Summary of Discussion Points

Presented by the Business and Industry Advisory Committee (BIAC) to the OECD Working Party No. 2 on Competition and Regulation

“INCREASING COMPETITION IN PAPERLESS PAYMENT INSTRUMENTS”*

June 6, 2006

1. Introduction

1. The Business and Industry Advisory Committee (“BIAC”) to the OECD appreciates the opportunity to comment to the Working Party on Competition and Regulation for discussion at the June 6, 2006 Roundtable on Increasing Competition between Payment Cards.

2. Competition is now broadly viewed as the best available mechanism for maximizing consumer welfare.1 It is widely accepted that market-driven outcomes and competition should form the foundation of economic and regulatory policies.2

3. Deregulation and regulatory reform in numerous OECD countries have reduced consumer prices and significantly improved quality and service.3 For example, U.S. deregulation over the past few decades in several industries, including airlines, telecommunications, railroads,

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1 See Paul Crampton, Competition and Efficiency as Organizing Principles for All Economic and Regulatory Policymaking, First Meeting of the Latin American Competition Forum, Paris, at 3 (Apr. 7-8, 2003) (“Competition and efficiency ought to provide policy coherence to all economic and regulatory policy decisions.”).

2 See id; see also Timothy J. Muris, Chairman, Fed. Trade Comm’n, Creating a Culture of Competition: The Essential Role of Competition Advocacy, Address before the International Competition Network (Sept. 28, 2002), available at http://www.ftc.gov/speeches/muris/020928naples.htm (“Competition advocates have won many victories over the last few decades. We have largely won the intellectual debate: Economists and legal scholars around the globe now recognize the benefits of competition to consumers and to the economy as a whole. We are winning the legal debate: Courts now recognize the importance of efficiency and robust price competition in evaluating mergers and business conduct. Lastly, and perhaps most critically, we are starting to win the policy debate: From airlines to electricity to telecommunications, industry after industry has been privatized or liberalized. Legislators more frequently are turning to competition policy, rather than to more burdensome forms of regulation, to create a well functioning marketplace.”).

3 See Crampton, supra n.1, at 3 (citing OECD, Report on Regulatory Reform, Volume II, at 252 (Paris: 1997)).
trucking, financial services, natural gas, and electricity, has significantly improved consumer welfare.4 Similar results have been obtained in Europe within sectors such as energy, postal, airlines, and telecommunications.5

4. Experiences with deregulation confirm that competition should be stimulated and maximized except in cases of market failure or where other overriding public interest objectives give rise to a need for regulation.6 Consequently, BIAC has advocated that competition authorities and sectoral regulators should exercise caution when considering intervention.7 Before authorities intervene, moreover, BIAC has advocated the need to be certain that the conduct in question is anticompetitive, that enforcement action is necessary to protect consumers, and that the remedy imposed will, on net, benefit consumers.8 BIAC also has urged authorities to proceed with particular care when considering whether to intervene in high-technology industries undergoing rapid transition.9 Intervening too quickly and perhaps too aggressively can inhibit innovation and future market growth.10

5. One industry where the propriety of regulation is currently debated involves payment cards. Courts and regulators in several countries have considered or are considering the competitive and societal implications of various payment card system practices. In some countries, these

4 See Robert Crandall & Jerry Ellig, Economic Deregulation and Customer Choice: Lessons for the Electric Industry (Center for Market Processes 1997) (reporting that real prices for natural gas, long distance telecommunications, airlines, trucking, and railroads dropped at least 25% and often close to 50% within ten years of deregulation), available at https://www.mercatus.org/pdf/materials/839.pdf; see also Anne K. Bingaman, Asst. Atty. Gen., U.S. Dep’t of Justice, Address before the Commonwealth Club of California (July 29, 1994) (“The salutary effect of competition on innovation has been demonstrated repeatedly in this country when a variety of previously regulated industries have been deregulated, either in whole or in part.”).

5 The relevant provisions in Europe are: (1) the Airspace Regulation Nr. 551/2004 (on the organisation and use of airspace in the single European sky), the Service Provision Regulation Nr. 550/2004 (on the provision of air navigation services in the single European sky), and Regulation 793/2004 (on common rules for allocation of slots at Community airports); (2) Council Directive 1996/92, EC (concerning common rules for the international market in electricity); (3) Directive 97/67/EC (on common rules for the development of the internal market of Community postal services and improvement of quality service), and Postal Directive 2002/39/EC (defining further steps in the process of gradual and controlled market opening and further limiting the service sectors that can be reserved); and (4) Regulation Nr. 2887/2000 (on unbundled access to the local loop).

6 See Crampton, supra n.1, at 2.

7 See, e.g., BIAC, Summary of Discussion Points, Presented at the OECD Competition Committee Roundtable on Competition on the Merits (June 1, 2005); see also BIAC, Session 1: Bringing Competition into Regulated Sectors, Presentation to the OECD Global Forum on Competition (Feb. 17, 2005); BIAC, The Roles and Tools of Competition Authorities: Fundamental Considerations, Presentation to the OECD Global Forum on Competition (Oct. 17, 2001).


9 See id.

10 See Joel I. Klein, Asst. Atty. Gen., U.S. Dep’t of Justice, Rethinking Antitrust Policies for the New Economy, Address at the Haas/Berkeley New Economy Forum, Portola Valley, California (May 9, 2000) (“[S]ince we believe that free and competitive markets maximize innovation and consumer welfare, we tend to disfavor regulation generally and certainly as a way to remedy abuses of market power. Ongoing regulation is invariably inefficient, both because it under-deters competitive behavior and because it can be exploited by opportunistic rivals to hamper procompetitive conduct. Thus, where possible, we seek structural, market-based solutions to serious competitive problems, because these solutions mean that consumers, not government agencies or existing monopolists, will get to choose when longstanding monopolies yield to innovative technologies and innovative business models.”).
investigations have resulted in regulation or other agreements adjusting payment card rules and pricing. This submission provides an overview of the payment cards industry, including the unique economics affecting the industry, and discusses the various practices that are under debate. We also provide an overview of innovation in this dynamic and rapidly evolving industry. We conclude by advocating that, as with other industries, competition authorities and sectoral regulators should exercise caution when considering intervention. Before intervening, authorities should be sure that the targeted behaviour is anticompetitive, that intervention is necessary to protect consumers, and that the measures imposed will, on balance, benefit consumers.

6. Regulators also should consider the impact that intervention may have on the global economy. In particular, imposing jurisdiction-specific technical and functional requirements to achieve competition, fraud protection, and financial security may chill innovation and impact the ability of consumers to use cards for international transactions. Thus, BIAC advocates that authorities should proceed with special care in this high-technology and rapidly evolving industry, given concerns about the potential for hampering innovation and future competitive growth.11

II. Overview of the Payment Cards Industry

7. It has been observed that, “[i]n the last half of the twentieth century, payment cards—credit, debit, and charge cards—have quietly revolutionized how we pay for goods and services.”12 Frank McNamara introduced the first general purpose charge card, the Diners Club card, to U.S. consumers in 1950. Bank of America followed with the first general purpose credit card in 1958. French banks introduced the first general purpose debit cards in the 1960s. Globally, purchasers used 1.8 billion general purpose payment cards to pay for $2.7 trillion worth of goods and services in 2002.13 In 2005, payment cards accounted for 17% of personal consumption expenditures in Europe and 26% in the United States.14

8. As the use of payment cards has increased, volume on more traditional payment instruments has declined. In the U.S., for example, cash and checks accounted for more than 90% of personal consumption expenditures in 1970,15 but for only 61% of those expenditures in 2004.16 Between 2000 and 2003, check volume in the U.S. fell for the first time ever. During that period, the number of checks paid fell by 12.4%, while the number of non-cash payments grew by 3.8%.17 Europe has seen a similar trend, with check usage declining from 2000 to 2004 at a

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11 See id; see also Debra A. Valentine, Gen. Counsel, Fed. Trade Comm’n, Antitrust in a Global High-Tech Economy, 8th National Forum for Women Corporate Counsel, Washington, D.C. (Apr. 30, 1999) (“The benefits of correct antitrust enforcement are huge, because proper enforcement will positively affect the possibilities for innovation today and the quality and prices of products tomorrow. But because the path of innovation is fraught with uncertainty and technology is changing with lightning speed, the potential costs of enforcement errors can loom large.”).
12 DAVID S. EVANS & RICHARD SCHMALANSEE, PAYING WITH PLASTIC xi (2d ed. MIT Press 2005).
13 Id.
14 Point of Sale (POS) for Visa and MasterCard (September 2005). Visa Business Research and Reporting.
15 Id. at 85.
rate of 12% per year and card payments growing 5.5% per year during this same period. In Canada, roughly 80% of all consumer transactions by dollar volume in 1993 were completed using cash or check. By 2003, this number had fallen to 50%.

9. The rise in payment cards use has been made possible by cooperation, as well as competition, among various market participants. So-called “co-opetition,” the combination of competition and cooperation, is an important element in the payment industry as in other markets. Market participants cooperate in key areas to generate efficiencies for consumers, such as investing in technological innovation, product development, and sharing networks to minimize transaction costs. Participants compete in every other dimension—interest rates, fees, service, and innovative offerings.

10. Despite the popularity of payment cards, the business, academic, and regulatory communities have debated the economics that underlie the industry. Payment cards are an example of what many economists describe as a “two-sided” or “platform” product. A market is two-sided “if the platform can affect the volume of transaction by charging more to one side of the market and reducing the price paid by the other by an equal amount; in other words, the price structure matters and platforms must design it so as to bring both sides on board.” Two-sided markets have three distinguishing characteristics: (1) they appeal to at least two distinct groups of customers; (2) the value obtained by each group increases with the size of the other; and (3) an intermediary must connect the two. Payment cards display each of these attributes:

- Two distinct groups of consumers demand payment cards: cardholders (who use the cards for purchases) and merchants (who accept the cards as payment).

- A cardholder obtains more value from his card as the number of locations at which he can use it increases. Conversely, a merchant obtains more value as the number of cardholders increases. Thus, for a payment card system to work, cardholders must hold and use cards, and merchants must accept them. Cardholder and merchant demand is interdependent.

- To coordinate the two sides of the market, the card companies create a platform through which cardholders and merchants interact. Card companies must maintain a critical mass of customers on each side of the market.

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18 European Central Bank Blue Book (March 2006) (quoted figures do not take cash payments into account).

19 See The Benefit of Electronic Payments in the Canadian Economy, Global Insight and Visa Canada Association (2004).


23 See Timothy J. Muris, Payment Card Regulation and the (Mis)Application of the Economics of Two-Sided Markets, 2005 COLUM. BUS. L. REV. 515, 516 (2005); see also Richard A. Epstein, The Regulation of Interchange Fees: Australian Fine-Tuning Gone Awry, 2005 COLUM. BUS. L. REV. 551 (2005) (“two-sided markets are those in which the value attributed to the goods and services received by parties on one side of an exchange depends not only on the intrinsic properties of those items, but also on the number of parties located on the other side”).
11. Firms competing in platform industries often employ strategies that appear to defy traditional economics when only one group of customers is considered.24 Newspapers are a classic example of a two-sided product, connecting readers and advertisers. Readers may appear to pay too low a price because the total price paid by all subscribers does not cover the newspaper’s production costs. It is efficient for the newspaper to “subsidize” readers, though, because increased circulation increases the demand for, and the price of, newspaper advertising. Advertisers benefit from this “subsidy,” because this increased readership raises the value of advertising in the newspaper.25

12. Payment systems face much the same challenge as newspapers. Because they must attract both merchants and consumers, they must, inter alia, design a pricing strategy to attract the constituent group that has the most alternatives. With payment cards, that group appears to be cardholders, who, in deciding which payment cards to carry and use, can and do play competing card systems against one another.26 Hence, card networks tend to use the funds collected from merchants to attract cardholders. American Express, Discover, and other three-party systems accomplish this goal by directly setting the rates that merchants and cardholders pay to participate in their systems. In four-party systems, the member issuers and acquirers, not the systems, set rates for cardholders and merchants, respectively. MasterCard, Visa, and other four-party systems balance cardholder and merchant demand indirectly through the rate at which their acquirers and issuers exchange transactions, the so-called interchange rate. The interchange rate influences the terms on which issuers market cards to consumers and acquirers sign merchants to accept those cards.

13. The essential interchange structure pre-dates the formation of the Visa and MasterCard systems. When Bank of America owned and managed the BankAmericard system, it franchised the operation to banks operating outside of California. For the system to work, Bank of America needed a mechanism to allow a card issued by one franchisee to be used at a merchant signed by another participant in the system. Bank of America solved the problem of interchange in a multi-party payment system with a rule that allocated all of the revenue on each transaction to the issuing bank. This solution was criticized, though, because acquirers asserted that they were not being rewarded for expanding the system, and issuers were convinced that acquirers structured their relationships with merchants to deprive issuers of revenue. When Bank of America spun off Visa in the early 1970s, Visa implemented the Interchange Reimbursement Fee, which sought to address the criticisms of the previous arrangement. Thus, proponents observe that the early emergence of the interchange fee and the continued presence in the payment cards industry testify to the inherent logic of interchange fees in equilibrating the two sides of the market.

14. Interchange systems have evolved differently in different jurisdictions. After a comprehensive review of interchange fee developments and issues in several jurisdictions, Stuart Weiner and

24 See id. at 517.
25 See id. (comparing the role of the subsidy in newspaper operations with that of the interchange fee in coordinating a credit card network).
26 See Benjamin Klein, et al., Competition in Two-Sided Markets: The Antitrust Economics of Payment Card Interchange Fees, at 5 (2006) (on file with authors). Competition among the member banks has resulted in a large variety of payment cards available to consumers. In addition, the Visa and MasterCard networks offer merchants an option of establishing their own proprietary cards—developing a co-branded card with member issuing banks. The presence of co-branded cards can increase both competition in the payment card market and the variety of card choices available to consumers.
Julian Wright concluded that a number of complex and interrelated factors, many country-specific, play a role in interchange developments.\textsuperscript{27}

15. Both the interrelated nature of the two sides of the payment cards market\textsuperscript{28} and the heterogeneous factors that impact the payment cards market across countries\textsuperscript{29} signal the need for great caution when considering the propriety of regulatory intervention.

\section*{III. Costs and Benefits of Payment Systems, Interchange Fees, and Merchant Charges}

16. Significant dialogue is occurring globally regarding the interchange fee and, more broadly, the net social cost of card-based payments and the appropriate regulatory response to the increasing usage of payment cards and other forms of electronic transactions. During the past decade, central bankers, competition authorities, and courts in Australia, Europe, Mexico, Spain, the United Kingdom, and the U.S., to name just a few, have studied the issue. The results of these inquiries have varied. Authorities in Australia, Europe, and elsewhere have intervened to reduce the rates that merchants pay for access to electronic payments. Authorities and courts in the U.S., on the other hand, thus far have refrained from action. The business community is split on the issue, with merchants and retail groups on one side and financial institutions and payment systems on the other.

17. The relative cost of different forms of payment is a critical issue in deciding whether intervention in the payment card industry is justified. Merchants and some enforcement authorities have asserted that payment cards are relatively more costly than other forms of payment, including cash and check, and that payment cards are “overused” in a social welfare sense. For example, the Reserve Bank of Australia and the UK’s Office of Fair Trading (“OFT”) have asserted that credit card systems charge unjustifiably high fees to merchants, while card issuers provide cardholders with below-cost services and loyalty rewards. According to this view, higher-cost and less efficient forms of payment drive out less expensive ones because consumers are not charged the full marginal cost of using their cards.

\subsection*{A. The Cost and Benefits of Payment Instruments}

18. Financial institutions and payment card systems argue that benefits, as well as costs, must be considered when comparing different payment methods. They note that electronic payment methods, such as payment cards, enable funds to be moved more quickly, more securely, and more reliably than traditional forms of payment and offer consumers more methods to pay for goods and services.

19. Relatively limited data exist to determine whether payment cards are, on balance, more efficient to society than other forms of payment. In an early article, Alan Frankel asserted that payment

\begin{footnotesize}
\begin{footnotes}{27}See Stuart E. Weiner & Julian Wright, \textit{Interchange Fees in Various Countries: Developments and Determinants}, 4 REV. NETWORK. ECON. 290, 291 (2005) (concluding, after a comprehensive review of interchange fee developments and issues in several jurisdictions, including Australia, Canada, Denmark, Mexico, the Netherlands, Spain, Sweden, the UK, and the U.S., as well as EU cross-border, that a number of complex and interrelated factors, many country-specific, play a role in interchange developments).
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\begin{footnotes}{28}See Epstein, \textit{supra} n.21, at 551-54.
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\begin{footnotes}{29}See Weiner & Wright, \textit{supra} n. 27 (concluding that “[t]o adequately test existing and future theories, richer data will be required”).
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cards using interchange fees are less efficient than other forms of payment. Specifically, Frankel concluded that so-called “price coherence” helps encourage payment card use rather than competing products, despite differences in relative operating costs. Frankel asserted that this price coherence shifted the cost of financial institutions’ exercise of market power onto consumers who use a competing payment system, at the expense of social welfare. According to Frankel, besides burdening consumers, price coherence across payment mechanisms also constrains merchants’ choices.

20. More recently, in a paper on the social costs and benefits of various payment instruments in the U.S., authors Daniel Garcia Swartz, Robert Hahn, and Anne Layne-Farrar assert that previous empirical studies addressing these issues have been incomplete because they did not adequately consider the effects on all parties involved in payment transactions and did not include economic benefits in their calculations. After a detailed examination of both costs and benefits, the authors conclude that electronic payments are more efficient from the standpoint of society as a whole than other forms of payment, particularly cash and check. Ric Simes, Annette Lancy, and Ian Harper drew similar conclusions from their study on the social costs and benefits of various Australian payment instruments. Specifically, the authors found that the net social costs associated with credit card transactions are at most marginally higher than those for PIN debit transactions, while the net social costs associated with using credit or debit cards are lower than those associated with cash or checks. Similarly, studies by national central banks in Europe, including the central banks of Norway and Sweden, have confirmed that cash and checks use more total resources from all participants than electronic payments. The results of these studies, coupled with those of Simes, et al. and Garcia-Swartz, et al., cast doubt on the propriety of intervening in such a complex, empirically difficult area.

21. Proponents of payment card systems also take a different view regarding whether payment cards are cross-subsidized and thus overused. They note that it is common for merchants to provide services that only some customers consume (e.g., free beverage refills, free parking, knowledgeable sales staff, and fitting rooms). Throughout the economy, consumers who do not use these services cross-subsidize consumers who do. Depending on the service, the demographics of those consumers cross-subsidizing and being cross-subsidized will vary so that, for example, low income consumers at times cross-subsidize and at other times receive cross-subsidies from high income consumers. Such cross-subsidization may create “overconsumption” of, say, coffee refills. Given its ubiquity, proponents of payment card

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30 See Alan S. Frankel, Monopoly and Competition in the Supply and Exchange of Money, 66 ANTITRUST L. J. 313 (1998) (defining “price coherence” as “the phenomenon in which the price paid by a consumer for a product does not vary with modest differences in the costs imposed on the merchant by the customer’s choice of brands or payment methods”).

31 Id. at 314.


systems and some economists argue that such cross-subsidization is neither anticompetitive nor a basis for regulation.\textsuperscript{35}

22. Merchants claim that offering their customers the option to use a payment card is different than the provision of other services because the interchange fees set by the payment systems do not allow merchants to choose the size of the subsidy. In many countries, including the U.S., however, payment card system rules allow merchants to offer a discount to customers paying with cash, checks, or non-signature based debit cards. In several countries, such as the UK, the Netherlands, and Sweden, merchants also can surcharge customers paying with payment cards. Industry observers note that a discount for cash and checks is analytically equivalent to a surcharge for payment cards.\textsuperscript{36} Most merchants do not offer discounts or surcharge (when allowed). The Interim Report concluded that this merchant behaviour may be due to factors such as the lack of merchant information or the prohibition of surcharging through means other than network rules.\textsuperscript{37} Industry proponents, however, attribute infrequent merchant discounting and surcharging to merchants’ desire to retain credit card customers, who typically have more options for places to shop than cash or check customers and who are more likely to take advantage of merchant sales because they have access to credit.\textsuperscript{38}

23. Industry proponents also assert that merchants can avoid the cross-subsidization of payment cards by choosing not to accept payment cards. Some merchants assert that they have no choice but to accept these systems’ cards for payment regardless of the price charged. Observers have noted, however, that retailers accept payment cards because their consumers demand to pay with these methods. Accepting payment cards so as not to lose sales to another retailer is an important aspect of competition among retailers. Acceptance of payment cards is thus arguably indistinguishable from other forms of competition such as hiring knowledgeable salespeople, providing a clean and well-designed environment, and offering “free” parking. Moreover, not all merchants accept all electronic payment methods. Price apparently plays an important role. Only about two-thirds of the U.S. merchants that accept Visa and MasterCard also accept the more expensive American Express cards.

\textbf{B. Cost and Benefits to Merchants of Electronic Payments and Merchant Acceptance over Time}

24. Although the participants in the debate may disagree about the total social costs of payment cards, there does appear to be consensus about the cost to merchants of accepting payment cards over time. For example, the total amount that U.S. merchants paid to accept payment cards roughly tripled between 1996 and 2004. These increases were largely fuelled by year over year double-digit increases in the number and volume of card payments for goods and services.

25. When measured in percentage terms, in contrast, the cost to merchants of accepting electronic payments has declined. In the U.S., American Express charged a system wide merchant

\textsuperscript{35} For an economic analysis of this issue, see Klein, \textit{et al.}, \textit{supra} n.26.

\textsuperscript{36} \textit{See id.}

\textsuperscript{37} European Commission Competition DG, Interim Report I Payment Cards: Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, at 124 (Apr. 12, 2006).

\textsuperscript{38} \textit{See Klein, \textit{et al.}, supra} n.26.
discount rate of more than 4\% when it was launched in the 1950s. Today, its average system wide discount is approximately 2.5\%. Similarly, the percentage rates that merchants pay to accept Visa and MasterCard transactions in the U.S. are lower than those charged by their predecessor systems. When Bank of America launched its credit card system in the 1950s, it set a discount rate of 5\%. Today, the average merchant discount on the Visa system is below 2.1\%. Likewise, in the EU, weighted average merchant service charge rates on credit card transactions have fallen for all international payment card networks—MasterCard, Visa, Diners Club, American Express, and JCB. 39

26. As the volume of electronic payments has increased, so have the number of merchants accepting them. Payment card systems began as niche products, targeting particular groups of merchants and consumers. The Diners Club and American Express systems, for example, began as travel and entertainment cards for executives and international travellers. The MasterCard and Visa systems, on the other hand, originated to provide middle-class American families with access to credit at retailers that could not afford to offer their own credit programs. 40 Today, all of these systems, and many others, are accepted at a wide variety of merchants. This widespread merchant acceptance of payment cards has expanded consumer choice of payment methods at the point of sale.

C. The Interchange Debate

27. Critics of interchange fees predominantly comprise the merchants who fund the interchange through merchant discount fees. Some urge regulators to eliminate the interchange fee altogether, while others recommend capping it. 41 Most enforcement agencies who have intervened in this area have chosen the latter path:

- In 1997, a group of retailers complained about interchange before the European Commission’s Competition Directorate. The retailers alleged that the interchange fees on both credit and debit cards amounted to a price-fixing cartel in violation of EU competition law. They also objected that acquirers were not permitted to disclose the actual interchange fees to merchants. In its decision, the Commission held that the interchange fee is an agreement among competitors that restricts the freedom of banks individually to decide their own pricing policies, and distorts the conditions of competition in the Visa issuing and acquiring markets. With respect to the acquiring market, the Commission held that the interchange fee, the primary component of the merchant service charge, likely constitutes a de facto floor for the merchant service charge, having the effect of distorting acquiring banks’ behaviour vis-à-vis their customers at the resale level. After a lengthy investigation, the European Commission in July 2002 announced a settlement with Visa under which Visa agreed to set its interchange with reference to a cost-based cap, to increase transparency of interchange fees.

39 Interim Report I Payment Cards, supra n.37, at 45.

40 Credit card networks also have provided middle-class America with nationwide payment capability in the absence of nationwide banking. Paying for a hotel in New York with a check drawn on a California bank account was and probably still is not possible.

41 Some merchants, for example, object to the inclusion in the interchange fee of certain identifiable costs that they assert cover items that do not benefit merchants particularly. Merchants objected unsuccessfully to the inclusion of the costs of the payment guarantee, the cost of processing, and the cost of free funding, in Visa’s interchange fee approved by the European Commission in July 2002, on the grounds that these costs are of benefit to cardholders and not merchants. See Commission Decision 2002/914, 2002 O.J. (L 318) 17 (EC).
rates, and to reduce its credit card interchange fee on all cross-border transactions gradually during the subsequent five years. The modified interchange fee that the Commission imposed under the settlement accomplished the Commission’s goals: it is (1) based on objective criteria (certain identified costs) and (2) transparent to merchants. The EU also has opened interchange proceedings against MasterCard.42

- In August 2002, the RBA intervened regarding credit cards. The RBA capped interchange fees, but not merchant discounts. It also eliminated the so-called no-surcharge rule, effectively allowing merchants to impose a fee on consumers for using credit cards. The RBA’s actions sought to remedy the perceived overconsumption of credit cards, in light of the RBA’s determination that the effective per-transaction price that consumers paid to use payment cards was significantly lower than the operating costs involved in the payment cards system. In capping interchange fees and allowing merchants to charge customers for using payment cards, the RBA sought to promote price signals to users of payment services and thereby encourage efficient choices. The RBA is also publishing merchant service fees across all networks to increase transparency. As discussed below, the RBA’s intervention has been the subject of much controversy.

- In September 2005, the UK OFT issued a formal finding that MasterCard’s system of setting interchange fees was anticompetitive, violating Article 81 of the EC Treaty as well as UK competition law. The OFT found that MasterCard’s interchange fee was unduly high because it enabled issuers to recover more than the cost of transmitting and processing payments. The OFT concluded that unduly high interchange rates restrict competition among acquirers and issuers. The OFT also concluded that merchants passed on the fee to consumers by raising retail prices. On appeal, the OFT appear to have reconsidered its handling of the MasterCard case since last year’s decision. Industry participants observed that there were “material divergences” between the OFT’s Defence, lodged on February 28, 2006, and its Decision, adopted on September 6, 2005. The OFT will hear the appeal against the MasterCard Decision in the Fall of 2006.43

28. The EU also is considering additional intervention. Last year, the European Commission launched a sector inquiry into certain financial services, including the payment cards industry. On April 12, 2006, it issued its Interim Report on Payment Cards (“Interim Report,” or “EC Interim Report”), and anticipates publishing its final report later this year. In the Interim Report, the Commission expressed serious concern about the current scheme of interchange fees, concluding that interchange fees vary considerably across the EU; that its inquiry did not


43 See Order, at 5-6, Cases 1054-56/1/1/05 (Competition Appeal Tribunal May 9, 2006) (“It was accepted by the OFT . . . that, in the Defence, the conclusion that the arrangements for setting the [interchange fee] infringed Article 81(1)/section 2, and did not satisfy Article 81(3)/section 9, had been reached by a different route from that in the Decision, and that the route taken in the Defence was in substitution for the route taken in the Decision.”).
confirm the possible justifications for interchange fees that rely on economic efficiency arguments; and that the setting of interchange fees in some cases may have the object and/or effect of creating market entry barriers to competition between local and foreign member banks. Pursuant to the Lisbon Agenda and the EU goal of instituting the Single Euro Payments Area (“SEPA”) and the Internal Market for Payments, the Commission as well as the European Central Bank (“ECB”) are tackling issues that they view as potential obstacles to SEPA and the Internal Market for Payments.

29. As noted previously, challenges to interchange fees have come not only from regulatory authorities, but also from private plaintiffs. In 2005, numerous merchant groups in the U.S. filed nearly 50 individual and class action lawsuits against the payment card associations. They allege, among other things, that setting interchange rates amounts to illegal price fixing. The cases have been consolidated for pre-trial proceedings before Judge Gleeson in the Eastern District of New York.

IV. Honour-All-Cards and No-surcharge Rules

30. Other common industry practices have been challenged, as well. For example, both the Honour-All-Cards rule and the no-surcharge rule have been challenged as anticompetitive, although these challenges were unsuccessful in the EU. Honour-All-Cards rules, which require a merchant that agrees to accept one particular card on a system to accept all other cards issued on that system, have been challenged as tying arrangements that limit merchant choice. No-surcharge rules have been criticized for limiting the ability of merchants both to signal to consumers the relative costs of different forms of payment and to steer consumers to their preferred payment type. Payment card systems have defended the rules as output-enhancing practices that protect the goodwill associated with the entire system from opportunistic behaviour that merchant participants otherwise could undertake.

31. Proponents of Honour-All-Cards rules assert that these rules offer substantial efficiency benefits. Every time a system introduces a new issuer or a new variant on previously issued cards, it does not have to negotiate with each merchant that previously agreed to accept its card or develop a new brand name for the new variant. In addition to avoiding significant transaction costs, the proponents of these rules assert that the presence of an Honour-All-Cards rule prevents individual merchants from blocking the introduction of new cards that would increase the utility of the system as a whole to all merchants and all consumers.

32. Similarly, proponents of no-surcharge rules assert that legitimate business justifications support their implementation. In the U.S., these rules typically have two elements. First, they require

44 See Interim Report I Payment Cards, supra n. 37.
45 Other legal challenges at the network level in the U.S. have involved issues besides interchange, but still have targeted primarily the open networks (MasterCard and Visa). These challenges have focused on three main issues: (1) exclusivity, (2) the Honour-All-Cards rule, and (3) the scope of permissible activities of the cooperative networks.
46 Even the merchant plaintiffs in the Visa Check/MasterMoney Antitrust Litig., No. 96-CV-5238 (JG), 2003 WL 1712568 (E.D.N.Y. Apr. 1, 2003) (Wal-Mart litigation) agreed there were significant benefits to the Honour-All-Cards rule and did not challenge its necessity. Specifically, the Wal-Mart plaintiffs accepted the guaranteed acceptance benefits of the Honour-All-Cards rule, but challenged the claim that it was necessary to achieve these benefits by extending the rule from credit cards to debit cards. The European Commission has recognized the value of the Honour-All-Cards rule, upholding Visa International’s Honour-All-Cards rule in 2001 and concluding that abolishing the rule would not increase competition substantially. Council Decision 2001/782, 2001 O.J. (L 293) 24, 37-38 (EC).
merchants to provide prior notice to consumers when there are fees that apply to the use of a particular payment system, so that undisclosed fees at the point of sale do not surprise consumers. Thus, no-surcharge rules leave merchants free to set different prices for different payment systems, but they require merchants to disclose both prices to consumers prior to purchase. Second, no-surcharge rules generally have a most-favoured-nations requirement. This aspect of the rule prevents merchants from selectively using differential prices at the point of sale to distinguish between comparable card systems. In the U.S., these provisions typically encompass Visa, MasterCard, American Express, and Discover. According to proponents, the no-surcharge rule prevents merchants from surcharging and thus imposing a negative externality on a payment card system and its brand name by not “accepting” the system’s card in the way that the cardholder expects.

33. In the EU, no-surcharge rules appear to be more restrictive. European no-surcharge rules do not allow merchants to charge customers more for using a payment card, effectively prohibiting merchants from offering discounts for cash or other forms of payment. The European Commission declined to challenge Visa’s no-surcharge rule in 2001 because it found that the policy had no appreciable effect on competition.47 More recently, the EU Interim Report identified the no-surcharge rule as a possible entry barrier, stating that it may hinder development of non-cash payment instruments.48 Nevertheless, even where surcharging and discounting are allowed, the practices are not widespread, leading the Commission to recommend further inquiry into the effects of this policy.49

34. Notwithstanding the proffered justifications, both the Honour-All-Cards and no-surcharge rules have been abandoned or abrogated in a number of jurisdictions. In the U.S., the Wal-Mart litigation resulted in a settlement that ended Visa’s and MasterCard’s extensions of their Honour-All-Cards rules to off-line debit cards. The RBA recently announced its intention to strike down both the extension of the Honour-All-Cards rule to off-line debit and the no-surcharge rule. Surcharging is permitted in Sweden, the Netherlands, and the UK.50 In Denmark, Danish law prohibits merchants from surcharging for Dankort cards.51 UK MasterCard has announced the repeal of its no-surcharge rule throughout the EU. Variations throughout the world in applicability of the Honour-All-Cards and no-surcharge rules illustrate the empirical complexity and the lack of consensus on competition issues in the payment card industry.

V. Australia: A Case Study

35. As noted above, authorities in a number of jurisdictions have imposed regulatory constraints on interchange fees and have limited or eliminated the application of the Honour-All-Cards and no-surcharge rules. The most controversial and widely debated intervention is that of Australia.

47 See id.
48 See Interim Report I Payment Cards, supra n.37, at 124-25.
49 See id.
50 See id. at 123-24; see also Decision No. CA/98/05/05, at 14 (O.F.T. Sept. 6, 2005), republished in Competition Act 1998 Pub. Reg. (UK Office of Fair Trading Credit Cards (Price Discrimination) Order 1990 declared illegal MasterCard and Visa’s no-surcharge/no-discrimination rules, as of March 7, 1991); Weiner & Wright, supra n.27, at 297-98 (plotting national variations in application of Honour-All-Cards and no-surcharge rules).
51 See Interim Report I Payment Cards, supra n.37, at 123.
36. The RBA began considering interchange fees and related acceptance practices in the late 1990s. In 2001, the RBA issued a report stating that allowing payment systems to capitalize on the strategic interest of merchants in maximizing foot traffic could create perverse incentives for choice among payment systems. The RBA was concerned that payment card systems such as Visa and MasterCard were more expensive than legacy payment systems such as cash and check, and that the role of interchange in subsidizing card issuance and use might lead to the overconsumption of payment cards relative to other forms of payment.

37. These concerns prompted the RBA to regulate Australia’s payment card industry. In August 2002, the RBA required all major payment card systems to eliminate their no-surcharge rules. Later that year, the RBA announced an interchange rate formula for the bank-owned systems (Visa, MasterCard, and Bankcard), effective October 2003. The RBA did not regulate either American Express or Diners Club, three-party systems without an explicit interchange framework. The RBA recently announced plans to extend its regulatory regime to embrace debit systems as well, eliminating Honour-All-Cards rules that bundle debit and credit cards and bringing interchange rates on competing debit systems into close alignment.52

38. The results of the RBA’s actions in the Australian credit cards industry may prove instructive for other jurisdictions contemplating similar actions.

- Perhaps the most intriguing aspect of the intervention in Australia is the impact on consumers, because that impact has policy implications elsewhere. The RBA has asserted that its intervention helps consumers through greater competition and lower merchant costs. Nevertheless, it appears that results among consumers vary considerably. While the RBA has stated that non-cardholding consumers are benefiting, cardholders have experienced increased costs and lower benefits. In a paper discussed at a recent New York Federal Reserve conference, economists Howard Chang and David Evans identified negative impacts on Australian consumers. They estimate that cardholders had seen their annual fees and finance charges increase by AU$148 million since the imposition of the RBA rate caps. Chang and Evans also reported that rewards programs have been cut following the RBA regulation. According to the RBA, though, issuers have introduced more low interest rate cards. In addition, the RBA reports that lower merchant costs are being passed through to consumers with lower prices, although it has acknowledged that “[i]t is, however, not possible to monitor the speed and extent to which [the reduction in retail prices] is occurring, as the effect is relatively small compared to changes in the overall price level of the economy.”53 It further has stated

52 In contrast to Australia, Mexico’s Central Bank intervened in the payment card industry due not to perceived overconsumption, but underdevelopment of the credit card market and low usage of credit cards. The Central Bank’s intervention was three-fold: (1) to improve transparency, the Central Bank required issuers to inform their clients of all fees charged to them, and to inform the Central Bank of such fees in advance; (2) to improve participation in the payment card industry, the Central Bank required all banks to allow payment of credit card balances through electronic transfers, which would allow procompetitive credit card balance transfer arrangements, and the Central Bank also modified the Honour-All-Cards rule so that merchants decide whether to accept only credit cards, only debit cards, or both; and (3) regarding interchange fees, which banks in Mexico set through the Association of Mexican Banks, and not Visa or MasterCard, the Central Bank reduced both debit and credit card interchange fee schedules, and introduced several categories of interchange fees specific to different types of businesses. Unlike the RBA’s cost-based cap, the Mexican Central Bank’s intervention was a value-based methodology. The Mexican Central Bank has stated that it is still too early to observe the effects of the intervention in Mexico on discount rates. However, it states that consumers have not experienced increases in annual or initial fees for credit cards due to the regulation. See Jose L. Negrin, The Regulation of Payment Cards: The Mexican Experience, 4 REV. OF NETWORK ECON. 243, 244, 260 (2005).

that “the fact that it cannot be separately identified does not mean that it has not happened.”54

• Merchants have benefited substantially from the RBA’s intervention. Merchant discount rates for credit cards issued on the bank-owned systems have dropped from 1.45% to .97%. The discount rates on American Express and Diners Club have also declined, but by much less. American Express, for example, has reduced its discount rate from 2.58% to 2.38%. Weighted by volume, the average rate that merchants pay for credit card acceptance across all systems has declined from 1.61% to 1.17%.

• As noted above, one concern of the RBA was the perceived overconsumption of credit cards. It appears that the RBA’s regulatory intervention has affected the use of credit cards. The rate of spending growth on credit cards has fallen from 2005 through February 2006 to 8%, the lowest rate of growth since the RBA began collecting data in the early 1990s.55 The RBA’s intervention has also shifted share from the now regulated networks to the unregulated networks, which remain unconstrained in their ability to offer attractive deals to issuers and benefits to cardholders. Thus, proprietary credit card systems operating in Australia have benefited from the rate advantage, as the American Express and Diners Club share of credit card transactions has increased by approximately 20%. From October 2003 through August 2005, dollar volume on the American Express and Diners Club systems increased at about twice the rate as on the bank-owned systems (18.8% versus 9.6%).

• Moreover, Simes, et al. have asserted that several methodological problems existed in the RBA’s study assessing the costs of payment cards, casting doubt on the RBA’s premise for intervention—the perceived greater social cost of credit cards.56

39. The primary purpose of competition law and enforcement is to enhance consumer welfare by preserving competition on the merits.57 If intervention were to prove harmful to consumers, on balance, the propriety of the intervention would have to be reconsidered. As BIAC has observed previously, a “primary consideration in preserving competition on the merits is ensuring that the enforcement process itself does not undermine benefits to consumers.”58 Despite assertions from the RBA that consumers have benefited from the intervention in Australia, empirical data do not confirm net benefits for consumers. Rather, the data show that intervention benefited merchants and the unregulated card networks.59 In the absence of empirical evidence pointing to net consumer benefits, and in the face of a general consensus that

54 Id. Specifically, the Bank estimates that when fully passed on to consumers, the Consumer Price Index (CPI) will be 0.1 to 0.2 percentage points lower than it would have been without the RBA’s intervention. The RBA stated: “There are no statistical techniques with fine enough calibration to separately identify this change against a background where the overall CPI increase is about 2.5 per cent.” Id.


56 See Simes, et al., supra n.33.

57 See Summary of Discussion Points, supra n.7, at 4.

58 See id. at 1.

consumer welfare is the touchstone of competition law, BIAC urges authorities to proceed cautiously before pursuing similar interventions in other jurisdictions.

VI. Competition and Innovation

40. Besides pricing and non-price rules, competition authorities typically address the degree to which the practices of industry participants allow for and result in innovation. As with many aspects of the payments industry, observers are divided over the question of innovation. Proponents of the industry emphasize a sophisticated payment card infrastructure, rapidly evolving technologies, and anticipated innovations that will bring enhanced convenience and security for consumers.

41. The U.S. Department of Justice (“DOJ”), in contrast, challenged the networks’ alleged failure to innovate in a lawsuit filed in 1999. The Department’s primary claim involved the overlap in membership, ownership, and governance. DOJ argued that this overlap, known in the industry as duality, suppressed competition between the associations and blunted their incentive to innovate. According to the complaint, duality dissuaded management from “proposing competitive initiatives likely to lead consumers to switch from one brand to the other.”

42. The U.S. district court rejected the claim that duality had suppressed the companies’ drive to innovate. The centrepiece of DOJ’s claim was the failure of the two companies to launch smart cards in the U.S. On this issue, the district court found that the lack of a business case, not duality, explained their absence in the U.S. The court similarly rejected DOJ’s other evidence of suppressed innovation—an alleged delay in developing a protocol to secure payment card transactions on the Internet, the absence of comparative advertising between Visa and MasterCard, and Visa’s failure to pursue a premium card product before MasterCard launched its own product.

43. The district court found, instead, that Visa and MasterCard had compiled an impressive record of independent innovations. The district court pointed to the companies’ respective successes “in mov[ing] from inefficient, labor-intensive, paper-based systems to sophisticated electronic systems.” The district court also highlighted Visa’s record of innovation regarding fraud control, noting that Visa’s successful efforts in these areas had “created a competitive advantage for Visa over MasterCard.” The district court noted that MasterCard, on the other hand, had a long string of product innovations. The district court observed that MasterCard had been the first to introduce a reward card with no pre-set spending limit for high-end business travellers as well as Fleet cards and Purchasing cards.

44. Despite the decisive ruling of the U.S. district court on this issue, concerns about innovation in the payment industry have resurfaced. The RBA, in building its case for regulatory

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62 Id. at 364.
63 Id.
64 Id. at 365.
intervention, asserted that Visa and MasterCard had inhibited the development of new payment technologies. 65

45. To rebut these assertions, Visa and MasterCard point to steady improvements in the reliability, security, and efficiency of payment cards. Average settlement time on Visa transactions in the U.S., for example, has dropped nearly 20% since 1999, falling from an average time of 2.2 days in 1999 to 1.8 days in 2004. 66 In the UK and France, Visa and MasterCard have successfully deployed an EMV Chip + PIN antifraud technology. In the U.S., Visa’s fraud rates fell by an annual rate of 7% from 1999 to 2004 as volume grew by 14% per year over this same period. 67 The companies also observe that new technologies are constantly emerging to extend the reach of electronic payments. 68 They point to the development of “contactless” cards, cellular-based acceptance terminals and the steady expansion in the types of cards, e.g., first credit cards, then debit cards, then stored-value cards, etc. 69

46. Other regulatory perspectives further complicate the debate about innovation. Concerns about national security, privacy, consumer protection, and the safety and soundness of the banking system often lead countries to impose requirements on payment systems and their participants. These legitimate concerns may limit the development of new technologies. 70 To the extent that non-competition considerations are relevant to regulatory intervention, they should be articulated in a transparent way and implemented so as to permit the maximum level of competition possible within that framework.

47. BIAC previously has observed that “[t]raditional competition law, particularly in its enforcement, cannot foreshadow the pace of invention. A focus on short-term allocative efficiency may result in enforcement activities that could adversely affect the incentives to innovate and the long term benefits to society that flow from dynamic efficiencies.” 71 Given our current state of knowledge, regulators should exercise extreme caution when considering intervention in the payment card industry; preserving the current dynamic environment of the payment card industry is preferable to premature intervention that may chill future innovation and hamper competition.

VII. Conclusion

48. Numerous issues relating to competition in the payment cards industry are highly controversial and subject to conflicting viewpoints. The economics underlying the industry are complex and not yet well understood, given the two-sided nature of the product. Existing theory provides some insight into fee levels and changes, but a number of complex factors shape interchange developments. Many of these factors are unique to particular countries, and further empirical work is necessary to account adequately for these individualized factors.

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65 See, e.g., Philip Lowe, Asst. Governor, Address to Banktech.05 Conference, Sydney (September 2005).
66 Visa Business Research and Reporting.
67 Id.
69 See id.; see also Brown & Plache, supra n.16, at 67-71.
71 Summary of Discussion Points, supra n.7, at 7.
49. For these reasons, BIAC recommends for the payment cards industry the same approach it has recommended generally. Namely, competition should be maximized except in clear cases of market failure or where other overriding public interest objectives justify regulation. Before intervening, regulators should be certain that the conduct in question is anticompetitive, that enforcement action is necessary to protect consumers, and that the proposed remedy will benefit consumers. Regulators should be cognizant, moreover, of the high-technology and rapidly evolving nature of the industry, as well as the interoperability that payment cards can provide for travel and commerce in this increasingly globalised world. Regulators should refrain from intervening in ways that would hinder innovation, stymie international transactions including travel and commerce, and impede competition.