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# MIF: The Root of Evil or Just a Scapegoat?

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## MIF: The Root of Evil or Just a Scapegoat?

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**M**ultilateral Interchange Fees (“MIF”) and their appropriate regulation under EC competition law have triggered a vigorous debate over the last years among academics, jurists, and economists. This debate has been further incited since the Commission of the European Communities issued its decision in MasterCard<sup>1</sup> in December 2007 and initiated formal proceedings against Visa Europe Limited<sup>2</sup> in March 2008. Since 1992, when the MIF was first brought to the Commission’s attention following complaints by merchants and after the benchmark Visa decision in 2002,<sup>3</sup> many domestic decisions have been issued<sup>4</sup> and sector inquiries have been conducted

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<sup>1</sup> 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 MC Decision], *available at* [http://ec.europa.eu/comm/competition/antitrust/cases/decisions/34579/provisional\\_nc\\_decision.pdf](http://ec.europa.eu/comm/competition/antitrust/cases/decisions/34579/provisional_nc_decision.pdf) (provisional non-confidential version).

<sup>2</sup> 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>.

<sup>3</sup> Case No. COMP/29.373 – VISA International – Multilateral Interchange Fee, 2002 O.J. (L 318) 17 [hereinafter *Visa II*], *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002D0914:RO:NOT>.

<sup>4</sup> Indicatively, see the U.K. *MasterCard* decision which was later set aside by the U.K. Competition Appeal Tribunal in June 2006 (Decision of the U.K. Office of Fair Trading of Sep. 6, 2005, Case No. CP/0090/00/S, MasterCard UK Members Forum Limited; CAT decision, Case Nos. 1054/1/1/05, 1055/1/1/05, and 1056/1/1/05, MasterCard UK Members Forum Limited, MasterCard International Incorporated, and MasterCard Europe Sprl; and CAT decision of Jul. 10, 2006, Royal Bank of Scotland Group v. Office of Fair Trading.

both at the EC<sup>5</sup> and national levels.<sup>6</sup> Nonetheless, even if one would expect that after 16 years of debates, decisions, complaints, objections, inquiries, and research, that the Competition Authorities would have a clear idea about the appropriate treatment of MIF, it is no exaggeration to assert that—for the most part—we are still in the dark.

## **I. THE VISA INTERNATIONAL (*VISA II*) DECISION**

The first major EC decision, *Visa II*<sup>7</sup>, made clear that the Commission was not too happy with MIF, as it presumed that MIF had a negative impact on competition between banks in the European Economic Area (EEA). Given that at that point (2002), there was not enough evidence or data to indicate the exact nature and magnitude of that presumed “harm”, the Commission took a rather moderate approach towards MIF. Although it held MIF to be an agreement on price which restricted competition and infringed Article 81(1) of the EC Treaty by *effect*, it did accept Visa’s efficiency claims and granted it an exemption under Art. 81(3), on the condition that Visa reduce the MIF level and assess them according to the issuers’ costs.

In particular, the Commission accepted that the MIF agreement promoted a large scale international payment system with positive network externalities,<sup>8</sup> that it benefited both merchants<sup>9</sup> and cardholders,<sup>10</sup> and that it was indispensable for the efficiency of the

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<sup>5</sup> Press Release IP/07/114, European Commission, Competition: Commission sector inquiry finds major competition barriers in retail banking (Jan. 1, 2007), *available at* <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/114&format=HTML&aged=1&language=EN&guiLanguage=en>.

<sup>6</sup> *See* Press Release, Hungarian Competition Authority, Sector inquiry in the banking sector (Feb. 5, 2007), *available at* [http://www.gvh.hu/gvh/alpha?do=2&st=2&pg=154&m129\\_doc=4413](http://www.gvh.hu/gvh/alpha?do=2&st=2&pg=154&m129_doc=4413).

<sup>7</sup> *Visa II*, *supra* note 3.

<sup>8</sup> *Id.* at para. 8.1.3 (83).

<sup>9</sup> It benefited merchants since the MIF could not exceed a certain benchmark, which reflects the costs of services provided by the issuer to the direct or indirect benefit of merchants.

system (albeit not its existence), as it allowed issuers to recover the costs of services provided to merchants, even in the absence of a contractual relationship between them. Finally, the Commission held that the net result of the MIF agreement did not eliminate competition between either issuers—since they could freely set their client fees—or between acquirers—since the MIF was only *one* component of the merchant service charge (MSC) and they could still compete in the others. Therefore, the Commission found all conditions of Art. 81(3) to be satisfied.<sup>11</sup>

On December 31, 2007, this Art. 81(3) exemption expired. On March 26, 2008, the Commission announced that it had initiated formal proceedings against Visa Europe Ltd.:

[I]n relation to its multilateral interchange fees (MIF) for cross-border point of sale transactions within the EEA using Visa branded consumer payment cards, and the "Honour-All-Cards-Rule" as it applies to these transactions. The proceedings will seek to establish whether these practices constitute infringements of Article 81 of the EC Treaty and Article 53 of the EEA Agreement, which forbid restrictive business practices such as price fixing.<sup>12</sup>

It seems doubtful that the Commission will not take further issue with Visa's current MIF. The Commission had enough time to conduct research and collect data about the actual and potential impact of MIF on the market and information about the operation of other open card payment systems in domestic markets—some of which operated without any MIF.

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<sup>10</sup> It benefited cardholders since it could encourage more retailers to accept the Visa card, and it could even lead to lower retail prices, due to decreased merchant costs.

<sup>11</sup> *Visa II*, *supra* note 3, at para. 8.3.3 (106).

<sup>12</sup> 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>.

## II. THE *MASTERCARD* DECISION

Another cause for concern for Visa Europe is the precedence set by the Commission's decision in *MasterCard*, released just prior to the Commission's Visa Europe announcement. In a very long and detailed decision, the Commission rejected most of the efficiency claims it had previously accepted in the Visa case: It rejected MasterCard's argument that MIF enhance the efficiency of open card-payment systems, holding that "there is no presumption that MIFs in general enhance the efficiency of card schemes [...] but the efficiencies of a MIF will depend on the concrete evidence put forward by the parties,"<sup>13</sup> which in the Commission's view, MasterCard failed to provide. Moreover, the Commission held that although MIF resulted in enhanced network effects to the benefit of the issuers, this benefit could not offset the presumed consumer harm from the resulting inflation in the merchant fees. Consequently, as long as not *all* customers seemed to benefit from the MIF, the "fair share of benefit to consumers" condition of Art. 81(3) could not be satisfied.<sup>14</sup> As to the indispensability condition of MIF, the Commission held that MasterCard "has not proven to the requisite standard that its current MIF is indeed indispensable to maximise system output and to achieve any related objective efficiencies,"<sup>15</sup> arguing that several payment card systems in the EEA have been successfully operating without an MIF for a long time.<sup>16</sup> Therefore, the Commission concluded that Art. 81(3) could not apply and ordered MasterCard to desist

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<sup>13</sup> MC Decision, *supra* note 1, at para 8.2.3.

<sup>14</sup> *Id.* at para. 8.3.3.

<sup>15</sup> *Id.* at para. 8.4.2.

<sup>16</sup> *Id.*

from setting intra-EEA fallback interchange fees,<sup>17</sup> essentially breaking any predetermined link between the two sides of the market (issuers and acquirers). In practice though, such choice sets the MIF level at zero, as issuers and acquirers are required to compete for profit-maximization independent of each other.

It is evident from the Commission’s ruling that its approach towards MIF regulation was far more rigid than the one in 2002. Not only did the Commission choose to intervene and regulate MIF again—which is in itself a major decision—but it also took a rather extreme stance towards them: to have them practically mandated at zero. It might be true that the Commission presented an impressive amount of data or evidence to support its decision, but it is equally true that there are still many concerns about the expedience of such a rigid regulatory intervention on MIF.

### **III. MANDATING MIF AT ZERO—HOW WISE?**

The first thing to observe is that setting the MIF at zero is as much a “collective price-fixing”, as setting them at any other level; hence, the antitrust concerns remain. Even if privately determined MIF may be regarded as an unfavorable “price-fixing”, one must admit that at least there is a certain rationale about this specific “price level”, namely costs, demand conditions, competition among issuers and acquirers, externalities between merchants and consumers, and so forth. On the contrary, the Commission’s “price-fixing” at zero does not seem to be too far from an abstract idea that “the lower the price the better”. True as this might be as a general perception, it can end up being a

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<sup>17</sup> *Id.* at art. 3, 209: “Within six months after the notification of this decision the legal entities representing the MasterCard payment organisation **shall formally repeal the Intra-EEA fallback interchange fees, as well as the SEPA/Intra-Eurozone fallback interchange fees.**” (emphasis added)

rather simplistic thought, if the particularities of MIF and the context in which they operate are disregarded.

If we focus on the role of MIF in the two-sided platform market of payment cards and the fact that MIF are not a simple price, but rather a balancing instrument which helps the two platforms of the market interact with each other, achieve economies of scale, and produce positive network effects, it is evident that the MIF level is determined by a series of factors, and it can accordingly be positive, negative, or even zero—but the latter would only be by happenstance.

Economic literature seems to confirm this thought. Even if different models with different assumptions reach different conclusions about the optimal (profit-maximizing<sup>18</sup> or socially optimal<sup>19</sup>) MIF, they all seem to be unanimous on this point: the optimal MIF is generally non-zero. As to the argument that it is possible to have MIF set at zero, like some domestic card-payment systems (or like the Federal Reserve did in the United States with regard to checks), one could argue that the crucial issue is not whether it is *possible* or not, but whether such choice is *more efficient* than the current one. Can the Commission guarantee that a zero MIF will be more efficient than the privately set MIF? It is highly uncertain that it can.

The zero MIF could have more implications and consequences for the system than one would think. Since the exchange between issuers and acquirers will be “at par”, then the system must find another way to retrieve these costs, because otherwise it will make a

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<sup>18</sup> R. Schmalensee, *Payment Systems and Interchange Fees*, 50 J. INDUS. ECON. 103-22 (Jun. 2002).

<sup>19</sup> J.-C. ROCHET & JEAN TIROLE, TWO-SIDED MARKETS: AN OVERVIEW (Institut d' Economie Industrielle, IDEI Working Paper, 2004), available at <http://isis.ku.dk/kurser/blob.aspx?feltid=122003>.

loss. The most apparent solution seems to collect these costs from cardholders. Supporters of this alternative suggest that it is only fair that cardholders directly the cost of the payment services offered to them, and even though this will result in higher fees, it will render prices more transparent and will create incentives for banks to seek efficiencies, lower their costs and aggressively compete on prices.<sup>20</sup> As a consequence, the merchant discount level will presumably fall and therefore the average level of retail prices shall descend as well, to the benefit of all consumers.<sup>21</sup> But in order for this alternative to function, the system will also have to abolish some network rules imposed on merchants, such as the no-surcharge rule for using cards instead of other payment instruments and the non-discrimination rule between different card brands, so that price signals sent to consumers are not distorted.

Although it might seem ethically fair that every consumer directly bears the exact costs of the payment instrument he chooses to use, this is hardly the case in modern economies. Even cash payers do not bear the total cost of their chosen payment method as subsidizations and cross-subsidizations are a reality between different payment instruments. Beyond that, such a practice could have detrimental effects on card issuing and usage and subsequently result in a reduction of the cardholder side of the market platform. This practice, causing such detriment to the network size and efficiency, could assumingly be accepted if there was strong evidence that it would simultaneously produce benefits able to outweigh the damage caused.

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<sup>20</sup> D. Balto, *The Problem of Interchange Fees: Costs without Benefits*, 21(4) EUR. COMPETITION L. REV. 223 (2000).

<sup>21</sup> A. Frankel, *Monopoly and Competition in the Supply and Exchange of Money*, 66 ANTITRUST L.J. 313, 343 (1998).



The evidence that exists is scarce. First of all, there are transaction costs that merchants must incur in order to differentiate prices according to the payment instrument used, and it is highly uncertain whether it is practical or even beneficial for them to do so. In addition, merchants are generally reluctant to resort to this solution even when they are allowed to. Examples where surcharging was allowed but rarely used in practice can be found in the United States, the Netherlands, United Kingdom, and Sweden and they all seem to confirm this assumption.<sup>22</sup> But even if merchants were eager to incur transaction costs and deal with consumer discontent and chose to surcharge, the aspired efficiencies remain uncertain, since they presuppose perfect competition in all sides of the market and this is hardly the case here. As Evans and Schmalensee (2005) point out:

[W]ithout perfect competition everywhere, abolishing an NSR (i.e. *No Surcharge Rule*) does not generally lead to an efficient outcome. In particular, imperfect competition among issuers then tends to lead to under-provision of card services, and merchants could use surcharges as a mechanism for price discrimination. Economic welfare may be lower than at profit-maximizing equilibrium with an NSR—even if card usage is excessive in the latter case.<sup>23</sup>

In other words, not only is it doubtful whether such practice increases economic and social welfare, but it might even have a limiting-output effect. Furthermore, if merchants do not pass the reduction of their costs as lower prices, non-card payers will not be better-off, cardholders will be worse-off, as they will incur higher fees, and

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<sup>22</sup> S. Chakravoti, *Theory of Credit Card Networks: A Survey of the Literature*, 2(2) REV. NETWORK ECON. 50-68, 55 (June 2003); ITM Research, *The Abolition of the No-discrimination Rule* (mimeo, Amsterdam) (March 2002); U.K. Office of Fair Trading, *UK Payment Systems: An OFT Market Study of Clearing Systems and Review of Plastic Card Networks*, OFT658 (OFT, London) (May 2003), at 114-15, available at [http://www.offt.gov.uk/shared\\_offt/reports/financial\\_products/oft658.pdf](http://www.offt.gov.uk/shared_offt/reports/financial_products/oft658.pdf); IMA Market Development AB 2000, *Study Regarding the Effects of the Abolition of the Non-discrimination Rule in Sweden: Final Report, Results and Conclusions* (mimeo, Lerum, Sweden) (February 2000), at 18.

<sup>23</sup> D. EVANS & R. SCHMALENSEE, *THE ECONOMICS OF INTERCHANGE FEES AND THEIR REGULATION: AN OVERVIEW* 26 (MIT Sloan Working Paper, No. 4548-05, May 23, 2005), available at <http://ssrn.com/abstract=744705>.

ultimately social welfare will be harmed if merchants end up using surcharges to price discriminate in an anticompetitive way.

In conclusion, one could well argue that not only is setting MIF at zero an impractical solution, but it can be expected to cause detriment to the card payment market, having little or no guarantees at all that it will produce benefits able to compensate for that damage. Besides, mandating MIF at zero may also have the effect of forcing open systems to turn into unitary ones (or at least conclude franchising agreements), in order to be able to unilaterally set an implicit “interchange fee”, without any antitrust scrutiny. It is evident though that in practice very few banks will have the resources to operate their own proprietary systems, and consequently this will probably leave the market with very few issuers, to the obvious detriment of competition.

#### **IV. IS THERE A MARKET FAILURE?**

One could also argue that the main thought running the *MasterCard* decision (and to a lesser degree the *Visa II* one) is a tacit presumption that cards are used “too much” and this seemingly constitutes a market failure. Besides, absent a market failure, the national competition authorities would have no reason to intervene and in practice regulate the market. The Commission’s general view seems to be that, apart from being quite unnecessary, MIF are also too high and this encourages issuers to subsidize cardholders, who then use cards *too much*, and this oversupply of cards assumingly constitutes a market failure. But on this point, one could object that, first there is no sound evidence (if any) about whether cards are indeed used “too much”, to the detriment of other payment instruments, and second, even if they were, whether this would

constitute a “market failure”. This would be the case if all social costs and benefits of each payment instrument were balanced and, comparing the respective outcomes, one could affirm with certainty that one is better than the other. At this point though, the available data may at best suggest the social costs of each payment instrument, and focusing only on this, it may be true that cards are a relatively expensive payment instrument. As long, though, as their social benefits are not estimated, one cannot reach sound conclusions about whether the extensive use of cards would harm or enhance social welfare. Therefore, one should hesitate in characterizing any “overuse” of cards a “market failure”, which would make regulatory intervention necessary—all the more to such an extreme degree as setting MIF at zero. Neither the Commission’s decision in *Visa II* nor *MasterCard* took into consideration the inter-brand competition between different payment systems, which could justify any subsidization of the card payment industry, as being indispensable to allow cards to compete with cash or checks, both of which are also subsidized.

## **V. WHO ARE THE CONSUMERS HARMED BY MIF?**

Another issue that was not made clear by the *MasterCard* decision—but that constitutes the very essence of the Art. 81(1) prohibition—is the identity of consumers who are allegedly harmed by the MIF. Is it the merchants who incur inflated MSC? The decision seems to conclude so, but has the Commission really balanced those presumably “inflated” merchant costs against the augmentation of their sales and revenues due to the extended use of cards by cardholders, many of whom would not buy as much had not cards provided them with rewards and credit? Is the Commission able to measure this

gain-and-loss balance and prove that the merchants are actually harmed? Or did the Commission focus on the merchants' complaints about high MSC and disregarded that merchants, doing what they do for a living, are inherently and inevitably after one thing: low costs and high margins for profit? But if low prices were really the essence of healthy competition, authorities would not bother regulating predatory pricing, but rather would simply enjoy it.

Maybe the presumed "harmed consumers" are cardholders. But that seems like an unlikely claim as well. Cardholders receive rewards, receive credit, enjoy many social benefits, and seemingly have the non-cardholders subsidize them.

Then perhaps the non-card payers harmed? If this is the case, then what is the Commission's evidence that the retail prices of products are indeed inflated due to high MSC, which are passed-on to the overall prices of goods? At best, the Commission may have evidence about the level of MIF in different card payment systems (most of which domestic), which may indeed be lower than the one of MasterCard or Visa, but is there any evidence to suggest a resulting reduction in the average product prices in these countries due to low (or absent) MIF? Are the average product prices indeed lower than those in other countries where the default MIF operates? So far the Commission has not presented such evidence. At the end of the day, what evidence is there—or even the common sense of it—that if merchant costs are low, due to zero MIF, then the merchant will pass this reduction of cost on to its product prices? Merchants are after profit because this is what they do, and there is no better way to achieve that than to have a lower cost base and to continue to sell at the same prices they sold before the MIF abolishment.

Finally, perhaps acquirers are the “harmed consumers”. Despite the fact that acquirers—namely banks—can be hardly considered consumers for the purposes of Art. 81(1), one should bear in mind that most acquirers are also issuers at the same time, and whatever loss they might make by paying the MIF, they collect it by receiving it in a different transaction.

## **VI. WHAT SHOULD BE DONE THEN?**

To the degree that there are still doubts about the appropriateness of mandating MIF at zero, or even the existence and nature of the implied “market failure” and consumer harm due to MIF, one cannot help wondering whether there is indeed a need for regulatory intervention on MIF, let alone one so rigid, like the one in the *MasterCard* decision. In general, regulatory intervention is necessary when a certain malfunction is observed in the market, which renders such intervention indispensable or at least, desirable. Assuming that this is established, an intervention will be further made only if there is evidence or at least strong presumptions that it is capable of resolving the problem, and more important, that it will not cause more harm than benefit. Not everyone is convinced that such guarantees currently exist as to the Commission’s solution to the MIF “problem”. Which begs the question: What should be done then?”

Given the difficulties of the MIF issue, it may be better to ask: “What *could* be done then?” The uncertainty caused by the complexity of MIF and the need for more evidence should not constitute a reason to abstain from any intervention whatsoever, especially when there are strong indications that something is not working well in the EEA card market. Nonetheless, it is only reasonable to suggest that MIF are not the root

of evil for all identified market distortions. It is more probable that any problems derive from the market environment in and competition conditions under which MIF operate and which allow them to function in an inefficient way to the detriment of economic and social welfare.

Therefore, it is probably preferable that competition authorities focus their efforts on enhancing the competitive environment of the card payment market, which is in itself a necessity even irrespective of the MIF debate. In other words, antitrust authorities could try to increase competition in the acquiring market which is found to be highly concentrated, by scrutinizing the vertical agreements and respective restraints, as well as the terms and agreements under which the established joint ventures of acquirers operate. If entry barriers in the acquiring market are removed and competition is incited, merchant fees can be expected to fall due to price competition in the market, which is always preferable than any arbitrary capping of the MIF, which has been proven in practice inefficient to significantly decrease merchant and retail prices.

Respectively, competition in the issuing market could be increased by removing rules which foreclose the market, such as the prohibition of co-branding, as well as the “blending” practice of acquirers, which distorts price signals (and therefore price competition in the issuing market), since it equalizes the costs incurred by merchants for all cards even though they are issued by different networks.

Moreover, it is essential that governance arrangements among members of the system come under antitrust scrutiny because, although some arrangements *are* indispensable for the operation of an open system, there is an inherent peril that such

agreements between competitors go too far and essentially have serious anticompetitive effects.

Finally, although surcharging is not customarily used in practice, even when it is permitted, and the removal of the no-surcharge rule may not in itself suffice to resolve the problem, its abolition can only produce benefits. On the one hand, merchants will not be obliged to surcharge and therefore be harmed in any respect; on the other hand, those who will surcharge, even if it is just a fraction, will contribute to the enhancement of inter-system competition by sending the correct price signals to consumers. At the same time, even the “threat” that cardholders may face additional costs for using cards at some outlets, could deter issuers from setting too high MIF.

Although there are no guarantees that the aforementioned suggestions will resolve all problems relating to interchange fees and that the card payment market will be freed of all of its possible distortions, solutions to market problems which leave pricing decisions to the market are generally preferable than rigid pricing regulations. A moderate and rather “indirect” intervention on interchange fees, which aims at correcting the distortions of the market where MIF operate, at creating conditions for an increase of competition, and ultimately at having the competitive forces “determine” the optimal MIF, may well have more chances of success than any extraneous “desistance order”.