

Remarks on Interchange Fees: Central Bank Perspectives and Options

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Let me say a few things about the payments system and the question of interchange fees in Mexico. Mexico is a relevant case, not because the market is so big—and I am going to provide some numbers regarding the size and the characteristics of the market—but because I believe we are the first emerging market to be actively involved in the analysis of payment card regulation. Of course, the precedent of what we do will be important, and this has attracted a great deal of interest on the part of the industry.

First, I will go through how we got involved in this. Then, I will make a diagnosis of how things are developing. I will talk about the steps we have taken so far, and, finally, I will mention some of the preliminary lessons we have learned.

One of the Bank of Mexico's mandates, like many other central banks, is to seek the proper functioning of payments systems, so we initially got involved in the development of high-value payments systems. In fact, we played a central role in developing an electronic large-value payments system, a delivery-versus-payment clearing mechanism, and a nationwide clearinghouse for checks.

Regarding retail payments, our participation, until recently, was concentrated in developing a retail electronic system to allow payments in real time between bank account holders.¹ We have developed a platform that is big and powerful enough to do low-value payments at very, very small cost in real time. In fact, we are starting with this already.

The reason why we became more involved in other aspects of retail payments systems is that the Mexican congress passed a law last year in reaction to continuous complaints about the level of bank commissions, particularly those related to retail payments systems.² There is a widespread public perception that banks' commissions are too high. Those commissions pertain not only to fees charged on checks, payments, and so on, but

also to credit card fees. Of course, interchange fees play a very important role here.

Let me give a few numbers and talk about the situation in the payment card industry in Mexico. The main thing to keep in mind is that Mexico is still a very *undercarded* country. Most retail payments are still done with cash and checks. Now that we have a platform for electronic transfers at very low cost, we expect this to change rapidly.

The total number of cards in Mexico, although small, has been growing extremely fast. The number of credit cards has doubled from 2001 to 2004, and debit cards have been increasing over 20 percent per year in the last few years. Despite this, the use of cards at points of sale (POS) is limited when compared with countries of similar development.

I don't want to go into a lot of detail with the numbers, but there are two or three basic things that we have noticed in looking at international comparisons.

One is that debit cards in Mexico are mostly utilized at ATMs for drawing cash. Also, the number of POS is low and the number of payment card transactions at POS is relatively limited. We have a general perception that the level of interchange fees in Mexico is high in international comparisons—even though I know it is very difficult to perform such comparisons—so we suspect that the high level of interchange fees has something to do with this situation.

Additionally, we noticed there are important entry barriers for nonbanks in the payment card industry. Card associations are not allowing non-issuers to participate in the acquiring business, and only banks are allowed to join the switches. The problem that we face goes far beyond the narrow question of interchange fees. It is a question of market structure, which is heavily concentrated in Mexico, both on the issuing and acquiring sides. It is a question of transparency. And it is a question of competition.

We look at this question of interchange fees as one aspect of the whole problem of developing a more competitive banking sector. Through interchange fees, all banks are interconnected for the provision of card-payment services. This is organized around interchange fees charged on many different services, including credit and debit cards.

It is worth mentioning that interchange fees in Mexico are not determined by a platform of card associations, as in the majority of countries, but rather by banks through the Mexican banking association. The mechanism followed by banks to set interchange fees is known only to them. All banks are subject to the same interchange fee structure, but they are free to set their own merchant discount rates. Issuers are also free to set cardholders' benefits and commissions.

Until very recently, the interchange fee structure in Mexico was characterized by the same proportional interchange fee schedule for credit and debit card transactions at small merchants, which, of course, is odd because there is a lot of risk associated with credit cards that is not involved in debit card purchases.³

The same interchange fee schedule applies to all platforms. Therefore, there is no competition between them in terms of interchange fees.

Also, interchange fees are based on merchants' volume of sales, rather than on the line of business. There is a strong discrimination of merchants that lack bargaining power.

The general perception was that the level of interchange fees was high for international standards, in particular those applied to debit transactions carried out by small merchants.

Finally, interchange fees have remained fixed for the last five years, despite the huge increase in the volume of transactions and the clear evidence that cost related to issuing had come down quite sharply in the last years.

From this very brief overview, it can be inferred that there is a general perception that consumers' commissions are high, that the card market is very concentrated on both issuing and acquiring sides, and despite recent growth in electronic payments—including debit and credit cards—the payment card industry is still underdeveloped. There is also an imbalance, as I mentioned before, between the number of POS and the number of cards and between the number of debit cards and the frequency of their use at POS.

When the laws were passed last year, we at the bank saw an opportunity to launch a real reform of the retail payments system. The general goal should be, of course, to increase disclosure and transparency in order to foster competition and to encourage the use of more efficient payments systems.

A point was made earlier regarding competition and regulation, which was what should the authority do and what the role of the central bank should be in this matter. The Mexican congress took a very pragmatic approach, because it gave the Bank of Mexico the power to regulate all payments systems, which includes interchange fees. Of course, the competition commission is ultimately charged with determining whether a system is competitive or not. The competition commission can act on its own behalf if there are complaints regarding the structure of competition. But we can proceed on our own if we perceive that a payments system is not operating efficiently.

Let me explain what we have been doing so far. I repeat, the objectives of the regulation are increasing transparency in order to foster competition

and encouraging the use of more efficient payments systems.

Some strange things occur in Mexico. When we get together with the banks, they say, “We are on the same wavelength as you. We also want to encourage the use of more efficient payments systems.”

But if you look at the fees’ structure in one specific market segment, for instance checks versus electronic payments, the price structure that was prevailing was not encouraging the use of electronic transfers at all. So we got together with the bank association, we told them what we saw, and they recognized that there was something wrong there. Hence, they have agreed to revise their fee schedules. Despite these imbalances in fee schedules, the more general point—and I will come back to this later—is that we are not keen on regulating prices at the Bank of Mexico.

Getting back to what we have done, we got together with the banks and made a general proposal to them to overhaul the retail payments systems, which included the regulation of some prices. Of course, we got a very strong reaction from the banks and the industry. Therefore, we went back and said, “Let’s analyze each retail payment independently. Let’s analyze electronic transfers, ATMs, debit cards, and credit cards, and take each a step at a time.”

Then we asked a commission from the International Monetary Fund (IMF), comprised of experts from Australia, the Netherlands, and so on, to advise us. We had a first diagnosis of the retail payments system in Mexico, and then we started a dialogue with the banks that has already produced some tangible results. It was mentioned before that in Australia this *voluntary* approach was not paying off. In our case, this *induced* voluntary approach is producing a better reaction on the part of the industry.

As a consequence of this interaction, in the middle of 2004, we issued regulations to improve transparency and competition. The regulation required banks to disclose their fees to customers and to inform the Bank of Mexico in advance of any changes in their commissions. We also made it compulsory for banks to allow the payments of credit balances through electronic transfers from any other bank.

We are studying additional measures to promote competition. For instance, we are analyzing eliminating restrictions on banks and nonbanks for entering the acquiring market. This is something quite important that the IMF mission pointed out to us.

We realize that it is not only the structure of fees, but the competitive structure that is lacking there. We need more industry participants. We need more participants on the acquiring side, hopefully nonbanks, and we

also need more participants on the issuers side, hopefully also nonbanks. We are looking at these issues right now.

In order to enhance the use of more efficient systems, the Bank of Mexico made the honor-all-cards rule more flexible to allow the possibility of merchants accepting only debit cards. We are also promoting very, very keenly the adoption of chipknip technology, to hamper fraud and, thus, further reduce interchange fees.

A related issue is that we are coordinating with the Ministry of Finance, which is engaged in a large program to subsidize the installment of POS, for tax transparency purposes. The adoption of this chipknip technology, together with the effort of the treasury to have most of the transactions done by cards, is our goal for a potentially very large development, particularly of debit cards.

Let me report what has happened since we took the steps that I mentioned. We have been having meetings with the industry regularly and have agreed to form a working group in which the banks will disclose the mechanism of setting the interchange fees and provide the Bank of Mexico a detailed cost structure, which are two elements, of course, that are important for this discussion.

Second, the banks have agreed unilaterally to reduce interbank fees substantially. They have already decreased the interchange fees for credit cards by 43 basis points and 134 basis points for debit cards, making debit cheaper, as it should be. Additionally, the bank association eliminated the highest bracket for proportional interchange fees and introduced several special categories based on retailers' line of business, increasing the system efficiency.

The Australian experience made evident that interchange fee reductions may not translate entirely into lower discount fees. This is a problem we are looking at. It also showed that cardholders' benefits may go down when a reduction in interchange fees takes place. It is too recent to judge the impact of these first steps in Mexico, but the banks have pretty much agreed together that the reduction of interchange fees will actually translate into an equivalent reduction in discount rates.

Let me conclude by discussing briefly some of the lessons that we have learned. The lessons, of course, are very much in the spirit of what we have heard earlier.

One is that interchange fee regulation is very complex, particularly because it is not obvious what the socially optimal fee should be.

Secondly, once financial authorities are convinced that interchange fees have to be shifted in a particular direction, it is better to do so through

cooperation with industry participants. However, having a credible regulatory threat helps to keep all participants honest.

Thirdly, for interchange fee reduction to have an impact, authorities must have a mechanism to make sure that such reductions will be translated into lower discount rates.

Fourthly, central banks need to increase the resources directed to these areas, given their growing importance and complexity. In particular, we should devote resources to empirical research.

Finally, authorities have to be aware that promoting and improving efficiency in retail payments systems is a long-run, continuous process.

As Tom Hoenig was saying, we don't have to wait for an economic theory to produce general results that are applicable to policy decisions on a general basis. If we know, or we have high suspicions, that the industry is heavily concentrated, that there are barriers to entry, that commissions are too high, etc., without fixing prices, we can move in the right direction. We don't know exactly what the level of fees should be, but we know they should probably be lower just by looking at the data.

So we tell the banks, "I hate writing regulations. It is one of the most boring things that a central banker can do. If you don't want me to write these things, you do it on your own. Go back to the table and look at your own fee structures. These are the objectives that we have, and we want to do it on a cooperative basis. If you don't come up with something that makes sense to us, then we will have to sit down and write all these regulations, which puts us in a very bad mood."

ENDNOTES

¹SPEI.

²Law for the Transparency and Reordering of the Financial Services, issued in January 2004.

³Regarding transactions carried out at POS, there were and still are two interchange fee schedules for debit transactions and one for credit. In the case of transactions performed with credit cards, the scale is proportional (*ad valorem*). In the case of debit transactions, the first scale is proportional and is exactly the same used for credit sales; this is applied to transactions carried out at rather small merchants that do not belong to the Association of Self-service and Department Stores (ANTAD). The second debit scale is a set of fixed fees (nonproportional), applied only to transactions performed at ANTAD merchants.