investments in a European card scheme. At the same time, banks should not neglect the opportunities that a "SEPA for cards" offers. The scope for growth available for cards at the point of sale is still substantial

in Europe, especially in some countries. The great upward potential for card transactions is a business case in itself, even for a scheme that operates with a low MIF. Making use of these opportunities will require that banks reposition their card services and fees, especially towards the merchants, and promote the use of cards as the secure, easy and cost-efficient instrument for day-to-day payments in SEPA.

In addition, further empirical evidence on multilateral interchange fee issues is required to facilitate strategic decision-making by market actors regarding the development of new card schemes and new payment instruments.

Overall and as stated in the 7th SEPA Progress Report (European Central Bank (2010)), the Eurosystem's public stance on interchange fees is neutral. This is an issue within the field of competence of the European Commission. However, the Eurosystem shares the view that it is critical for the success of the Single Euro Payment Area that cards can be issued, acquired and used throughout the euro area to make euro payments without any geographical differentiation.

Transparency and clarity with respect to the real costs and benefits of different payment instruments are indispensable for a modern and harmonised European retail payments market. Interchange fees (if any) should be set at a reasonable level and should not prevent the use of efficient payment instruments.

A sharp increase in cardholder costs could induce consumers to use less efficient means of payment, thereby hampering the success of, and objectives pursued by, the SEPA project. Therefore, interchange fees (if any) should be set to promote overall economic efficiency in compliance with competition rules. The Eurosystem recommends that a close dialogue take place between emerging new card schemes and the European Commission on the compatibility with competition law of the MIFs they plan to charge. Guidance in the form of a regulation might even be considered as the ultima ratio (see European Central Bank (2010)).

## ANNEXES

## I OVERVIEW OF INTERCHANGE FEE ARRANGEMENTS FOR DEBIT AND CREDIT CARD PAYMENTS IN EUROPE IN 2010

Country	Payment card scheme	Scope	Type of transaction	Interchange fee	
				Debit	Credit
AT	MasterCard	International	General trade	From € 0.053 + 0.22% to € 0.053 + 0.3%	1%
	Visa	International	General trade/ supermarket/petrol	1%	1%
BE	Bancontact/MisterCash	Domestic	General trade	€ 0.056	na
BG		Domestic	General trade	na	na
CY	MasterCard	International	General trade	1.75%	1.75%
	Visa	International	General trade	1.50%	1.50%
	MasterCard	International	Supermarket/ insurance	1.45%	1.45%
	Visa	International	Supermarket/ insurance	1.20%	1.20%
	MasterCard	International	Petrol/government/ utilities/education/ charities	1.00%	1.00%
	Visa	International	Petrol/government/ utilities/education/ charities	0.90%	0.90%
	MasterCard	International	Government	Min € 0.46, max € 46.00	Min € 0.46, max € 46.00
	Visa	International	Government	Min € 0.45, max € 45.00	Min € 0.45, max € 45.00
	MasterCard	International	Utilities	Min € 0.25, max € 62.96	Min € 0.25, max € 62.96
	Visa	International	Utilities	Min € 0.24, max € 61.20	Min € 0.24, max € 61.20
CZ	na	na	na	na	na
DE	Electronic-cash debit card scheme	Domestic	General trade	0.30%	na
	Electronic-cash debit card scheme	Domestic	Petrol	0.2% < € 51.13 and 0.3% > € 51.13	na
DK	The Dankort	Domestic	Online	€ 0.12	na
	The Dankort	Domestic	Point of sale	na	na
		International	General trade	na	0.75%
EE	MasterCard, Visa, Amex	International	General trade	na	na
ES	ServiRed; Sistema 4B; Euro 6000	Domestic	General trade	0.57%-0.74%	0.57%-0.74%
FI	International card schemes	International	General trade	0.31%-1.15%	0.9%-1.125%
FR	Cartes Bancaires	Domestic	General trade	€ 0.1067 + (0.21% + 0.xx%)	na
GR	MasterCard	International	General trade	na	na
	Visa	International	General trade	€ 0.05 - € 0.30	na
	Visa	International	General trade	na	0.5%-1.5%
	American Express	International	General trade	na	na
	Diners	International	General trade	na	na

Country	Payment card scheme	Scope	Type of transaction	Interchange fee	
				Debit	Credit
HU	MasterCard	International	General trade	na	na
	Visa	International	General trade	€0.26 - €0.30	na
	Visa	International	General trade	na	0.55%-0.95%
	Amex	International	General trade	na	na
IE	Laser	Domestic	General trade	€0.0381	na
	MasterCard; Visa; Amex	International	General trade	na	na
IT	Bancomat/ PagoBancomat	Domestic	General trade	€0.12 + 0.1579%	na
	MasterCard, Visa	International	General trade	na	na
LT	Visa	Domestic	General trade	Bilateral agreement or 0.9%-1.5% (Visa)	Bilateral agreement or 0.9%-1.5% (Visa)
	Visa	International	General trade	0.15% + €0.015 to 0.19% + €0.015	0.5%-0.75%
	MasterCard	Domestic	General trade	Bilateral agreement or 0.4% + €0.05 to 1.05% + €0.05 (MasterCard)	Bilateral agreement
	MasterCard	International	General trade	0.1% + €0.05 to 0.13% + €0.05	0.14% + €0.05 to 0.18% + €0.05
LU	Debit card scheme	Domestic	General trade	None	na
	International card schemes	International	General trade	na	na
LV	MasterCard, Visa	Domestic	General trade	0.5%-0.6% or bilateral agreement between banks	0.85%-1.0% or bilateral agreement between banks
	International card schemes	International	General trade	na	na
MT	Quickcash	Domestic	General trade	na	na
	Cashlink	Domestic	General trade	na	na
	APS Premier	Domestic	General trade	na	na
	International card schemes	International	General trade	na	na
NL	PIN, MasterCard, Visa	Domestic	General trade	Bilateral agreement, fixed fee €0.01-€0.02	0.80-1.90% (Mastercard), VISA 0.55-0.95%
	MasterCard, Visa JCB, Amex, Diners	International	General trade	EEA default fee -	EEA default fee Bilateral agreements
PL	MasterCard	International	General trade	1.60%	1.45%
	Visa	International	General trade	1.45% + €0.05	1.50%
PT	Multibanco	Domestic	General trade	0.8% [min = €0.05; max = €1.00]	na
	Multibanco	Domestic	Government/service/ special payments	0.70%	na
	Multibanco	Domestic	Low value payments	0.50%	na
	MasterCard; Visa; Amex	International	General trade	na	na
RO	MasterCard; Visa; Amex	International	General trade, online	1%	na
	MasterCard; Visa; Amex	International	General trade, paper-based	1.50%	na
	MasterCard; Visa; Amex	International	Petrol	0.70%	na



Country	Payment card scheme	Scope	Type of transaction	Interchange fee	
				Debit	Credit
SE	MasterCard; Visa	International	General trade	Fixed Fee	Fixed + Ad Valorem
	American Express	Domestic	General trade	Fixed Fee	Fixed + Ad Valorem
					na
SI	Activa; BA; Karanta; Visa	Domestic	General trade		0.60%-1.30%
	Activa; BA; Karanta; Visa	Domestic	Petrol		0.00%-0.80%
SK	International card schemes	International	General trade	na	na
UK	MasterCard, Visa, Solo, Amex, Diners	Domestic	General trade	€0.107	0.90%

Source: European System of Central Banks (2010).

Notes: "na" stands for "not applicable". Figures from Spain represent yearly weighted average MIF values. These have been obtained as a result of internal calculations aimed at integrating, into a single metric, fees that were originally separated by card type and that were not always recorded as ad valorem fees. Therefore, these average values apply to both credit and debit cards, and are only presented for illustrative purposes here.

## 2 REVIEW OF SELECTED LEGAL ASSESSMENTS OF INTERCHANGE FEES

### 2.1 DECISIONS AT THE EU LEVEL

#### 2.1.1 MASTERCARD – EU COMMISSION

*Commission decision of 19 December 2007 (Case No Comp/34.579 MasterCard, Comp/36.518 EuroCommerce and Comp/38.580 Commercial Cards)*<sup>30</sup>

The Commission decided in December 2007 that MasterCard had breached Article 81 of the Treaty and Article 553 of the EEA Agreement by, in effect, setting a minimum price (the intra EEA fallback interchange fee), which merchants must pay to their acquiring bank for accepting payment cards in the EEA.

#### RELEVANT MARKET

The relevant product market was considered to be the market for acquiring payment cards.<sup>31</sup> MasterCard was not, from the Commission's point of view, a product offered jointly to cardholders and merchants, but rather a vehicle for issuers and acquirers to offer distinct services to two groups of customers, including two different ways of pricing, a transaction fee (merchants) and an annual fee (card-holders). The geographical market was considered to be national at present.

#### CONCLUSION

The Commission found that MasterCard could still be considered to be operating as an association of undertakings, despite its listing on the New York Stock Exchange in May 2006, since these changes did not affect the principle that the multilaterally set fallback interchange fee will apply as a fall-back to card transactions in the absence of bilateral agreements. The commercial interests of the scheme owner and the commercial interests of the organisation's (MasterCard) member banks were, according to the Commission, related as far as an MIF is concerned.<sup>32</sup>

From the Commission's point of view, both issuers and acquirers may benefit commercially

from an MIF, directly or indirectly.<sup>33</sup> MasterCard's argument that there was no less restrictive alternative to the MIF, since bilateral negotiations between all banks would be impossible taking the high number of banks involved into consideration, was not taken on by the Commission, which claimed that there were successful card schemes operating without a MIF in the EEA and that the MIF restricted competition between acquiring banks by inflating the base on which acquiring banks set charges to merchants and, thereby, define a floor for the merchant fee. The Commission therefore found that an MIF was not objectively necessary for the cooperation of banks in the MasterCard system and the viability of the scheme.

MasterCard's position that the MIF was not a fee for services or a price for specific services, but a balancing mechanism for cardholder and merchant demands was not taken into account by the Commission. First, they could not consider MasterCard's system as a joint payment system, since the costs for issuing and acquiring could be separated and, second, MasterCard was not able to demonstrate the link between the MIF and its objective efficiencies.

The Commission agreed that merchants might benefit from enhanced network effects, but this did not necessarily offset the losses that result from paying inflated merchant fees, since

30 Available at: [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=1\\_34579](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_34579)

31 MasterCard claimed that the relevant product market should be the market where different payment card system's services compete with each other and with all other forms of payment, including cash and cheques.

32 By maximising member banks' proceeds from interchange fees, a scheme owner can also increase its own revenues and, ultimately, dividends to its shareholders (be they banks and/or public investors).

33 An MIF allows a payment organisation to raise the marginal cost of all acquirers in a collective manner that enables the acquirers to set a higher price for merchants. The additional revenues are then transferred to the card-issuing bank. For banks with an issuing business, the MIF thereby creates a direct source of revenues. For acquirers without any issuing business, the MIF also generates revenues, albeit indirectly. Acquirers expect that some issuers "invest" a portion of their revenues from the MIF in promoting further card usage, which may, in turn, lead to some increase of transaction volumes at merchant outlets. Hence, both issuers and acquirers may benefit commercially from an MIF, be it directly or indirectly.

the MIF included cost elements that are not related to services which sufficiently benefit merchants, e.g. the free funding period and issuing banks' costs for setting up and managing bank accounts. The objective efficiencies of an MIF should benefit all customers, including those that bear the costs of the MIF, merchants and purchasers, which MasterCard had not been able to demonstrate.

From the Commission's point of view, MasterCard had not offered any factual or empirical evidence that the MIF was indispensable so as to maximise system output and achieve the claimed efficiencies.

#### ACTIONS TAKEN AFTER THE COMMISSION'S DECISION

March 2008: MasterCard appealed the decision to the European Court of First Instance.<sup>34</sup>

June 2008: MasterCard provisionally repealed its cross-border MIF, which was the subject of the Commission's decision.

October 2008: MasterCard revised its acquirer pricing structure in the EEA, which included increasing certain existing acquirer fees, introducing a new fee on acquirers and repealing certain acquirer fee waivers.

MasterCard decided on 1 April 2009 to cut cross-border MIFs and to repeal recent scheme fee increases, awaiting the outcome of its appeal to the European Court of First Instance. The maximum weighted average MIF per transaction was reduced to 0.30% for consumer credit cards and to 0.20% for consumer debit cards. In addition, MasterCard agreed to change its system rules in order to increase transparency and competition in the payments cards market. The decision was reached in mutual understanding with the Commission.

The Commission stated in its Q&A paper supporting MasterCard's decision that an appropriately set interchange fee could help to optimise the utility of a card network to merchants and final consumers. In order for a

MIF to fulfil the conditions of Article 81(3) of the EC Treaty,<sup>35</sup> the methodology to establish the MIF needed to provide for adequate safeguards to balance the negative effects of the MIF. The benchmark applied by MasterCard in its revised methodology aimed at providing such a safeguard. It capped the MIF at a level that a merchant would be willing to pay if he were to compare the cost of the customer's use of a payment card with those of non-card (cash) payments. The measures announced by MasterCard were therefore considered by the Commission to be sufficient in order not to pursue MasterCard for non-compliance with the December 2007 decision or for contravening the antitrust rules.

#### 2.1.2 VISA INTERNATIONAL – EU COMMISSION

*Commission decision of 24 July 2002 (Case No COMP/29.373)*<sup>36</sup>

The Commission decided in July 2002 that the modified Visa multilateral interchange fee arrangements fulfilled the conditions for exemption under Article 81(3) of the EC Treaty and thus granted an individual exemption that remained into force until 31 December 2007.

The decision related to Visa's cross-border interchange fee scheme for consumer cards within the EEA Member States. Its origin was a complaint by *EuroCommerce* who considered interchange fees as a mechanism to shift onto merchants the costs of a free advantage offered to cardholders. The setting of the MIF amounts could also, according to EuroCommerce, be considered as a price-fixing cartel since the level of the fee was said to be agreed on between the banks without any pressure from the market. *Visa* stated that bilateral agreements between banks on

<sup>34</sup> From 1 December 2009 the European General Court.

<sup>35</sup> Where a MIF is restrictive under Article 81(1) of the EC Treaty (agreement between undertakings), the parties must demonstrate that, despite the restrictive effects, the conditions of Article 81(3) are met: 1) empirical proof that the MIF creates efficiencies that outweigh the restriction of competition; 2) consumers get a fair share of those benefits; 3) there are no less restrictive means of achieving the efficiencies; and 4) competition is not eliminated altogether.'

<sup>36</sup> Available at: [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=1\\_29373](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_29373)

interchange arrangements were permitted and it was only in the absence of such an agreement that the MIF was applied.<sup>37</sup> The MIF was necessary, according to Visa, as a financial adjustment to the imbalance between the costs associated with issuing and acquiring and the revenues received from cardholders and merchants. Before the Commission came to a decision, Visa modified its MIF scheme by (i) lowering the level of the MIF, (ii) initiating a cost study to be carried out of the three cost categories of the MIF and (iii) allowed member banks to reveal information about the MIF levels.

#### RELEVANT MARKET

Two types of markets could be distinguished according to the Commission: the system/network market (inter-system) or upstream market – competition between different payment systems, e.g. different card schemes, and possibly also other means of payment – and the intra-system markets or downstream markets – competition between financial institutions for card-related activities, e.g. issuing of cards to individuals and acquiring merchants for card payment acceptance. The relevant inter-system market was considered by the Commission to comprise all types of payment cards.<sup>38</sup> Regarding the intra-system market, the Commission found that Visa cards could be considered a distinct product for card issuing and card acquiring. The main focus of the Commission's analysis, however, was on the inter-system market. The relevant geographical market relating to payment cards was considered as still mainly national, although the market for inter-system competition might be wider than the national markets. However, since Visa held an important market position, even on a worldwide market, the precise geographical market definition could in this case be left open.<sup>39</sup>

The Commission did not take any position on the Visa market position; it was only mentioned that there was a great variety on the national markets in the number of cards, and in the volume and value of transactions across Member States. Moreover, the Commission stated that the market power of Visa should not only be

measured in terms of market shares; Visa had important network economies as almost all banks issued Visa cards and as Visa cards were accepted in some four million merchant outlets throughout the EU.

#### CONCLUSIONS

The Commission's conclusion was that the MIF in the Visa system amounted to an appreciable restriction of competition within the meaning of Article 81(1) of the EC Treaty and Article 53(1) of the EEA Agreement. However, the amended MIF contributed to technical and economic progress, while providing a fair share of these benefits to each of the two categories of user of the Visa system, and no other alternative, less restrictive than the revised Visa MIF, existed at present. According to the Commission, the MIF did not eliminate competition between issuers or acquirers, nor did it eliminate competition between Visa and its competitors. The modified Visa MIF therefore fulfilled the conditions for an exemption under Article 81(3) of the EC Treaty and Article 53(3) of the EEA Agreement.

#### ACTIONS TAKEN AFTER THE COMMISSION'S DECISION<sup>40</sup>

Visa's exemption remained in force until 31 December 2007. On 3 April 2009, the Commission adopted a Statement of Objection against Visa Europe. The Commission's preliminary view was that the MIF set directly by Visa Europe restricted competition between acquiring banks, inflated the cost of payment card acceptance for merchants and ultimately increased consumer prices. However, an MIF was not illegal as such, but had to contribute to technical and economic progress and benefit consumers.

In April 2010, Visa Europe committed itself to cap the yearly weighted average cross-

<sup>37</sup> In the EU region, the MIF is set by the Visa EU board.

<sup>38</sup> Visa argued that all consumer payment instruments should be comprised, while EuroCommerce argued that Visa was active on the market for card networks, while three markets should be distinguished within the Visa system, namely card issuing, card acquiring and transaction processing.

<sup>39</sup> Visa argued for an EU-wide or even world-wide market.

<sup>40</sup> Available at: [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=1\\_39398](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_39398)

border MIF applicable to transactions with its consumer immediate debit cards at 20 basis points (0.20%) for four years. The cap would also apply separately in each of those EEA countries for which Visa Europe directly set specific domestic consumer immediate debit MIF rates and in those EEA countries where the cross-border MIF rates applied in the absence of other MIFs.

On 8 December 2010, the Commission made Visa Europe's commitments legally binding for four years.<sup>41</sup> In its decision, the Commission stated that the MIF applied by Visa Europe was in conformity with the merchant indifference methodology (tourist test). An MIF set above the level compliant with the tourist test would not appear to create efficiencies that would outweigh the possibly anti-competitive effect of the MIFs, and a fair share of the resulting benefits would not be passed on to consumers (merchants and their subsequent purchasers). A reduction of the MIF to a level compliant with the tourist test would benefit merchants and their customers, both card users and non-card users. The commitments made by Visa Europe were therefore considered suitable to remedy competition concerns expressed in the Commission's Statement of Objection.

## 2.2 NATIONAL DECISIONS

### 2.2.1 LATVIAN COMMERCIAL BANKS – LATVIAN COMPETITION COUNCIL

*Latvian Competition Council decision, 3 March 2011*<sup>42</sup>

The Latvian Competition Council (CC) decided in March 2011 that 22 Latvian commercial banks had breached the Competition Law by participating in a multilateral agreement on the interchange fees for card payments, thereby restricting competition in the Latvian cards market.

### RELEVANT MARKET

The market for issuing of payment cards and for acquiring of card payment services (POS and internet) in Latvia.

## CONCLUSIONS

The banks were not able to provide evidence that the benefits of the MIF counterbalanced the restrictions to competition, but focused on explaining the necessity of cards payments. The CC therefore found that an MIF was not considered necessary for promoting the cards market.

The MIF had fixed the minimum merchant service charge (MSC) set by acquiring banks, thus restricting acquiring banks' capabilities to set lower MSCs than the MIF, i.e. to set the service price on the basis of free competition. Competition among acquiring banks was restricted, since they were aware that merchants would pay the same minimum MSC as other acquirers. The CC found that the MIF was not related to the issuing banks' actual costs, but constituted an actual income for them. Since acquiring banks were also issuing cards, high MIFs were to the benefit of both issuing and acquiring banks. The CC therefore found that the banks had motivation to obtain a financial gain from the MIF.

The CC concluded that the multilateral agreement on MIFs was considered an agreement between competitors that – by object and effect – hampered, restricted and distorted competition in the relevant markets by excluding the most important tool for competition, i.e. competition based on price.

### 2.2.2 MASTERCARD AND BANKS – ITALIAN ANTITRUST AUTHORITY

*Italian Antitrust Authority decision, 4 November 2010 (I720)*<sup>43</sup>

41 The Commission's decision of 8 December 2010 relating to proceedings under Article 101 of the Treaty on the Functioning of the European Union and Article 53 of the EEA agreement (Case COMP/39.398 – Visa MIF).

42 Only a brief summary was available in English for drafting this paper (available at: [http://www.kp.gov.lv/?object\\_id=1084&module=news](http://www.kp.gov.lv/?object_id=1084&module=news)).

43 Only a brief summary was available in English for drafting this paper (available at: <http://www.agcm.it/en/newsroom/press-releases/1827-i720-payment-cards-antitrust-authority-fines-mastercard-and-eight-banks-for-agreements-restricting-competition.html>).

The Italian Antitrust Authority (AGCM) found that MasterCard company and eight banks had established agreements restricting competition designed to maintain high inter-bank fees for payments by credit or debit cards issued by MasterCard, by bundling this type of cost together with merchant membership fees, with direct consequences for consumer prices.

### CONCLUSIONS

The AGCM found that MasterCard, as an association of businesses, had fixed an Italian-specific MIF that was not derived from the system's overall economic efficiency. Incentives for MIF inflation derived from the fact that higher MIFs (i) increase the direct proceeds for card issuer banks, (ii) increase the proceeds of acquirer banks, as the transaction volume of the expanding scheme increases, and (iii) the increased number of transactions lead to greater brand-name exposure for the MasterCard scheme itself, which translates into increases in scheme proceeds from license holders.

By including membership fees and establishing specific clauses that hindered the making of comparisons with other schemes/payment instruments in their contracts with merchants, banks gave an undue advantage to the MasterCard brand, the scheme as a whole and the banks themselves. Individual banks used the membership mechanism to manifest a unitary agreement with MasterCard in order to promote the schemes expansion by passing the MIF on to merchants and, consequently, to the prices effectively applied to consumers.

### 2.2.3 PAYMENT CARD SCHEMES – HUNGARIAN COMPETITION AUTHORITY

*Hungarian Competition Authority decision, 24 September 2009 (Vj-18/2008)*<sup>44</sup>

The Hungarian Competition Authority (GVH) found in September 2009 that the uniform interchange fees in transactions using payment cards of Visa Europe and MasterCard Europe, set by the Hungarian banks, breached the Competition Act. As a result of this practice,

competition between payment card schemes and acquiring banks was distorted.

### RELEVANT MARKET

The market of payment card schemes and card acquiring.

### CONCLUSIONS

Banks had uniformly determined the level of interchange fees for both major international card schemes, thereby impairing (i) competition between Visa and MasterCard and (ii) competition between acquiring banks. As a result of the agreement, the levels of merchant service charges were indirectly influenced, since the interchange fee served as an artificial minimum price. The GVH did not contest that collective multilateral agreements could produce substantial efficiencies, but no evidence had been provided to show that the restriction of competition had been limited to the reasonably necessary level, and that a due share of the benefits had reached cardholders and retailers. On the contrary, (i) the level of the MIF had remained unchanged for years, despite changes on the market and decreased costs, (ii) a uniform MIF was applied for both credit and debit cards, despite credit cards being more expensive, and (iii) no cost analysis had been made, nor had the demands of the market been taken into account. The restriction of competition was considered by the GVH to originate mainly from the common treatment by banks of both card payment schemes. The GVH also found that the two payment card schemes (Visa and MasterCard) had taken part in the restriction of competition, since their operational rules had enabled banks to set interchange fees (which could be applied for both schemes) uniformly. This had served the interests of the card schemes, since it had excluded an element of competition between the schemes.

<sup>44</sup> Only a summary of the decision was available in English for drafting this paper (available at: <http://www.gvh.hu/domain2/files/modules/module25/10769E8D7015B1618.pdf>).



#### 2.2.4 INTERCHANGE FEE IN VISA AND MASTERCARD SYSTEMS – POLISH OFFICE OF COMPETITION AND CONSUMER PROTECTION

*Polish Office of Competition and Consumer Protection decision, 29 December 2006 (DAR 15/2006)*<sup>45</sup>

The Polish Office of Competition and Consumer Protection (OCCP) published its decision on interchange fees in Visa's and MasterCard's system on 4 January 2007, in where it found that 20 Polish banks participating in the agreement on the multilateral setting of interchange fees had restricted competition by means of the joint setting of interchange fee rates.

#### RELEVANT MARKET

The relevant product market was considered to be the market for acquiring services, involving the settling of consumer's liabilities to merchants for products and services purchased by means of payment cards. The relevant geographical market was considered to be the territory of Poland.

#### CONCLUSIONS

The OCCP found that the interchange fee constituted the major part of the merchant service charge (sometimes more than 90%), and thus set a de facto floor for the merchant fee. Those fees led to an artificial growth of merchants' costs, which translated into higher prices in shops, affecting all customers (including those paying with cash).

The banks claimed that even if interchange agreements were restricting competition, interchange fees were necessary for the functioning of four-party card systems and that they fulfilled the requirements for exemption, due to their beneficial impact on the economy. In that respect, the OCCP found that the interchange fee was not indispensable for the functioning of the scheme, since there were four-party card schemes that worked well without any interchange fees.<sup>46</sup>

The banks also claimed that the interchange fee was an instrument for the optimal distribution of costs, which led to a maximisation of

the system's size. According to the banks, interchange fees were an indispensable income source for issuing banks, allowing them to cover the costs related to card operations and to avoid charging cardholders. The OCCP found that the interchange fees set in both the Visa and the MasterCard systems before 2006 were not determined on the basis of any objective criteria, and that the cost analysis provided early in 2006 was based on flawed or incomplete assumptions. Those fees did not, therefore, fulfil the first condition of the exemption, i.e. contributing to improving the production or distribution of goods or to promoting technical or economic progress.

Regarding the issue of allowing consumers a fair share of the benefits resulting from the agreement, the banks claimed that there was a relationship between the amount of the fee and the costs incurred by the banks in relation to activities and services provided to the benefit of merchants. The OCCP did not accept these arguments, stating that the growth of interchange fees was not related to a reduction of charges paid by card users and that the business of payment card issuing was highly profitable, which indicated that the interchange fee performed a role of an additional income source, not a subsidy allowing a reduction of charges paid by card users. With regard to the three cost categories discussed in the Commission's Visa decision, the OCCP pointed out that they did not correspond to activities that would give merchants real benefits.<sup>47</sup>

45 Available at: [http://www.uokik.gov.pl/news.php?news\\_id=1004](http://www.uokik.gov.pl/news.php?news_id=1004).

46 Dankort (Denmark), Bank Asept (Norway) and PIN (the Netherlands).

47 Financing deferred payments is not one of the payment system services provided to retailers. It is a service provided by card issuers directly to individual holder of cards that allow late payment.

Regarding the costs of the payment guarantee, the OCCP found that it was being paid twice, namely, first, by cardholders to their bank in case of a lack of funds and, second, by merchants as part of the MIF. In addition, considering the benefits reaped from MIFs, banks might not pay sufficient attention to the "quality" of their customers, which could contribute to increasing MIFs further.

With respect to payment processing costs, the OCCP found, considering the significant variety of processing costs, that there had to exist a convincing direct relationship between a given activity and the benefits that merchants receive therefrom.

The President of the OCCP did not find that the interchange fee would allow merchants a fair share of the benefits resulting from the interchange fee, since the cost base on which the fee built also included services provided by banks to card users.

#### **ACTIONS TAKEN AFTER THE DECISION**

All the banks involved lodged an *appeal with the Court of Competition and Consumer Protection* (SOKiK). The banks claimed that the market on which the infringement was to occur had been erroneously defined. All of the appeals were examined and decided jointly by the Court. SOKiK upheld the charge of an erroneous definition of the relevant market and modified the OCCP's decision at the very first hearing in the case (12 November 2008), finding no restrictive practices on the market as defined by the OCCP.

The OCCP did not agree with this decision and lodged an appeal against the SOKiK's judgement with the *Court of Appeal*.<sup>48</sup> The appeal was based on both substantive and procedural grounds, claiming, inter alia, that the findings of the SOKiK that the relevant market had been erroneously defined were incorrect and that its ruling conflicted with the jurisprudence of the European Commission, in particular with the latter's decision in the MasterCard case. On 22 April 2010, the Court of Appeal repealed the decision of the SOKiK and submitted it back to the SOKiK for review. The Court of Appeal shared the views expressed by the OCCP regarding the definition of the relevant market and the position of the EU Commission, as expressed in its decisions on cross-border interchange fees for Visa and MasterCard payments.

#### **2.2.5 SERVIRED – SPANISH TRIBUNAL FOR THE DEFENCE OF COMPETITION**

*Case A 318/02, SERVIRED Interchange fees*

In April 2005, the Spanish Tribunal for the Defence of Competition (TDC) rejected an application by ServiRed (a civil partnership of

Spanish banks) seeking individual exemption for a system setting interchange fees for card payment transactions.

The interchange fee structure proposed by ServiRed was based on a categorising of merchants by sector, depending on the average turnover in the market sector to which each merchant belonged, without any difference between debit and credit cards.

The TDC found it unacceptable that a uniform interchange fee should be charged on all card transactions, both credit and debit, without taking any cost or risk criteria into consideration. It stated, for example, that the financing of the free funding period and the payment guarantee created greater costs in respect of credit card transactions than those incurred through debit card transactions. Notwithstanding a fundamental lack of transparency, the proposed interchange fee would also, according to TDC, contribute to establishing a higher floor for the merchant service charge to be paid by the merchants.

The TDC found that the agreements between banks to set an interchange fee were equivalent to the concerted practice of fixing prices, thereby constituting a breach of the Spanish Competition Act. The TDC referred to the Commission's Visa decision,<sup>49</sup> stating that the level of costs which Visa International was granted for cross-border transactions represented a clear signal of the costs that might be authorised at a national level. ServiRed had failed to prove that the requirements for an exemption were fulfilled and the TDC therefore rejected ServiRed's application for an individual exemption.

Nevertheless, TDC acknowledged that the fixing of interchange fees between card issuers could contribute to technical and economic progress provided that it met the conditions set out in the Spanish Competition Act. In order for it to grant

48 Ruling available at: [http://www.uokik.gov.pl/news.php?news\\_id=2045](http://www.uokik.gov.pl/news.php?news_id=2045)

49 Commission decision of 24 July 2002 (Case No COMP/29.373).

an exemption, the TDC deemed it essential that the following conditions be met:

- A differentiation between credit (deferred debit) cards and debit cards, in accordance with the different costs involved.
- Debit card interchange fees may only include defined authorisation and processing costs, and should be expressed as a fixed amount per transaction.
- Credit and deferred debit card interchange fees may only include defined authorisation and processing costs, and should be expressed as a fixed amount per transaction. The risk of fraud should be based on a real figure, such as a percentage of the transaction volume.
- Different interchange fees could be applicable in the case of different ways of making purchases (e.g. by post, telephone and internet).
- Interchange fees must be made public.

#### **2.2.6 SISTEMA 4B – SPANISH TRIBUNAL FOR THE DEFENCE OF COMPETITION**

*Case A 314/2002 SISTEMA 4B*

In December 2001, Sistema 4B applied for an individual exemption for a system to set interchange fees for transactions between banks arising from payments made with cards issued by its members. The TDC rejected the application in April 2005, with the same reasoning as that given for ServiRed above.

#### **2.2.7 EURO 6000 – SPANISH TRIBUNAL FOR THE DEFENCE OF COMPETITION**

*Case A 287/00 Euro 6000*

In July 2001, the Spanish company Euro 6000 had been granted an exemption for its interchange fee setting. The interchange fees were set by grouping merchants in different sectors according to their activity. The fee for

each of these sectors was set on the basis of objective information, such as the sectoral turnover per business and year in terms of interchange. In a new decision (11 April 2005), the TDC stated that since the granting of the exemption in 2001, the Commission's Visa decision (2002) had provided greater certainty regarding the methodological criteria to be observed when determining authorisations of the interchange fee, making it essential that the fee reflected the costs and the real risks inherent in the service provided.

The TDC declared that all three systems for card payments on the Spanish market should be treated in the same way, so that the decision on ServiRed was extended to include the systems of Sistema 4B and Euro 6000. All three systems had to abandon their present arrangements by 15 July 2005.

#### **2.2.8 MASTERCARD – UK OFFICE OF FAIR TRADING (SET ASIDE BY THE COMPETITION APPEAL TRIBUNAL IN JUNE 2006)**

*Decision No. CA98/05/05 of 6 September 2005 (Case CP/0090/00/S)*<sup>50</sup>

The UK Office of Fair Trading (OFT) found in September 2005 that the collective agreement between members of MasterCard UK Members Forum Limited setting a fallback MIF for consumer credit and charge cards between 1 March 2000 and 18 November 2004 was restricting competition. The decision was set aside by the Competition Appeal Tribunal in June 2006.

#### **RELEVANT MARKET**

The OFT found the relevant market to be split into three: the wholesale market for the provision of card transaction services between issuers and acquirers, the acquiring market and the issuing market. The relevant geographical market was identified as the United Kingdom.

<sup>50</sup> Available at: [http://www.offt.gov.uk/shared\\_offt/ca98\\_public\\_register/decisions/mastercard.pdf](http://www.offt.gov.uk/shared_offt/ca98_public_register/decisions/mastercard.pdf)

## CONCLUSIONS

Despite the divergent outcome, the OFT stated that there were considerable similarities between the reasoning and conclusions drawn in the OFT's decision and the EU Commission's Visa decision, despite the Commission's decision dealing only with cross-border card payments and the OFT's decision being restricted to intra-UK arrangements.

The OFT stated in its decision that the MIF agreement created an appreciable restriction of competition in two ways: first, it gave rise to a collective agreement on the level of the MIF (essentially, a collective agreement on the price) applying to almost all domestic transactions, which significantly restricted the scope for acquirers to compete on price by acting as a price floor. Second, the MIF agreement resulted in parties recovering costs of services provided that were not essential to the operation of the MasterCard scheme as a viable payment transmission mechanism (extraneous costs), e.g. the cost for providing an interest-free period. The recovery of extraneous costs through the MIF generated extra interchange revenue for issuers and distorted competition between the MasterCard scheme and other payment systems, and also between issuers within the MasterCard scheme.<sup>51</sup>

Payment card networks have the benefit of providing universal acceptance, as well as increasing the ease and reducing the costs of entry into the scheme. In principle, the OFT accepted that a collective agreement on the level of an MIF could benefit consumers and satisfy all exemption conditions if set at an appropriate level, not higher than the costs of the payment transmission services incurred by issuers. However, the MIF went beyond this as it included costs that were not necessary for the transmission of the payment transaction and was therefore not indispensable for attaining the benefits which may arise from a collective agreement. In addition, consumers<sup>52</sup> were not considered to be receiving a fair share of any benefits arising from the MIF agreement,

since the costs for the unnecessary highly set MIF were passed on to all the merchants' customers, including those who used other payment methods. Since the MIF was used as an instrument for the recovery of extraneous costs, the OFT concluded that it was not set at an appropriate level, and did not, therefore, satisfy all exemption conditions. No penalty was imposed, as the MIF agreement to which the decision related was no longer in force.

## THE COMPETITION APPEAL TRIBUNAL

The OFT's decision was submitted for appeal to the Competition Appeal Tribunal (the Tribunal), which set the decision aside on 19 June 2006.<sup>53</sup>

The main reason for setting the decision aside was that the OFT's defence in court diverged from the reasoning in its decision of September 2005.<sup>54</sup> In addition, the period of infringement in the OFT's Decision was limited to 18 November 2004, when responsibility for setting the default interchange fee was transferred from the members of MasterCard UK to MasterCard International. Due to the above reasoning, the OFT wanted to withdraw its decision with a view to investigating further MasterCard's and Visa's current arrangements, claiming that the changes to MasterCard's arrangements meant that the Tribunal's judgement might not, after all, give definitive

51 First, if the MIF had not covered the costs for the free funding period, issuers could have competed more in relation to the prices they charged cardholders. Second, the extra revenue from a higher MIF meant that cardholders spending more on MasterCard cards were more attractive to issuers than would otherwise have been the case.

52 The concept of consumers should be understood to include consumers in general, not only consumers using MasterCard cards.

53 Decision available at: <http://www.catribunal.org.uk/archive> (search for MasterCard).

54 The divergences related to: (i) abandoning the counterfactual that in the absence of the collective price restriction (multilaterally agreed interchange fees), issuers and acquirers would enter into bilateral agreements, with arbitration as fallback and (ii) introducing a new counterfactual, to the effect that the MasterCard scheme could operate without an interchange fee, with issuers and acquirers honouring transactions "at par", as well as (iii) the withdrawal of the position that MasterCard's arrangements met the first condition for exemption under Article 81(3) and (iv) that payment transmission costs should be measured by reference to those of the Maestro debit card scheme.

guidance on the law applicable. To avoid any uncertainty, which might have been the case if the OFT had withdrawn its decision, the Tribunal decided to set the decision aside.

On 19 October 2005, the OFT issued a statement of objections against Visa, and on 2 February 2006 the OFT opened an investigation of the new MasterCard arrangements, which had come into effect after 18 November 2004. On 9 February 2007, the OFT expanded the scope of its investigation to also include immediate debit cards. The OFT is currently awaiting the judgement of the European General Court in the appeal proceedings brought by MasterCard against the decision of the European Commission regarding MasterCard's interchange fee arrangements, before taking any further action.

### 3 LEGAL ASSESSMENTS (ARTICLE 101 OF THE TREATY ON THE FUNCTIONING OF THE EUROPEAN UNION, FORMERLY ARTICLE 81 OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY)

	Commission MasterCard December 2007	Commission Visa July 2002	CC Latvian commercial banks May 2011
<b>Relevant market</b>	Card acquiring	Main focus is on inter-system market; the market for Payment cards	Card issuing Card acquiring
<b>Agreement between undertakings or decisions by associations of undertakings</b>	Yes	Yes	Yes
<b>MIF justification by card schemes and/or financial institutions</b>	The MIF is a tool to balance cardholder and merchant demand and does not have the function of a "price"	The MIF balances the conflicting interests of merchants and cardholders by allocating the costs of the system between the two user groups	A MIF is necessary in order to ensure cards payment system and to promote the use of card payments
<b>Contributes to promoting technical or economic progress</b>	No, MasterCard has failed to demonstrate a casual link between the MIF and its targeted efficiencies	Yes, a large-scale international payment system with positive network externalities	No, banks have not been able to provide any evidence that the benefits of the MIF agreement counterbalance the restrictions in competition
<b>Allowing consumers a fair share of the benefits</b>	No, the MIF includes elements that are not related to services which sufficiently benefit merchants	Yes, the modified MIF provides a fair share of the benefits to each category of user of the Visa system	
<b>Indispensability</b>	Not proven, several EEA card schemes are currently operating without a MIF	No alternative, less restrictive than the revised Visa MIF exists at present, which would achieve the advantages and benefits to consumers	
<b>Non-elimination of competition</b>		The MIF does not eliminate competition between issuers, nor does it eliminate competition among acquirers, since they can still compete on other components, apart from the MIF	



	AGCM MasterCard and eight Italian banks November 2010	GVH Hungarian financial institutions, Visa and MasterCard September 2009	OCCP 20 Polish banks in Visa and MasterCard systems January 2007	TDC ServiRed, Sistema 4B, Euro 6000 April 2005	OFT MasterCard September 2005 (set aside in June 2006)
		Payment card schemes (Visa, MasterCard) and card acquiring (financial institutions)	Card acquiring	Payment cards	Card issuing Card acquiring Provision of card transactions
Yes	Yes	Yes	Yes	Yes	Yes
			The MIF is an indispensable income source for issuing banks, allowing them to cover the costs of their card operations and to avoid charging cardholders	An interchange fee is indispensable for the operation of the network	The MIF is a balancing mechanism enabling distribution of costs between participating issuers and acquirers
No, the MIF specific to Italian-banks was not derived from the system's overall economic efficiency	No, collective multilateral agreements may produce substantial efficiencies, but no evidence is at hand that the restriction of competition has been limited to the reasonably necessary level	No, the MIF has not been determined on the basis of any objective criterion, since the cost analysis behind the MIF is based on flawed or incomplete assumptions	Yes, as long as it meets the conditions set out in the Competition Act, but ServiRed has failed to prove this	Yes, the MIF has increased the ease and reduced the costs of entry. Transaction costs are reduced in comparison with a fee structure based on bilateral agreements	
No, to promote the scheme's expansion, MIFs were passed on to merchants and, consequently, to the prices applied to consumers	No, cardholders and merchants have not received a due share of the benefits	No: cardholders – the MIF is an additional income source for banks, not a subsidy that allows a reduction of charges; merchants – the MIF cost base also includes services provided by banks to card users, which do not benefit merchants  Not analysed since the MIF does not meet the first and second conditions for exemption		No, the recovery of extraneous costs excludes consumers from a fair share of the benefits arising from the MIF	
					Yes, (i) issuers and acquirers can enter into bilateral agreements, (ii) issuers are free to compete regarding services to cardholders and (iii) there is some scope for intrascheme competition on the acquiring market

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