

# Interchange Fees: Central Bank Perspectives and Options

## General Discussion

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*Chair: Guillermo Ortíz*

**Mr. Chakravorti:** I have a question for the central banks up there. The Fed hasn't done much with this issue, so this question is mainly for the other central banks. The issue is the extension of credit with credit cards and how that benefits the merchant. That really hasn't been covered in this conference very much. When you look at these costs in the interchange fee, are any of those benefits to merchants by the extension of credit somehow captured? And the follow-up question to this has to do with the debit-credit substitution that we hear about often. Are there some studies to look at the substitution as to who uses the credit and how to discriminate at the point of sale on something like that? I know these surcharge policies have been removed, but do we actually see that in practice?

**Mr. Lowe:** I'll just make one observation. In our credit card standard, we included the cost of the interest-free period as one of the eligible costs. This is not a reflection of a judgment that the extension of such credit is of value to the merchant. It may well be of value, but, as I said before, including this cost was a pragmatic and transparent way of coming to an interchange standard.

I think we have heard a couple times over the course of this conference that for the merchant base as a whole, accepting credit cards is not of great benefit. Accepting these cards does not increase aggregate sales. For an individual merchant, if the competitors aren't offering credit cards, then doing so may create a benefit. But for the merchant base as a whole, I think there is a question mark over whether acceptance of credit cards increases aggregate sales.

**Mr. Ortíz:** In our case in Mexico, as I mentioned before, the number of points of sale in relation to the total amount of transaction payments systems, compared with other countries, is very small. Debit cards were most-

ly utilized just to draw money from ATMs. One problem, of course, was that the interchange fee for point of sale transactions was the same for credit as for debit. They were both calculated on an *ad valorem* basis. This is changing now.

Merchants were forced to pay high fees for acceptance of debit cards that obviously don't carry the same kind of risk. We were aware of this and are doing something about it.

**Mr. McAndrews:** This is for Guillermo Ortíz. You mentioned you would like to get more participants in the payments system. I wondered if you could discuss for a moment how far you think you can go or how the competition in banking itself can affect the sorts of outcomes you expect to achieve through regulation of the payments system in Mexico, given the high concentration in Mexican banking.

**Mr. Ortiz:** Well, that's the real question. We don't have answers; we have some ideas. For example, credit card issuance today in Mexico is limited only to banks. There are a number of very successful credit card companies operating in the United States, which are not necessarily linked to a banking operation. We are considering opening that market because, again, there is a very high concentration.

Both on the issuing and the acquiring side, the four largest banks account for about 75 percent of all transactions. On the acquiring side, it is even more concentrated. I think two banks account for almost 70 percent of transactions on the acquiring side. So we have to bring in more players. How we go about it is something we have to look at carefully, because some of the switches are owned by the banks only. There are no nonbank participants in the switches. This is something that the banks themselves must be aware of. This situation simply cannot go on, particularly in light of the degree of concentration.

As we were discussing previously, a high degree of concentration does not necessarily mean a low degree of competition. But if you have a concentrated market, the likelihood of having less competition is higher than if you have more participation. This is a key aspect of our reform, and we are working on that.

**Mr. Durieu:** I have a question for Gertrude Tumpel-Gugerell. You mentioned in your excellent speech that the European Central Bank prefers a market-driven approach for the integration of domestic debit schemes in

Europe. We saw earlier that inefficiency in the market leads to an increase in the interchange fee. Do you not feel that the integration of debit schemes in Europe would take place at much higher prices and would push aside the most efficient schemes we have today? I just referred to the 10-cent charge by the most efficient schemes today in several European countries, but I refer also to the move from switch to Maestro in the United Kingdom, where Wal-Mart, Tesco, and other big players did not have a chance to prevent an increase of cost of more than 50 percent. Could you comment?

**Ms. Tumpel-Gugerell:** I understand your concern, but the idea is to open national systems and to make them ready for pan-European use. Enough competition between the systems has to be ensured. What we have at the moment is not enough competition. It is important to use the experience of low-cost systems and apply standards to them so they can be used by other participants in Europe as well.

**Mr. Gabeiras:** This is directed to Philip Lowe. Flying all over this conference is the idea that a decrease in interchange rate drives the market to a decrease in the discount to the merchant. This is going to be translated into the prices to the consumers, one of the sides of the two-sided market, and that is something very good for the consumers. This implies the necessity of gauging the impact in the price index on the measure taken on the interchange rate. If we are not able to show that is true through the index, frankly nobody can affirm that this is true. How are you planning to create some mechanism? I don't know if your bank is responsible for inflation control or not. Have you planned to input some mechanism to check if this information is true or false?

I ask because in our small market in Spain, we have had a quite interesting experience. The interchange rates have decreased by 40 percent from 1999 to 2005. The merchant discounts have decreased roughly the same percentage, and nobody has checked whether it has an impact on the inflation rate.

**Mr. Lowe:** I wish I could say that we could monitor that easily, but the reality is that we can't. The effect that we are talking about is relatively small in the scheme of things, and it is impossible to measure it precisely or even to monitor it. But as I said before, I find it very difficult to accept the proposition that merchants have a significant reduction in their costs and keep that all to themselves. Even a monopolist faced with lower costs

will lower its prices to expand output. And the retail sector is not monopolistic. It is very competitive. I think that says if costs go down, prices will go down. They may not go down the next day, but over time, if merchants face lower costs, they will lower their prices. I would like to be able to demonstrate that, and show the proof of that, because it would help in the public relations of the reforms. To say that merchants have the power to keep all the profit from lower costs and not pass any of it on, seems to fly in the face of commercial reality and economic theory.

**Mr. Roylance:** I have a question for the panelists in relation to the subject of cross-border acquiring. In Europe, the European Commission changed the rules of the card associations to allow acquirers to acquire transactions from other countries within the European community.

In the work that we at TransAction have done with merchants in the pan-European region, some of our clients have gained significant efficiencies and cost advantages by making use of this new arrangement. Have any of the central bankers who are present considered or looked at cross-border acquiring in other parts of the world? I would be interested to hear your views on that.

**Ms. Tumpel-Gugerell:** The European situation was explained already, so no comment from my side.

**Mr. Hoenig:** For clarification, you're saying that in terms of cross-border and the effect on merchants related to scale?

**Mr. Roylance:** This relates to a situation where an acquiring market can be opened up by two alternative methods. An acquiring market can be opened to new entrants, and more efficient entrants, by removing barriers to entry in a domestic market and encouraging new entrants to enter the acquiring market. The Australians are looking at doing that. The Mexicans, clearly, are looking at doing that also. In Europe, the rules have been relaxed to allow an acquirer to acquire a transaction from a merchant in a different country.

So, for example, an acquirer in England can acquire transactions from a merchant in France. This is an alternative way to bring new acquirers into a market where it is highly concentrated. We've heard no discussion of this so far, and I just wondered if anyone is looking at this option. It seems to be quite a robust alternative because it makes use of large, efficient acquir-

ers with economies of scale in other countries, who can deliver lower prices to merchants in a market with smaller economies of scale.

**Mr. Hoenig:** I am not familiar with it, so it is hard for me to answer it, other than to say if you can, in fact, enhance entry, allow for scale to bring the cost down, and increase competition, the outcome is generally favorable. That is what I would be expecting from that, but I haven't seen the studies and I haven't seen the outcomes from it. Certainly, opening up the markets is a much-improved way of bringing greater benefit to the consumer in the end. I'd be very receptive to it in that sense.

**Mr. Ortíz:** I hadn't thought about it, but it sounds like a very good idea.

**Mr. Doyle:** My concerns revolve around the universal payments system and the role of the Fed in this country that has worked marvelously well.

The access to the payments system and the diversity of its participants are my primary concerns. From the standpoint of the consumer, the small and the large banks that are here, and the merchants, I have heard many comments that the conditions which developed Visa and MasterCard in the 1970s are no longer present. I would take issue with that, because there are certain players, like myself at Texas First Bank, who would not be able to participate for my customers, my small-business people that I represent, and my small community were I not able to participate in a card association.

That would be alright with regard to credit because we are on the margin. Our volume of scale is not what these folks in this room represent, therefore we have to be much more efficient, but we also have to have some income in order to be players. We can get squeezed out very easily. Many are already doing that on the credit side. They are selling their card portfolios. You've seen that. It is absolutely essential. We can make a choice in credit, but we *cannot* make a choice in debit because that is our core customer. We cannot leave that market. Somehow or another, as you do your deliberations and your studies, don't forget us, because we do a good job representing small businesses in our communities.

**Mr. Hoenig:** Believe me, given the location of our region and the number of community banks we have, I am very much aware of your circumstances. I do know it has been an issue with the smaller banks across the country for as long as I can recall. That is what I said in my comments.

Efficiency is one of the major issues, but access is the second major issue

in terms of assuring all the players can have access. For all the discussion and all the tension around this, I don't think we've talked about access and the importance of it, and that is one of the things that the card associations have provided.

That doesn't negate the importance of the discussion that we had in the previous panel in terms of entrance and numbers of players so that it remains a competitive market as well, because that, over the long term, gives you and the community banks a more certain access through time. It is a delicate matter, but I recognize it as extremely important, and I recognize that the current system has provided access.

*Mr. Evans:* I have one comment on the dialogue between Philip Lowe and José Gabeiras on the passing on of the interchange fee. I agree with Phil that we would expect in even a monopolistic market that some portion of the reduction in merchant discount is going to get passed on to the consumer. The understanding I have of the Australian retail sector (and this may be partly out of ignorance on the Australian market) is that it is not very competitive; rather, it is actually quite concentrated if you go industry by industry. Again, I am not an expert on this, but in the supermarket sector in Australia, about 70 percent of sales is concentrated in two firms.

I don't think we can operate under the assumption in Australia that we can reason by way of economic theory that the entire merchant discount is going to be passed on to consumers. I would expect that some portion would be passed on to consumers and some portion would fall into the pockets of the merchants as higher profits. I do think we could all agree that we should be thankful to the Australians, as was pointed out previously, for giving us this wonderful laboratory experiment from which over the next few years we'll be able to actually learn something.

*Mr. Balto:* I thought Mr. Schmalensee did a good job of phrasing the question about regulation as "Is there a market failure?" I want Guillermo and Phil to answer my question. Do you see market failure as being a necessary precedent for your taking regulatory action? Also, what was the market failure that each of you identified in looking at your markets?

*Mr. Lowe:* As I tried to say before, we started with the observation that the low-cost payment instrument was being offered to consumers at the high price. Normally that doesn't happen. Normally, if a good is produced with lower resource costs, it is offered to consumers at a lower price, not a

higher price. From that observation, we tried to understand why debit cards were typically offered to consumers at higher per-transaction prices than credit cards despite having lower resource costs. Obviously, one explanation—although not a full explanation—is the very large difference in interchange fees in the two systems.

We thought we understood that part. But then we asked why the interchange fees are so different in these systems. Are these interchange fees subject to normal competitive forces?

I think we correctly came to the conclusion they are not. We've heard over the past two days that these fees are constant for many years in many countries, even though costs change a lot. That doesn't sound like a normal competitive market. They are essentially set by a scheme. That doesn't sound very competitive.

When we looked more closely, the competitive pressures that are operating in those markets appear to push the fees up, not down, through time. That doesn't sound like a normal, competitive market either.

We came to the conclusion that these interchange fees, by and large, are not subject to the normal type of pressures that normal prices are subject to, and, in turn, they were leading to distorted price signals to cardholders. The combination of those two observations led us to think rightly that there was a case for some type of regulatory intervention.

**Mr. Ortiz:** I could say some of the same things that Philip mentioned. The general answer, of course, is, "Yes." If there was a market failure, that would be grounds for at least looking for an explanation and then, ultimately, seeing if public policy can compensate for this market failure.

What we saw immediately was the underdevelopment of the whole retail payments system, particularly cards and electronic payments, and the fact that, at least from raw data, it was much more expensive to do transactions in Mexico. So we asked, "Why is that?"

We started looking at the different arrangements, specifically in the case, for example, of debit and credit cards. They were charging the same interbank fee for both, which doesn't make any sense to us because the risks are different. They were charging *ad valorem*. There were other things that rattled us. For example, Wal-Mart told us that in Mexico, despite the fact they had developed their own platform for processing transactions, they were still paying a fee to the bank, which was very high, and it was the highest one they were paying in the world. That made us a little bit suspicious that there may be some sort of market failure there. Those are the elements that we saw. Again, we are in the process of really analyzing this.

**Mr. Posner:** For both Phil and Guillermo, the question I have is about the three-way networks, as opposed to the Visa-MasterCard networks, and whether it is safe to ignore them.

**Mr. Lowe:** I suspected I would get asked this one. It is not a correct characterization to say that we've ignored them. Our general approach has been to determine whether the various prices in the payments system are being set in reasonably competitive markets. The same question has been asked with respect to American Express. We have looked at the American Express-merchant relationship and asked, "Is that competitive?" By and large, it is.

Merchants have, however, complained that they don't have very much bargaining power. What we have tried to do there is to at least remove restrictions or a lack of transparency that might have artificially affected merchants' negotiations with American Express. We asked American Express to publish its average merchant service fee so that merchants would know what other merchants were paying. We have asked them to publish their market share, so that people know just what presence they have in the market. I think more importantly, we have asked them to change their merchant contracts to remove the anti-steering provisions. They have agreed to do all these things.

Now a merchant can say to a cardholder who presents an American Express card, "Yes, we accept American Express, but it is a lot cheaper for us to take a Visa. Would you consider using a Visa?" American Express has had a clause in its merchant contracts that prevented merchants from doing this.

What we try to do is make sure the market is working competitively. I think the difference with the four-party schemes is there is no floor under the merchant discount. In the four-party schemes, the interchange fee sets a floor. That floor is not determined by normal competitive forces. In three-party schemes, there is no floor.

If the merchants see value, they'll accept the American Express cards, but the negotiation over the fee is not influenced by the floor set by the interchange fee. We saw how important that floor is when we reduced the interchange fee in four-party schemes and the merchant fees came down one for one. So the floor is really driving the outcome there. This is not the case with the American Express arrangements. There is no interchange fee and there is no floor.

I heard earlier that the banks are busy moving their Visa and MasterCard



portfolios to American Express. That simply is not correct. There has been a *small* increase in American Express's market share. What is going on in Australia is not very different to what is going on anywhere else in the world. Therefore, I think the characterization that somehow all the four-party cards have been turned into three-party schemes is just not an accurate description of what has been going on.

**Mr. Roylance:** Are you going to mention surcharging?

**Mr. Lowe:** When we set a standard for the four-party schemes that required the removal of the no-surcharging rule, American Express agreed voluntarily to remove the rule. We haven't had to use our regulatory tools.

**Mr. Rodrigues:** Philip, you have a lag effect in banks moving their portfolios to American Express. They have moved their schemes; you just haven't seen the volume yet. I've purposely not talked about this, but I am afraid the fact is incorrect. The consequence is that the banks offered greater rebates by American Express than by Visa, post the issuing banks, post the introduction of regulation. They have chosen to introduce split cards with a very clear message: "For this account, use your American Express card to get points wherever it is accepted and your Visa or MasterCard wherever the merchant isn't an American Express acceptor."

I would respectfully suggest that has raised the price in the market. This is an absolutely classic piece of economic analysis, where averages don't reflect segment charges. You are absolutely right. If you get AmEx to publish average rates, you will see rates coming down. You will see them coming down because Coles Myer, God bless them, pushed AmEx to the wall. The big merchants exert pressure on AmEx, drop the fees, the average fees come down, and the unintended consequence is a raising of cost of doing business for small merchants in Australia. That will come out in time. The data series will show it. To say, "I'm afraid there has not been a change," is not correct.

To be clear, I understand your consumer price index (CPI) argument. We had a debate about proof, but it is equally true that the consequence of intervention—and I am not arguing the case for or against intervention, I am simply commenting on consequence—is that the banks have chosen to recover fees from customers in other places. I think if you are going to talk about CPI, the introduction of card fees has to be put into the equation, because that will raise the CPI. In other words, no one has taken cost out

of the system. They simply pushed cost around the system.

I respect the fact that you have a point of view, have chosen to act, and have some desire to move things around the system, but we have to be careful about suggesting that the consequence of the action is to remove costs from the system.

*Mr. Ortiz:* I think the impact of cards fees on CPI is negligible—absolutely negligible—compared to anything.

*Mr. Lowe:* Two of the banks have issued co-branded American Express cards, as Mr. Rodrigues said. Those cards have, in fact, been moderately successful. As a result, there has been an increase in American Express' market share. But it is small. I think we need to keep that in perspective.

It is also true that if someone switches from a Visa card to an American Express card, the merchant will have, at the moment, a higher merchant discount, so there is a higher cost there. That is certainly true. But again, one needs to keep these things in perspective. While the merchant has a higher cost as a result of any switch to American Express, it has much, much lower costs on all the transactions on Visa and MasterCard. To my mind, it is inconceivable that merchants could end up with higher costs as a result of this reform. American Express would have to end up with a huge increase in its market share. That may happen, but, in my judgment, is it very unlikely.

You mentioned banks have recovered fees in other places. They have increased annual fees and cut back reward schemes. Good! Credit card users are heavily subsidized, at least at the per-transaction level. One of the intentions of the reform process was to try to rebalance the relative prices that cardholders face. To the extent that reward schemes have been cut, that was an intended consequence of the reform—to change the relative prices. People often point to this as a negative of the reforms. I would argue exactly the reverse; it is a positive aspect of the reforms.

*Mr. Ortiz:* Before turning to Tom Hoenig to bring this to a close, let me say a couple things. First, I don't know how I come out of this conference—more enlightened or more confused.

Second, I think we have to recognize the point made by the industry in the sense that both Visa and MasterCard have provided an important service, but the problem is whether the interchange fee is a question for

public policy. I think so. From all this discussion, there are enough grounds for all of us to be looking at the public policy aspect of this.

Third, I want to thank Tom again, who put together a fantastic conference.

**Mr. Hoenig:** Thank you. I will be very, very brief. I want to thank the participants. I said this at the opening of the program. I do want to thank Visa and MasterCard. I agree with Guillermo; we have a phenomenal payments system. Whether and how it develops is a very important issue that is still outstanding. I also want to thank the merchants who came, because I know you have important issues. Bringing the merchants together helps the dialogue and helps understanding, which is what our goal was for this conference.

I am sure we are going to agree to disagree on a lot of these points, but there has been something accomplished here. For me, I have a better understanding (I think other central banks do too), and I think perhaps even the participants here do as well.

There is more that will develop in this global payments system of ours. I want to thank all of you for helping us take a step forward.