

Interchange in a Changing Market: Observations from the Euro Area Perspective

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Originally, I planned to begin with the following quote by Socrates: “I know nothing except the fact of my ignorance.” Although Socrates did not speak about interchange fees, his phrase somehow reflects the fact that we—at least as far as the European Central Bank (ECB) is concerned—are still at the very beginning of a process of understanding the precise effects of interchange fees. However, now, in the midst of the very interesting discussions that we have had at this conference, I feel much more inclined to make reference to another element of Socrates’ work, namely his conviction that dialogue is the instrument through which to overcome ignorance. Dialogue furthers knowledge and brings about explanation. I can assure you that, just as Socrates predicts, my colleagues and I will return to the ECB with many useful insights and new ideas for our work on interchange fees.

The ECB approaches interchange fees from the perspective of our main priority currently: payment integration in the euro area. You may ask yourself why, six years after the introduction of the single currency, an integrated payment area has not yet been achieved. Much of my presentation will focus on this question and will explore the ways in which further integration can be achieved. Integration is a priority for the ECB because we regard it as an important means of creating a more competitive market in payment instruments. Were the fragmented markets currently in evidence in the euro area to remain in place, this, in our view, would fuel resistance further to integration and thus would help vested interests to preserve the status quo.

My presentation will look first at interchange fees in the euro area and discuss the role and focus of the ECB. I will then give an overview of the fragmented payments landscape in the euro area and, before concluding, I will concentrate on some legal and competition policy aspects.

The interchange fee can be an important tool to increase the acceptance of a card scheme by bringing on board both sides of the market—the merchants and the customers—and by making this profitable for both the

issuing and acquiring banks. It can also be used strategically to extend the market, for example, in overcoming the chicken-and-egg problem commonly encountered in the inception of payment networks. These benefits of interchange fees are sometimes overshadowed by the fact that such fees also may be used to extract rents from one side of the market—in the case of card schemes, usually the merchants. Under which economic circumstances and framework of rules this is likely to occur is not yet fully clear.

Interchange fees are currently emerging as a topic of debate in the euro area, as there have been a number of merchants' complaints claiming that some card schemes levy excessive charges. Moreover, several national competition authorities and the European Commission (EC) have recently stepped in to address the issues surrounding the pricing of card schemes.

In the euro area, international card schemes set a default fee, namely a fee which is used by issuers and acquirers in the event that no bilateral or multilateral agreement is in place. It can be applied to both national and intra-European transactions. In regard to national card schemes, which are mainly debit card schemes, there is currently quite some fragmentation across euro area countries on the question of interchange fee practices and levels. In some member states, interchange fees have long been an established part of the card business and have been accepted by stakeholders. They may be set by the scheme or bilaterally between the members. They may be *ad valorem* or fixed. In other countries, they do not exist at all. In some cases, the introduction of interchange fees and, subsequently, of merchant fees has given rise to strong merchant resistance and has led national authorities to intervene and set fee levels.

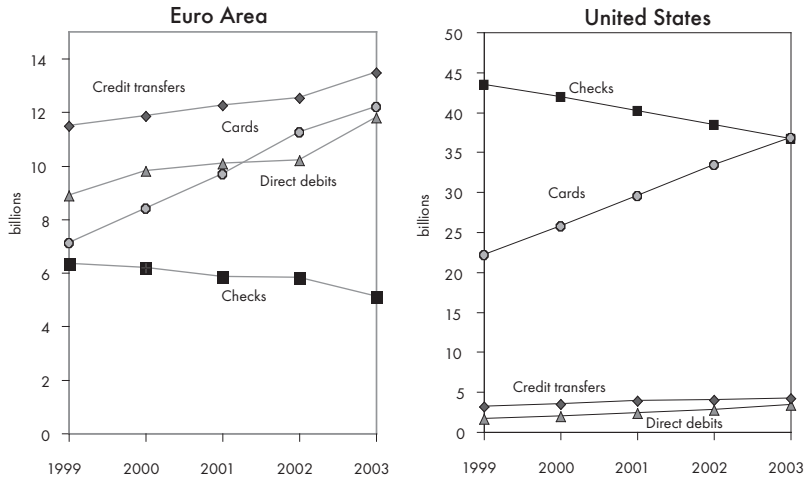
The differences in interchange fee practices and levels between national and cross-border payments within the euro area are an impediment to euro area integration. They result in different charges being applied for national and cross-border payments and thus in payments being treated differently. For example, merchants often complain that the high interchange fee and the resulting merchant fee for international cards, which, for the moment, are the only cards that can be used for transactions between euro area countries, prevents them from accepting these cards. Euro area citizens thus may find themselves in the uncomfortable situation of not being able to use their cards.

There are two forces that come into play in order to ensure the equal treatment of national and cross-border transactions. On the one hand, public regulators can ensure a harmonized level. On the other hand, the card industry itself can make a substantial contribution to the objective of

payment integration. Enhanced transparency and pan-European standards will lead to an increase in competition, which, in turn, can be expected to influence costs and fee practices, including interchange fee practices, and to promote euro area integration. The integration work of the banking industry, supported by the ECB, will gradually do away with the national/cross-border distinction.

Interchange fees and their impact on efficiency so far have not been a key issue for the ECB because the main focus of the ECB's role in the field of payments since the introduction of the single currency has been the establishment of structures and standards to ensure the safety of payments in Europe. The Eurosystem, which comprises the ECB and the 12 national central banks of the euro area countries, acts as an operator, having established TARGET (trans-European automated real-time gross settlement express transfer), an RTGS (real-time gross settlement) payments system allowing for the settling of large-value euro payments in a very safe manner. As overseer, the Eurosystem has adopted standards that the various payments systems need to meet, most importantly, the "Core Principles for Systemically Important Payment Systems," the standards for payments systems. A subset of those principles also serves as a basis for retail payments systems in the euro area that are of systemic or prominent importance.

With structures and standards for ensuring safety in place, the ECB has started to shift its focus toward efficiency. Together with the national central banks, the ECB acts in this area mainly as a catalyst. It encourages change, plays the role of facilitator, and helps to remove obstacles. The catalyst role is currently directed toward encouraging the establishment of a single euro payments area, or SEPA. The establishment of the SEPA is a project led by the European banking industry and strongly supported by the Eurosystem. It covers all payment instruments and their supporting infrastructures, but the initial focus will be on cards, credit transfers, and direct debits. While the national payment instruments and infrastructures within the euro area are for the most part very efficient, they have a very strong national identity and, as they stand, cannot cater for pan-European needs. The goal of the SEPA is to create within the euro area a truly European payments area equalling the efficiency of the best national payment instruments and infrastructures. The Eurosystem is engaged in a fruitful dialogue not only with the European banking industry, but also with all other stakeholders in the payments system, be they customers, merchants, corporate users, or the national or community legislators.

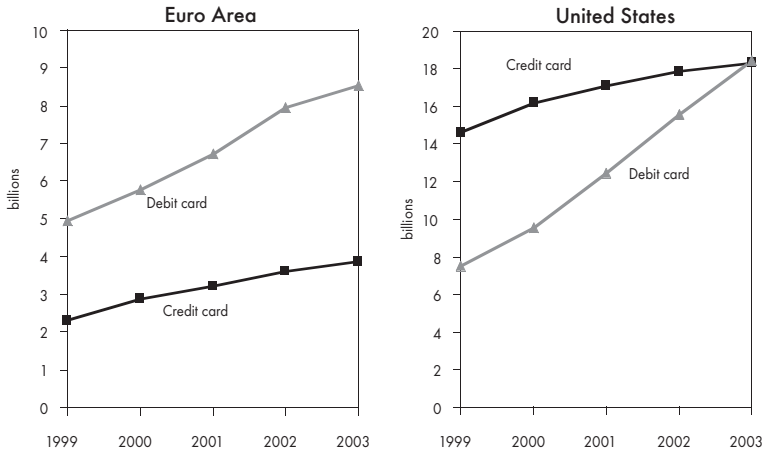
Chart 1:*Trends in Payment Instrument Use***Number of transactions:**

Sources: BIS Red Book and ECB Blue Book

In my view, there are enormous efficiency gains to be made in the areas of payment processing and payments system infrastructures in the euro area. Current infrastructures were built for the legacy currencies, meaning those replaced by the euro. But nowadays, six years after the introduction of the single currency, payments systems can no longer satisfy only national needs. There is a clear euro area dimension to any payments system, and relevant adjustments clearly are needed. The key concern is whether the industry is able to generate the standards that are necessary to ensure compatibility between systems. Only when compatibility and transparency are ensured will there be a positive effect on volumes and competition, generating the increased efficiency that we would expect in an integrated, single market in Europe.

I would now like to explain why there is this need for greater efficiency and further integration in payments—in particular in card payments—by presenting some data on trends and developments.

Customers and businesses in the euro area are, as in other parts of the world, increasingly using “electronic payments,” as illustrated in Chart 1. Paper-based payment instruments—checks, for instance—are losing

Chart 2:*Debit vs. Credit***Number of transactions:**

Sources: BIS Red Book and ECB Blue Book

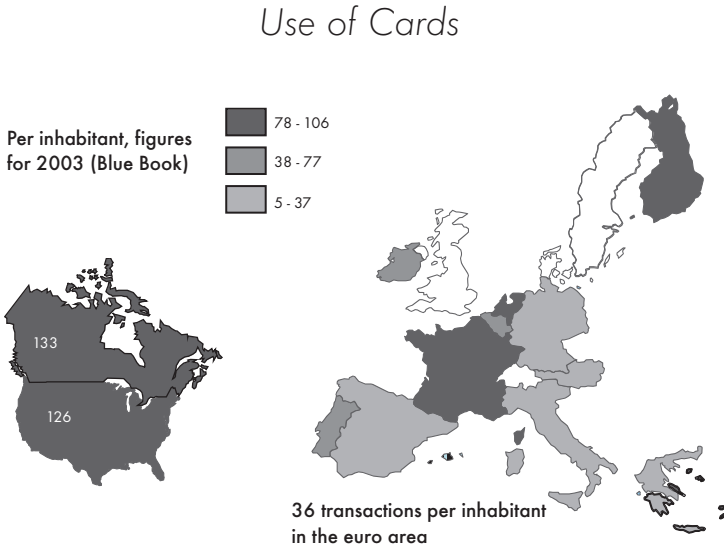
market share. In the past, card payments have not been as popular in the euro area as other payment instruments, such as credit transfers (or “wire transfers,” as they are known in the United States) and direct debits.

Cards—both debit and credit—however, have proven to be very successful in recent years in the euro area. Statistics show that in the last five years the use of cards has almost doubled. Cards are currently one of the three most popular cashless payment instruments, with credit transfers, card payments, and direct debit currently enjoying very similar market shares in the euro area. The U.S. payments system, as can be seen on the right-hand side of Chart 1, relies mainly on cards and checks alone.

As shown in Chart 2, the growth in the market for cards can, to a large extent, be attributed to debit cards. These currently account for more than two-thirds of all card payments.¹ The euro area hosts more than 20 three- and four-party card schemes, the majority of which are national debit card schemes available only for payments in their national markets.

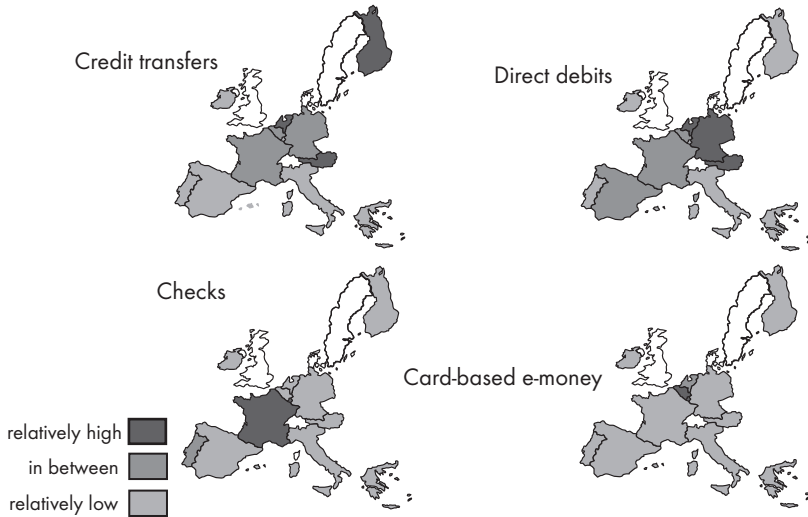
Currently, card payments in countries other than that where the card was issued are generally possible only via the international card schemes, Visa and MasterCard. Discussions are currently taking place regarding the possibility of setting up a new European debit card scheme.

Map 1:



Map 1 shows that Europe is still, to a large extent, composed of national markets with different payment habits and industry structures. Averages do not tell the whole truth. The use of cards—as with other payment instruments—varies substantially among the euro area countries. In the euro area, there are a few countries with relatively high levels of card use—France, the Netherlands, Finland, and Luxembourg—and a few with moderate use—Ireland, Portugal, and Belgium. In the remaining five euro area countries, however, cards are not as popular as other payment instruments, with payments made instead using cash, credit transfers, or direct debits. In none of the euro area countries is the level of card use as high as in North America. Euro area citizens make an average of 36 card payments per year. In the United States, the figure is almost four times higher, at 126 transactions.

I should, however, point out, by way of a caveat, that the data are certainly not fully comparable between the United States and the euro area. Indeed, even within the euro area we are currently working on the enhancement of the quality of these data. In any event, the observation can be made that, while in many euro area countries card use currently represents only a small fraction of card use in the United States, the position of cards is strengthening everywhere.

Map 2:*Payment Habits*

Differences in payment habits are not confined to cards. We also see significant differentials in the use of all other payment instruments, illustrated in Map 2. Credit transfers are more popular in the Netherlands, Austria, and Finland than elsewhere in the euro area. Direct debits are, on average, twice as popular in Germany, Austria, and the Netherlands as in other euro area countries. Checks are in excess of 10 times more popular in France than elsewhere, and e-money has been most successful in replacing other means of payment in the Benelux countries (Belgium, the Netherlands, and Luxembourg). Moreover, for most instruments, such differentials are increasing over time.

As card payments are picking up, they are becoming an increasingly relevant issue for regulatory and competition authorities.

Efficiency-oriented regulation in the field of payments so far has been carried out principally by legislatures and competition authorities, both at the national and at the European level. As the card industry is still largely fragmented, most of those regulatory and competition activities are pursued at the national level. At the European level, the European Commission is responsible for initiating legislative measures.

In the European Union, interchange fees have been investigated or are currently under investigation by the EC and several national entities, that is to say, the British, French, Dutch, and Danish authorities.

The regulation of interchange fees is no trivial matter. Take, for example, the bundling of costs in the interchange fee. By “bundling of costs,” I mean the practice of providing a package of services, for example, a free funding period or a payment guarantee together with a fee for the transaction itself. Bundling normally means that the fee is provided as a package which cannot be split without bilateral agreements.

Various aspects of this issue have been presented by the EC (which was looking at Visa) and by the U.K. Office of Fair Trading (which was looking at MasterCard). However, those investigating authorities arrived at different conclusions. The EC regarded the bundled interchange fees as providing a fair level of services to both merchants and cardholders, thereby contributing to technical and economic progress. The fees were therefore considered to fulfil the conditions for an exemption under the competition rules of the EC Treaty. The Office of Fair Trading, on the other hand, considered that the bundled interchange fee would not qualify for an exemption under the U.K. Competition Act. Their argument was that any additional services should be a matter of choice for the cardholder and the merchant; otherwise, unnecessary burdens would be placed on consumers.

However, we should keep in mind that the Visa decision relates to an EU-wide cross-border interchange fee for consumer cards, while the Office of Fair Trading’s preliminary conclusion regarding MasterCard is restricted to transactions made in the United Kingdom.

Some governments and central banks (for example, the Danish government and the Reserve Bank of Australia) have been taking action to restrict the level of interchange fees and limit the conditions of the agreements between the parties involved. This is a straightforward, but often controversial, way of taking action, as the regulatory authority is thereby placing restrictions on the market. The advantage of such measures is mainly on the consumer side, even though it could be argued that a restriction on such costs, in the long run, could force service providers to cut their processing costs. However, factual costs incurred by the participating entities have to be covered, if not directly, then indirectly from other services. The ECB is following developments in these countries with great interest.

There are also a couple of other European competition cases regarding cards that should be mentioned. The EC challenged nine major French banking groups and Groupement des Cartes Bancaires (CB) in July 2004

for sharing out the market for the issuance of CB cards in France in order to restrict competition from new entrants. Furthermore, the national competition authority of the Netherlands decided in April 2004 that Interpay had abused its dominant position by charging excessive rates for the provision of network services for debit card transactions.

As you can see from these examples, European competition authorities have recently stepped up their activities in the field of interchange fees, aiming to combat abuse of dominant positions in the card market, both at the national and at the community level. However, when considering such issues, it is important that the relevant national authorities are aware of the euro area integration for cards, allowing them to help promote and facilitate the establishment of pan-European card services. In so doing, they will help to enhance competition not only in the national markets, but also in the euro area market.

An integrated card market in Europe is the principal concern of the ECB, and the enhancement of competition is a key means of achieving this goal. The ECB considers interchange fees to be the result of business agreements between market participants in a free and open market, and the ECB relies on competent authorities to ensure that such fees are not set at a level which is harmful to society. At the same time, by encouraging the industry to adopt procedures and standards that ensure compatibility and transparency, the ECB seeks to facilitate further integration. And integration, in my view, is the key means of increasing competition; facilitating consolidation; and, as a result, enhancing the efficiency of the European card industry to the benefit of business, consumers, and public authorities. But integration must come first.

Finally, I would like to emphasize our role and objective.

The ECB operates in a specific environment different from the ones in which central banks usually operate. In Europe, the introduction of the single currency established new conditions and requirements. The ECB pursues the objective of integration across the euro area, and the integration of payments services is part of this wider objective. Indeed, establishing the SEPA is one of our main priorities in the field of payments. From this stems our interest in interchange fees, which are part of the legal, technical, and commercial conditions necessary in order to promote integration.

We are aware of the problems and issues at stake in relation to interchange fees. For the moment, we see our role as a facilitator for the banking industry: We are contributing to the SEPA card scheme framework, which the industry is developing, and we are trying to steer the market toward

transparency and integration. We are monitoring market developments and initiatives closely and stand ready to intervene if progress is lacking.

The SEPA is a key project in order to reap the full benefits of the single currency. More competition in the financial sector is needed to foster growth in the euro area. But in order to establish a truly integrated payments area, banks need to progress swiftly. In the six years since the introduction of the euro, there has been enough time to prepare for the next step. The banking industry, with the help of central banks, should use the current window of opportunity and chart a course toward integration.

ENDNOTE

¹ The number of transactions carried out using debit cards has grown over the past five years at a rate of 17 percent, with the use of credit cards increasing at a rate of 15 percent. Overall, the use of non-cash payment instruments has grown at an annual rate of 3.4 percent.