European Commission Turns up the heat on Card Payment Fees

Introduction

The European Commission has confirmed that (on 23rd June 2006) it has sent a statement of objections to Mastercard in relation to its preliminary view that Mastercard restricts competition between member banks (by pre-determining a minimum price retailers must pay for accepting Mastercard and Maestro branded payment cards). In its press release, the Commission highlights that the suspected competition issue identified by the investigation illustrates one of the potential problems identified in the financial services sector competition inquiry as regards payment cards (see following section).

This is not the first time that the European Commission has investigated card payment fees. In 2002, the European Commission (in its Visa decision) fixed the underlying cost components for consumer card interchange fees within the Visa card system, obliged Visa to conduct an in-depth cost study to justify the level of each of the costs and set an annual ceiling on Visa interchange fee rates which will last until 2007. The Commission, in the Visa decision, found that multilaterally set interchange fees in the Visa system restricted competition between banks for providing services to cardholders and merchants, as they largely determine the fees charged to both consumer groups.[1]

The Office of Fair Trading has also been investigating interchange fees in the UK. In September 2005 it issued a decision finding that Mastercard's domestic interchange fee arrangements infringed the UK and EC competition rules. Mastercard appealed to the Competition Appeal Tribunal and, in its defence, the OFT changed its case against the interchange fee arrangements in a number of important respects. It then decided to withdraw its decision but the Competition Appeal Tribunal instead decided to set the motion aside. The OFT has indicated that it will continue its investigation into Mastercard's current interchange arrangements, as well as those of Visa.

European Commission interim report into Payment Cards

In April of this year, the Commission, as part of its' inquiry into retail banking, published its interim findings in respect of payment cards (with the final report to be published by the end of this year). The aims of the inquiry are (i) to show how differing forms of organisation, structure and governance of payment systems in the European Union can produce differing competitive outcomes; and (ii) to provide evidence to shape the future development of the Single European Payment Area initiative. The evidence gathered for the inquiry suggests that the characteristics of some payment systems lead to significantly higher prices for firms and consumers in some Member States.

Basics of Payment Card structures

When a cardholder uses a card to purchase goods/services, the bank that issued the card (issuer) debits the retail price from the cardholder's account. The issuer then pays the bank that

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[1] Visa interchange fees were allowed only after Visa committed itself to set interchange fees on the basis of objective costs incurred by issuers for providing concrete services to merchants and to allow member banks to disclose these fees to merchants.

acts for the merchant (the acquirer), the retail price less an interchange fee and the acquirer pays the merchant the retail price less a merchant fee. Payment card systems often have network effects or externalities (as the more cardholders there are in the system, the more valuable the system is for merchants and the more merchants there are in the system the more valuable the system is to cardholders thus raising the barriers to entry for potential new-entrants).

Overall findings

The Commission found that some (but not all) card payment networks offer consumers a means for easy and convenient cross-border payments but businesses (in particular small firms) largely do not benefit from market integration in card payments. Existing domestic card networks offer in some respects a good value proposition to customers and often charge lower fees to cardholders than the large international networks (e.g. MasterCard and Visa).

The interim findings of the payment cards inquiry are divided into two parts: (i) financial analysis of the industry; and (ii) potential barriers to competition.

Financial Analysis of the Industry

Divergence in profitability between issuing and acquiring

The interim report found that profitability is far higher for card issuers than for acquirers (with one possible reason for this being that card issuers may have market power relative to acquirers). The report highlighted that, in the Commission's view, the reason why issuing is several times more profitable than acquiring in the majority of countries is the role played by the interchange fee as a cost and revenue element in the payment card system.

The interim report suggests that, even in the absence of an interchange fee, other revenues alone would in many cases generate a healthy profit for issuers (i.e. even without interchange income, card issuing would generate positive profits in 20 out of 25 countries).

The European Commission is of the view that whether card issuers can offer payment cards at affordable prices to consumers in the absence of interchange revenues is of relevance for a competition analysis of interchange fee agreements. If the transfer of revenues were necessary for the operation of the card payment system, then interchange fee agreements may not be caught by Article 81(1) of the EC Treaty, even if the fees determine the price charged by an acquirer to merchants. However, the Commission's view is that the findings of its interim report on the profitability of card issuing cast doubt on the assumption that, in the absence of interchange fees, issuers could not recoup their costs from cardholders.

Acquirers' Revenues

The report found that the merchant fee (i.e. the price per transaction that a business (merchant) pays to the acquirer for accepting cards) varies considerably across the European Union with price dispersion existing at five levels:

- Businesses in some countries pay a far higher merchant fee than others;
- Businesses pay a far higher merchant fee on average to accept credit rather than debit cards;
- Businesses pay a far higher merchant fee on average to accept cards issued in the international networks than in the domestic networks;

- International payment systems make smaller businesses pay more than larger businesses;
- Businesses in some sectors pay a much higher merchant fee on average than in others.

The acquiring banks' practice of charging businesses the same level of merchant fee for accepting cards issued by different networks (known as 'blending') may weaken inter-network price competition which in turn may lead to businesses paying higher acquirer fees.

In addition, the interim report found that small merchants tend to get less than favourable deals than larger merchants although this may not constitute discriminatory treatment in itself (as it may be justified to some extent by the fact that larger merchants bring higher transaction volumes and therefore may significantly scale down the fixed costs).

However, the interim report also found that the less favourable treatment was not nearly as marked in the debit card sector which would tend to indicate that the scale of small customers may not be the sole reason for this discrepancy (which the interim report noted could be a measure for the exercise of market power by banks within a given system).

Issuers' revenues – interchange fees

The results of the inquiry show that interchange fees vary considerably across the EU (with the report stating that this is an indicator that the market for card payment services is not working effectively in some Member States) with price dispersion being similar to those for the merchant fee:

- Acquirers in some Member States pay far higher interchange fees on average than in others;
- Acquirers pay far higher interchange fees on average for international credit and debit card transactions than for domestic debit card transactions;
- Many acquirers pay a higher interchange fee on average for domestic MasterCard/Visa transactions than for corresponding cross-border transactions.

The results of the inquiry show that there is no significant negative relationship between the cardholders' fees and the credit card interchange fee at country and network level. The empirical evidence suggests that if the interchange fee increases by 1 Euro only 25 cents are passed on to consumers in lower cardholder fees – this result challenges the hypothesis advanced by some industry participants that an increase in interchange fees exactly equals a decrease in cardholder fees.

The interim report went on to say that its preliminary findings may provide indications that the setting of interchange fees could possibly be the source of market power in some Member States and that there are indications that the setting of interchange fees in the international systems may possibly have the object and/or effect of creating market entry barriers to competition between local and foreign member banks (see section on fallback interchange fee systems below).

The interim report goes on to say that it is possible that interchange fees are too high, notably if merchant acquirer fees increase with interchange fees but issuers do not pass the additional interchange fee revenue back to cardholders – in this case, high interchange fees are a way to transfer rents to the side of the scheme where they are less likely to be competed away.

Fallback interchange fee systems

The interim report notes that at least one of the international systems has created an order of precedence for cross-border and domestic interchange fees (a "fallback" interchange fee system). First, bilaterally agreed fees always take precedence over multilateral interchange fees set by a board of member banks (this holds for both cross-border and for domestic fees). Second, where banks neither bilaterally nor multilaterally agree on the level of domestic interchange fees, multilaterally set cross-border fees will apply to domestic payment card transactions as well. The effect of the "fallback" interchange fee system is as follows:

- In the absence of an agreement between member banks, there will always be an interchange fee that acquirers pay to issuers, whether a multilaterally agreed default fee at local level or a multilaterally agreed cross-border fee and this of necessity excludes the possibility that acquirers pay no interchange fees to issuers;
- At domestic level, local member banks of an international system may charge each other preferentially low rates (on the basis of bilateral agreements) while applying higher fallback rates (set by a local board of banks) to foreign banks or other "outsiders" that attempt to compete with them;
- Where local boards of banks multilaterally set domestic interchange fees in the international systems, they appear to view cross-border interchange fees as a minimum benchmark for setting these domestic fees.

A specific issue relevant for competition within the Mastercard and Visa systems is the co-existence of bilaterally and multilaterally agreed interchange fees.

The former are often referred to as 'on-us' fees. Strictly speaking, on-us transactions are transactions where one bank is both the issuer and the acquirer. However, in countries where an inter-bank association acquires, for instance, Maestro or Mastercard transactions, local banks that are co-shareholders of this inter-bank association may be able to offer lower fees to the association. This means that parties to these "on-us" agreements can offer lower merchant fees and thereby prevent new competitors from entering the market.

Potential barriers to Competition

The investigation has identified a number of potential barriers to competition in the market for card payment services:

- The vertical integration of card payment systems may impede new entrants, in particular non-banks, from competing with the incumbent in one segment of the market – however, in Austria and the Netherlands, the market for processing and acquiring services, respectively, has been opened up after the de-integration of the systems (which has now lead to lower merchant fees in the Netherlands);
- Joint ventures between local banks to acquire merchants may remove the competitive pressure on merchant fee levels because merchants only have one offer for the network concerned;
- Diverging technical standards across the EU may hinder acquirers, processors and terminal vendors from operating efficiently on a pan-European scale;
- Agreement on preferential interchange fees between local banks and high fallback fees for foreign banks may raise the costs for foreign banks wishing to enter the market;

- Bilateral clearing arrangements between local banks could make market entry more difficult (as new entrants depend on sponsoring banks, who have little incentive to sponsor potential competitors);
- Some governance arrangements within card payment systems risk distorting conditions for competition between members (e.g. in certain networks associate members have to communicate business sensitive information to the principal members without reciprocal information sharing);
- Some payment system membership requirements may hinder non-banks from domestic acquiring and new entrants from cross-border acquiring (e.g. certain systems require members to be a financial institution or have a local establishment);
- High joining fees for card payment systems and their structure may discourage new entry and expanded card issuing;
- Network rules may also prevent or make entry more difficult - e.g. the prohibition on merchants charging customers for paying by card ("surcharging") may hinder the development of alternative non-cash payment instruments, as the true costs are hidden from consumers via cross-subsidies (i.e. banks can not recover their costs solely from cardholders and have to recover these costs from their entire customer-base). However, the report recognises that the reason banks do not implement more cost-based pricing is that the bank that first opted to implement a cost-based pricing would face a first-mover disadvantage.

Vertical integration/governance of Card Payment Systems

The report highlights that the card payment industry generally distinguishes between "open" or "four-party" card payment systems and "closed" or "three-party" card payment systems, where the scheme owner also engages in the financial aspects of the payment card business by issuing cards and acquiring merchants (e.g. American Express, Diners Club and JCB). However, in addition to this distinction, the report also notes that other factors need to considered when assessing the vertical integration of a card payment system (e.g. whether the scheme owner switches authorisation requests itself, processes transactions itself, clears and/or settles transactions itself, acquires merchants and sells and/or rents POS equipment).

The report highlights that, where card payment systems do not have a multilateral clearing platform (and therefore banks have to arrange clearing (and chargebacks) bilaterally (termed 'peer-to-peer clearing') this may raise the cost of market entry to the card system for foreign banks.

As a consequence, the Commission indicate they may consider the separation of scheme ownership and other activities (as part of the Single European Payments Area initiative).

The report also highlighted that the need to find a local "sponsor" for access to a clearing system based on bilateral clearing arrangements may inhibit market access. The possibility of sponsorship may not be sufficient to allow market entry where local banks have no commercial interest in sponsoring a potential competitor. In order to promote cross-border competition, card payment systems should be invited to set objective and verifiable rules that grant new entrants a right of access to sponsorship by one of the incumbent banks, or - if technically feasible – set up a multilateral clearing platform. Similar concerns may arise where membership in a card payment scheme as such relies on being sponsored by a principal member, normally an incumbent in the market.

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