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Last December, after a thorough investigation, the European Commission ruled that the multilateral interchange fees (MIF) charged for cross-border transactions made with MasterCard and Maestro debit and credit cards violated EC Treaty regulations.¹ The Commission said that MasterCard's fee structure restricted competition among acquiring banks and "inflated the cost of card acceptance by retailers without leading to proven efficiencies." MasterCard was given six months to comply with an order to withdraw the fees or it will incur daily penalty payments of 3.5 percent of its daily global turnover in the preceding business year. Javier Perez, president of MasterCard Europe, disappointedly responded that "market forces, not regulation, should drive key decisions such as the setting of interchange fees and retailers' choices over

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¹ Commission Decision 19/XII/2007 of 19 December 2007, Cases COMP/34.579 MasterCard, COMP/36.518 EuroCommerce, and COMP/38.580 Commercial Cards (not yet reported) [hereinafter Decision], available at http://ec.europa.eu/comm/competition/antitrust/cases/decisions/34579/provisional_nc_decision.pdf (provisional non-confidential version).

which forms of payment to accept."² And, in an attempt to annul the Commission's decision, MasterCard has now lodged an appeal to the European Court of First Instance.³

Payment pricing and competitive efficiency have recently attracted a lot of controversy. This has led to some spectacular antitrust litigation not only in Europe but also in the United States and Australia. Ultimately, the central issue concerns whether the specific circumstances of payment markets are such that public policy or antitrust intervention can be expected to improve economic welfare. To date, there is little consensus—neither among policymakers nor economic theorists—on what constitutes an efficient fee structure for card-based payments. Admittedly, appropriate pricing arrangements for payment instruments are a complex matter, since payment networks are subject to large economies of scale and give rise to strong usage and network externalities. These factors have likely resulted in significant concentration in the retail payments industry.⁴

There seems to be widespread agreement that the ongoing shift from cash and paper to electronic forms of payment can confer large economic benefits. Not only are electronic payments cheaper to “produce” than cash, but they also offer benefits over cash in terms of greater security and access to credit lines. Consequently, increased consumer benefits allow merchants to attract additional sales that would otherwise not

² Press Release, MasterCard Worldwide, MasterCard Europe to Challenge European Commission Decision on Cross-Border Interchange Fees (Dec. 17, 2007), *available at* http://www.mastercard.com/us/company/en/newsroom/pr_EC_Decision_Press_Release_Statement_191207.html.

³ Press Release, MasterCard Worldwide, MasterCard Files Appeal of European Commission Decision (Mar. 3, 2008), *available at* http://www.mastercard.com/us/company/en/newsroom/pr_EC_Decision_Appeal.html.

⁴ C. Kahn & W. Roberds, *Why pay? An introduction to payment economics* (University of Illinois, unpublished mimeo) (2006).

have occurred.⁵ But, in many cases, card-based payments in particular have remained more expensive—at least for merchants—than cash and paper-based alternatives. The price of card payments is hidden from most consumers, because contractual agreements (no-surcharge rules) between the card providers and merchants prohibit merchants from imposing extra charges on customers who pay with cards. Instead, the cost of card payments is reflected in merchant discounts (fees paid by merchants to the card companies). When the cards are provided through a four-party scheme such as MasterCard or Visa, the interchange fee, paid by the merchant's bank to the consumer's bank, usually accounts for a significant portion of the merchant discount. This fee has triggered a great deal of merchant dissatisfaction.

Do the level of prices for card payments and their peculiar asymmetric structure reflect the exercise of market power by the card providers? Or do they simply reflect the nature of the service provided? To answer these questions it is important to note that the consumption of card payment services involves two sides of the transaction—a consumer and a merchant—each of whom takes actions, enjoys benefits, and incurs costs.

Economic theory has shown that setting the right price structure (e.g., the ratio of the acquirer and issuer prices) is crucial for consumer card usage, merchant acceptance decisions, and resulting levels of economic welfare and efficiency.⁶ Interchange fees can be viewed as instruments to attain this optimal price structure, and to provide necessary incentives to guarantee the participation of all parties in the card payment system. An

⁵ W. Bolt & S. Chakravorti, *Consumer Choice and Merchant Acceptance of Payment Media: A Unified Theory* (De Nederlandsche Bank, mimeo) (on file with the authors) (2008).

⁶ J-C Rochet & J. Tirole, *Platform Competition in Two-Sided Markets*, 1 J. EUR. ECON. ASS'N 990-1029 (2003).

important lesson of this analysis is that the socially optimal interchange fee will depend on both benefits and costs realized by each side of the transaction. Consequently, regulated interchange fees such as purely cost-based or zero fees are unlikely to attain full efficiency.

In the *MasterCard* ruling, the European Commission apparently took the view that (too) high interchange fees inefficiently subsidize card payments leading to excessive use of debit and credit cards. This can give rise to welfare losses since merchants will raise their goods prices in response to these expensive card payments, harming all consumers—both card and cash users. By requiring the removal of the multilateral interchange fee, the Commission has proposed that MasterCard’s issuing and acquiring side maximize their profits “in isolation” and independently from each other. This effectively sets the interchange fee to zero and breaks, so to speak, the “two-sided link”. This begs the question of whether cards are really being overused, and more importantly, how consumers will respond to the change in MasterCard’s fee structure.

If the withdrawal of interchange fees translates to higher cardholder fees and decreased reward programs, then it is reasonable to assume that consumers will respond by reducing their use of debit and credit cards. Especially in a world where cash use (and own bank’s ATM use) is heavily subsidized, charging consumers for card payments may inefficiently discourage the use of debit and credit cards. The Commission’s self-declared “war on cash” may then take a different turn. Moreover, three-party schemes like American Express have no formal interchange fee and so the Commission’s regulation

does not apply to them, which could distort the competitive level playing field even further.

Ideally, payment prices faced by consumers should be based on underlying resource costs. Cash is more expensive than cards; paper is more expensive than electronics. The Commission should allow prices to be geared that way. Of course, two-sidedness also requires taking demand conditions into account. Norway presents an interesting case. For many years already, Norway has explicitly priced point-of-sale and bill-payment transactions based on underlying costs. Even cash is priced by charging own bank's ATMs when used outside opening hours. Norway has rapidly shifted to electronic payments, faster than countries that have not priced like the Netherlands. The quid pro quo has been the elimination of bank-float revenues and the payment of nearly market interest rates on checking accounts.⁷

Regulating payment card fees is not easy. Because theory provides little guidance on the right direction of price regulation, empirical evidence must play a greater role in assessing potential market failure. Society would be better off if it relied more heavily on the most efficient payment system. But efficiency of payment systems is measured not only by the costs of used resources, but also by the social benefits it generates. Good public policy is characterized by a careful trade-off between the costs and benefits of regulation. The cost of unintended consequences can be significant and usually arises

⁷ W. Bolt, D. Humphrey & R. Uittenbogaard, *Transaction Pricing and the Adoption of Electronic Payments: A Cross-Country Comparison*, 4(1) INT'L J. CENTRAL BANKING 89-123 (2008).

when regulators have to act under uncertainty and limited information.⁸ But it appears the Commission is sure about its case: a few days ago EC Commissioner Neelie Kroes announced plans to reinvestigate Visa's fee structure, now that Visa's "antitrust exemption" ended in December.⁹ There is still more to come!

⁸ M. Katz, *What Do We Know About Interchange Fees and What Does it Mean for Public Policy: Commentary on Evans and Schmalensee*, in INTERCHANGE FEES IN CREDIT & DEBIT CARD INDUSTRIES: WHAT ROLE FOR PUBLIC AUTHORITIES? 121-137 (Kansas City: Kansas City Federal Reserve, 2005).

⁹ Press Release MEMO/08/170, European Commission, Antitrust: Commission initiates formal proceedings against Visa Europe Limited (Mar. 26, 2008), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/170&format=HTML&aged=0&language=EN&guiLanguage=en>.