COMPETITION & DFS WORKING PAPERS

02 Lessons Learned from the Interchange Fees Antitrust Investigations

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Introduction

Since the early 1990s, credit and debit card schemes such as Visa, Mastercard, and American Express have been under the microscope of the EU and US antitrust authorities.[1] Although a variety of potentially anti-competitive practices in this sector have been investigated by authorities – refusing to provide access to the card schemes[2] and price-fixing cartels[3] – the investigations into interchange fees and associated scheme rules have been the most prominent on both sides of the Atlantic.[4] These investigations can provide valuable lessons for how to construct and design interchange fees. This brief summarizes the main interchange fee cases in the EU and US and identifies lessons for developing markets.

Interchange fees, the card processing fees paid by an acquiring bank[5] to an issuing bank[6] when a customer uses a payment card, are needed to balance the economics of payment cards. Without such fees, payment cards unequally distribute costs/revenues between both sides of the market - issuing banks would not be motivated to issue cards where ATM and POS penetration is low, while acquiring banks would not be motivated to expand their POS and ATM networks where card issuance is low.[7]

However, interchange fee investigations have highlighted an assortment of questionable commercial practices by card schemes, and acquiring and issuing banks that have kept interchange fees at a level that disadvantages merchants (and customers), even as the modularization of financial services has led to an overall increase in competition in the industry and a decrease in transaction costs.[8]

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[1] The card schemes have also been under investigation in other countries such as Canada, Israel and South Korea, which are out of the scope of this brief. For more information, see Fumiko Hayashi and Jesse Leigh Maniff. 2014. Interchange fees and network rules: A shift from antitrust litigation to regulatory measures in various countries.

[2] Such as the refusal by Visa Europe to admit Morgan Stanley as a member of the Visa scheme (See Case COMP/D1/37860 – Morgan Stanley/Visa International and Visa Europe 3 October 2007).

[3] See the Groupement des Cartes Bancaires cartel (COMP/D1/38606 – Groupement des Cartes Bancaires "CB" 17 October 2007).

[4] For an in-depth discussion of other potential competition issues in the payment cards sector beyond interchange fees and their associated scheme rules, see the EU Commission. 2007. Report on the retail banking sector inquiry.

[5] An "acquiring bank" is a bank that allows merchants to accept card payments through the provision of point of sale terminals.

[6] An "issuing bank" is a bank that issues cards to cardholders.

[7] Mark McCullagh and Charles Niehaus. EAC Multilateral Interparty Fees. Presentation to CGAP on 10 May 2018 (Unpublished).

[8] Martin Yan. 2016. 4 Key takeaways as financial services go modular.

Box 1. Card Fees and Rules

There are a variety of typical fees related to the usage of payment cards:[9]

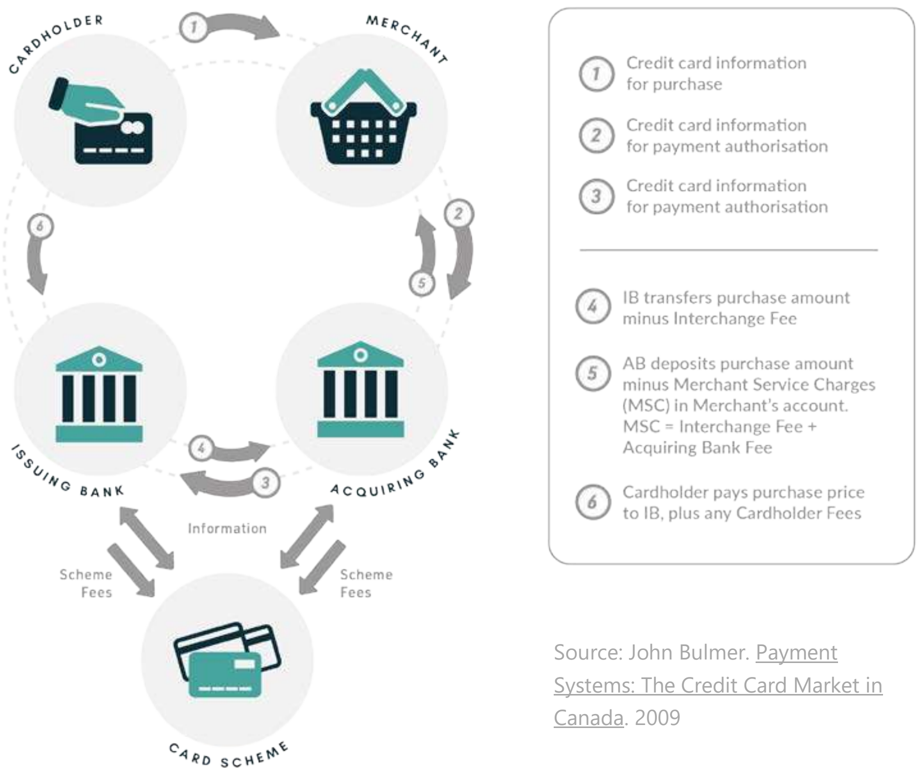
i. **Cardholder fees:** the annual fees an issuing bank charges a cardholder for issuing the card as well as any interest and transaction fees incurred by the cardholder for purchases;
ii. **Interchange fees:** the payment card processing fees paid by an acquiring bank to an issuing bank when a merchant accepts a payment card for a purchase;[10]
iii. **Acquiring bank fees:** the fees an acquiring bank charges a merchant for providing the merchant account and the point of sale (POS) service;
iv. **Scheme fees:** the various fees that the issuing and acquiring banks pay the card schemes to be a member of those card schemes; and
v. **Merchant service charges (MSC):** all the fees that an acquiring bank charges a merchant per transaction for accepting the card, which includes the fees (ii) and (iii) indicated above.

[9] These are fees typical of a four-party card scheme such as Visa or Mastercard. In the American Express card scheme, which is a three-party card scheme, American Express usually plays the role of both the issuing and acquiring bank, and thus no interchange fees are charged. Furthermore, not all fees are charged in every four-party card scheme, as business models are influenced by regulation and competition.

[10] In the case of automatic teller machines (ATMs), interchange fees are the payment card processing fees paid by an issuing bank to the ATM acquirer for cash withdrawals.

Figure 1.1 provides a pictorial representation of the flow of funds and information in a card payment transaction.

Figure 1.1. Flow of Information and Funds in Cash Payments



Source: John Bulmer. Payment Systems: The Credit Card Market in Canada. 2009

The card schemes may also create specific scheme rules for merchants, such as the exclusivity rule, the "honor all cards" rule, and the no-surcharge rule. The exclusivity rule is a contractual provision in card schemes that prohibits issuing banks of one card scheme from issuing cards for competing card schemes.[11] The "honor all cards" rule requires merchants to accept all of a scheme's cards if they accept any of that scheme's cards – e.g., both Visa-branded credit and debit cards. This is an example of a "tying arrangement".[12] The no-surcharge rule prohibits merchants from

[11] The US's Department of Justice (DOJ) successfully challenged the exclusivity rules imposed by Visa and Mastercard in court in 2001. The court found these rules substantially reduced competition by reducing output, innovation, and consumer choice through the exclusion of competing networks from the partnership with the majority of card-issuing banks. See United States v. Visa U.S.A. Inc., 163F. Supp.2d 322, 340-42 (S.D.N.Y. 2001).

[12] After extensive litigation in the US, in settlement agreements Visa and Mastercard agreed to delink the acceptance of credit cards from the acceptance of debit cards in their scheme rules so that a merchant could accept one but not the other. See In re Visa Check/MasterMoney Antitrust Litig., 297

surcharging cardholders who use their payment cards, even if those transactions are more expensive to the merchant due to the service charge.[13]

F. Supp. 2d 503 (E.D.N.Y. 2003) Both the Australian Payment Systems Board and the EU have declared these tying arrangements to be anticompetitive.

[13] In the US settlement agreements with Visa and Mastercard, merchants were temporarily given the right to surcharge (see In re Visa Check/MasterMoney Antitrust Litig.), while several nations have prohibited the use of these clauses outright, including the UK (1990), Sweden (1994), Netherlands (1995) and Australia (2003) (See Nguyen, T. 2003. EC Antitrust law in card payment systems). In addition, the EU has banned surcharging as of 1 January 2018 under the Second Payment Services Directive (PSD2).

1. Interchange fee investigations in the EU

The inter-European Economic Area[14] (EEA) interchange fees of both Mastercard and Visa Europe have been investigated by the European Commission (the Commission), leading to commitments from both card schemes to cap interchange fees. Concurrently, in April 2015 the EU's Council of Ministers and the European Parliament adopted the Interchange Fee Regulation,[15] which since December 2015 has capped interchange fees for cards issued and used in the EU at a maximum of 0.20% for debit cards and 0.30% for credit cards.

a. Mastercard

In 2002, the Commission opened an investigation regarding Mastercard's inter-EEA interchange fees for consumer payment cards. Mastercard had put in place a mechanism that effectively determined a minimum price merchants had to pay for accepting Mastercard-branded cards. This mechanism was applied to all cross-border card payments in the EEA and to domestic card payments in 8 EU Member States. The Commission took the view that the creation of an artificial price floor restricted competition due to the fact that the fee inflated the base on which acquiring banks charged prices to merchants for accepting Mastercard payment cards. It held that this behavior constituted an infringement of Article 101 of the Treaty on the Functioning of the EU (TFEU), which prohibits vertical cartels that restrict competition.[16]

Although Mastercard argued that its EEA interchange fees contributed to a maximization of the system's output and therefore were eligible for an exemption under Article 101(3) of the TFEU, Mastercard failed to submit the required empirical evidence to demonstrate any positive effects on innovation and efficiency which would allow the passing on of a fair share of the benefits to consumers.[17] The

[14] The EEA includes all the EU countries as well as Iceland, Liechtenstein and Norway. Inter-EEA interchange fees are those that are charged for transactions between an EU Member State and Iceland, Liechtenstein and/or Norway (e.g., when a Norwegian uses her credit card in Germany).
[15] Regulation (EU) 2015/751 of the European Parliament and the Council of 29 April 2015 on interchange fees for card-based payment transactions.
[16] European Competition Network. 2012. Information paper on competition enforcement in the payments sector.
[17] Ibid.

Commission thus issued a prohibition decision[18] on 19 December 2007, ordering Mastercard to cease and desist the application of the artificial price floor mechanism for EEA interchange fees.

Although Mastercard appealed the decision, it also submitted unilateral undertakings[19] in April 2009, which included a commitment to reduce its cross-border EEA interchange fees to 0.30% of the transaction value for consumer credit cards and 0.20% of the transaction value for consumer debit cards. The European Court of Justice (ECJ) confirmed the Commission's decision and dismissed Mastercard's appeal in 2014.

In April 2013, the Commission opened another investigation into Mastercard's interchange fees. This investigation was focused on (i) interchange fees in relation to payments made by cardholders from non-EEA countries (as opposed to fees for cross-border transactions within the EEA that were already prohibited in 2007); (ii) all rules on "cross-border acquiring" in the Mastercard system that limited the possibility for a merchant to benefit from better conditions offered by banks established elsewhere in the EU; and (iii) related business rules, such as the "honor all cards rule".[20]

On 9 July 2015, a "Statement of Objections"[21] was issued in regard to this investigation, setting out its two main concerns:

(i) Although interchange fees still varied considerably between EU Member States, Mastercard's rules prevented retailers in a high-interchange fee country from benefiting from lower interchange fees offered by an acquiring bank located in another Member State ("cross-border acquiring"). Mastercard's rules on cross-border acquiring appeared to limit banks' ability to compete cross-border on price for acquiring card payments and so restricted competition in breach of EU antitrust rules.

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[18] European Commission. 2007. Antitrust: Commission prohibits Mastercard's intra-EEA Multilateral Interchange Fees.

[19] European Commission. 2009. Antitrust: Commissioner Kroes takes note of Mastercard's decision to cut cross-border Multilateral Interchange Fees (MIFs) and to repeal recent scheme fee increases.

[20] European Commission. 2013. Antitrust: Commission opens investigation into Mastercard inter-bank fees.

[21] European Commission. 2013. Antitrust: Commission sends Statement of Objections to Mastercard on cross-border rules and interregional interchange fees.

(ii) The high levels of Mastercard's "inter-regional interchange fees" (i.e. the fees paid by an acquiring bank for transactions made in the EU with Mastercard cards issued in other regions of the world) did not appear justified. These high inter-regional fees increased prices for retailers and could lead to higher prices for products and services for all consumers in the EU, not just those using cards issued outside the EU or those paying with cards in general.

b. Visa

Following the expiry of a Visa exemption decision in December 2007 and the adoption of the first Mastercard decision above, the Commission opened an antitrust investigation against Visa Europe in 2008 in relation to interchange fees for cross-border EEA and certain domestic point of sales (POS) transactions. The Commission's preliminary view was that Visa's cross-border EEA interchange fees appreciably restricted competition in the acquiring markets to the detriment of merchants and, indirectly, their customers, by inflating the base on which all acquirers set merchant service charges.[22] It found further that the restrictive effect in the acquiring markets was reinforced by the effect of the interchange fees on the scheme in issuing markets as well as by other network rules and practices, such as the "honor all cards" rule.

To settle the investigation, Visa Europe committed[23] in 2010 to reduce the maximum weighted average interchange fees for consumer debit cards for cross-border transactions and national transactions in those EEA countries where it sets the interchange directly to 0.20%. Visa's commitments also included a number of measures to increase transparency and competition in the payment cards markets, including charging merchants different fees depending upon the type of card used, registration and publication of all interchange fee rates, and prohibiting acquirers from mandating the bundling of the processing of all Mastercard and competing schemes' transactions, which in effect resulted in merchants contracting exclusively with one acquirer. Following a market test, the Commission made the commitments legally binding[24] on Visa Europe in December 2010 for four years by a decision under Article 9 of Regulation 1/2003.

[22] European Competition Network. 2012. Information paper on competition enforcement in the payments sector.

[23] European Commission. 2010. Antitrust: Vice President Alumnia welcomes Visa Europe's proposal to cut interbank fees for debit cards.

[24] European Commission. 2010. Antitrust: Commission makes Visa Europe's commitments to cut interbank fees for debit cards legally binding.

Following the 2010 decision, which focused on consumer debit cards, Visa Europe made further commitments[25] concerning the inter-EEA interchange fees for consumer credit cards in 2014. It agreed to reduce to 0.30% the maximum weighted average interchange fees for consumer credit cards for (i) inter-EEA transactions (i.e., transactions between an EU Member State and Iceland, Liechtenstein and/or Norway), (ii) national transactions in those EEA countries where Visa Europe sets consumer credit interchange rates directly, and (iii) transactions with merchants located in the EEA with Visa credit cards issued outside the EEA but used within the Visa Europe territory. These commitments were made binding in February 2014 for four years by a decision under Article 9 of Regulation 1/2003.[26]

There is still an ongoing investigation against Visa Inc. and Visa International Service Association regarding inter-regional interchange fees, with a supplementary "Statement of Objections" sent to Visa in July 2012[27] and a hearing held in February 2018.[28]

c. Interchange Fee Regulation

The Commission's proceedings in the Mastercard and Visa cases above have focused on inter-EEA transactions. Most transactions in the EU, however, are domestic transactions (i.e., when a consumer uses his card in his own country) or EU transactions (i.e., when an EU consumer in one EU Member State uses his card in another EU Member State) and were not covered by the Commission's proceedings. The interchange fees on these transactions, however, have showed wide variations between countries, as per the EU 2007 banking sector inquiry.[29] They have been challenged by national competition authorities and ultimately lowered in several EU Member States. Mastercard[30] and Visa have also faced lawsuits for damages in certain EU Member States.

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[25] European Commission. 2013. Antitrust: Vice President Alumnia welcomes Visa Europe's proposal to cut interbank fees for credit cards.

[26] European Commission. 2014. Antitrust: Commission makes Visa Europe's commitments to cut interbank fees and to facilitate cross-border competition legally binding.

[27] European Commission. 2012. Antitrust: Commission sends supplementary statement of objections to Visa.

[28] CPI. 2018. EU: Visa fights antitrust charges.

[29] European Commission. 2007. Antitrust: Commission prohibits Mastercard's intra-EEA Multilateral Interchange Fees.

[30] Mastercard was sued for GBP 14 billion in damages for allegedly fixing interchange fees under the U.K.'s consumer antitrust class action rules, in addition to at least 10 separate lawsuits from retailers

In April 2015, the Interchange Fee Regulation was adopted by the EU Council and EU Parliament, which since December 2015 has capped interchange fees for cards issued and used in the EU at a maximum of 0.20% for debit cards and 0.30% for credit cards. The aim of the Interchange Fee Regulation is to lower transaction costs for European retailers and establish a level playing field for the card payment market as a whole. The caps of the Interchange Fee Regulation do not apply to inter-regional transactions, such as the inter-EEA transactions discussed above.

The regulation explicitly applies only to four-party card schemes such as Visa or Mastercard and thus in theory exempts American Express (Amex) cards where there are only three parties (as usually American Express plays the role of both the issuing and acquiring bank, and no interchange fees are charged). A recent ECJ ruling,[31] however, has found that an Amex-issued card with a co-branded partner, such as an airline, is a four-party scheme, and therefore the regulation applies to those cards. In such an instance, as there is no interchange fee, the cap applies to the general fee charged to retailers.

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seeking damages of GBP 1.2 billion. In July 2017, however, the U.K. Competition Appeal Tribunal blocked this class action lawsuit, and Mastercard has won lawsuits filed by retailers such as Asda and Next. 28 July 2017. Competition Appeal Tribunal blocks class action against Mastercard. Financial Times. 30 January 2017. Mastercard wins ruling in legal battle over fees.

[31] Case C-304/16 American Express Company. 7 February 2018.

2. Payment scheme investigations in the United States

In the United States, all three of the main card payment schemes - Mastercard, Visa, and American Express – have been investigated for anti-competitive conduct concerning the rules prohibiting steering customers to payment methods with lower fees. As set out below, although both Mastercard and Visa have agreed to settlements, American Express recently won its case against the Department of Justice (DOJ) and several US states in the Supreme Court.

Similar to the EU Parliament's regulatory approach, the U.S. Federal Reserve Board has taken direct regulatory action against interchange fees following the passage of the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Durbin Amendment allowed the Federal Reserve Board to cap debit card interchange fees received by large debit card issuers in 2011 through the implementation of Regulation II.[32]

a. Mastercard and Visa

In 2010, the DOJ and 17 states commenced legal proceedings against Mastercard, Visa and American Express for certain "non-discriminatory provisions" in their scheme rules that prohibited merchants from "steering" retail customers to cheaper payment methods such as competitor cards or cash through discounts, rewards, and cost information. This prohibition in the scheme rules ultimately discouraged interchange fee competition between card schemes. The underlying case theory was that "if a card with high fees could be turned down in favor of a card with lower fees, then the issuer would have an incentive to offer lower fees in general."[33]

Both Mastercard and Visa settled with the DOJ by entering into consent decrees in which they agreed to certain amendments to the scheme rules for merchants. These included allowing merchants to offer consumers discounts or rebates for using a particular type of payment, a particular card scheme or a low-cost card in that

[32] Fumiko Hayashi and Jesse Leigh Maniff. 2014. Interchange fees and network rules: A shift from antitrust litigation to regulatory measures in various countries.

[33] Bruce Sokler, Robert Kidwell and Farrah Short. 2016. What Have Merchants Gained from Payment Card Antitrust Litigation?

scheme, as well as allowing merchants to post the cost of the different payment types.[34]

Concurrently, a number of merchants (in their personal capacity or as part of a class action) sued Mastercard and Visa and their issuing banks over the same scheme rules, alleging that the rules illegally inflated the interchange fees. These lawsuits leveraged the DOJ's actions, and initially resulted in large cash settlements for the merchants and certain changes to the scheme rules. One specific settlement for 19 retailers and trade associations for USD 7.25 billion - considered the largest antitrust class action settlement at the time[35] – was approved by a New York trial court in December 2013. However, 8,000 merchants, including Home Depot, Walmart and Target, opted out thereafter of the settlement, thereby dropping its value to USD 5.7 billion.[36] Certain merchants appealed the approval, and the settlement was reversed on 30 June 2016 based on issues with counsel representation for the various plaintiff classes. Other merchants petitioned the US Supreme Court to revive the settlement agreement, but the Supreme Court declined in March 2017 to hear the case, sending both sides back to the bargaining table.[37]

b. American Express

American Express did not settle the 2010 DOJ investigation, and recently the Supreme Court ruled in its favor on appeal. In an initial ruling in 2015, the US District Court ruled that American Express, despite its 26.4% market share, held sufficient market power such that its anti-steering rules could still prevent price competition in the market overall by negating incentives to offer lower interchange fees.[38] Although the court recognized that card schemes compete in two distinct but related markets (the market for card issuance to consumers and the market for card acceptance by merchants), it found that consideration of the merchant market alone was sufficient to identify anticompetitive harm.

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[34] The ability of merchants to levy a surcharge on credit and debit card payments was not authorized, as had been sought by some of the merchant plaintiffs. DOJ. 2010. Attorney General Holder speaks at Visa, Mastercard, American Express conference and NYT. 2010. US reaches deal in credit-card antitrust suit.
[35] Bruce Sokler, Robert Kidwell and Farrah Short. 2016. What Have Merchants Gained from Payment Card Antitrust Litigation?
[36] Amanda J. Segal. 2017. The Visa/ Mastercard antitrust settlement: A new beginning?
[37] Ibid.
[38] Bruce Sokler, Robert Kidwell and Farrah Short. 2016. What Have Merchants Gained from Payment Card Antitrust Litigation?

This analysis was turned on its head by the Second Circuit Court of Appeals, which reversed this first district ruling in September 2016 and let the American Express scheme rules stand. Central to the ruling was the fact that the credit card companies act in a "two-way market" and that the initial court had "erred in excluding the market for cardholders from its relevant market definition."[39] The Second Circuit emphasized that by focusing the analysis only on the merchant side of the market, while ignoring implications for the cardholder side of the market, the court did not properly account for the interdependence between the two sides of the market, and that the separation could erroneously penalize "legitimate competitive activities . . . no matter how output-expanding such activities may be."[40] Further, neither American Express's ability to raise fees in regard to merchants nor its cardholders' continued usage of American Express cards proved market power, as those increases were used to boost cardholder rewards and the continued usage was evidence of competitive benefits to the cardholder.[41] The court held that "in order to succeed, a credit card network must find an effective method for balancing the prices on the two sides of the market."[42]

The Second Circuit Court of Appeals' decision was upheld by the US Supreme Court on 25 June 2018.43 In Ohio vs American Express Company, the US Supreme Court held that American Express' anti-steering provisions did not violate federal antitrust law as they were necessary for it, with its specific business model, to combat friction with merchants in the "two-sided platform" market of credit card networks. Key to this analysis was the fact that two-sided platforms exhibit indirect network effects, which these platforms must take into account before making a price change on either side, or else: *"They risk creating a feedback loop of declining demand. Thus, striking the optimal balance of the prices charged on each side of the platform is essential for two-sided platforms to maximize the value of their services and to compete with their rivals."*[44]

The Supreme Court distinguished American Express from the other card networks as it uses "a different business model, which focuses on cardholder spending rather

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[39] PYMNTS. 2018. Why the Amex case may decide the future of two-sided markets.
[40] J. Gregory Sidak and Robert D. Wiling. 2016. Two-sided market definition and competitive effects after United States v. American Express.
[41] Ibid.
[42] PYMNTS. 2018. Why the Amex case may decide the future of two-sided markets.
[43] Ohio vs American Express Company 585 U.S. 1 (2018)
[44] Ibid.

than cardholder lending."45 Thus American Express, unlike its rivals, must continually invest in its cardholder rewards program to maintain its cardholders' loyalty, and to fund those investments, it must charge merchants higher fees. To avoid such higher fees, merchants use steering at the point of sale to dissuade cardholders from using Amex cards, which American Express combats with anti-steering provisions in its contracts. The decision is particularly noteworthy as the Supreme Court has championed, for the first time, the consideration of both sides of a two-way market in its antitrust analysis of credit card networks. The Second Circuit Court of Appeals' decision had already been heralded as incorporating into the US antitrust doctrine important economic principles for analyzing alleged restraints of trade in a two-sided market,[46] and the Supreme Court decision may now have ramifications on the antitrust treatment of other "two-sided markets" such as those of digital or superplatforms[47]. As Sidak and Wiling have argued, examining only one side of a two-way market will necessarily distort the outcome of that analysis and could condemn legitimate business conduct that enhances, rather than decreases, consumer welfare.[48] It remains to be seen what effect the Supreme Court ruling will have on the Visa/ Mastercard settlements and other "two-sided" markets.

c. Regulation II

Section 1075 of the *Consumer Financial Protection Act of 2010* (or Title X of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, P.L. 111-203), also known as the *Durbin Amendment*, authorizes the Federal Reserve Board to prescribe regulations to ensure that the amount of any interchange transaction fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the transaction.

Regulation II, issued on 29 June 2011, establishes standards for assessing whether such a debit card interchange fee is reasonable and proportionate, and includes a cap of 21 cents plus 0.05% of the transaction (and an additional 1 cent to account for fraud protection costs) on the interchange fee for large issuers. The standards allow for this fraud-prevention adjustment to an issuer's debit card interchange fee if the

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[45] Ibid.

[46] J. Gregory Sidak and Robert D. Wiling. 2016. Two-sided market definition and competitive effects after United States v. American Express.

[47] Superplatforms are digital platforms dominant across more than one sector, such as Amazon, Google or Facebook in the US, and Alibaba in China. See David Porteous and Olga Morawcynski. 2017. Inclusive digital ecosystems of the future.

[48] Ibid.

issuer develops and implements policies and procedures reasonably designed to achieve the fraud-prevention standards set out in the rule. Certain small debit card issuers, government-administered payment programs, and reloadable general-use prepaid cards are exempt from the interchange fee limitations.[49] The regulation also forbids certain non-discrimination rules for card schemes, including rules that restrict the number of networks over which debit transactions may be processed to less than two unaffiliated networks, and ones that inhibit a merchant's ability to direct the routing of a debit transaction over any network that the issuer has enabled to process it.

The Durbin Amendment and *Regulation II* were motivated by concerns that the interchange fees received by banks were not being set by competitive market forces, and that a competitive market arguably would drive down interchange fees, which would benefit merchants and ultimately consumers.[50] This regulation, however, has not been without controversy, with the main resistance coming from financial firms, banks, and the card schemes themselves,[51] and there are still calls for its repeal.

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[49] See the Federal Reserve website page on Regulation II (Debit Card Interchange Fees and Routing).
[50] Darryl E. Getter. 2017. Regulation of debt interchange fees.
[51] Washington Post. 2011. Retailers fight back on debit-card swipe fees.

3. Other country approaches to interchange fees

In a variety of other developed and developing countries, the financial services regulator has taken the initiative in regulating interchange fees or merchant fees by regulatory intervention, often without undertaking a prior investigation. The first central banks to introduce such regulation were the Reserve Bank of Australia (for interchange fees in 2003,[52] following an inquiry into card payments systems in 2000) and the People's Bank of China (for merchant fees[53] in 2002).[54] The South African Reserve Bank fixed interchange fee levels in 2014 following a 2006 banking inquiry, while the Central Bank of Venezuela and the Reserve Bank of India capped merchant fees in 2009 and 2012, respectively.[55]

In addition, interchange and merchant fees have been capped and non-discrimination rules have been lifted by national legislation in several jurisdictions; these include certain EU Member States (e.g., Denmark, Spain, and Poland) as well as Canada, Argentina, Malaysia, and South Korea. Lastly, there are currently four countries – Canada, Denmark, New Zealand, and Norway – which have zero interchange fee schemes in place for debit cards.[56] The 2007 EU banking inquiry[57] provided evidence that interchange fees are not intrinsic to the operation of card payment systems, as several national systems operate without an interchange fee mechanism, generally resulting in lower merchant fees.

As has been highlighted by Hayashi and Maniff,[58] there is a shift in public authority involvement from pursuing antitrust litigation to employing regulatory and legislative measures to address policy issues raised by payment card pricing or rules. Such an approach has many advantages. Unlike fines and decisions by a competition

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[52] Richard A. Epstein. 2005. The regulation of interchange fees: Australian fine-tuning gone awry.

[53] Merchant fees in this context consist of an interchange fee, a switch fee, and a merchant acquirer fee.

[54] Fumiko Hayashi and Jesse Leigh Maniff. 2017. Public authority involvement in payment card markets: various countries, August 2017 Update.

[55] Ibid.

[56] For a detailed survey of the state of interchange and merchant fees in 38 countries as of August 2017, see Fumiko Hayashi and Jesse Leigh Maniff. 2017. Public authority involvement in payment card markets: various countries, August 2017 Update.

[57] European Commission. 2007. Antitrust: Commission prohibits Mastercard's intra-EEA Multilateral Interchange Fees.

[58] Fumiko Hayashi and Jesse Leigh Maniff. 2014. Interchange fees and network rules: A shift from antitrust litigation to regulatory measures in various countries.

authority or court, regulatory and legislative measures add legal certainty and a clarity of standards going forward. They can induce other card schemes to proactively adjust their practices, which is less likely with individual antitrust judgments. Further, regulatory measures in particular can be implemented more quickly than litigation and give the regulator more flexibility than a competition authority in designing structural reforms necessary to enhance competition.[59] Lastly, such an approach allows regulators to evaluate issues such as interchange fees and scheme rules in a wider context, which is increasingly important given the rising prominence of other matters such as card payments security and mobile and digital payments.

[59] Maria Chiara Malaguti and Alessandra Guerrieri. 2015. Multilateral interchange fees: Competition and regulation in the light of recent legislative developments.

4. Lessons learned for developing markets

The antitrust investigations and litigation surrounding interchange fees focus on (i) mechanisms put in place by the card schemes to set a minimum level of interchange fees that result in excessively high fees, and (ii) the associated scheme rules, such as the non-discriminatory provisions, which reinforce the high fee levels by preventing merchants from guiding customers toward cheaper alternatives. The EU investigations have been focused on the former, while the US litigation has been concentrated on the latter. In both instances, the investigations/litigation have been followed by settlements as well as legislative action. Many other nations have directly legislated or regulated these fees, albeit with different models (from fee caps and prohibitions on non-discriminatory scheme clauses to the imposition of zero interchange fee schemes).

The litigation and investigations have revealed the true nature of the European and US payment card markets. Given the two-sided nature of payment card markets, pricing is opaque, and the cardholder does not directly face the cost of using a particular card. Further, although the card schemes lack dominant market shares, the bargaining power in the relationship is in favor of the scheme, so the merchants are often forced to accept the scheme rules, whatever their form, if they wish to accept payment cards. These rules usually include contractual restrictions that ensure merchants cannot charge different prices (to reflect the different card fees) to consumers who use different cards. There is thus a propensity for payment card schemes to use these dynamics to keep interchange fees high, and clearly market dynamics have often failed to ensure robust competition.

Although in the United States and Europe the use of payment cards is ubiquitous, in developing markets the use of payment cards for merchant payments varies substantially by region. In Latin America, in particular, there is a relatively high use of pre-paid payment cards[60] by the low-income population in countries such as Brazil, Mexico, Chile, and Peru. This has been fueled in some countries by the disbursement of conditional cash transfers by the governments through such pre-paid cards, e.g., Bolsa Familia[61] in Brazil and Prospera[62] in Mexico. In Africa, payment cards are often

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[60] Americas Market Intelligence. 2016. 2017 Trends for Latin America's payment industry.
[61] The World Bank. 2010. Safety nets how to: Making payments.
[62] Oportunidades has been renamed Prospera. BTCA. 2011. Bansefi Visa debit and prepaid cards create oportunidades for Mexico's financially underserved.

limited to the middle and upper classes (with the exception of South Africa), and merchants often surcharge payment cards (e.g., Ghana[63]), thereby disincentivizing their use. There have been initiatives by the card schemes to extend their card adoption by bundling their payment card with a national identification, as in the case of Mastercard in Nigeria[64] and more recently in Pakistan.[65] However, the Nigerian initiative has not seen much adoption to-date, due mainly to concerns with the issuance of the actual cards[66] and the Pakistan card has yet to be rolled out.

Given the great diversity of the role of payment cards in developing markets, the relevance of the lessons learned from the interchange fees litigation/investigations depends largely on the state of development of the merchant payments use case in a particular country and whether there are true competition issues based on the actual market conditions. It should be noted that interchange fees can equally serve as a catalyst for card issuance by issuers, and thus card adoption, in an ecosystem with low card adoption. They can also disincentive surcharging in the overall card ecosystem, which is a barrier to card uptake and to the adoption of digital payments in general. Therefore, the regulation of these fees should only be considered by developing market regulators once a critical mass in card payments has been achieved.[67]

That said, financial sector regulators in developing markets would be well-advised to monitor these payment card markets even in their infancy and consider regulatory or legislative intervention once payment cards reach a critical mass, if market conditions warrant such an intervention (e.g., excessively high interchange fees that are not benchmarked to merchants' cost of accepting cash.) As the above research has shown, there are several models for the regulation of interchange (and merchant) fees, and an in-depth review of the specificities of each the models and their respective track records would be recommended before authorities decide whether to intervene (and if so, when and how).

Yet the lessons learned go beyond specific recommendations for the payment card markets. Similar competition concerns may arise wherever a two-sided market exists

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[63] Roland Amoah, Rajesh Bansal, Aneth Kasebele and Ariadne Plaitakis. 2017. BTCA. Ghana: Building an inclusive digital payments ecosystem: The way forward. page 8.
[64] Mastercard. 2013. Mastercard to power Nigerian identity card program.
[65] Dawn.com. 2017. Mastercard to optimize National Identity Cards with e-payment functionality.
[66] Punch. 2017. National identity card: Is the January deadline by the Nigerian Immigration Service feasible?
[67] As per discussion with Mark McCullagh, expert on interchange fees, on 12 April 2018.

and the scheme or platform owner is able to dictate the membership rules on one side while preventing customers on the other side from reacting to price competition. In such a scenario, competition issues can provide an additional argument for regulatory intervention with respect to pricing regulation.

Further, lessons can be learned for interconnection fees charged for mobile money transactions, even if not all elements characteristic of typical payment card schemes are present in such a scenario. Such interconnection or "interparty" fees are required at a transactional level to balance the economics for the various parties in the mobile money ecosystem.[68] The interchange fee litigation suggests that there should be some sort of proportionality between the pricing of a connection (be it interchange or mobile money interoperability) and the cost of such transaction to the scheme participants. Where the costs charged are not clearly correlated with the actual costs incurred for service provision or they do not correspond to the value such transactions represent relative to other alternatives, then there may be room for regulatory intervention by either competition authorities or sectoral regulators. Potential scenarios in mobile money include:

(i) The imposition of excessive termination fees[69] by a mobile money provider who has significant market power in bilateral and/or multilateral interoperability agreements;

(ii) Anti-competitive access pricing or refusal to provide access to a switch where the switch's controlling shareholders are private banks or other private entities; and

(iii) The imposition of a traditional banking price structure for interconnection in a private switch, even if mobile money offers significant cost savings in terms of infrastructure and resources that could be passed on.

Similarly, mobile money providers can use scheme rules to minimize competition. For example, providers have prohibited agents and merchants from contracting with other providers (agent/merchant exclusivity[70]) and have required agents or

[68] Mark McCullagh and Charles Niehaus. EAC Multilateral Interparty Fees. Presentation to CGAP on 10 May 2018 (Unpublished).

[69] Fees that are imposed by a receiving mobile money operator to a sending mobile money operator for off-net transfers.

[70] Safaricom, until 2014, had inserted exclusivity clauses in its contracts with its mobile money agents in Kenya. See Daily Nation. 2014. Safaricom ordered to share M-Pesa agents with other telecoms.

merchants to prioritize their branding over that of competitors[71]. Such rules also reinforce the market power of these “scheme operators”.

That said, regulators should apply the lessons learned from the interchange fee litigation in the EU and US to card payments and mobile money in developing markets with caution, as much turns on the stage of market development and the specific market structure and infrastructure at hand. Regulators in less-developed digital payment markets should fashion a balanced approach that takes into account both the lessons learned and the benefits accrued from the imposition of interchange fees.

[71] As highlighted in CGAP’s Agent Management Handbook.