Draft regulation on interchange fees: what's in it for consumers?

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DRAFT REGULATION ON INTERCHANGE FEES: WHAT'S IN IT FOR CONSUMERS?

EU member states and the European Parliament would do well to draw on lessons learned from countries where interchange fees have been regulated. **Andrea De Matteis** discusses draft regulation on interchange fees and digs deeper

On 24 July 2013, the European Commission published a proposal to regulate interchange fees for card-based payment transactions (the "Regulation"). On the same date, the commission published a proposal to revise the Payment Service Directive (the "PSD2").

This legislative package follows a public consultation on the Green Paper "Towards an integrated European market for cards, internet and mobile payments", which the commission opened on 11 January 2012. The Regulation and the PSD2 are accompanied by an Impact Assessment on their expected effects on the EU payment industry. According to the European Central Bank, this industry represents more than 1 percent of the EU GDP, *i.e.*, 130 billion euros per year.

What's in it for consumers? This article answers that question by giving an overview of the reforms proposed by the commission, focusing on the caps at the level of interchange fees ("IF") for payment card transactions, the background behind the proposed caps, as well as insight into their hoped for benefits and unintended consequences for consumers and society. It also outlines some thoughts on the valuable lessons that may be learned from countries where IF have been regulated.

1. Overview of the proposed reforms

The Regulation provides for caps at the level of IF for payment card transactions. IF are the fees paid by an acquirer (*i.e.*, the bank or payment service provider of a merchant) to the issuer (*i.e.*, the bank or payment service provider of the cardholder) for each transaction, to compensate the issuer for the services it provides to the merchant in each transaction. In a two-sided business like the card payment business, card schemes balance the interests of both sides, merchants and cardholders, so that each party pays its fair share of the costs for the benefits it receives. This is done through the IF, which "balances" the scheme by ensuring that merchants pay their share for the benefits they receive from accepting cards.

Merchants receive a wide variety of benefits from card acceptance, including more customers, higher sales per customer, the ability to make sales via the Internet, reduced costs of cash (e.g., cost of handling, theft, loss, counterfeit), quicker check out, automated point of sales, etc. In addition, the merchant is guaranteed payment when accepting cards – the merchant gets paid even if the cardholder fails to pay for the transaction. The bulk of these merchant benefits are provided by issuers. The IF provides revenues to issuers for the services and benefits they provide to merchants.

Without the IF (or if the IF is set too low) merchants extract value from the scheme without paying for it and the scheme is imbalanced as a result. As discussed below, this imbalance results in consumers paying more in fees (or receiving fewer benefits) to compensate for the value merchants extract without paying any compensation.

Card schemes set IF at levels that maximize acceptance by merchants and issuance to cardholders, thereby maximizing

the output of the scheme. This is achieved by setting IF at levels that minimize the cost merchants incur to accept the cards while simultaneously keeping the levels high enough to ensure that the cost to cardholders is contained at the level that maximizes the number of cardholders willing to carry and use the card.

The Regulation sets IF caps at 0.2 percent of the value of the transaction for debit cards and 0.3 percent for credit cards. These caps will apply only to consumer cards, which represent the vast majority of cards in the EU. The caps will not apply to commercial cards (*i.e.*, cards that are issued to undertakings, public entities and self-employed persons, and are used for business expenses) and cards issued and acquired by three-party schemes such as American Express. The IF caps will apply to three-party schemes only to the extent that they use payment service providers as issuers or acquirers, thus operating as four-party schemes.

The IF caps would be introduced in two stages: (1) two months following the date the Regulation becomes effective, the caps will apply to cross-border transactions as well as cross-border acquired (domestic) transactions; (2) after two years, the caps will also apply to domestic transactions, *i.e.*, transactions where the issuer and the acquirer are established in the same member state. Member states will be permitted to maintain or introduce lower caps through national legislation.

The caps indicated above will also apply to any other "net compensation" received by an issuer from a card scheme in relation to IF capped transactions. This is intended to avoid card schemes circumventing the caps by providing issuers with financial incentives beyond the levels set by the caps.

While the focus of this article is on the IF caps, the proposed reforms also set a number of mandated rules related to card payments:

- *Cross-border acquiring and issuing*. Any restrictions in card scheme rules or licensing agreements preventing acquirers or issuers from doing business cross-border will be prohibited. This provision is aimed at facilitating cross-border acquiring and issuing.

- *Separation of scheme and processing*. Card schemes will be obliged to keep separate scheme and processing entities, and to deal with their processing entities at arm's length so as to avoid any discrimination between their processing activities and third party processors. Payment schemes will not be allowed to bundle brand and processing services. This measure aims to allow third-party processors to compete for customers of card schemes.

- *Co-badging*. Issuers will have the right to co-badge cards (or other devices) with competing payment brands. Card schemes will be prohibited from imposing any fees for the use of a competing payment brand on the co-badged card.

- *Unblending*. Acquirers will be obliged to offer merchants separate merchant service charges ("MSC") for different categories and brands of cards. Blended MSC will be allowed only if merchants request them in writing. Acquirers will also be required to outline upfront to the merchant the composition of the MSC, *i.e.*, how much of it is composed of IF, scheme fees – and therefore their margin.

- *Honour All Cards Rule ("HACR")*. The HACR will be limited. Card schemes will be able to provide that cards may not be refused on the basis of the identity of the issuer. However, merchants will be allowed to refuse cards not "subject to the same regulated interchange fees", *i.e.*, commercial cards and cards issued and acquired by three-party schemes.

- *Steering*. Merchants will be allowed to steer cardholders towards the merchants' preferred payment method. The commission intends to permit cardholders to have the choice of which payment brand to use on a co-badged card. It is not clear how this would be workable in real world applications.

- *Surcharge*. Surcharges (*i.e.*, the extra charge imposed by some merchants for card payments) on consumer debit and credit cards subject to IF caps will be prohibited. Surcharges for cards not subject to IF caps will be allowed; however, surcharges may not exceed the cost borne by the merchant for the use of payment cards.[1]

- *Transparency*. Acquirers will be obliged to provide merchants periodically with information on transactions amounts and the amount of any charges, indicating separately the IF amount.

It is unclear when the proposed Regulation will be adopted by the European Parliament and the Council. It is in particular not certain if it will be adopted before the European Parliament elections of May 2014.

2. Background of the IF caps: regulation vs. antitrust enforcement

The main reason that the commission has proposed regulation to reduce IF is that the commission believes market based IF is too high and the commission's effort to reduce IF through antitrust enforcement has, to a large extent, failed. The commission has recognized this failure in its Impact Assessment accompanying the proposed reforms.[2] The commission blames differences in national timelines and procedures as well as fragmented enforcement for this failure.

However, there are probably more reasons that have undermined a uniform and coherent application of competition law.

The first reason is that there is considerable debate regarding the commission's conclusion that IF is too high. For example, growing numbers of consumer organizations contest this point of view and have expressed concern that regulated IF will impose higher costs on consumers. Even the commission has taken different views over time and national competition authorities ("NCAs") have followed diverging and often conflicting approaches. The uncertainty on this point is seen in the commission's continuously transforming approach to IF over the past two decades.

Initially, the commission (DG Comp) considered that no antitrust action was needed and dismissed complaints brought by merchants against IF. Then, the commission considered IF as compliant with the competition rules, provided that they were based on issuing costs. Issuing costs methodologies were developed by card schemes following this approach (see *Visa* decision of 2002).[3]

In a two-sided market like the payment market, card schemes balance the interests of both sides so each pays its fair share

In recent years, as lobbying by merchants in Europe and throughout the world intensified, the commission replaced the issuing costs methodology and embraced a new and untested methodology, the so-called "tourist test" or Merchant Indifference Test ("MIT"; see MasterCard's Undertakings of 2009[4]). The IF that meets this test is set at such a level that the MSC paid by the merchant is at the same level as the "avoidable" cost of cash to the merchant. In other words, the commission seeks to set the IF at the level at which the merchant is "indifferent" as to whether s/he receives a card or cash payment. However, there is no reliable and accurate data at hand to apply this methodology and studies of the commission toward this end are still ongoing[5] (despite the absence of reliable data, the commission argues in its proposed Regulation that the 0.2/0.3 percent caps are set on the basis of the MIT). It is not surprising that the MIT is a controversial tool for setting IF in that it focuses solely on the merchants' indifference and excludes consideration of consumer interests in a properly set IF. Since any IF impacts consumers and merchants at the same time, it is likely that the MIT will continue to attract considerable criticism even if reliable data is obtained to ensure merchant "indifference."

The approach of certain NCAs that have opened cases in relation to IF has been modeled following the commission's approach. They first endorsed an issuing costs methodology. For example, the Bank of Italy (Banca d'Italia) in 2004 cleared the IF of the Italian domestic scheme PagoBANCOMAT on the basis of issuer costs plus a 10 percent margin.[6] Then, they adjusted their approach to that taken by the European commission and started requiring adherence to the MIT. For example, the Italian Competition Authority (Autorità Garante della Concorrenza e del Mercato) in 2010 approved the IF of PagoBANCOMAT on the basis of an issuing costs methodology for a transitory period after which the MIT would apply.[7]

Conflicting methodologies and approaches have significantly limited the ability of NCAs to coherently apply competition law. This has also prevented new pan-European schemes – such as Monnet – from developing detailed business plans and eventually entering the market. Indeed, IF regulation that essentially requires a payment scheme to provide benefits to merchants without compensation to the issuers that generate those benefits is likely to impede new schemes from entering the market.

The second reason antitrust enforcement has failed is that, by seeking to apply the cartel provisions under the Treaty to IF, the commission was attacking an essential feature of a well-established business model that has proved beneficial to the development of the payments industry in Europe and in the rest of the world.

As stated above, card schemes set IF at a level that maximizes acceptance by merchants and issuance to cardholders, thereby maximizing the output of the scheme. The commission has met understandable resistance from card schemes when trying to significantly constrain their ability to do so.

This resistance has put in question the commission's recent approach through litigation both at the EU and at the individual member state level. At the EU level, although the General Court has recently fully endorsed the commission's approach[8], an appeal by MasterCard is still pending before the Court of Justice. At the hearing before the Court of Justice on 4 July 2013, questions posed to the commission's lawyers raised serious doubts as to whether MasterCard qualifies as an "association of undertakings" under the cartel provisions of the Treaty, which is the legal basis of the commission's enforcement action.[9] At the member states level, some domestic courts have quashed infringements decisions adopted by the NCAs against IF (*e.g.*, in the United Kingdom,[10] Italy,[11] and Poland[12]).

3. What will be the impact on consumers?

The rationale behind the commission's proposed IF caps is that they will enhance consumer welfare: if IF are capped, MSCs will drop, and merchants will pass on this MSC reduction to consumers through reduced retail prices.

This measure has sparked an intense debate regarding its actual effect on consumers and the EU payment industry.

In a two-sided business like the card payment business, if revenues from merchants are reduced due to decreased IF, issuers need to increase revenues from cardholders (or reduce cardholder benefits) to compensate for the revenue losses.

This is demonstrated by experience from countries like Australia, Spain and the United States, where IF were reduced. In each case, following a mandated reduction of IF, cards become more expensive for consumers as issuers charge higher consumer fees to make up for the revenue lost when merchants no longer pay for the benefits they receive. This experience also shows that any reduction in costs to merchants is not passed on by merchants to consumers in any noticeable reduction in retail prices.

Several consumer associations are concerned that the proposed IF caps will result in higher costs and reduced benefits for cardholders. The Impact Assessment states that "there is a risk that consumers face increased card issuing and maintenance fees by [issuers] that compensate for reduced revenues from MIFs."[13] Commissioner Barnier himself stated in a letter of 25 June 2013 that cardholder fees have been increasing in Spain, as well as in other countries where IF were regulated, such as France and Denmark.[14]

The Regulation has triggered intense debate regarding its unintended consequences for the European payment market

In Spain, from 2006 to 2010, IF were reduced by almost 60 percent. Cardholder fees increased by 50 percent. More specifically, cardholder fees increased from 22.9 to 34.3 euros for credit cards and from 11.1 to 17.3 euros for debit cards. In this way, savings of 2.75 billion euros for merchants corresponded to cardholder fee increases of 2.35 billion euros.

This problem is compounded by the fact in countries where IF have been reduced, there is no evidence that retail prices have decreased. The Impact Assessment recognizes that "[i]solating visible retail price decreases resulting from a cap on interchange fees is […] likely to be difficult."[15]

In perfectly competitive markets, the reduction of an input cost would in theory be passed onto the consumer. In reality, if profits are under pressure, merchants can be expected to increase their profits rather than passing these savings on to consumers.[16]

Another reason IF caps may not result in decreased retail prices is that the Regulation caps IF, not the MSC paid by the merchant to its acquirer. The largest merchants, which have more negotiating powers with their acquirers and operate with so-called "interchange fee plus arrangements", are most likely to see decreased MSC. Smaller merchants are not likely to benefit to the same extent from the reductions.

4. The wider policy perspective: impact on tax revenues and innovation

Data from Australia, Spain and the United States has shown that forced reductions of IF can inhibit, rather than encourage, the growth in electronic payments. Data from Spain, for example, demonstrates that the reduction of IF has not resulted in more card transactions (in lieu of cash).

This is because consumers, when facing increased cardholder fees, find it cheaper to use cash. Price elasticity between consumer demand for cards and their price is very high, significantly higher than the elasticity between those of merchants, for which MSC are a deductible expense.

This has harmful implications for all those member states that are fighting against the shadow economy in order to increase tax revenues. It is widely recognized that electronic payments reduce the shadow economy and increase tax revenues. In times of crisis, governments seek to increase tax revenues by resorting to measures to increase electronic payments.

Regulation of the level of IF also has an impact on security and innovation. If revenues for card payments are reduced, issuers will not be in a position to invest in costly innovations like mobile payments, electronic wallets, contactless technology or increased security.

For example, with contactless technologies, the break-even point for the adoption by issuers of this new and innovative technology is extended as the revenues and margins decrease. The problem is exacerbated by the fact that, as a result of the IF caps, card schemes will find it more difficult to offer lower IF for low value transactions to provide incentive for the use of contactless technology, since doing so would further decrease the issuers' revenues. IF caps may, in fact, delay diffusion of contactless technology.

Domestic schemes will find it more difficult to invest in the offering of card-not-present capability for their cards in e-commerce environments. The same is true for security standards. The creation and diffusion in Europe of the more secure and advanced EMV standard for chip cards was possible because it was supported by a sustainable business model.

5. Impact on competition among all players

Ensuring a level playing field for all players active in Europe is one of the commission's priorities for the proposed reforms.

However, the IF caps only apply to four-party schemes such as MasterCard, Visa and the domestic four-party schemes (*e.g.*, Cartes Bancaires, PagoBANCOMAT, Bancontact-Mister Cash, Multibanco, ec-giro, etc.), while they do not cover three-party schemes such as American Express (which typically is more expensive for merchants) and PayPal.[17]

The commission has considered it appropriate to exclude three-party schemes from the IF caps (except when an issuer or acquirer is involved in the transaction) because they have limited market shares in the EU and different fee structures than four-party schemes, and this would have made it more complicated to uniformly regulate them.

However, as recognized by the commission on several occasions,[18] even "pure" three-party schemes work with an IF, albeit an "implicit" IF.

The exclusion of this implicit IF from the application of the caps raises serious concerns for the efficacy of the Regulation. Despite the commission's claimed goal of ensuring a fairly high level of market competition, in fact, the proposed Regulation does not create a level playing field among competitors.

The exclusion of three-party schemes from the application of the Regulation will drive consumers toward three-party schemes, thus impairing competition. Three-party schemes will be allowed to keep their existing cardholder fees and benefits, while issuers of four-party scheme cards will not be able to continue to provide the same level of services and cardholders fees to their customers. This is what happened, for example, in Australia, which saw a noticeable increase in market share of three-party schemes. Merchants will not benefit either given the fact that a three-party scheme (*e.g.*, American Express) transaction is generally more expensive to them than a four-party scheme transaction.

Conclusion

The proposed Regulation has triggered an intense debate regarding its unintended consequences for the European payment industry. Experience from other countries shows that there is a high risk that consumers will be harmed by the IF caps.

The proposed IF caps do not take into account the different state of development of card payments in each member state. In many EU countries, consumers do not use cards on a regular basis. Particularly for these countries, it would be more effective to provide incentives to consumers to use payment cards and therefore maintain higher IF. In fact, some member states have already expressed their opposition to the caps proposed by the commission because they want to retain the freedom to set domestic IF at levels higher than those proposed by the commission.

In addition, the proposed caps significantly undervalue the benefits merchants receive from accepting payment cards. Larger merchants will surely benefit in the short run from the Regulation as they are likely to see reduced costs. These reduced costs come at a price, however if they impede innovation and the shared objective of increasing use of electronic payments. Moreover, smaller merchants may very well fall further behind in their efforts to compete with larger merchants as the small will not see the same cost reductions as the large.

It remains to be seen whether, as a result of the intense debate regarding the proposed Regulation, changes will be made to the currently proposed draft to preserve consumer welfare and the ability of the European payment industry to continue to innovate and remain competitive. ■

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Footnotes

1 This wording is in line with Article 19 of Directive 2011/83/EU of 25 October 2011 on consumer rights (Consumer Rights Directive or CRD).

2 Impact Assessment, pp. 22-28.

3 European Commission's decision of 24 July 2002 in Case COMP/29.373 – *Visa International – Multilateral Interchange Fee.*

4 MEMO/09/143 of 1 April 2009.

5 Invitation to tender COMP/2008/D1/020 – study on "Costs and benefits to merchants of accepting different payment methods" and invitation to tender COMP/2012/003 – "Survey of merchants' costs of processing cash and card payments".

6 Bank of Italy's Decision n. 49 of 1 July 2004 in Case I624 – *PAGOBANCOMAT*.

7 ICA's Decision n. 21614 of 30 September 2010 in Case I724 – *COMMISSIONE INTERBANCARIA PAGOBANCOMAT.*

8 Judgment of the General Court of 24 May 2012 in Case T-111/08 – MasterCard Inc and Others v Commission.

9 See MLex article "MasterCard defends card-fee legitimacy before EU courts" of 4 July 2013.

10 Judgment of the Competition Appeal Tribunal (CAT) of 10 July 2006 [2006] CAT 14.

11 Judgment of the Administrative Court of Lazio n. 6171 of 11 July 2011.

12 Judgment of the Court of Appeals in Warsaw of 22 April 2010 – *Interchange fee* (Ref. No. VI ACa 607/09).

13 Impact Assessment, p. 78.

14 Letter of 25 June 2013 to Mr. Longo:" You refer to the Spanish market, where, according to one study financed by MasterCard, a reduction of MIFs has allegedly led to higher payment costs for consumers. Other studies on the payments market in Spain suggest that a lack of true competition between Spanish banks could be the main reason behind the observed price increases". Increases of fees for consumers in France and Denmark are noted but considered "little or negligible".

15 Impact Assessment, p. 55.

16 It is worth noting that, even in a competitive industry such as airline travels, companies such as Ryanair choose to impose extra-charges on consumers for card payments, and thereby generate incremental revenues.

17 The IF caps proposed for four-party schemes will apply to three-party schemes only to the extent that they use payment service providers as issuers or acquirers, being substantially similar in their functioning to four-party schemes.

18 Commission's Green Paper "Towards an integrated European market for card, internet and mobile payments", paragraph 4.1.1: "Three-party schemes – under which there is only one PSP servicing both payers and payees – apply an 'implicit' interchange fee that may raise similar issues of lack of competitive constraints". Recital 22 of the Regulation: "Interchange fees (fees paid by acquiring banks to incentivise card issuing and card use) are implicit in three party payment card schemes".