

Topics of this issue:

- 1. The European Commission's decision on MasterCard MIF**
- 2. EC rules out CB's MERFA**
- 3. Neelie Kroes (DG Competition) on SEPA for Cards**

1. The European Commission's decision on MasterCard MIF

At long last, the European Commission has published its decision on the MasterCard's intra EEA Multilateral Interchange Fee (MIF). The Commission prohibits the MasterCard MIF and gives MasterCard six months time to comply with this decision.¹ (A decision with respect to commercial cards has been postponed.) Shortly afterwards, MasterCard Europe said that it will appeal to the European Court of First Instance.

Competition Commissioner Neelie Kroes said: "Multilateral interchange fee agreements such as MasterCard's inflate the cost of card acceptance by retailers. Consumers foot the bill, as they risk paying twice for payment cards: once through annual fees to their bank and a second time through inflated retail prices paid not only by card users but also by customers paying cash. The Commission will accept these fees only where they are clearly fostering innovation to the benefit of all users."

In an accompanying paper ("frequently asked questions")² the Commission provides further information about its decision. The Commission interprets an interchange fee as a "mechanism that restricts price competition". As such, it has to fulfil certain conditions in order to be accepted (inter alia improve efficiency and benefit consumers) (see Article 81(3) EC). According to the Commission, "MasterCard's MIF operates with unrealistic assumptions and MasterCard failed to submit empirical evidence to demonstrate any positive effects of its MIF on the market" (p. 2). Therefore, the Commission concluded that it could not accept the MasterCard MIF.

The Commission stresses, however, that the MasterCard decision does not imply that interchange is per se illegal. It may be acceptable if it is "indispensable to creating efficiencies that may outweigh the restriction of competition" (p. 6). Unfortunately, it remains rather obscure, what this means in practise. The Commission only refers to the general provisions in Article 81(3) EC. The only concrete examples of conditions allowing the use of

¹ See press release from 19.12.2007. <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1959>.

² MEMO/07/590 "Antitrust: Commission prohibits MasterCard's intra-EEA Multilateral Interchange Fees – frequently asked questions", Brussels, 19.12.2007 <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/590&format=PDF&aged=0&language=EN&guiLanguage=en>

MIF are one-off SEPA investments “To the extent that proceeds from a MIF are dedicated to cover one-off expenses for upgrading existing payment card schemes to SEPA standards this may possibly be considered in evaluating the existence of objective efficiencies of a MIF under Article 81 (3) EC.” (p. 5)

Our comment:

The Commission has passed a tough ruling on interchange and at this moment it seems unclear whether and to what extent interchange may still be applied in the future. In its reasoning, the Commission follows the argument adhered to by many competition authorities that the interchange fee is a “price” and that the setting of a multilateral interchange fee restricts price competition. It thus rejects the theoretical argument put forward by many researchers that interchange is not a price but a balancing fee. The decision goes beyond earlier verdicts of the Commission (as in the Visa case) or other competition authorities such as the OFT in the UK or the Reserve Bank of Australia. In all of these cases, the outcome was a cost-based interchange. Only in Poland, interchange was rejected outright.

What are the implications? At the moment, there are still many question marks:

First, MasterCard is going to appeal. Thus, the Commission’s decision will be scrutinized by European judges.

Second, technically, the decision only applies to intra EU cross-border transactions. For national transactions, national competition authorities will have to decide.

Third, interchange is not per se declared illegal. But it is unclear under what conditions interchange will be accepted.

What can be said is that it is well possible that the judges will confirm the Commission’s ruling. Moreover, judged from the arguments published, it seems likely that interchange will be allowed only under very restrictive conditions. Finally, the Commission hints that it has been coordinating its decision with national regulators (Frequently asked questions, p. 6). Thus, it is not unlikely that card payments schemes in Europe will have to function without interchange, in the future. We do not have the space in this newsletter to elaborate in detail on the consequences. However, a few brief comments are in order.

First, in the debit market high interchange meant that MasterCard and Visa had problems to compete with low interchange (national) debit systems. This disadvantage has vanished.

Second, it was believed that high interchange would be a powerful instrument to attract issuers. This instrument has also been removed.

Third, one of the distinguishing features between debit and credit is interchange. With interchange uniformly set to zero (and credit cards moving towards EMV and PIN-only) the difference between credit and debit cards becomes smaller.

Fourth, as long as Amex does not fall under the Commission's ruling, it will have the possibility to set its (implicit) interchange without restrictions. Thus, Amex will become relatively more attractive for issuers.

Fifth, in many countries, card holder fees will have to rise and/or additional card benefits (like loyalty programs) will have to be reduced. (Is this intended by the Commission?)

2. EC rules out CB's MERFA

In January 2003 the Groupement des Cartes Bancaires, announced a newly introduced membership fee structure to the EC. Part of the Ruling was the introduction of so called MERFA (Mecanisme Regulateur de la Fonction Acquereur), which basically is a charge payable by issuers who have substantially lower acquiring volume than issuing volume. On 17. Oct. 2007, the Commission finally decided about the case. The mechanism was considered as an infringement of competition and accordingly forbidden.

Our comment:

The MERFA decision has close connections with the decision in the MasterCard case. In both cases, the Commission had to decide about pricing rules in networks. MERFA produces a revenue stream in the opposite direction of the regular interchange fee, which is paid from acquirers to issuers. It is well known that the Interchange in the CB scheme is relatively low. It has been approved by the French competition authority since the late 1980's. In particular the Interchange in the CB scheme is following a "fee for service" approach, which consists only of

- a contribution to the issuers processing costs,*
- a contribution to collective security measures on the issuer side and*
- an individual risk measure (TICO).*

We believe that such sort of purely cost based interchange fee is working well in a market, where for all participants issuing and acquiring volume are (nearly) balanced. The introduction of MERFA was an attempt of CB, to introduce a balancing element into the fee structure to prevent free riding of issuers on the infrastructure on the acquiring side. Even

when acknowledging that we do not know whether the imposed charges actually were appropriate, we wonder whether the reasoning of the Commission is correct. The Commission focuses solely on the effect on the issuing side of the French payment card market, stating that “new entrants have not been able to issue cards at the lower prices they intended”. Moreover, the Commission denies that there is any effect on the acquiring side, at all: “The Groupement has not been able to demonstrate an economic need to balance the acquiring and issuing activities, which are remunerated independently of the measures at stake. Moreover, the main tariff measure (the so-called “MERFA”) does not in fact encourage acquiring”. In our view, the very fact that the French market is only attracting foreign issuers to undercut the market prices but not foreign acquirers (as far as we know) shows that French acquirers are contributing a net value to the system. In the pre-SEPA world, when French banks ran the card payment infrastructure in a concerted effort, the lack of a balancing element did not affect the functioning of the system. Now that SEPA (which is strongly endorsed by the Commission) hinders national banking industries to jointly run a closed system in each country, the Commission is preventing the introduction of appropriate commercial agreements, by simply denying the very facts.

3. Neelie Kroes (DG Competition) on SEPA for Cards

On December 3rd, 2007 Neelie Kroes (European Commissioner for Competition Policy) gave a remarkable speech on “Key challenges and trends for Europe’s retail payment systems”.³ Her speech contains a number of strong statements concerning “SEPA for Cards”. She speaks out against simply closing down the existing national schemes: “I do not want to see low cost national card schemes being replaced by more expensive payment card schemes, using SEPA as an excuse and a pretext for this move.” (p. 2) Moreover, she does not see the need for a scheme to cover the entire SEPA area (31 states). “The Commission and the ECB feel there is no need that the key element of SEPA compliance should be the coverage of all 31 SEPA states.” (p. 3)⁴ According to Kroes “SEPA compliant” can be defined as follows: “the very concept of a Single Euro Payment Area requires that cards be technically and commercially capable of being accepted everywhere” (p. 3).

³<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/07/780&format=PDF&aged=0&language=EN&guiLanguage=en>

⁴ It is somewhat odd that she accuses the banks to have defined „SEPA compliant“ as implying that the 31 states of the SEPA territory have to be covered.

No new light is shed on the MasterCard case but Neelie Kroes says something interesting about the envisaged direct debit MIF: “Even if it can be argued that a MIF for direct debit transactions might be necessary in the initial phase or during the transition to SEPA, the justification for keeping it once migration is achieved would have to be very convincing.” (p. 4).

Our comment:

The speech is remarkable because it highlights the tension between a policy approach that tries to achieve co-ordinated standardisation and a policy approach that tries to foster competition. So far, the mantra of the EU Commission has been that standardisation is a pre-condition for competition. Indeed, this idea has its merits. There are numerous examples where proprietary standards have been used to close markets. However, if everything is standardised, the only parameter determined by competition is price. In scale markets such as payments, price competition between suppliers of identical products will lead to high concentration if not monopoly. Moreover, the function of competition to discover new and superior products is stifled. If everything is standardised, there is no competition between different solutions.

Thus, it is not surprising that the competition commissioner becomes concerned about the approach chosen for SEPA implementation. The alternative model, proposed by Kroes, opens the way for a truly market driven process of integrating European debit and ATM schemes. Such a process is likely to be similar to developments we have seen in the U.S. where a ragbag of POS and ATM schemes has been integrated mainly via mergers and acquisitions. The opening up of national schemes to foreign members and the incorporation of some of the schemes is a first step in this direction. Such a process may require some time, but if the Commission truly believes in the benefits of competition, Mrs. Kroes' colleagues should support her approach. Of course, the model sketched out by Mrs. Kroes will imply that the convergence to fewer schemes, each covering a wider part of the SEPA area, will take longer than initially anticipated.

A major problem on the road to more scheme competition is, however, the approach of the Commission towards interchange. What Commissioner Kroes fails to see is that the national schemes which she is always citing as laudable examples (in her speech as well as in the

MasterCard decision) of low or zero interchange were basically closed shops.⁵ Within these closed shops, not only prices were set jointly but also investment decisions were often taken jointly (“burden sharing”). Now these closed shops are expected to open up and compete across borders. But that implies that there is less reliance on joint decision making and more reliance on incentives via price. Cartes Bancaires tried to execute this and was rebuffed. The large 4-party credit card systems are already more open and accordingly rely more on internal price mechanisms such as interchange and are equally rebuffed. Thus, what is lacking is a consistent vision of how payment networks should be properly constructed.

Finally, it is also surprising that the Commission and the ECB are so concerned about a potential duopoly in the card market. After all, in the past, each European country usually had a monopoly debit card system.

Should you have any questions or comments please contact

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⁵ On page 6 of the „frequently asked questions“, the Commission states that there is hardly any research on balancing mechanisms - apart from interchange. A well-known and time-honoured mechanism is “burden sharing”. Whether this is preferable from a competition policy point of view is open to debate.