Malte Krueger and Christoph Strauch (PaySys Consultancy GmbH Frankfurt)
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Preserving interchange: from explicit to implicit MIF

Introduction

The collective setting of interchange fees is interpreted by many competition authorities as collective price fixing. It is argued that the collectively set interchange fee is used to set a minimum price on the acquiring side of the market. So far, these concerns led to the introduction of regulatory regimes which basically meant that a kind of cost-based interchange was introduced. In practise, this implied a reduction in interchange rates. Examples are the OFT decision in the UK and the decision by the Reserve Bank of Australia. The recent MasterCard decision of the EU Commission, however, seems to be more serious threat against interchange in general.

The decision of the EU Commission apparently rests on the idea that interchange is a price for services rendered by issuers to acquirers. Such a price could be, in theory, negotiated bilaterally. If it is fixed collectively for all issuers and acquirers, this does, indeed, look like a "restrictive business practise" violating Article 81 of the EC Treaty. It is well known, however, that this argument is not accepted by everybody. In particular, there is a large body of theoretical literature that suggests that interchange should not be interpreted as a price. Apparently, the EU Commission rejects these arguments in favour of a focus on the economic outcome of interchange, namely a "floor under the MSC". Since the non-confidential version of the MasterCard decision has not yet been published, we do not know what arguments the commission is putting forward. Judging from the first explanations given, it will be very difficult indeed, to meet the conditions for an exemption as set out in Article 81 (3) of the EC Treaty (provided, of course, the decision is approved by the European Court of Justice).

So, what could be done to save MIF or at least the desirable effect of a MIF, namely to bring both market sides in balance to an efficient outcome? In this article we are developing a method of setting a sort of MIF which should be in accordance with he principles of the EC Treaty (i.e. no collective price setting and thus no violation of Art. 81) and which will hopefully provide a better outcome by increasing competition. We suggest to call this new type of MIF "**implicit MIF**" in contrast to the current **explicitly charged MIF**. Note, that we neither argue that recent MIF actually is optimal set nor that the methodology currently employed by the card organisations is the best possible.

The implicit interchange is introduced through implementation of the new role of an "**interchange trader**" which takes on its own behalf the commercial responsibility for negotiating individual fees with each issuer and acquirer, and receives income from the spread. The respective fees paid by acquirers and paid to issuers may be considered as an **"implicit interchange"**, even when there will no direct flow of fee from an acquirer to an issuer and these fees are not uniformly set! Moving from an explicit to an implicit interchange fee would also make it much easier to defend the principle of interchange against anti-trust concerns. With the implementation of the role of an interchange trader, the traditional 4-party card schemes are transformed into 5-party schemes. In the following, we will argue that current 4-party payment systems already can be interpreted as 5-party systems as well and that a few alterations in the organisation of these systems would make the 5-party character more explicit.

Implicit MIF in 5-party schemes

Card payment systems are usually classified as 3-party or 4-party systems. In 3-party systems, one single institution serves both, as issuer and acquirer. In 4-party systems, there are a large number of institutions serving as issuers and/or acquirers. Some systems may require its members to be active on both sides of the market. However, this is not an essential ingredient of 4-party systems. In fact, in the two largest 4-party systems, MasterCard and Visa, there are institutions that offer only acquiring services, whereas others offer only issuing services and some are active as issuers and acquirers.

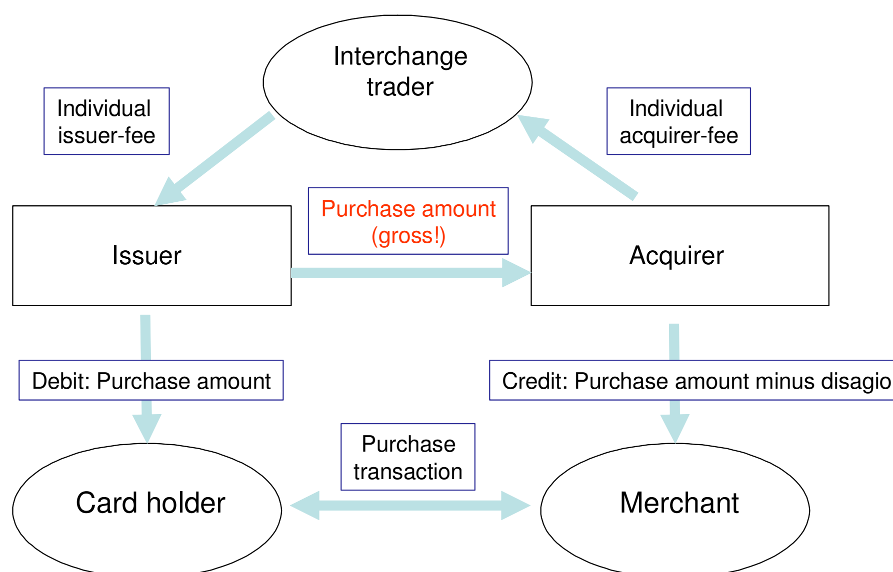
In addition to the four parties mentioned, 4-party systems are employing a fifth party with responsibility for

- licensing and managing the brand,
- setting and supervision of the rules, and
- provision of central switching, clearing and settlement services.

In order to be able to perform these functions, the card organisation charges issuers and acquirers a number of fees: membership fees, assessment fees, processing fees, etc. The card organisation does not, however, pay or receive interchange fees. So, the term "4-party system" is reflecting the fact that the fifth party is only providing the platform but is not commercially involved in the delivery of the payment services through the platform.

These interchange fees are paid from acquirers to issuers (in a few systems the payment is from issuers to acquirers). As a rule, interchange fees are set by the card organisation, i.e. collectively by its members. The collectively set interchange fees apply to all issuers and all acquirers. This is interpreted by the EU Commission (and others) as setting a common floor for merchant service charges. Thus, according to this view, a minimum price is fixed collectively. Competition authorities are believed to have no issues with a fee paid from acquirers to issuers, when the fee would be bi-laterally negotiated between each pair of issuer and acquirer.

The architecture of the 5-party-system with interchange trader



Clearly, it is not practically to negotiate individually interchange fees bi-laterally between each pair of issuers and acquirers due to the large number of bi-lateral relationships. By the

way, it would also be inefficient, given the small bi-lateral volumes. The straigtforward way to overcome such an ugly constellation is to bundle volumes via use of "**traders"**. To implement the role of a trader would mean to introduce a player who negotiates "interchange fees" separately on both sides with full commercial responsibility. More explicitly, the "**interchange trader**" would, on the one side of the market, negotiate an individual price with each acquirer for presenting transactions and, on the other side, negotiate a remuneration with each issuer individually for honouring all presented transactions. As usual, the trader will earn **revenue from the spread** between average prices on both sides.

Naturally (but not necessarily), the role of the trader would be taken over by the card organisations. This would transform the traditional 4-party systems into 5-party systems, where the fifth party is really participating in the business rather than only providing a platform. Of course, this model will require some changes in the commercial relationships between issuers, the card scheme and acquirers and the commercial structure of entire systems.

Some straightforward implications are that acquirers would no longer pay an interchange fee directly to the issuer for feeding transactions into interchange. They just would pay the agreed fee to the trader (for instance the card organisation). On the other side, issuers would receive the agreed fee from the trader for honouring all presented transactions. In this case, there no longer would be an explicit flow based on a uniform interchange fee. There simply would be two prices, one paid by acquirers and one paid to issuers. Of course, there would be an implicit interchange fee: the part of the acquiring fee that the card organisation passes on to issuers. A fraction of the acquiring fee, the "spread" is retained by the card organisation. Note that the card organisation is not primarily interested in the level of interchange but in spread income (i.e. spread times volume). Accordingly there would be plenty of room for the interchange trader to further develop the market through negotiating special rates to provide incentives for particular sectors, countries, technologies etc. On the other side, issuers and acquirers will compete with each others to produce the best value for the system in order to get the most attractive rates from the trader.

To which extent actual changes in the legal structures (with regard to liabilities and provision of payment guarantee) is required or whether the commercial model can be implemented based on changes in the fee structure only is believed to be of no relevance with regard to the anti trust concerns. For ease of implementation we would prefer a pure commercial solution.

Consequences

The new set-up would make it much more difficult to argue that this sort of implicit interchange constitutes a restrictive business practise. After all, one company, on behalf of its role as interchange trader, simply sets a price for its services and another price for its inputs – just like a manufacturer of shoes charges wholesalers a price X per shoe and pays other wholesalers a price Y for leather. Of course, it could still be the case that this company has market power. However, the proper indicator of market power would be the spread (and the profits it implies) – not the level of interchange.

Such a re-organisation of their business models may provide a way for card schemes to retain the desired economic effect of interchange. One should, however, not make the mistake to see such a move as merely cosmetic. Once the schemes, as interchange traders, are the commercially responsible counterparty for issuers and acquirers – receiving the entire acquirer fee and paying out the entire issuer fee, there will be incentives for negotiating

differentiated rates and maximising the profit out of the spread. In particular, it can be expected that very large issuers will get better deals than small issuers and very large acquirers will get better deals than small ones. In fact, schemes may be tempted to contract with large merchants directly – opening the way for “self acquiring”. Thus, it can be expected that there soon will be a range of acquirer fees and a range of issuer fees. In this case, the implicit interchange fee will be a weighted average of all fees.

A vision only?

Some of these tendencies can be observed already: This approach can hardly be implemented in interbank organisations where customers are also shareholders. Also this approach is in obvious conflict with the traditional “not for profit” set up of card organisations. But with the incorporation of MasterCard and Visa (the latter not yet completed) the basic prerequisites are fulfilled. Thus, the explicit move towards a 5-party system would only accelerate tendencies that have already gained momentum with the incorporation of MasterCard in 2006. As an incorporated company, MasterCard has already become a more active “5th party”. Its strong capital base allows it to lure issuers with special “incentives” or large merchants or entire sectors with lower rates.

Finally, we would like to point out that it can also be observed that a three party scheme like American Express is issuing cards through bank partners. Even if these cards legally are issued by Amex and the bank only serves as distribution partner, the commercial model is not far from the one mentioned above because the bank gets a volume-based commission from Amex. So, the 3-party organisations are also in a position to take the direct way to a 5-party system, not taking the detour through the four-party model as Bankamericard with Visa and the couple of regional American Banks with the Interbank Card Association (now MasterCard) did. .