

# Interchange Fees: Antitrust and Regulatory Perspectives

## Panel Remarks

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*Chair: David A. Balto*

**Mr. Balto:** Our four speakers are David Teal, Bernhard Friess, John Vickers, and Renata Hesse. Everybody who is speaking here is only expressing their own opinion and not the opinion of their agencies. Many of these enforcers have ongoing enforcement efforts. For that reason, they cannot disclose information about those ongoing enforcement efforts. Each of them will have an opportunity to explain why they are here and what they do in terms of payments system competition. Let's start with David.

**Mr. Teal:** I'll say at the outset that Canada has not had any cases involving interchange directly. This makes it a little bit challenging to prepare comments for this panel. Having heard the comments earlier, I think there is enough coming out of the Canadian experience that can provide some insight and some help in terms of the discussion that has taken place.

Canada—to our knowledge—is the only market that is still nondual. That was a decision made by the card companies, and it continues to this day. It has introduced some interesting dynamics in the Canadian market, and we heard some comments from Mr. Constantine on his views on the dual nature of markets.

In Canada, Visa is the largest issuer, followed by MasterCard. There is the debit card system, and we have representatives from the Interac Association, the dominant debit card system, here with us today. It is an on-line PIN-based card system. There is considerable membership overlap between the credit card associations and the debit card association, although they are not linked in any way other than through board membership.

In terms of duality, I want to make a couple of comments. This has prompted the card industry in Canada to take a look at the way they approach the market. MasterCard is the second-largest card issuer in Canada, and they have had to consider their approach to the market, given

the fact that they don't have duality to grow their card base. As a result, they have adopted a rather more aggressive approach, which is the best way to describe it in terms of membership criteria. They have also used interchange as a competitive tool to attract new membership. They have had notable success in this regard. They have converted one of the major retailer-based credit card systems—the Canadian Tire System—to a MasterCard-based system. They have also attracted Loblaws, which is one of our major grocery chains that have entered into the financial system, and they are now a MasterCard issuer. As well, MBNA, in making a decision as to with whom to go, has adopted the MasterCard network.

Turning to the other area, I thought I'd touch on a topic raised earlier—the Interac case. I should note that this is a case that goes back to 1990. It started around an issue involving fees. Interac requested an opinion from the Competition Bureau of Canada as to the impact of a fee increase. It surrounded their shared ATM network. We had a look at it. At the time, Interac was rolling out the debit card products, and we were concerned about the abuse issue that was embodied in their governance, membership rules, and fee structure.

We pursued the case. It was settled in 1996 with a consent order, which addressed each of those areas. At this point, the consent order has been amended three times, so it is a living document. I suspect this will come up more in the general discussion period.

*Mr. Friess:* I guess I sit here as one of those government officials, who, as Noah Hanft said, carry a MasterCard-brand card in their wallets, so I propose just speaking about Visa today and not MasterCard. I am going to tell you about the 2002 decision that the European Commission, as a European competition authority, took on the Visa cross-border European interchange fees.

Just one remark at the very beginning. We, the European Commission, are not and were not regulating the market; we were acting as a competition authority. That means we were looking at whether there was a competition problem in the market, and we are trying to resolve that problem in cooperation with the companies and the association concerned.

I would like to make three basic points about our decision. The first one: What was the competition problem identified? The second one: What were the basic efficiency justifications that the Commission recognized in Visa's interchange fees? And third, what was the remedy that Visa proposed and that we accepted?

The competition problem, as we analyzed it, was two-fold. First, interchange fee arrangements as collective agreements between banks, we felt, have a distorting effect on price competition in the downstream markets. They fix a very important cost component for acquirers, who pass it on to merchants, and therefore they fix the prices for the merchant discount rates in the acquiring market.

We found there were certain elements of lock-in for merchants because retailers typically find it cheaper with less loss of revenue to pass on these interchange fees as a small increase of retail prices than to leave or to abandon the Visa system. And we found that because data change fees were declared a business secret, retailers didn't have any information about the amount of the fee or about how it was constituted, and they were not effectively able to negotiate prices in that market.

The second distortion we identified was that there was an upward pressure on interchange fees. We heard about that earlier. When card networks compete for issuing bank customers, they do so by offering higher interchange fees rather than lower interchange fees, and in fact, we can see that, in Europe at least, interchange fees have risen over time and have done so constantly, unless, in individual instances, a regulator has intervened.

What were the basic efficiency justifications, on the other hand, that the Commission accepted? There were at least two. First, the Commission recognized that multilateral interchange agreements can be more efficient than a bilateral network of bilateral agreements between all member banks in a system.

Secondly, the Commission recognized that interchange can be what was called in an earlier discussion a kind of balancing tool between the various sides of a network. So, in other words, the Commission accepted that some kind of shifting of costs within the system can help reach the maximum average marginal utility of the card payment for each category of user in the system. But because of the difficulty of measuring that maximum average marginal utility, some acceptable proxy for that was to be found.

That leads me to the remedy that Visa proposed, and which at the time, the Commission found to be sufficient to give a clearance for the interchange fee agreement.

Before I describe the remedy, there are two important things to understand. First of all, European competition law requires not only that we have efficiencies in an agreement when we carry out our rule-of-reason examination, but also that we look at whether a fair share of the benefit of that deficiency is passed on to consumers and is passed on to the customers in

a relevant market. That is a very important criterion we have to meet.

Secondly, when we look at efficiencies and we look at justification of often *prima facie* restrictive agreements in our rule-of-reason approach, the burden of proof shifts to the defendant, shifts to the association of the parties to the agreement. So it was up to Visa to come up with a proposal, which they did, and it was up to us to check whether that proposal was sufficient to remedy the competition concern.

Now, very briefly, what was the proposal? Visa proposed an objective benchmark for the interchange fee based on the cost of services that issuing banks provide to acquiring banks for the benefit of merchants. This is in line with justifications that the two large networks have given us over many years, where they have been saying that essentially interchange fees are remuneration for services within the system.

Visa proposed—and we accepted—three different cost-cutting areas that were part of that benchmark: the cost of processing transactions, the cost of providing a payment guarantee for fraud and for cardholder default, and the cost of providing an interest-free period until the payment is settled. As a complementary remedy, Visa promised to relax the secrecy of their arrangements and to allow their banks to inform merchants about the cost components and the amount of the interchange fee.

What are the lessons we have learned from that and what is our thinking now? One thing that maybe was not intended but has happened is that the decision has set *de facto* an enforcement standard for other competition regulation authorities at the national level within the European Union. So what we see now is that—we heard about the Spanish competition authority previously—more and more national competition authorities in Europe are applying the same standard in their cases.

At the same time, we think we have to continue learning. Our own approach has to evolve. The implementation of such a cost-based remedy is not simple. There are lessons to be learned from that. We now better understand the variety of concerns about the competition between payment networks in the European market, and we observe, in particular, that the large networks seem to be trying to displace, to push aside, and to take over the many quite-efficient and low-cost debit card networks within the European Union. I think that is a public policy issue, and we realize that there are issues beyond interchange fees. If we think about price competition for merchants, then this is not only a matter of interchange fees; it can be a matter of other conditions of competition in card-acquiring markets. There are issues for competition authorities to look at, other possibly

restrictive rules of networks, and indeed we have been speaking to Visa and MasterCard for the last two years. Some of the rules that were in place two years ago are the rules on interchange fees that, in the meantime, have been removed and abolished by these two networks.

*Mr. Vickers:* Before I went to the Office of Fair Trading (OFT) in the United Kingdom, I worked for the central bank, the Bank of England, and of course, these central banks are monopolists. Indeed I was on the committee that set a monopoly price (the short-term interest rate) for a couple years. So this conference, where central banks meet antitrust, I thought was the most irresistible prospect. That was one reason why I very much wanted to be here.

Another reason is the Kansas City Fed is the most fantastic entrepreneur and host of conferences of this kind. I want to join others in expressing thanks and congratulations for this event.

The third reason is that this interchange topic is extraordinarily interesting and important. I say that from a European perspective, particularly in the United Kingdom, because the United Kingdom accounts for a very high proportion of European credit card transactions. The contrast with France, for example, is very stark. Credit cards, as a means of payment, are extremely important in the United Kingdom, relatively much more important than elsewhere in Europe. I was going to tell you how much money is involved, but I realized I am in America and even £100 billion doesn't sound like very much. By European standards, it is quite big stuff.

We do have ongoing proceedings involving MasterCard—that case began because MasterCard notified their then-arrangements—and with Visa. It would be wrong for me to talk about how those proceedings are going.

I did want to let you know, however, that I did not recognize Noah Hanft's description of our proceedings, and neither did I recognize, in my parochial U.K. context, the remarks about class-action lawyers and the remarks about economists and their motivations. Maybe I am not perceptive. Maybe things in the United Kingdom are different.

The paper I wrote, called "Public Policy and the Invisible Price," is being circulated. I realize the title is not going to be very popular with everybody in the room, but one reason I chose it was that the first question here is whether Adam Smith's invisible hand is going to guide the invisible price through the workings of normal competitive forces to a broadly sensible and efficient place.

That depends on many things. It depends very much on the factual situations and, as the opening paper for this conference showed, factual situations vary from place to place. My conclusion is that the invisible hand cannot be relied on in the factual situation we have in the United Kingdom. You cannot be sure that it will guide interchange fees by the major credit card associations in desirable ways.

I don't want to get into the economic discussion we had previously beyond saying that I think there are two quite important principles to have come out of this new literature. The first is whether there is differential intensity of competition—particularly price competition—as between the acquiring side and the issuing side. And the second is the question of what Rochet and Tirole called “merchant resistance”—the competitive interaction between merchants in different sectors and how that can affect the relationship between marginal merchant benefit and average merchant benefit. Those principles which come out of the literature are quite relevant, though.

One of the topics for this session is, if there is to be public policy intervention, how it would differ, as between regulatory approaches and competition-law approaches. I want to say a little bit about that.

Partly because we at the OFT have these live competition cases before us, I thought I'd talk about restaurants rather than credit cards for a moment, again following what Jean-Charles Rochet said. He wisely said that if the government intervened in the restaurant market to dictate how the bill should be split between a person hosting a dinner and a guest at that dinner, it would be a very unhappy form of government intervention. I am sure that is right on the facts there.

I don't want to suggest terribly strong analogies with credit cards, but if it was an association of restaurant owners who dictated how the bill was to be split between the host and the guest, then I think there might well be some questions. Shouldn't the government be interested then? Shouldn't competition law be doing something about it?

And you might be told, “There is a new literature showing that this is actually desirable, because it can be socially very embarrassing to decide how bills are split. It can expand demand for restaurants if this arrangement is in place.” Maybe arguments like that could be put forward.

But if one asked, “How is the bill split?” and was told, “The arrangement is that one party has to pay 180 percent of the bill and the other party gets a rebate of 80 percent of the bill,” then I think there might be further questions from a competition point of view. It is very different factually from

credit cards, but that is what one might have in mind if one pursued the restaurant example.

I mention that because, if we look at the structure of European competition law in cases to do with agreements, we have two broad questions. The first one: Is it anticompetitive? This is a question of law and fact. If it is, then the burden of proof shifts, and the question is whether the arrangements or the agreements bring benefits in ways that benefit consumers, don't contain clauses that are not indispensable to the bringing of those benefits, and don't eliminate competition.

In the paper, I do talk a little bit about this question of whether an interchange fee has the effect of putting on one side of the market not just all the costs of the payments system services and of completing the transaction satisfactorily, but indeed more than all the costs. It seems to me that is an interesting benchmark. It is not dispositive of any case, of course, but it is an interesting benchmark.

One might take the view that there should be complete freedom to divide the dinner bill, as it were, anywhere between zero and 100 percent. Beyond those bounds, the burden of proof should be on those who would want to go further. That seems to me entirely respectful of the recent economic literature, because it is a point about the burden of proof. It is not a point about tight caps and lids, so there would be room for further argument about elasticities and so forth. It would require evidence and proof, but with the burden shifted in that way.

Just to take a different example from the competition arena, suppose people come along to us with a three-to-two merger in some industry, and they claim tremendous efficiency gains. If they say, "Here is some theoretical literature that shows you shouldn't worry about it," we'd say, "Well, prove it."

There may be a similar architecture of the argument on the application of competition law to four-party credit card schemes, at least in Europe. You can criticize that approach as being far too regulatory. You also can criticize that approach as being far too liberal. Maybe the baseline should be at par. Why should there be any collective cost-shifting at all? The approach is one where points can be made for and against it in both directions.

Finally, regulation versus competition is one of the issues here. Regulation, as distinct from competition, will need a separate law or regulatory body, whether it is a central bank, competition agency, or some other body, to apply it. It may be a much more direct process than competition proceedings. It may have less scope for challenge than there is

in competition proceedings. It is very important to a U.S. audience to stress that in Europe, competition law isn't necessarily enforced by agencies bringing a case to court.

We in the United Kingdom take decisions, which are then subject to a full-merits appeal. Those appeals can be from either side and, indeed, our track record in the relatively early days of U.K. competition law is that all of our interventions have been substantively upheld on appeal. A number of our noninterventions have gone down. That's a point in which some people might be interested.

The other point is with full-merits appeal, not just judicial review, the review tribunal can impose its own decision. It has the power to do that, though on occasions, it has referred matters back to us. In the spirit of "Let's get Real," let's understand European competition law and how it operates.

Competition law also allows for self-assessment. That is particularly important in the last year or so, because the notification system for agreements, which Visa and MasterCard in Brussels and elsewhere have employed in the past, has now gone. Objective self-assessment of where organizations and their responsibilities stand in relation to the law, I think, is extremely important, not just for businesses, but in this sphere. It may be a very important question for central banks to keep an eye on too.

*Ms. Hesse:* I was thinking a little bit when we were talking earlier about what the role of competition law is. We've been hearing a lot about regulation and regulators and what regulators should do. One of the things I wanted to talk about is the fact that we at the Department of Justice, at least, don't really think of ourselves as regulators. We don't tend to think of solutions to marketplace problems that result in government regulation over long periods of time.

You can point to certain cases that people know about (not in the payments network area) where we do a lot of regulation, but by and large, we believe that businesspeople know how to run their businesses better than we do. We try to address competition problems as they arise and resolve them in ways that keep us out of it to the greatest extent possible.

In that framework, when people here talk about keeping regulators out and how regulators shouldn't be involved in setting interchange, I have to say that, thinking of myself as a regulator, I agree. I don't think you would be finding the antitrust division with a lot of interest in going out into the marketplace and saying, "We are going to decide what the right interchange rate is or the right switch fee that networks should be charging to merchants."



The large reason for that (and the guiding force for us) is that competition and healthily functioning competitive markets do the job pretty well. What we try to do is preserve competition in marketplaces. I'll talk quickly about a couple of cases, which we have done recently, somewhat in response to Lloyd Constantine's comment that we were asleep at the switch.

We've had two relatively significant cases in the payments network area recently. First was the U.S. Visa case, of which all of you seem to be quite aware. Then in 2003, we sued to enjoin a merger between First Data and Concord, which was related to the PIN debit network services market.

In the Visa case, as all of you know, we were recently reaffirmed by the Second Circuit and the cert. petition was denied. Now I occasionally get an MBNA offer for an American Express card in the mail. I think that is pretty cool, because as a cardholder and a consumer, that says to me that I have another choice for a bank-issued credit card. And that is really the preservation of choice in the marketplace. Bringing to people four bank-issued credit cards, as opposed to two previously, we think, is a positive thing. We think it is going to be a positive thing for merchants. We think it is going to be a positive thing for consumers. And overall, we think it is going to be good for innovation and prices in the market for general-purpose card services.

In the First Data-Concord case, the case was settled virtually on the day we were supposed to begin trial, with First Data's agreeing to divest its NYCE network. The merger was about merging the Star and NYCE PIN debit networks, which were two of the three largest PIN debit networks in the United States. We looked at the deal and saw that the combined firm would control—with Visa's Interlink—about 80 percent of PIN debit network transactions that flow from merchant point-of-sale terminals in the United States.

That looks like a pretty concentrated market to us. Generally, we think that it gets close to looking like a duopoly. Unless somebody comes up with a really good explanation why the duopoly is going to be more efficient and bring better prices, services, and products to consumers, we look at three-to-two mergers generally as not positive things for the marketplace, since they typically don't bring good things to consumers.

What do those two cases tell you? First, again in response to Lloyd's comment, I think we have been doing a fair amount. These are antitrust markets, since we believe credit and debit are clearly different markets. In the First Data-Concord case, we thought there was substantial evidence to support a PIN debit market, as opposed to a signature debit market. We think these

markets are very important. In fact, they are vital to the U.S. economy.

All of you know how having credit cards and debit cards have changed how you transact business, both through the Internet and retail. Now you can go into a Starbucks, hand them your Visa card, and buy your \$3 cup of coffee with a credit card instead of having to use cash. It increases convenience for all of us, so these cards are incredibly important to the U.S. economy. We pay a lot of attention to them for that reason.

Secondly, we do believe these markets tend to be fairly concentrated. There are not that many people who are offering services to consumers on the credit side and on the debit side. You will be able to count on us, particularly if you are seeing a merger in a payment market, looking at deals pretty closely. It is just for the reason I mentioned before, which is that our role is to preserve competition in the marketplace. If we see a transaction that looks like it is going to cause greater concentration in one of these markets, we are going to look at it very hard. We are going to expect the merging parties to be able to give us substantial, credible evidence that the merger is going to bring better prices and better products to consumers in order for us to begin to contemplate approving it.

Thirdly and finally, we are not the cure-all. As I was saying, we address relatively narrow issues as they come to us, either through merger transactions or through complaints when we become aware of conduct. I have been talking a lot about mergers, but obviously we also look at conduct issues. We address these problems as they come to us and in the context they come to us.

You are unlikely to see us taking on a project of overhauling an entire market in the way that it functions, unless for some reason a particular competitive issue dictates that result. You are also going to see us coming up with pretty narrow structural remedies for whatever the competitive problem we found is, because again, we do think our role in the marketplace is to keep markets functioning in a healthy way, and again, we don't believe that we are as good at running these businesses as most business-people are.