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THE *MASTERCARD* JUDGMENT: A FUNDAMENTAL QUESTION UNRESOLVED

The *MasterCard* judgment leaves an unresolved question: what are the permitted MIF levels? **Andrea De Matteis** discusses the implications of that judgment for interchange fees in Europe

With its *MasterCard* judgment, the ECJ has finally ruled that multilateral interchange fees (MIFs) may be permitted only when they produce sufficient and proven benefits for merchants. In other words, MIFs will continue to be allowed if they are set at levels that are considered beneficial for merchants.

The ECJ leaves an unresolved question: what are the permitted MIF levels? This article explains how the European Commission has tried – so far unsuccessfully – to answer that question. The article first gives an overview of the MIFs and their benefits for cardholders and merchants, analyzes the *MasterCard* judgment and the main questions before the ECJ, then provides insight into the methodologies employed to identify the permitted MIF levels and finally addresses the hoped-for benefits and unintended consequences of the proposed MIF Regulation.

1. MIFs and their benefits for cardholders and merchants

Multilateral interchange fees (MIFs) 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 MIF.

Merchants receive a wide variety of benefits from card acceptance, including more customers, higher sales per customer, the ability to sell via the Internet, reduced costs of cash (e.g., cost of handling, theft, loss, counterfeiting), quicker check-out, automated points of sale, 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. Issuers provide the bulk of these merchant benefits. The MIF provides revenues to issuers for the services and benefits they provide to merchants.

Without the MIF (or if the MIF is set too low), merchants extract value from the scheme without paying for it. This results in consumers paying higher fees (or receiving fewer benefits) to compensate for the value merchants extract without paying any compensation. Cards become more expensive or less attractive for consumers as issuers charge higher consumer fees, or reduce consumer benefits, to make up for the revenue lost when merchants no longer pay for the benefits they receive.

2. The ECJ judgment: MIFs are permitted if they provide benefits to merchants

In September 2014, the European Court of Justice (ECJ) ruled on the legality of MasterCard's MIFs that applied in December 2007 to cross-border card-based transactions in the European Economic Area (intra-EEA cross-border MIFs).

This long-awaited judgment continues a saga that began 22 years ago, when MasterCard (formerly Europay) spontaneously notified the European Commission (the commission) of its intra-EEA cross-border MIFs, and the merchants' associations (British Retail Consortium and EuroCommerce) made their first complaints.

Initially, the commission dismissed those complaints as groundless. Interchange fees were considered perfectly legitimate and compliant with EU competition rules. Then, in 2002 in a case concerning Visa, the commission decided that MIFs were compliant, provided they were based on issuing costs. Issuing costs methodologies were developed by card schemes following this approach. In 2007, as a result of the increased lobbying by merchants in Europe and throughout the world, the commission changed its approach and prohibited MasterCard intra-EEA cross-border MIFs because – despite the fact that those MIFs were based on issuing costs – there was not sufficient evidence that the levels then in force were beneficial enough for merchants.

With its September 2014 judgment, the ECJ has finally confirmed the commission's 2007 decision and ruled that MIFs may be permitted only when they produce sufficient and proven benefits for merchants.

3. The main questions before the ECJ

In reaching these conclusions, the ECJ considered essentially three questions: (1) whether the intra-EEA cross-border MIFs were agreed upon by competitors; (2) whether they restricted competition or were objectively necessary for the functioning of the MasterCard scheme; and (3) whether they could be exempted from the application of the competition rules on the basis of efficiencies.

1) Were the intra-EEA cross-border MIFs agreed upon by competitors?

The ECJ found firstly that MasterCard intra-EEA cross-border MIFs were in fact not set by MasterCard independently, but by competing undertakings (the banks) through a so-called association of undertakings (MasterCard itself). The ECJ considered MasterCard to be an association of undertakings because – despite the IPO on the New York Stock Exchange in 2006 – it continued to be an institutionalized form of coordination of the conduct of the participating banks.

Based on that assessment, the ECJ dismissed MasterCard's defense that after the IPO it became a public company owned by a large and dispersed number of non-banking shareholders. MasterCard pointed to the fact that MasterCard is a commercial entity separate from its banking customers, pursuing its own commercial interests and required to act in the interest of its public shareholders, not the banks. MasterCard also unsuccessfully argued that it could not be qualified as an association of undertakings because there is no commonality of interests among its customers in higher MIFs: issuers are interested in receiving higher MIFs, while acquirers are interested in paying lower MIFs.

2) Did the intra-EEA cross-border MIFs restrict competition, or were they objectively necessary for the functioning of the MasterCard scheme?

The finding that MasterCard intra-EEA cross-border MIFs were in fact set by the banks led the ECJ to apply the EU competition rules on agreements between competitors and qualify the intra-EEA cross-border MIFs as restrictions on competition. According to the ECJ, the intra-EEA cross-border MIFs restricted competition because their effect was to set a floor for the charges imposed by acquiring banks on merchants (merchant service charges, MSCs).

Without the MIF (or if the MIF is set too low), merchants extract value from the scheme without paying for it

The ECJ held that MasterCard's intra-EEA cross-border MIFs did not escape the competition rules on the basis of previous case law regarding "objective necessity." According to that case law, those restrictions that are objectively necessary for the operation of the system are allowed. The ECJ considered that the MIFs were not objectively necessary for the MasterCard system. On the basis of a narrow interpretation of previous case law, the ECJ ruled that the fact that a given operation is simply more difficult to implement or even less profitable without the restriction concerned cannot be deemed to give that restriction the "objective necessity" required in order for it to be classified as ancillary and escape the competition rules. The adverse consequences for the functioning of the MasterCard system in the absence of the MIFs do not mean that the MIFs must be regarded as being objectively necessary, since the system is still capable of functioning without those fees. MasterCard claimed instead that four-party payment systems cannot operate without default settlement terms between banks issuing cards to consumers and those acquiring transactions for merchants, which requires the setting of an interchange fee.

3) *May the intra-EEA cross-border MIFs be exempted from the application of the competition rules on the basis of efficiencies?*

Finally, the ECJ confirmed that MasterCard's intra-EEA cross-border MIFs in force in December 2007 could not be exempted from the application of the competition rules on the basis of efficiencies. According to the ECJ, MasterCard failed to demonstrate to the required standard that merchants receive appreciable objective benefits from MIFs. Therefore, the ECJ deemed that it was not even necessary to examine the advantages flowing from the MIFs for cardholders – as claimed by MasterCard – since such advantages could not, by themselves, compensate for the lack of evidence of sufficient benefits to merchants. This is so even if – as recognized by the General Court – cardholders would bear much higher costs if the MIF were removed or reduced ('a reduction in the benefits conferred on cardholders or the profitability of the card-issuing business might be expected in a system operating without a MIF'; 'reduction in interchange fees led to an increase in the costs charged to cardholders or to the reduction of certain benefits').

4. An unresolved question: what are the permitted MIF levels?

The judgment leaves open the possibility that MIFs may be exempted from the application of the competition rules if payment schemes are able to demonstrate that there are appreciable objective advantages for merchants flowing from the MIFs that are sufficient to compensate for their restrictive effects. In other words, MIFs will continue to be allowed if they are set at levels that are considered beneficial for merchants.

The ECJ has not provided any guidance on the methodology that MasterCard and other payment schemes (e.g. Visa and domestic schemes) should follow in order to set their MIFs at levels that are permitted. The levels of 0.2 percent of the value of the transaction for debit cards and 0.3 percent for credit cards – which the commission proposed with the draft regulation on interchange fees for card-based payment transactions (draft MIF Regulation) – are not legitimized by the ECJ nor by any comprehensive study conducted so far. Nor does the ECJ suggest that interchange fees should be regulated through legislation.

The commission has tried to answer the question regarding what MIFs levels are permitted by resorting to diverging and conflicting approaches over the years. After giving its blessing to issuing costs methodologies in 2002, the commission disallowed them in 2007 and embraced a new and untested methodology to identify the permitted MIFs levels, called Tourist Test, or Merchant Indifference Test (MIT). This new methodology is said to have been first used during the Interim Arrangement of April 2009 between MasterCard and European Commissioner Neelie Kroes after the commission's decision on MasterCard's cross-border interchange of December 2007. Due to its complexities, however, there are no conclusive results of this methodology, which is highly controversial.

5. The Merchant Indifference Test: no conclusive results are available

According to the MIT theory, the MIF that meets the MIT 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 MIF at a level at which the merchant is "indifferent" as to whether he or she receives a card or cash payment.

It is not surprising that the MIT is a controversial tool for setting MIFs, in that it focuses solely on the merchant's indifference

It is not surprising that the MIT is a controversial tool for setting MIFs, in that it focuses solely on the merchant's indifference and excludes the consideration of consumer interests in a properly set MIF. Since any MIF impacts consumers and merchants at the same time, it is likely that the MIT will continue to attract considerable criticism even if reliable data are obtained to ensure merchant "indifference."

In any event, there are today no reliable and accurate data at hand to apply this methodology. The commission's first attempt to obtain some reliable data on the MIT dates back to a study that the commission ordered in April 2009. MasterCard sought access to the documents related to the study on the basis of the EU Transparency Regulation, but without success. On Sept. 9, 2014 (two days before the ECJ's judgment in relation to MasterCard's MIFs), the General Court, following an appeal by MasterCard, annulled the decision by which the commission refused to disclose those documents.

In June 2012, the commission published another call for tender to conduct a survey on merchants' costs of processing cash and card payments. Seven months later, while the studies were still ongoing, despite the absence of reliable data, the commission presented its proposal for the MIF Regulation, arguing that the MIF caps (0.2 percent of the value of the transaction for debit cards and 0.3 percent for credit cards) were set on the basis of the MIT.

Only on Feb. 19, 2014, seven months after its proposal for the MIF Regulation, did the commission publish the MIT preliminary results. These preliminary results are extremely low: the MIFs that comply with the test are 0.11 percent of the value of the transaction for debit cards, and 0.15 percent for credit cards. These levels are even below the proposed MIF caps under the draft MIF Regulation.

When introducing these results, the commission admitted that the process of collecting the data from merchants proved to be a very difficult and lengthy task. The commission indicated that there are several caveats to the preliminary results and that a broader analysis is necessary.

In fact, the preliminary findings are significantly incomplete and are themselves open to a number of criticisms, for the following main reasons:

- The survey concerned only 10 out of 31 EEA countries.
- Only 254 merchants were satisfactorily surveyed.
- Only large merchants (above 20 million euros in turnover) were surveyed.
- The survey concerned only face-to-face transactions (e-commerce ones were excluded).

Smaller merchants will be surveyed in a second phase of the project, which should target 2,000 merchants in the same 10 countries. It has not been ruled out that the results from the smaller merchant survey may alter the preliminary results. The final report on the survey should be available at the end of 2014.

The commission does not possess the necessary data to identify the MIFs' permitted levels under the competition rules

It is clear that at present the commission does not possess the necessary data to identify the MIFs' permitted levels under the competition rules. This is a fundamental flaw in the pursuit of antitrust enforcement by the commission and national competition authorities. It is possible, therefore, that pending the approval of the MIF Regulation, national competition authorities, regulators or judges could apply higher levels if the evidence in that particular country shows that merchants will receive sufficient benefit from such higher levels.

It is no surprise that the recent undertakings proposed by Pagobancomat and published by the Italian Competition Authority to close the investigation on MIFs for bill payments still rely on an issuing cost methodology.

This and other reasons should lead national competition authorities not to take new action against payment schemes, but instead to wait for the approval of the MIF Regulation.

6. The draft MIF Regulation

The draft MIF Regulation provides for caps at the level of MIFs for payment card transactions. Due to these proposed caps, even if MasterCard had been successful in its appeal before the Court of Justice, the upcoming MIF Regulation – if adopted in its current form – would have practically pre-empted any successful outcome of that litigation.

The Regulation sets MIF caps at 0.2 percent of the value of the transaction or, if lower, at 7 eurocents for debit cards, and at 0.3 percent for credit cards. The 7 eurocents cap was introduced by the European Parliament in April 2014.

The rationale behind the commission's proposed MIFs caps is that they will enhance consumer welfare: if MIFs are capped, MSCs will drop and merchants will pass this MSC reduction on 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 MIFs, issuers need to increase revenues from cardholders (or reduce cardholder benefits) to compensate for the revenue losses.

This is demonstrated by experience in countries such as Australia, Spain and the United States, where MIFs were reduced. In each case, following a mandated reduction of MIFs, cards became more expensive for consumers as issuers charged higher consumer fees to make up for the revenue lost when merchants no longer paid for the benefits they received. 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.

Regulation of the level of MIFs 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 such as mobile payments, electronic wallets, contactless technology or increased security.

The MIF Regulation contains also so-called business rules (such as mandatory separation between scheme and processing, co-badging, etc.), which will have a significant impact on the payments industry. Remarkably, they set requirements that are not justified under the antitrust rules. In the absence of evidence regarding a possible market failure, these rules have been heavily criticized as being disproportionate. Certain national competition authorities have expressed their concern and their preference for the application of antitrust rules, instead of regulation, to the conduct of card schemes.

Conclusion

Antitrust enforcement in relation to MIFs has been inconsistent and uncertain at both the EU and national levels. The commission has concerned itself with only one side of the two-sided market, namely the effect on merchants, overlooking the consequences for consumers. If the MIF is set too low, merchants extract value from accepting payments without paying for it. This results in consumers paying higher fees to remunerate the benefits merchants receive. The ECJ has recently sided with the commission, but did not address the fundamental question of what MIF levels are permitted.

It is worrying that the commission and national competition authorities have concluded proceedings against international and domestic payment schemes while studies on the permitted MIF levels have not yet produced complete and satisfactory results. These authorities have fined or prohibited the conduct of companies without having reliable data at hand on what is permitted and what should instead be prohibited.

The same methodological inadequacy is tainting the proposed caps of the MIF Regulation. A 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 innovation and the development of the payment industry in Europe. Experience from other countries shows that there is a high risk that the MIF caps will damage consumers.

Against this background, some EU member states have expressed their opposition to the caps proposed by the commission because they want to retain the freedom to set domestic MIFs at levels higher than those proposed, in order to provide incentives to consumers to use payment cards.

It is possible, therefore, that pending the approval of the MIF Regulation, national competition authorities, regulators or judges could apply higher levels if the evidence in that particular country shows that merchants will receive sufficient benefits from such higher levels. ■

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