

COMPETITION POLICY AND CREDIT CARD INTERCHANGE FEES IN NEW ZEALAND

Dr. Stephen Gale and Ben Gerritsen

Castalia

Ben.gerritsen@castalia-advisors.com (+644 913 2800)

Abstract

Competition authorities allege that banks should not be able to set or influence internal fees in credit card networks (known as ‘interchange fees’), because the banks are competitors in markets for issuing cards and providing services to merchants. This paper reviews the economic arguments underlying these allegations. We find that the two-sided nature of the credit card market poses unique challenges for competition law and policy. Simply dividing the total costs of the card network evenly between network users will not maximise profits for producers. Similarly, apportioning costs will not maximise profits due to the different demand characteristics of users.

JEL Codes: L00, L40, L42

Keyword(s): Competition, antitrust, banking, payment cards, two sided markets

Introduction

Competition authorities in a number of jurisdictions have expressed concern that because commercial banks are competitors in the markets for issuing credit cards and providing credit card services to merchants (an activity known as ‘acquiring’ transactions), banks should not be allowed to collectively set internal transfer fees within a credit card scheme (known as ‘interchange fees’)—or even all agree to the fees set by the scheme provider. In the United Kingdom and Europe, competition authorities (the Office of Fair Trading and the European Commission) have found that the process of setting interchange fees restricts competition in breach of competition law. Competition authorities in Australia, Canada, Chile, Colombia, France, Israel, Poland, South Korea, Spain, Switzerland, and Turkey have also looked into the competitive purpose and effect of credit card interchange fees, and required changes to interchange fees (Bradford, 2008).

In New Zealand, the Commerce Commission issued proceedings against the providers of credit card services in 2006, alleging that interchange fees and other scheme rules constitute price fixing (section 30 of the Commerce Act 1986), or otherwise result in a substantial lessening of competition (section 27 of the Commerce Act 1986). The Commission’s claim particularly focused on the impacts of the competition between banks in providing services to merchants, claiming that fees to merchants reflect a lack of competition due to the “price floor” set by interchange fees.

This paper reviews the proceedings against Visa and MasterCard and their member banks in New Zealand, and the economic arguments made by both sides of the

case. We believe this contribution is important for two reasons. Firstly, the arguments have relevance for future competition law claims in New Zealand involving network industries. Many of the arguments in the case concerned the definition of payment card markets as “two-sided markets”, and the implications of this classification for market definition. Secondly, competition authorities around the world will continue to scrutinise the approach to setting fees in payment card networks. Although the case in New Zealand was ultimately settled out of Court, application of the economic debate on interchange fees to the New Zealand setting provides valuable insights.

This paper is structured as follows. Section 2 reviews some of the interesting economic features of credit card networks, and discusses the main points of interest in two-sided market theory. Section 3 summarises the main economic arguments against credit card interchange fees—both in terms of competition law and economic efficiency. Section 4 summarizes the responses to competition law concerns, and how these responses apply to the claims made by the Commerce Commission. Section 5 concludes by reviewing the settlement reached in the New Zealand proceedings, and discussing unresolved issues.

Economic of Four-party Credit Card Systems

In this section we describe the economic features of credit card systems that affect competition for providing these services. We first review the financial flows within credit card schemes to explain who pays for credit card transactions, and what the payments cover. We then explore the unique two-sided characteristics of credit card networks, and explain how credit card schemes like Visa and MasterCard have

developed fee structures that maximise transaction volumes.

Flow of Payments in Payment Card Systems

Credit card networks need to set fees that encourage merchants to accept their card, while also encouraging consumers to pay for goods with credit cards. In this section of the paper, we highlight some important economic features of card networks, and illustrate how the fees charged to merchants on credit card transaction flow through into retail prices. We show that:

- Together, card-user and merchant service fees pay for system costs, including a margin to recover the fixed costs of providing the service
- Merchant service fees pass into retail prices, and so are ultimately paid by consumers (both card-users and cash-users)
- Lower card-user fees will mean higher card transaction volumes, but also higher merchant service fees and higher retail prices.

Figure 1 summarises how consumers can pay for goods and services indirectly using a payment card. In this case, the amount the consumer pays for the goods is P . The consumer pays the card network $P + p_b$ (sooner or later), the agreed price plus the card-user or “buyer” fee that we write as p_b . The p_b may be negative, due to fee holidays, cash-back offers and other reward schemes.

The card network pays the merchant for the goods, but withholds the merchant service fee (the price to the “seller” that we write as p_s)

Figure 1: Indirect Payment for Goods or Services

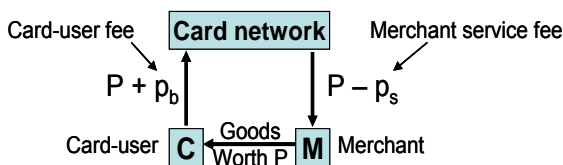
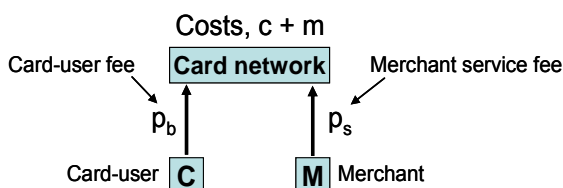


Figure 2 removes the value of the goods or services from the payment flows to focus on the fees. The combined fees paid by card-users and merchants cover the costs of the card network. These costs will comprise an overall marginal cost for providing the payment service, c , and an overall margin, m , so that the total of fees is given by:

$$p_b + p_s = c + m$$

Figure 2: Fees Pay for Overall Costs



In some industries the presence of a margin is used to highlight a competition problem, because suppliers are able to set prices above their marginal costs. However, in industries with large fixed costs, such as the card payment industry, margins are not necessarily a sign of market power because suppliers need to recover their fixed costs over time. The problem of recovering fixed costs essentially means that marginal cost pricing is not a viable strategy, and some type of average cost or Ramsey pricing is required in credit card networks to recover costs. In fact, many products and services provided in the banking industry relate to a common set of fixed costs, which need to be recovered through transaction fees.

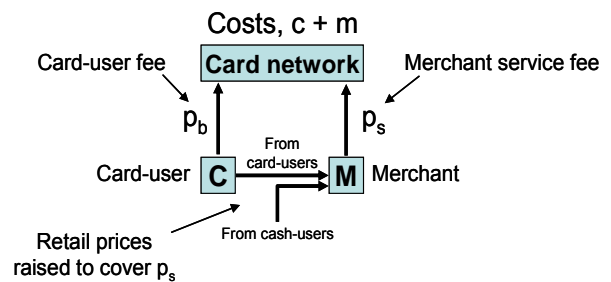
The presence of margins to recover fixed costs also means that producers will have strong incentives to maximise transaction volumes because the more volume they achieve the more profits they make. In this way, the profit maximising fee structure for credit card networks will maximize transaction volumes.

Merchants that accept different payment methods tend to charge the same price for the goods or services sold whether they are paid for by card, cheque or cash, even though one type of transaction may cost the merchant more. This effect is observed in many jurisdictions and is commonly referred to as “price coherence”. Because merchants operate in competitive markets, the merchant service fees paid by merchants pass into retail prices and are ultimately paid by both card-users and cash-users.

Figure 3 illustrates how merchant service fees are typically recovered by merchants

Authors should include an introduction and conclusion, written for the non-specialist, indicating the nature of their enquiry, the principal findings and the economic significance of these findings.

Figure 3: Merchant Fees are Recovered in Retail Prices



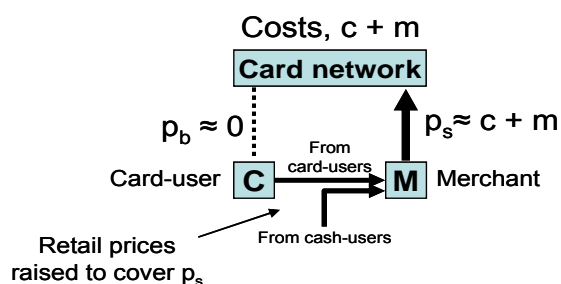
Simply dividing the total costs of the card network evenly between card-users and merchants will not maximise the volume of transactions on a network, and will therefore not result in a profit-maximising outcome. Similarly, trying to apportion costs will not maximize volume or profits because of the different demand characteristics of card-users and merchants. This feature of the credit card market is described in more detail in section 2.2 below.

To maximise their profits card networks channel a greater share of fees towards merchants, who tend to be

less responsive to price changes than card-users. In most countries, card-users fees p_b appear to be close to zero, or negative as a result of fee holidays for new credit cards and reward programmes. Even non-reward cards charge card-user fees only a small amount, and typically through annual member fees rather than transaction fees.

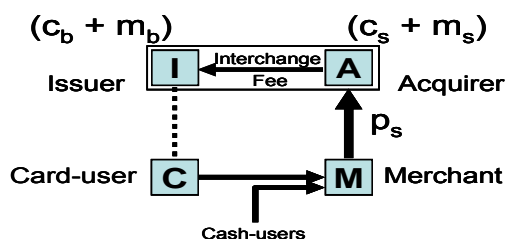
Figure 4 illustrates the differential fee structure favoured by card networks. Card-users incur no cost for using cards. Rather, fees (of the order of one percent of the transaction value) are charged to merchants, who in turn increase retail prices. This price structure clearly encourages consumers to use their credit card, helping to maximise transaction volumes and network profits.

Figure 4: Incidence of Costs with Low Card Holder Fees



So far we have presented card networks as a single entity. In fact, the major card networks (Visa and MasterCard) are made up of member banks that perform certain functions within the network. This means that four parties are now involved in completing card transactions—the card-user, card-user’s bank (the issuer), merchant, and the merchant’s bank (the acquirer). Figure 5 shows how four-party networks maintain the pricing structure used by a single card network shown in Figure 4. While a single network (such as American Express) can set prices to both card-users and merchants, four-party networks achieve the desired balance between merchant service fees and card-user fees through an interchange fee, paid by the acquiring bank to the issuing bank.

Figure 5: Interchange Fees in Four-party Networks



Where card-user fees are negligible, the interchange fee will be covering not only the acquirer’s costs and margin ($c_s + m_s$), but also the issuer’s marginal costs and margin ($c_b + m_b$). If the net price to card-holders is negative because of rewards, the interchange fee will be covering the net value of the rewards as well. The interchange fee mechanism enables four-party networks to achieve the fee balance on the two sides that is described above as maximising transaction

volumes and profit. The four-party networks can thus achieve much the same fee structure as if they were integrated schemes combining issuing and acquiring functions.

Economic Characteristics of Two-sided Markets

One of the unique features of the market for payment cards is that the card network needs to attract two distinct groups of customers—card-users and merchants—and convince them together to demand the network’s services. A supplier in this type of market has a different challenge than in a typical consumer services market, where suppliers can focus on supplying a single group of consumers with the service at a price and quality level that attracts a profitable level of demand.

This feature of the payment cards market has been described as a “two-sided market” (Rochet and Tirole, 2002). Assuming that the different consumer groups targeted by the network have different demand characteristics, then the price structure used by suppliers becomes at least as important as the total level of prices in maximising the value of the services provided by credit card networks. Rochet and Tirole (2004c) contend that the defining feature of a two-sided market is the ability for price structure to influence transaction volumes.

“A market is two-sided if the platform can affect the volume of transactions by charging more to one side of the market and reducing the price paid by the other side by an equal amount; in other words, the price structure matters, and platforms must design it to bring both sides on board.”

If few consumers hold a particular credit card, then merchants will not perceive value in accepting that card. Similarly, if few merchants accept a particular card then the value of that card to consumers will be small. Even where a large number of cardholders and merchants participate in a card network, the price charged on one side of the market still affects the participation of consumers on the other side. For example, in the payment card market an increase in the fees charged to card-users would be expected to decrease demand not only from card-users, but also from merchants.

Some commentators claim that if card-users and merchants are free to negotiate on prices then the effect of the interchange fee (in weighting fees towards the merchant side) could be cancelled out (Gans and King, 2001). However, other commentators note that fees often cannot be circumvented through negotiations—either due to the transaction costs associated with negotiating or specific network rules prohibiting such conduct (Rochet and Tirole, 2004). Accordingly, the networks’ choice of fees to merchants and cardholders

will commonly determine the costs borne by each consumer group.

Other commonly cited examples of two-sided markets include real estate agents (who need to attract home sellers and buyers), video game platforms (game-users and software developers) and newspapers (advertisers and readers). However, analogies with pricing in these industries are not perfect because credit card providers must attract card-users and merchants on a one-to-one basis for a transaction to take place. This tends to make the two-sided feature of the payment card market more challenging for networks.

In two-sided markets different consumer groups will inevitably have different responses to price changes, which means that simply splitting the total cost evenly or pricing each side of the market at marginal cost will not be optimal. Faced with two-sided demand firms typically choose to charge asymmetric prices, with one group paying a price substantially less than the other group, and sometimes paying a price below marginal cost and even below zero. Relating this feature back to the examples of two-sided markets cited above, real estate agents may only charge house sellers, video game platforms will charge software developers more than game-users, and newspapers will charge advertisers a greater share of their costs than readers, and indeed some newspapers will be provided to readers free of charge.

In the market for credit card payments, merchants are generally seen as more willing to pay a greater share of the network's costs than card-users. One explanation for this willingness to pay is that merchants not only accrue direct benefits through the added convenience of processing payments by cards (through lower cash handling costs and added security), but they will also internalise a subset of the benefits provided to card-users to attract them into their store (Rochet and Tirole, 2006b). This means that merchants are prepared to pay fees to enable card-users to implement their preference for credit cards (given the convenience benefits to the consumer and incentive rewards), because merchants are confident about their ability to pass these costs through into retail prices. In the same way that merchants are prepared to incur costs that help to attract consumers to shop with them (such as providing car-parking or child entertainment facilities), merchants will be willing to pay for payment methods that consumers demand, and will ultimately pass these costs into their prices.

The high level of merchant willingness to pay has caused concern, with claims made that merchants cannot resist increases in fees and are therefore "captured" by card networks that can exploit this willingness to pay. Rochet and Tirole (2006b) have developed a theory that card networks will tend to increase prices to merchants up until a limit where groups of merchants refuse to accept cards. This theory provides a credible explanation of actual interchange fee movements in New Zealand and overseas, where interchange fees increased following the establishment of the networks, and have recently declined in certain

merchant categories, such as supermarkets and petrol stations.

Allegations of Anti-competitive Effects

As mentioned in Section 1 of this paper, the Commerce Commission of New Zealand brought a claim against Visa and MasterCard and their member banks for enforcing an interchange fee on transactions in New Zealand. The concern of the Commerce Commission was that because commercial banks are competitors in the markets for issuing credit cards and acquiring card transactions, those same banks should not be allowed to collectively set interchange fees. By collectively setting fee levels (or agreeing to fees set by the MasterCard or Visa), the involvement of banks was alleged to constitute a horizontal agreement between competitors to fix prices.

The Commission claimed that the price being fixed was the merchant service fee (MSF), because a commonly agreed interchange fee provides a floor on the MSF and prevents acquiring banks from offering lower transaction fees to merchants. Specifically, the Commission alleged that interchange fees prevents acquiring banks from negotiating lower (or zero) interchange fees with issuing banks. If they could negotiate different interchange fees, then acquiring banks would pass any cost savings onto merchants through normal competitive processes and negotiations.

The New Zealand proceedings followed high-profile investigations and competition law cases in the United Kingdom and Europe. The Office of Fair Trading (OFT) in the United Kingdom conducted an inquiry into the rules and fees set by MasterCard, and released a decision in 2005 finding the MasterCard interchange fee mechanism constituted price fixing and reimbursed issuers for costs that were not indispensable for operating the system (OFT, 2005). This decision was set aside in 2007 on the grounds that it was not fair for the OFT to change the counterfactual to a collectively set interchange fee that was relied upon during an appeal.

The OFT has continued to investigate and monitor interchange fees, and has paid close attention to similar claims made against MasterCard by the European Commission (EC) relating to cross-border interchange fees. In December 2007, the EC found that MasterCard's multilateral interchange fee infringed Article 81(1) of the EC Treaty because it constituted a restrictive business practice that increased retailers' costs without leading to more efficient outcomes. MasterCard did not meet the exemption criteria under Article 81(3) because it had failed to show that its interchange fee benefited consumers and merchants. Since that decision, MasterCard has not proposed alternative fee arrangements that the EC considers contribute to technical or economic progress while allowing consumers a fair share of the resulting benefit, and in July 2008 MasterCard temporarily repealed its cross-border interchange fees.

Under competition law in many countries (including in New Zealand), price fixing is deemed to substantially lessen competition (known as *per se* liability). Accordingly, competition authorities will often not inquire into the underlying economic rationale for setting interchange fees on a multilateral basis, and will simply note that MSFs are higher as a consequence of interchange fees. However, the economic literature suggests that if issuing banks have more influence within card networks than acquirers, interchange fees can be used to direct revenues and profits towards issuers at the expense of merchants and consumers (Frankel and Shampine, 2006). Fixing interchange fees at higher levels will increase profits if issuers have a degree of market power over card-users, and are able to retain some portion of interchange revenues as profits instead of passing these benefits through to card-users in the form of rewards or fee reductions. The position of New Zealand banks as both issuers and acquirers tends to increase suspicion that interchange fees are used as a way to increase bank profits.

Claims have also been made that interchange fees promote excessive credit card use and are unfair to consumers paying by other methods. Prior to the regulation of interchange fees in Australia, the Reserve Bank of Australia (RBA) conducted a study which concluded that the costs of processing transactions on a debit card network were lower than processing transactions on a credit card network (ACCC and RBA, 2000). This led the RBA toward measures that would increase debit card usage relative to credit card usage in an effort to increase overall economic efficiency. There is an extensive body of economic literature challenging this argument, which suggests that any additional cost of credit card transactions comes with benefits that make credit cards comparable to other payment methods in terms of economic welfare (Garcia Swartz et al, 2006).

It appears that any impacts of interchange fees on economic efficiency effects are not relevant to competition law claims, falling instead under the mandate of central banks to ensure the efficiency of payment systems under direct regulatory interventions. Although competition law aims to improve efficiency by facilitating competition, the law does not directly attack areas of inefficiency. However, Farrell (2006) argues that distorting consumer choice away from the best available payment option is a concern for competition law. Farrell proposes that to achieve overall efficiency, interchange fees should be set at levels where merchants would be indifferent to method of payment that the consumer selects.

View of Interchange Fees as Pro-competitive

In broad terms, the economic counterargument to the problems identified above is that antitrust proceedings cannot succeed in dealing with any concerns over the credit card schemes' fees and rules. If credit card schemes are in some way too successful and thereby shown to be giving rise to major economic

inefficiencies, then a more appropriate remedy would be regulation (Rochet and Wright, 2009).

This section explains the view that credit card fees are pro-competitive. The basic argument is that interchange fees are a key feature in allowing four-party networks to compete with the American Express model, and are vital in continuing to promote credit cards.

First, we explain the economic counter to the idea that interchange fees are simply illegal because they fix MSFs. We then draw back to the wider question of whether any features of credit card systems restrict competition in a relevant market. We explain the idea that the relevant market should be payment schemes, not just the component activities within card schemes, like acquiring.

Although the Commerce Commission did not make any claims against the participants in the card schemes in respect of effects in a payment schemes market, we outline the difficulties in making such a case. We also describe how the card schemes have defended claims in other jurisdictions that interchange fees restrict competition in acquiring.

Do Multilateral Interchange Fees Fix Prices?

The economic counter to the price-fixing claim is that although interchange fees may technically fix a portion of MSFs, they should be seen as a legitimate cost that is set as part of a joint venture. Accordingly, interchange fees should not be *per se* illegal: a rule-of-reason analysis must be applied. The logic is as follows.

To form and operate a payment scheme in which transactions are completed using the cardholder's bank and the merchant's bank, the banks have to act together to form a network. Visa and MasterCard have facilitated the process of setting up two such networks. The banks and the schemes operate together as a joint venture (JV). None of the participants could individually form the network or provide the full set of necessary activities as effectively as the JV.

The Commerce Act 1986 anticipates that JVs will need to feature agreements between firms that might otherwise be competitors, including agreements that will specify the quantity and price of the outputs of the JV. Section 31 of the Commerce Act exempts JVs from the *per se* price fixing prohibition in section 30. The litigation in New Zealand would have tested whether the card schemes meet the legal requirements for being a JV, but the economic logic strongly suggests that these arrangements would be treated as *bona fide* JVs.

Under New Zealand law, a card scheme that qualifies as a JV has a legitimate interest in determining MSFs and cardholder fees to maximise profits. In other jurisdictions, if the JV has substantial market power, its efforts to maximise profits may be constrained. In New Zealand, and firm with substantial market power is only prevented from taking advantage of that market power to limit competition. As illustrated earlier, the

interchange fee is one way of setting the balance between prices on the two sides of the market in order to maximise transaction volumes and profits.

The association of interchange fees with price fixing appears to have arisen because the payments are made between horizontal competitors. In other in single-sided markets and sectors like telecommunications, such horizontal and reciprocal payments have been seen as a device to raise retail prices. In response, commentators point out that the prices on the two sides of the credit card market could be adjusted instead by the network (Visa or MasterCard) charging merchants (via acquirers) a higher processing fee for transactions, and lowering cardholder charges by paying a promotional bounty on transactions to issuers (Katz, 2001). This is essentially how American Express now operates. In this view, the interchange fee is a vertical arrangement between the card schemes (Visa and MasterCard) and participating banks. Vertical arrangements are usually assessed using a rule-of-reason approach (using section 27 of the Commerce Act in New Zealand).

Finally, we note that it may be illogical to seek to remove just one provision from the JV agreements because it influences MSFs and is therefore alleged to be price-fixing. Any provision in the agreements that affects the variable costs of issuers or acquirers must affect the prices charged to merchants and cardholders. Either all such provisions constitute price fixing, or none of them do. The competition authority needs to decide whether it wants to modify the schemes or prevent the four-party model from operating at all.

What is the Relevant Market?

As explained earlier, competition authorities in the United Kingdom, European Union, and New Zealand, have alleged that the interchange fee mechanism breaches competition law. In these actions, competition authorities have alleged that the interchange fee mechanism restricts competition in a market for acquiring.¹ The authorities contend that in the acquiring market banks compete for the custom of merchants to handle payments made to the merchants on a particular brand of credit card.

Defendants have argued that an acquiring market is not adequate in understanding the competitive effects of interchange fees. Defendants claim that the relevant market for any antitrust challenge to interchange fees is the market in which credit cards compete with other payment options like debit cards (EFTPOS in New Zealand), cheques and cash.²

Acquiring is clearly an area of rivalry between banks, and interchange fees are acknowledged to directly affect MSFs. However, given the wide acceptance of

the idea that market definition in competition proceedings should be determined to allow a full understanding of the relevant commercial pressures, defendants argue that the wider market is required.

The characterisation of card schemes by Rochet and Tirole (2006a) described earlier provides support for a broader market definition. If the interchange fee is raised (thus raising MSFs), cardholder fees will go down to some extent (or rewards increased) and cardholders will be more enthusiastic to use their cards. Up to some limit, merchants will make allowance for this increased preference because the quality of the card scheme increases with increased cardholder demand. The stronger cardholder preference makes it more risky for the merchant to decline payment by credit card because the cardholder is more likely to shop elsewhere. This feedback via the cardholder that increases the merchant's willingness to pay the higher MSF cannot be captured by considering just an acquiring market.

This interrelated demand from cardholders and merchants also complicates the usual test for thinking about the boundaries of a particular market—the SSNIP test (a “small but significant and non-transitory increase in price”). In relation to card payments, the SSNIP test could be applied individually—to merchant service fees, card-user fees or interchange fees—or only applied to the total of card-user and merchant fees. The application depends on whether card networks are viewed as comprising of three specific payment services—acquiring, issuing, and wholesale transaction processing—or whether instead networks are seen as providing a more general product that enables transactions between card-users and merchants. The most direct comparison to a hypothetical monopolist in a conventional one-sided market is to apply the SSNIP test to the sum of card-user and merchant prices, which make up the total revenue collected by a two-sided monopolist per transaction (Emch and Thompson, 2006).

Defendants in the European Union and United Kingdom have also argued that a focus on acquiring is misleading because an acquiring transaction (the merchant's bank processing a purchase made on a card) can only happen with an immediate associated issuing transaction (the cardholder's bank making payment for the purchase). Defendants argue that one cannot understand why acquirers would agree to pay interchange fees without analysing their effects on transaction volumes.

Do Interchange Fees Restrict Competition?

This section outlines the economic arguments that support the contention that interchange fees do not restrict competition in a payments schemes market. To our knowledge, no competition authority has ever succeeded in a case against credit card schemes in a wider payment schemes market. We also note the counter-arguments to the proposition that the interchange fee restricts competition in acquiring, relative to plausible counterfactuals.

¹ Different precise wording applies in each body of legislation. The Commerce Act in New Zealand refers to “a substantial lessening of competition”.

² Cash is an unusual “competitor” because it is provided free by the central bank, not commercially.

The competitive effect of interchange in a payment schemes market

The Rochet and Tirole (2006b) model is typical of many theoretical treatments of credit card schemes in concluding that the interchange fee will be chosen to maximise the volumes of transactions on credit cards, in order to maximise the profits of all participants.³

Maximising the volume of output of a JV would not normally be seen as a restriction of competition in New Zealand, unless there is some sort of predatory attack on other payment schemes like EFTPOS. In New Zealand, a predatory pricing analysis would be complicated by the fact that providers of EFTPOS, arguably the main competitor to credit cards, are the same banks that are participants in the credit card schemes. In practice the management structures of the credit and debit businesses within the banks appear to be set up to operate independently and competitively, but the Commerce Commission would treat the management teams as “associated persons” (under Sections 47(3) and (4) of the Commerce Act).

In the wider payment schemes market, the interchange fee is arguably less significant in assessing the market power of different payment schemes. As noted above, economists at the United States Department of Justice recommend that the relevant indicator of market power in two-sided markets is the total price, in this case, the sum of MSFs and cardholder fees (Emch and Thompson, 2006). The interchange fee is clearly not a floor to this total price.

Firms that achieve a strong market position are not subject to any particular form of regulation, but will be monitored by competition authorities for signs of exclusionary conduct that seeks to maintain their position. For example, in the credit cards market Visa was found to have breached competition law in the United States by prohibiting member banks from also issuing American Express or Discover cards.⁴

Finally, if the total price of credit card services were deemed too high, the only cause of action under the Commerce Act 1986 is to mount a price inquiry and to consider the costs and benefits of price regulation.

Revisiting the acquiring market

In the event that a Court chooses to focus on a narrow acquiring market, then the argument that the interchange fees underpin MSFs would be difficult to challenge. If the court was persuaded that MSFs would be lower under some other set of rules and arrangements for the interchange fee, then the higher fees could be equated with a lessening of competition. The counter-arguments raised in various jurisdictions are:

³ See also more recent work by von Weizsaecker (2009) at: <http://www.coll.mpg.de/download/Weizsaecker/CCvW%20Antitrust%20Problems%20of%204-Party%20Payment%20Systems.pdf>

⁴ *U.S. v. Visa U.S.A., Inc.* 2003 WL 22138519 (2d Cir. Sept. 17, 2003).

- It is wrong simply to equate higher prices with a lessening of competition in acquiring. The interchange fee will underpin the MSF but only in the same way as a manufacturer’s uniform wholesale price underpins retail prices. A particular interchange fee has no effect on the intensity of competition in the provision by banks of the acquiring service itself (improving the acquiring service itself, reducing costs and the acquirer’s “retail” mark-up over and above the interchange fee) (Wright, 2004)
- Even in an acquiring market, allowance should be made for the feedback effect of a higher interchange fee increasing the cardholder’s desire to use the card and hence the merchant’s ability to raise prices to accommodate that desire (Rochet and Tirole, 2006b)
- A lessening of competition needs to be assessed relative to some counterfactual. We view the counterfactual as what the card schemes could and should have been doing in the past, other than using the interchange fee mechanism. One possibility is that the schemes set up in New Zealand using a similar structure to American Express. In this arrangement, there would have been no competitive acquiring activity and hence no competition to be lessened (von Weizsacker, 2002).

The Settlement and Unresolved Issues

In the last months before court proceedings were due to begin in October 2009, the card schemes and the banks settled with the Commerce Commission.⁵ The settlements changed some of the card scheme rules, as they apply in New Zealand, and appear to have achieved a step down in interchange fees.⁶

In relation to the interchange fee paid to New Zealand issuers, the settlements specify that issuers can now unilaterally post their required interchange fees, subject to any agreements they may reach with acquirers, and subject to a maximum level determined by Visa or MasterCard.

The settlements would appear to rely on negotiations to raise interchange fees now being quite difficult so that interchange fees will not drift upwards towards the

⁵ See for a description <http://www.comcom.govt.nz/MediaCentre/MediaReleases/200910/commercecommissionandmastercardagr.aspx> accessed 8 Feb 2009.

⁶ See <http://www.comcom.govt.nz/MediaCentre/MediaReleases/200910/creditcardsettlementslowernewzeala.aspx> accessed 8 Feb 2009.

The settlement agreements with the banks have redacted the specific provisions affecting the interchange fees.

maximum level set by the card schemes. The downward pressure on interchange fees arises because acquiring banks can threaten to pass on any higher interchange fees in specific MSFs to merchants, encouraging their merchants to surcharge that issuer's cards differentially.

We note that the settlements allow issuers and acquirers to negotiate over interchange fees despite the fact that most participating banks are both issuers and acquirers, meaning that the negotiations will continue to take place between horizontal competitors. This can be seen as strengthening the argument that the schemes are legitimate JVs.

In the wake of the settlement, some interesting issues remain unresolved.

Cost-based fees in a fixed-cost industry

Regulators elsewhere have assessed whether an efficient interchange fee could be identified on the basis of costs. Indeed, banking regulators have long been keen to require bank fees to be "cost-based", a policy most evident in New Zealand in the Credit Contracts and Consumer Finance Act 2003. However, many diverse services in banking appear to be provided on the basis of a common set of largely fixed costs—such as computer hardware and database programs. This cost structure makes it very difficult to identify costs "caused by" any particular transactions. Rochet and Wright (2009) have suggested that any regulation of the interchange fee should be on the basis of issuers' costs or the merchant's avoided costs (in not having to provide store credit) but both of these benchmarks could be difficult to implement. Stores' costs of working capital and of carrying the default risk would be highly variable. On the issuer's side, marginal costs can be very small in what is a largely fixed-cost business, and there is still the question of how much of any marginal costs should be allocated to merchants.

Card schemes are no longer owned by banks

Most of the analysis of the competitive pressures amongst payment schemes and participants has been carried out at a time when the major card schemes were effectively co-operatives of participating banks. In this setting, the processing fees charged by the schemes were set largely just to recover costs with interchange fees set to maximise profits for the participating banks. Now with the schemes in private ownership, it is reasonable to expect that the schemes will be seeking also to maximise their profits. It is not yet clear how this will affect competition between the schemes and the banks' incentives to improve returns from their own schemes like EFTPOS.

The settlement closes the debate in New Zealand for the meantime, but these issues will be debated further and at great length in upcoming litigation in the European Union, the United Kingdom and the United States.

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