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Competition *policy brief*

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The Interchange Fees Regulation

On 8 June 2015 the Interchange Fees Regulation entered into force[1]. The Regulation will bring important changes for consumers, retailers and banks in the way they deal with costs and pricing mechanisms of every day payments with card and card based products.

What are interchange fees?

Each time a consumer uses a credit, debit or prepaid card to buy something in a shop or online, the bank serving the retailer (*acquiring bank)* pays a fee called '**interchange fee'** to the bank that issued the card to the customer (*issuing bank)*.

As the retailer generally incorporates the interchange fees in the price charged to consumers the fees increase retail prices of goods and services. Thus, interchange fees are passed on to *all* consumers, even those who do not use cards but pay in cash.

Interchange fees in practice

When a consumer pays €100 by card in a shop, the retailer receives only €99; the acquiring bank keeps €1. Of this €1, the acquiring bank pays an interchange fee of 70 cents to the issuing bank. The remaining 30 cents cover the fees the acquiring bank pays to the payment card scheme – that is the payment network used to process card-based payment transactions – and its own costs and profit margin.

Interchange fees are normally set by payment card schemes – like Visa and MasterCard and domestic schemes like the Italian Pagobankomat – or the national banking communities. Merchants have little possibility to influence the level of the fees.

In a nutshell

The Interchange Fee Regulation is intended to help create a single market for card payments across the EU. Card payments are particularly important for cross-border and internet payments and so competitive card payments are essential for the development of the internal market.

The Regulation will create a level playing field that will allow more competition and spur innovation in payments that is already taking off. The Regulation builds on competition investigations by the Commission and the National Competition Authorities, and in particular the Commission's proceedings against MasterCard and Visa. It should help the payments industry move on from its old anti-competitive practices with benefits to merchants, consumers and payment providers.

The regulation imposes a cap on interchange fees for the most frequently used cards. In addition, the new rules make it easier for merchants to use banks in other EU Member States when they offer a better deal. The regulation also introduces new business rules and transparency requirements to improve market conditions.

As a result, interchange fees vary widely between Member States which suggests that in many cases consumers may overpay. In 2011 retailers – and so consumers - paid €9 billion in interchange fees.

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0751&rid=1.Together with the proposal for a revised Payment Services Directive, the Interchange Fee Regulation was part of the Payment Package proposed by the Commissioners for Competition and Financial Stability, Financial Services and Capital Markets Union in July 2013 to improve the efficiency, competitiveness and security of European payments markets.

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What is the problem with interchange fees?

A key problem is that cardholders, who are unaware of the fees, are encouraged to use cards that generate higher fees. At the same time card companies compete to attract issuing banks by offering them high interchange fees. These 'reverse' market mechanisms in the payments market drive fees up rather than down.

This has contributed to the disappearance of a number of national (normally cheaper) card schemes, which have been replaced with schemes offering higher fees to issuing banks (for example in the UK, the Netherlands, Austria, Finland and Ireland).

Interchange fees are typically set by the payment card scheme. But interchange fees can also be set directly by the national banking communities or even bilaterally between certain banks.

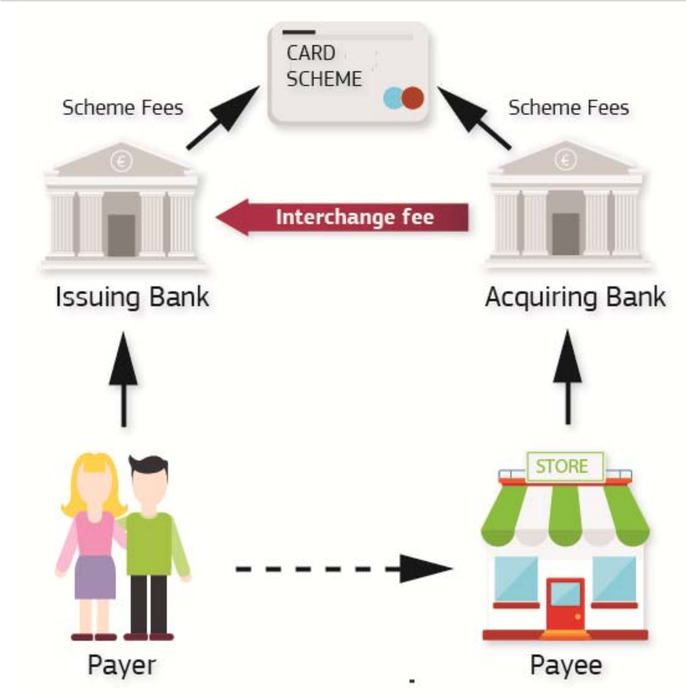
Like consumers retailers are often unaware of the level of these inter-bank fees which can be high and opaque. In any case, even if the merchant is aware of them, there is no room to negotiate lower interchange fees as the merchant is not involved in the negotiating process between the card issuing and the merchant's bank.

What is a payment card scheme?

A payment card scheme is the manager of a payment network of issuers and acquirers of payment cards like debit and credit cards. Members of payment card schemes are banks or other financial institutions that have the possibility to issue cards and acquire cards transactions that make use of the network.

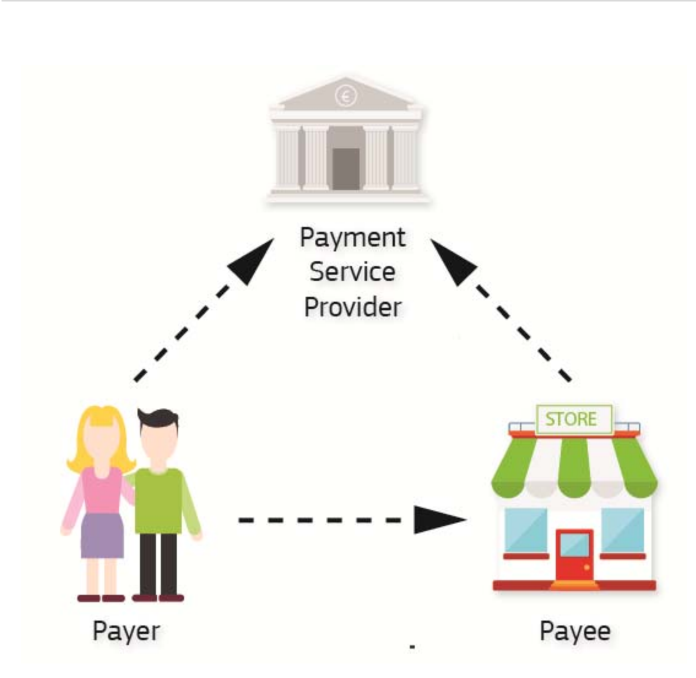
There are two types of payment card scheme: four-party or three-party card schemes.

Four-Party Card Scheme



A four-party card schemes consists of the issuing bank, the acquiring bank, the retailer and the cardholder. Most, but not all, four-party card schemes require the acquirer to pay an interchange fee to the issuer every time a transaction is made.

Three-Party Card Scheme

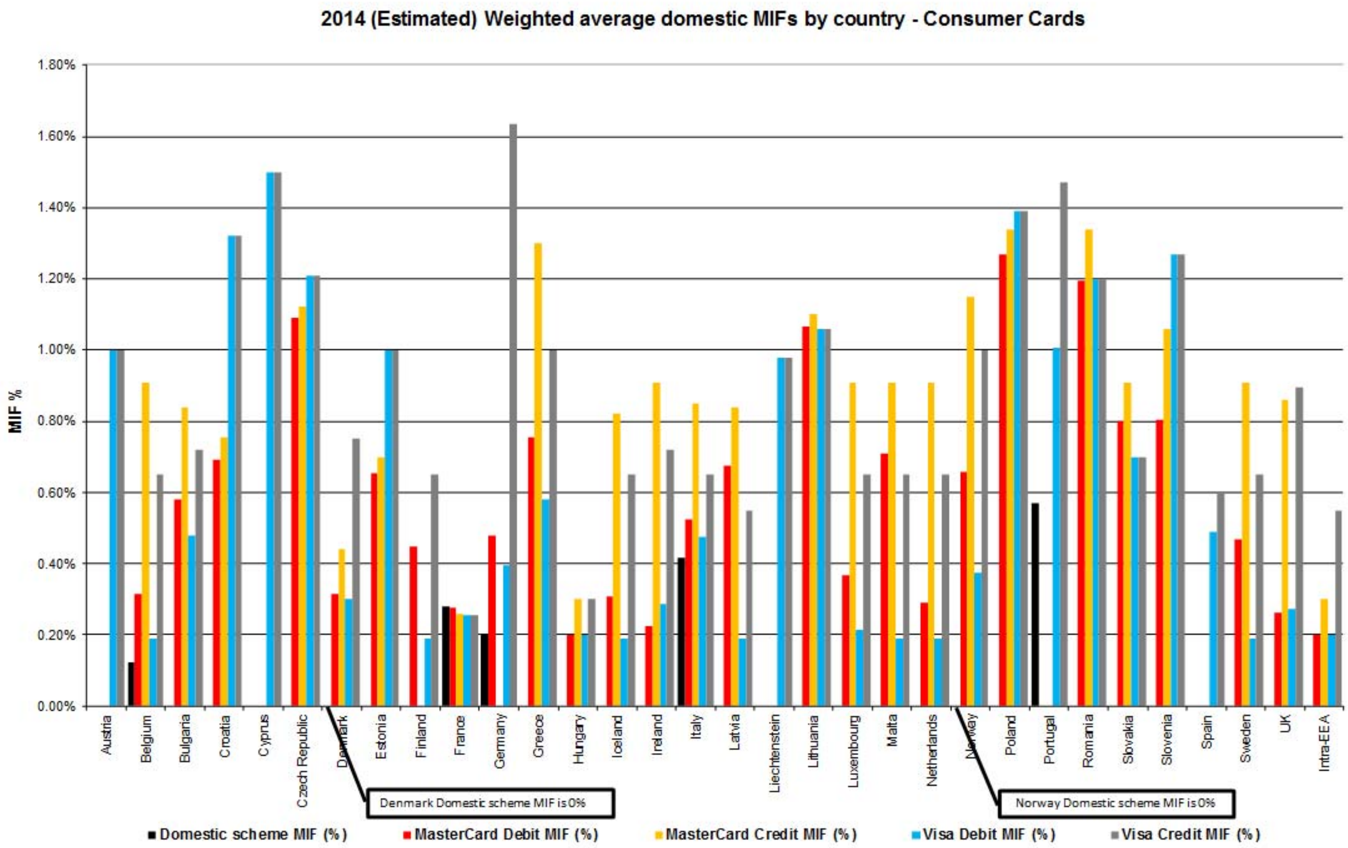


Three-party card schemes are composed of the card company that issues and acquires its cards, the retailer and the cardholder.

⇢ Examples of payment card schemes are Visa and MasterCard (four-party schemes) and American Express (a three-party scheme)

For payment card schemes, high interchange fees are beneficial as they encourage banks to issue cards. More issued cards means more transactions leading to more income for banks and card schemes.

practice the EU has 28 national markets with national differences in interchange fees ranging from 0.1% to more than 1.5%.



The average rates are estimated based on rate tables weighted by a hypothetical mix of transaction types (60% EMV or Chip, 20% Secure E-commerce, 20% Standard or Base)
Fixed MIF elements were turned into ad valorem by using an ATV of EUR 46.23 for debit and EUR 70.4 for credit cards (based on ECB data)
ECB's Euro reference rates of 2 January 2014 were used to calculate in non-EUR currency countries

For merchants and consumers interchange fees are problematic but they do not have sufficient counterweight to match the power of card schemes and banks determining fees collectively. This is also because retailers find it difficult to refuse commonly-used cards. After all, if a retailer refused such cards, he would run the risk that consumers would go to other retailers who do accept these cards. This is described as the "business stealing effect": individual retailers accept high costs for card payments to keep and grow their sales, although for retailers as a whole the level of sales does not depend on whether cards are used or not.

As said, this has a negative consequence for consumers. In fact, the customer who pays with a debit card or in cash pays for the air-miles given to the customer who is provided by his bank with a credit card.

Because card holders can normally use their card throughout the EEA, they have the impression that there is a well-functioning single market. However, the interchange fees are also a barrier to a seamless and efficient EU payment system as they vary a lot between Member States. In

In addition, rules applied by card schemes protect the high MIF countries from competition elsewhere: they oblige banks to charge the interchange fees of the country of the retailer so that retailers are prevented from receiving better prices offered in other countries.

The different interchange fees also make it more difficult for new players and new methods of payment to enter the market and drive innovation forward. Out of concern that fees they may receive from new players or new technologies will 'cannibalize' their revenues from debit and credit cards banks are generally reluctant to work with such new entrants. So most new technological developments such as contactless and mobile payments are still based on the existing interchange fee-based model for payment card payments. In contrast, banks are often reluctant to work with real alternative business models based on credit transfers or direct debits, although these are often a safer and cheaper way to pay, particularly for internet payments.

New ways to make a payment transaction

Credit transfers can for example be initiated through so-called Payment Initiation Service Providers using the online banking infrastructure on behalf of consumers. For instance, in the Netherlands, the cheap online payment solution (Ideal) is now the most commonly used way to pay on the internet. This is largely because the low interchange fees (below 0.2%) in the Netherlands meant banks did not have a reason to push for card payments. As a result, Dutch consumers do not have to pay credit card fees in order to shop online. This is a powerful alternative to online purchases with credit cards, and no interchange fees are involved.

What are the solutions introduced by the Interchange Fees Regulation?

Capping interchange fees

The Regulation ensures that interchange fees are at a rate so that retailers' average costs of card payments are not higher than those of receiving payments by cash. This ensures that merchants receive a share of the benefit of the efficiencies created by card payments. The so-called "merchant indifference test" is a concept originating from the academic works of *inter alia* Nobel prize winner Jean Tirole. The Regulation only caps interchange fees for the most frequently used cards that retailers cannot refuse or surcharge without risking losing customers.

The Regulation introduces a general cap applying to both cross-border and domestic transactions of 0.2% for debit cards and 0.3% for credit cards of the value of the transaction.

The caps are effective throughout the EU and so will establish a level playing field and end market fragmentation. But as different structures and philosophies apply to national debit card systems, the Regulation allows flexibility to Member States for such systems. For instance, Member States may allow the application of a fixed interchange fee of no more than 5 eurocents per transaction, possibly in combination with a maximum percentage fee, provided that on average the interchange fees are below 0.2%.

Member States may also generally define a lower cap than the 0.2% per transaction for debit cards and the 0.3% per transaction for credit cards.

Not all transactions will be subject to fee caps:

- Transactions with commercial cards (cards limited in use for business expenses where payments made with this type of card are *directly* charged to the company's bank account),
- withdrawals at automatic teller machines or at the counter of a bank
- and transactions with payment cards issued by three party schemes

are excluded from the caps.

Licensing rules

To promote competition across the Internal Market, companies who are licensed to issue cards or acquire card transactions should be able to extend their activities to the whole of the European Union. This is why the Regulation bans territorial restrictions in licences.

Separation between the scheme and the processing

Payment schemes often have their own subsidiary for the processing of payment transactions. But there are also numerous independent companies that process payments.

Companies processing payments

When a consumer pays by card in a shop, the payment transaction needs to be processed in order for the payment to arrive at the right bank account. Therefore, retailers make use of the services of a processing company. This company manages the communication and IT processes needed to make the payment, whereas the card scheme manages the commercial and contractual framework for the payment.

The Regulation requires schemes to separate their processing activities and prevent discrimination between different processors. This separation of scheme and processing should allow the processing market to become more competitive and so more efficient and innovative. A competitive market allows banks and retailers to choose the best processor for their card transactions.

Co-badging

Payments via mobile phones are increasing, and in the future we may see many different means of payment 'co-badged' on our mobile phones (e.g. debit card, credit card, loyalty cards at a store, premium cards, payment by credit transfer) and other devices such as wrist bands. It is important to leave the choice of the instrument to those who will bear its costs, *i.e.* retailers and ultimately consumers.

In order to ensure that the choice of payment application remains with the consumer and the retailer, the Regulation prevents schemes and card issuing banks from pre-conditioning this choice.

Transparency requirements

To increase transparency, the Regulation limits the practice of 'blending', charging a single price for transactions with different costs.

In their contracts with retailers, acquiring banks will have to specify individually the merchant service charges, the interchange fees, the scheme fees for each category and brand of payment cards. Once the transaction has been executed, unless he asks not to, the retailer will receive information for each transaction including the amount of the interchange fee.

This will improve transparency and will enable the retailer to check whether the caps have been implemented.

The "Honour all Cards" rule

Banks and schemes generally impose the so-called Honour All Cards rule on retailers. This is a tying obligation that obliges the retailer, if he accepts any card of a given brand, to accept all cards (including the more expensive premium cards) from the brand.

Under the Regulation, when accepting a certain category or brand of cards, merchants cannot be obliged also to accept another category or brand issued within the framework of the same payment scheme, except if the same interchange fee cap applies.

The practical effect of this new rule is that a merchant can choose to accept only debit cards and not credit cards, or to refuse premium cards. To improve consumer information, merchants will have to display the cards they accept at the entrance of the shop and at the till.

Freedom to steer consumers to preferred payment instruments

Currently most card schemes prohibit merchants from trying to steer their customers to their preferred payment means (eg by encouraging them to pay cash or accepting card payments only above a certain threshold). The Regulation prohibits any such rules. Retailers have the right to encourage consumers to use whatever payment means they prefer, for example by setting a threshold for card payments, informing the consumer of the costs of the different payment instruments, or rebating or surcharging. However, the final choice (between the payment means accepted by the merchant) remains with the customer.

Rebates and surcharges are addressed under the newly revised payment service directive (PSD II). Retailers always have the right to offer rebates when a specific payment instrument is used. As regards surcharges, the situation is more complex. Under the PSD II, retailers have the right to surcharge payments with cards that remained outside the scope of the Regulation. However, Member States have the option to ban surcharging on all cards, including the ones for which the interchange fees are not capped.

Surcharging cards

A consumer buys a good of €100 in a shop and wishes to pay with 'card XPS'. 'Card XPS' is burdened with a relatively high interchange fee of 3.5%, which is not capped by the Regulation. Therefore, the retailer adds 3.5% to the amount to be paid every time a consumer pays with a 'card XPS'.

In this situation, the retailer makes use of a payment card surcharge. This €3.5 for a €100 purchase is kept by the retailer to compensate for the higher costs and relatively high interchange fee that comes with the use of 'card XPS'. As a result, consumers who do not make use of this card will not cross-subsidise its use through relatively higher retail prices.

In consequence, the consumer pays €103.5 of which €3.5 is withheld by the acquiring bank (to be shared between the issuing and the acquiring bank) while the retailer receives the full €100 that it would have received if the payment had been made in cash.

Why is regulation necessary?

By its nature, competition enforcement is backward-looking. It can punish past behaviour, but it cannot establish rules for the future. Moreover, enforcers cannot address all companies at once, but must target specific companies or groups of companies. Finally, competition enforcement takes many years as decisions taken by competition authorities can be appealed through the court system. And issuers may decide to move quite quickly to issue cards with the highest interchange fees. So if a scheme reduces its fees before its competitors it risks losing market share. This means payment card schemes tend to delay changing their behaviour until they are forced to do so either by competition enforcement or by regulation.

Across the world, competition authorities and regulators have been trying to address the problems of interchange fees for many years.

Australia and the US, for instance, have adopted regulation capping interchange fees. Hungary, Spain, Poland and Romania have recently regulated interchange fees in national laws.

In terms of competition enforcement, the European Commission has adopted several decisions under EU antitrust rules, including the Commission's MasterCard decision of December 2007 and those for Visa Europe in 2010 and 2014.[2] National competition authorities have also

[2] According to the Decision, it is not excluded that interchange fees may be justified but, amongst other conditions, they must be set at a level

adopted prohibition decisions and opened proceedings. This has happened for example in Poland, Hungary, Italy, Latvia, the UK, Germany and France.

Confirming the Commission's analysis in the MasterCard decision, the Court of Justice of the EU decided in September 2014 that the interchange fees applied by the European banks to cross border transactions with MasterCard cards limit competition between acquiring banks within the meaning of Article 101(1) TFEU.

Certain payment card scheme rules preventing retailers from steering consumers in their choice of a payment instrument have also been held unlawful, most recently in a case brought in the US by the Department of Justice. In both the EU and US, 'victims' of high interchange fees are now filing claims for damages.

Despite competition enforcement and national regulation the European cards market has remained fragmented and interchange fees vary widely. So the Commission concluded that competition enforcement by itself would not create an EU-wide level playing field. Only regulation would enable the EU payments industry to move together from the old anti-competitive system to a new system that minimises the fragmentation between Member States, promotes competition and innovation, and allows consumers and merchants to benefit from the efficiencies created by card payments.

What are the benefits of the Interchange Fees Regulation?

Creating a level playing field for interchange fees will facilitate market entry of new players, enabling them to offer better prices to merchants, with benefits for both retailers and consumers.

Lower interchange fees will benefit merchants and consumers, particularly in Member States where current fees are high.

Retailers will pay less and so will be encouraged to accept card payments. They will also have more possibilities and be in a better position to choose an acquiring bank inside or outside their own Member State.

Consumers overall will benefit. Consumers using low cost means of payment such as cash or debit cards will no longer 'subsidise' the use of high fee cards which will instead have to compete on their own merits. This will promote a wider choice of more efficient and innovative providers.

Due to the higher competitive pressure in retailing than in retail banking it is likely that the cost savings to merchants will be passed on to consumers through lower retail prices more than the benefits of high interchange fees were passed on by banks to their customers. However, many factors influence retail prices: the pass-through will depend on the retail sector considered, the size of the merchant, its use of payment instruments, and the 'basket of purchases' (basket of goods and services being bought by the consumer).

It is also likely that reducing interchange fees will increase the use of cards. Limited interchange fees are generally associated with a higher acceptance and usage of cards. Overall, it is therefore likely that the Regulation will contribute to the acceptance by retailers of more efficient and safer electronic means of payment, to the detriment of cash. This is likely to contribute to the fight against tax evasion and the black economy.

Finally, a well-functioning internal market in the area of payment systems, with undistorted competition will invite innovation. Often the least secure or the least technologically advanced cards bear the highest interchange fee levels; nevertheless, caps on interchange fees do not seem to prevent migration to more modern solutions[3]. Conversely, new innovative or cheap payment solutions find it difficult to enter the market because of high interchange fees since banks prefer to co-operate with systems that maintain their existing revenues. Technology allowing payments with smartphones, on-line and in shops, with only one swipe, pay 'person-to person' with phones, or pay with a finger print is readily available. However, industry has so far not succeeded in making it widely available to EU consumers in part because of the uncertainty on permissible business models due to the ongoing competition proceedings at national and European level. The current legislation, enhancing the use of digital technologies and promoting the internal market is likely to facilitate growth and innovation based on competitive offers to those who chose to make use of the new services, not on hidden charges imposed on everyone.

Entry into force

The Interchange Fee Regulation was published on 19 May 2015 and has entered into force on 8 June 2015. Article 11 (no steering rules) applies as of that date. The caps on interchange fees will apply as of 9 December 2015. Most of the business and transparency rules will apply as of 9 June 2016.

that allows merchants to receive some of the benefits of these alleged efficiencies (analysis under Article 101(3) of the Treaty) but MasterCard had failed to demonstrate this. Cf. Case COMP/34.579, *MasterCard*, Commission Decision of 19 December 2007. http://ec.europa.eu/competition/antitrust/cases/dec_docs/34579/34579_1889_2.pdf. MasterCard offered undertakings covering cross border consumer interchange fees for consumer debit and credit cards, and Visa Europe offered commitments for consumer debit cards in 2010 and in 2013 for consumer credit cards.

3 This has been the case in Australia for the move to Chip cards and PIN authorisation.