APRIL 2008, RELEASE ONE

GCP
THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY

The Drama of Interchange Fees

Vitor Bento

SIBS - Sociedade Interbancária de Serviços

GCP
THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY
RELEASE: APR-08 (1)

The Drama of Interchange Fees

Vitor Bento*

I. The Curse of Cash

The main problem with the economics of card payments is that cash is used as its yardstick and cash payments, being the most socially inefficient means of payment, are made available at a price significantly below cost (often free of charge). To supply cash payments at a loss and in order to remain a profitable business, banks have to overcharge other services (cross-subsidization). This practice is a legacy from the times when bank services were bundled and jointly remunerated by the financial intermediation margin (interest received minus interest paid).[1]

Over time, banks have started unbundling their services and charging them to the direct beneficiaries, while reducing the financial intermediation margin. Nevertheless, cash payments (and check payments in most instances) remained a service offered free of charge, where their "production costs" are subsidized by revenues from other banking activities.

If cash could be properly priced, reflecting its social cost, all the discussion around card payments would become less biased.

* The author is the President of SIBS - Sociedade Interbancária de Serviços in Portugal.

[1] This free delivery of services was often a consequence of regulations prohibiting, or limiting, the remuneration of sight accounts.

II. Debit Cards

It was against this background that most debit card schemes were developed—either at a bank level or as a "cooperative arrangement" of banks. They were developed not as profit center, but as a way to save costs by replacing cash with (cheaper) electronic payments. As a consequence, payment services remain mostly underpriced.

The "cooperative model", for instance, was the one adopted by many European countries. This kind of model has worked well within a context of cultural, political, and institutional homogeneous settings, as provided by national communities. In a more diverse and disperse environment, however, this model is very difficult to replicate.

III. Credit Cards

Credit cards, on the other hand, were developed in the so-called Anglo-Saxon world and were conceived, from the beginning, as a profitable business, having their services duly remunerated. While replacing cash was the main driver behind the debit card model described above, granting personal credit was the main driver behind the development of credit cards.

Merchants more readily accepted being charged (more) for credit card payments than (less) for debit card payments. Although both payments are technically similar, the former were perceived as fostering potential sales by freeing the consumer from liquidity constraints, while the second were seen as a mere transfer of liquidity from the consumer. Hence, the price difference has been "acceptable" from the merchant's view.

Two alternative models were later used to expand credit cards: the so-called three-

party model (e.g., American Express and Diners) and the four-party model (e.g., MasterCard and Visa). Of these, the four-party model saw the broadest worldwide expansion, building very extensive networks of acquirers and cardholders in almost every country. The success of these models definitely contributed to a more open structure and a set of multilateral relationships and arrangements, including default settings. These features proved essential for the easy working of a system in which there were multiple, diversified, and distant interconnected players, and for the broader acceptance of cards. The crucial "default setting"—the true cornerstone of the four-party model—is the multilateral interchange fee (MIF) concept.[2]

Although it was created to promote credit cards, the four-party model also brought about debit card solutions, most of which replicated the main features of credit cards (including MIF). In Europe, these international debit card schemes competed with the nationally based ones and offered banks the opportunity to provide non-subsidized payment services, thus moving card payments towards a more rational economic model.

IV. The SEPA "Trilemma"

Sections II and III of this article are necessary to understand the foreseeable predicament of interchange fees in Europe. The European authorities are committed to creating a fully integrated payments area (single euro payment area or SEPA) among the countries that share the euro as their common currency, where:

[2] It is perhaps useful to remember that the four-party MIF model is, in the case of Visa, an evolution of what was originally a three-party model set up by Bank of America (back in 1958). MIFs were the mechanism that an originally closed and scope-restricted system found effectively balanced the different interests of acquirers, issuers, merchants, and cardholders and achieved a global reach.

> consumers, businesses and governments are able to make cashless payments … from a single payment account anywhere … using a single set of payment instruments as easily, efficiently and safely as … today in the domestic context.[3]

Albeit such an endeavor—a payments union—is a natural and inevitable consequence of the 1999 creation of a monetary union, it is arguable how much of it should come from spontaneous market developments and how much should be forced by "administrative" intervention of the authorities. While this article does not attempt to address this issue, it should be noted the European authorities, having undertaken a leading (and sometimes dominant) role, now face an interesting trilemma.

The authorities are currently pursuing three irreconcilable objectives:

(a) to promote the market integration required for SEPA;

(b) to preserve economic efficiency and rationality as demanded by the so-called "Lisbon Agenda"; and

(c) to please the widest political constituency by ensuring that the "European project", and SEPA in particular, are "popular" projects.

Unfortunately, at most two of such a tripod of objectives can be conciliated at one time, while the third has to be rescinded.

From these objectives and their dependencies, we can extrapolate the most likely outcome of the authorities' policy towards interchange fees (IF). If we combine **(a)** and **(b)**, IF have to be set competitively by the schemes (for the whole euro area) to provide appropriate incentives for their promotion and competition, but the result will be unpopular. If we combine **(b)** and **(c)**, IF will be set according to national markets

[3] European Payments Council and European Central Bank, SEPA – the shared vision, *at* http://www.ecb.int/paym/sepa/html/vision.en.html (last visited Mar.24, 2008).

specificities and history (as they are today), but that will lead to the persistence of the present market fragmentation along national borders. If **(a)** and **(c)** are combined, IF have to be administratively aligned with the lowest level now prevailing in the euro space (which means very close to zero), so that the price of payment services will not increase under SEPA, which could hurt its popularity. In this case, economic rationality and efficiency would have to be sacrificed.[4]

It is not necessary to be an expert on European politics to realize that the third scenario is the most likely outcome of the authorities' trilemma-solving exercise. This scenario is all the more likely since lack of economic efficiency can always be blamed on the market and on "greedy institutions" and since the merchants have succeeded in convincing the authorities that they are fighting to protect consumer interests.

V. The Belgian Example

What happened in Belgium, right after the announcement of the SEPA project, is perhaps the best illustration of what has been discussed in this paper. In Belgium, as in many other European countries, the payment system was developed around "cooperative" ventures comprising, among other things, a processor and a domestic debit scheme (working along the lines described above). When the SEPA project was formally announced and its consequences duly anticipated, local banks ended the "cooperative arrangements", sold the processor to a major IT company, and announced the replacement of the local debit scheme by Maestro.

[4] The authorities would disagree as they do not consider IF a proper market incentive, but rather a "concerted price". It is not the purpose of this article to argue for one or the other.

The decision is totally rational as the banks recognized that if forced to compete in a broader environment, their model of providing subsidized electronic payments would not make sense and so they chose to migrate to a business model with intrinsic economic rationality. This has become increasingly so since the model has proven to be the only one able to expand networks across national borders and work well at a transnational level.

The (political) problem with this decision was that the price of payment services, which must reflect their true costs (i.e., foregoing cross-subsidization), had to be increased, drawing criticism of SEPA and jeopardizing objective **(c)**. Furthermore, if the move by Belgium banks was successful, other European countries might implement similar migrations to the international debit schemes. That is, if the market was allowed to adjust to the new environment, objectives **(a)** and **(b)** would prevail over objective **(c)** and the authorities, and their SEPA project, would find themselves in a very difficult position. The only way to avoid this outcome was to prevent IF from being set by the market and to keep them as low as they are now in some markets where cross-subsidization prevails. In doing so, the authorities abandoned objective **(b)** in order to reconcile **(a)** and **(c)**.

Meanwhile, the Belgian decision to migrate their national scheme was reverted. It will be interesting to see how SEPA—a multinational, integrated payment system—will be implemented and put to work when the crucial incentive of the only payment card model that has succeeded, to date, in spontaneously fostering an extensive, worldwide, and multinational integrated payment system is being curtailed.