

Alternatives to Direct Regulation

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Good morning. It is a pleasure to be here. I want to thank the organizers for giving me the opportunity to participate in this very important conference. I enjoyed reading Alan’s paper very much. It is thoughtful, thorough, and not without a few choice controversial statements! In my comments this morning, I am going to do my best to steer away from potentially controversial statements and take what I hope is perceived to be an objective, neutral, central-banker approach.

Specifically, I want to focus on the range of policy options available to policymakers in evaluating credit and debit card markets, where one of those options may be do nothing and another may be to keep a watchful eye on industry efforts to self-regulate. Alan does an excellent job of addressing what I see as the more-interventionist options. I would like to try to complement his discussion by addressing less-interventionist options, without taking a position on what ultimately is to be preferred. In the final analysis, that, of course, will depend on a given country’s particular situation.

At the outset, let me stress that the views I express today do not necessarily reflect the views of the Federal Reserve Bank of Kansas City or the Federal Reserve System. They do, however, reflect in part the views of my colleagues, Terri Bradford, Fumiko Hayashi, Rick Sullivan, and Zhu Wang, with whom I have had discussions on Alan’s paper and related issues.

The table below, compiled by Fumiko Hayashi, shows public authority involvement in credit and debit card markets in various countries. It lists 26 countries or areas in which public authorities have taken some kind of action or initiated some kind of investigation, either on pricing issues—interchange and/or merchant service fees—or on surcharge rules. The table draws in part on the excellent summary in the RBA’s May 2007 *Review*, as well as other sources listed at the back of the table.

I do not want to dwell on the table—time does not permit—but rather I offer the table as a reference and also to make an obvious but important point: while authorities in some countries have taken action, authorities in other countries have not. Why is this?

There are several possibilities. First, despite our best efforts, I am sure the table is incomplete and omits some countries where policymakers have been active. Second, in many countries, credit and/or debit card markets may simply not be sufficiently

developed yet to register on policymakers' radar screens. And third, in those countries where credit and debit card markets have developed, perhaps public authorities believe these markets are indeed operating effectively, or at least not ineffectively enough to warrant policy action. It is this third group of countries that largely motivates the remainder of my comments.

Policy action or inaction can be thought of as falling along a continuum. At the one end, authorities may elect to take no action. At the other end, authorities may elect to take significant action. And in between, there will be a range of escalating intervention.

In the case of credit and debit card markets, one can think of four distinct categories along this continuum. One is to do nothing—let the market work. The second is to do a little—let the market self-regulate, but keep a watchful eye, and be prepared to intervene if necessary. The third is to do more—remove obvious structural impediments (what Alan calls vertical restrictions) to ensure competitive conditions. And the fourth is to do a lot—establish specific prices or guidelines for prices. I would like to consider each of these in turn.

First, under what conditions might authorities elect to do nothing? This is a situation in which the market is judged to be performing well, and competitive forces are seen to be at work. Either (i) existing firms are competing effectively, (ii) existing firms are facing potential competition from new entrants (that is, markets are contestable), or (iii) innovations from existing or potential competitors are helping ensure a competitive environment.

With regard to innovation, in the United States, for example, we have been seeing a number of alternative payment arrangements and mechanisms designed to challenge traditional credit and debit card practices. How effective they have been in fostering competition remains an open question, in my view. A few years ago, First Data Corporation, in cases where it operated on both sides of the market, attempted to increase the number of Visa transactions that it conducted “on-us.” More recently, Tempo, HSBC, and Capital One have been attempting to build the so-called “decoupled debit” market, whereby card transactions are routed over card networks but settled via the ACH. The prospects for innovation raise an interesting economic question. Does a market, or indeed a country, have to be a certain size—given the huge economies of scale in electronic payments—to give potential competitors and innovators a chance in achieving critical mass?

What about the second category along the intervention continuum, industry self-regulation? Here I am referring to situations in which industry participants take actions internally which they fear might otherwise be taken by outside regulators. Or, stated somewhat differently, industry participants take preemptive action in light of a perceived “regulatory threat.” Some possibilities include (i) making industry rules more transparent, (ii) relaxing industry rules by permitting more choices in acquiring, routing, and issuing arrangements, (iii) actively encouraging new entry by banks and nonbanks alike, and (iv) holding prices (for example, interchange and merchant service fees) below profit-

maximizing levels to deflect charges of undue market power. Such industry self-regulation reportedly can be effective. Guillermo Ortiz, Governor of the Bank of Mexico, for example, in discussing reforms of the Mexican payment system, has stated that “In our case, this induced voluntary approach is producing a better reaction on the part of the industry.”¹

The third category of intervention, policy-mandated removal of barriers to competition, contains a host of possible actions, many discussed by Alan. One set involves removing barriers to entry, for example (i) eliminating restrictive rules, such as net issuer rules, (ii) encouraging nonbank participation, and (iii) encouraging innovation among existing and potential competitors by clarifying legal uncertainties. A second set involves eliminating industry practices that restrict consumer, merchant, and other choices, for example (i) eliminating no-surcharge and honor-all-cards rules, and (ii) allowing merchants to steer consumers to preferred payment methods.

The fourth category of intervention, arguably the most interventionist of all, is for policy authorities to establish specific prices or guidelines for prices. Of course, this option has been much debated in recent years, is being debated during our program today, and undoubtedly will continue to be debated tomorrow!

I would like to close with an appeal for more research on “Alternatives to Direct Regulation,” both theoretical and applied. Evaluating such alternatives is fundamental to good policy, and devoting a section of today’s program to these topics explicitly recognizes this.

Interchange issues, of course, have received considerable attention in recent years, and appropriately so. But in my view, it is important that we see more research conducted on these “alternative” policy issues as well. For example, we need to learn more about merchant incentives and strategies in surcharging. We need to learn more about the impact of various industry rules on restricting competition. And we need to learn more about barriers to entry—both economic and artificial—in electronic payments.

At the end of the day—to come back to a point I made at the outset—the best policy or non-policy will, of course, depend on a country’s particular situation. But to get there, and to make that determination, policymakers will need solid research as well as effective industry dialog. This conference is an outstanding example of how to go about this.

¹ Guillermo Ortiz, “Remarks on Interchange Fees: Central Bank Perspectives and Options,” Federal Reserve Bank of Kansas City Conference, Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities?, Santa Fe, New Mexico, May 2005, p. 292.

Public Authority Involvement in Credit and Debit Card Markets: Various Countries

1. Interchange and Merchant Service Fees

a. Actions taken by public authorities

Country	Credit	Debit
Argentina	1999: Law 25.065 for Credit Cards was enacted. The law established norms that regulate various aspects related to the credit, debit, and retail card systems, such as the relationship between the cardholder and the card issuer and the relationship between the card issuer and the merchant. Among these norms was the setting of limits on the ability to implement price discrimination in merchant fees.	
Australia	2003: The Reserve Bank of Australia mandated Bankcard, MasterCard, and Visa to set interchange fees based on the cost-based benchmark.	2006: The Reserve Bank of Australia introduced interchange standards for the EFTPOS and Visa Debit systems.
Austria	2006: Following the European Commission's interim reports on the retail banking industry, Austrian banks agreed to review arrangements for setting interchange fees and announced that a reduction can be expected.	
Canada		Mid 1990's: Through a consent order from the Competition Bureau of Canada, Interac set interchange fee to zero.
Chile	2005: The Chilean Antitrust Court admitted a complaint filed by the National Economic Prosecutor alleging abuse of a dominant position by Transbank, the acquirer of all credit and debit cards issued in the country; the Court imposed a fine of approximately \$56,000. The National Economic Prosecutor requested, among other things, the modification of the Transbank price structure in such a way that it would be public, objective, and based on costs. The issue was finally solved with a partial understanding between the parties. According to this understanding, Transbank had to reduce merchant fee ceilings and present a self-regulating plan for setting prices.	
Colombia	2004(?): The Superintendent of Industry and Commerce, the Colombia competition authority, passed the new Inter-bank Exchange Tariff that allows merchants to negotiate fee rates with merchant acquirers. 2006: Credibanco (a Visa issuer) was required to exclude some costs included in its fee computation that were judged not to correspond exclusively to payment card services offered to merchants.	
Denmark	1990: Act of Certain Payment Instruments set a cap on merchant service charges (MSC) on internationally-branded credit/debit cards issued by Danish banks for domestic transactions at 0.75% of transaction value or	1990: Act of Certain Payment Instruments set Dankort MSC to be zero. 2003: Amendment to the Act introduced a positive MSC to Dankort transactions and reduced the fees on Maestro

	1.25% of transaction value with a minimum of DKK 1.95 on the internet.	and Visa Electron from 0.75% to 0.4%, with a maximum of DKK 4. 2005: Dankort MSC was replaced by an annual fee per retailer.
European Union	2002: The European Commission reached agreement with Visa to reduce its cross-border interchange fees by December 2007. The benchmark for its interchange fees was to be set at the level of the cost of supplying Visa payment services and would not exceed the cost of the services which issuing banks provide, wholly or partly, to the benefit of merchants. An investigation into MasterCard's interchange fees is ongoing as of October 2007.	
France	1990: The Paris High Court ruled that the methods for determining interchange fees could be accepted in accordance with the Competition Council's statement of objections.	
Israel	2006: Agreement between the banks and the competition authority to reduce interchange fees from 1.25% to 0.875% by 2012.	
Mexico	2006: Interchange fee reductions agreed to between the Mexican Bankers Association and the Bank of Mexico.	
Norway		Zero interchange fee (Bank-Axcept). The general position of authorities regarding the introduction of new payment systems in Norway has been that payers should cover costs. This position can be seen as early as in the 1974 report from the Payment Systems Committee.
Panama	June 2003 - July 2004: Under the 1998 banking law, the Superintendent of Banks issued regulations for banks that issue and manage credit cards. It established procedures for approving a credit card and authorized the charges for commissions and other related items.	
Poland	2007: Polish Office of Competition and Consumer Protection ordered banks to discontinue their multilateral interchange fee agreements.	
Portugal	2006: Following the European Commission's interim reports on the retail banking industry, Portuguese issuers and acquirers have met some of the Commission's concerns by reducing domestic interchange fees somewhat and removing preferential bilateral domestic interchange fees.	
South Korea	Korean Fair Trade Commission ruled that BC Card's (South Korea's four-party scheme credit card) joint pricing of merchant service charges was a cartel and imposed a fine of 10.092 billion Won and corrective	

	measures.	
Spain	2005: Spanish Competition Tribunal denied authorizing the interchange fee arrangements of the Spanish card schemes. In December, agreement reached between the Spanish card networks and merchants, coordinated by the Spanish Ministry of Industry, Tourism and Trade, for interchange fees to be reduced from a maximum of 2.32% to 1.1 % by 2008.	
Switzerland	2005: Agreement between the Swiss Competition Commission and credit card issuers to reduce interchange fees from 1.65-1.70% to 1.30-1.35%.	
Turkey	2005: Turkish Competition Authority made a decision on Interbank Card Centre (BKM)'s clearing commission rate by member banks. It is stated in the decision that, in order to grant exemption to the clearing commission formula proposed by the consultancy firm on behalf of BKM, certain cost items in the formula should be adjusted.	

b. Investigations initiated

Country	Credit	Debit
Brazil	2006 May: Banco Central do Brasil (the central bank of Brazil) issued Directive 1/2006. The directive's focus is on the payment cards industry (pricing: IF, discounts, customer fee; concentration; profitability; governance; etc). It does not establish either obligations or prohibitions and does not mandate any sanctions. 2006 June: Banco Central do Brasil's Economic Law Office and the Secretariat for Economic Monitoring agreed to cooperate with each other to collect payment card industry data and to coordinate public policy actions. 2006 September: Payment card industry data collection.	
Hungary	2006: Gazdasagi Versenyhivatal, the competition authority of Hungary, considered intervening in the payment card market. Interchange fees were regarded as too high compared to costs, especially in the case of debit cards. Price discrimination between 'on-us' (acquirer=issuer) and 'foreign' (acquirer≠issuer) transactions was considered to have adverse effects on issuer competition.	
New Zealand	2007: Proceedings initiated by the New Zealand Commerce Commission against Visa, MasterCard and member institutions of the two schemes, alleging price-fixing in the setting of interchange fees.	
Norway	2004: On the initiative of the Ministry of Finance, Kredittilsynet (the financial supervisory authority)	

	<p>established a project group to report on competitive conditions in the Norwegian market for international payment and charge cards.</p> <p>2005: “The regulation of interchange fees is also being considered in Norway,” stated in the 2005 Norges Bank (the central bank of Norway) Annual Report.</p>	
South Africa	<p>2004: The Task Group for the National Treasury & the South African Reserve Bank recommended that the Competition Commission should investigate the possibility of a complex monopoly in the governance and operation of the national payment system.</p> <p>2006: Following the findings in the research report <i>The National Payment System and Competition in the Banking Sector</i>, the Commission began a public inquiry into bank charges and access to the payment systems.</p> <p>2007: The inquiry is at the final, report writing, stage.</p>	
United Kingdom	<p>2005: The Office of Fair Trading (OFT) found that MasterCard’s interchange fee arrangements were illegal (September). The OFT issued statement of objections on Visa agreement (October).</p> <p>2006: The MasterCard finding was appealed and, since MasterCard had changed its method of setting interchange fees, the OFT consented to its decision being set aside by the Competition Appeal Tribunal (June). The OFT launched a new MasterCard investigation in February.</p>	

Annex. Zero interchange fee schemes

Country	Credit	Debit
Belgium		Zero interchange fee (Bancontact/Mister Cash)
Finland		Zero interchange fee (Pankkikortti)
Luxembourg		Zero interchange fee (Bancomat)
Netherlands		Zero interchange fee (PIN)

2. Surcharges (*Actions taken by public authorities*)

Country	Credit	Debit
Australia	2003: Prohibition on surcharging lifted.	2006: Prohibition on surcharging for Visa and MasterCard signature debit card transactions lifted.
Canada		1996: Prohibition on surcharging for Interac transactions was removed through a consent order by the Competition Bureau of Canada.
Mexico	1993: The Mexican Competition Commission reached an agreement with a number of banks, through which the banks could not forbid in their acquiring contracts that merchants offer discounts for cash payments.	
Netherlands	1997: Prohibition on surcharging lifted.	
Sweden	1995: Prohibition on surcharging lifted.	
Switzerland	2005: Prohibition on surcharging lifted.	
United Kingdom	1989: Prohibition on surcharging lifted.	

Sources:

Interchange and Merchant Service Fees

Argentina

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Surcharges

Canada

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