The Problem of Interchange Fees: Costs Without Benefits?

David Balto

Consumers are well aware of many payment systems costs, such as annual fees for credit cards, current account overdraft fees, late payment fees, and ATM fees. Far less transparent are "interchange fees"—the fees that banks pay one another for each credit card, debit card and ATM transaction made by their customers. Interchange fees have existed for over a quarter of a century, so some might assume they are a necessary fact of life. But they have increased significantly over the past few years, and thus disputes and controversies between merchants and banks over the fees are intensifying. In the United States a group of merchants have sued Visa and Mastercard seeking over $8 billion in damages for supra-competitive interchange fees.[1] Just last month, in a report to the Chancellor of the Exchequer, a U.K. study on banking services called for substantial reform of the use of interchange fees.[2] In Australia, the Competition Commission is studying the role of interchange fees.[3] In the United States alone inter-change fees amount to billions of dollars each year, so the resolution of these disputes can have a tremendous impact on the fee income earned by banks and other financial institutions and ultimately on the efficiency of the payment system.

It is generally not appreciated that interchange fees exist under a narrow and tenuous exception to the traditional antitrust skepticism towards collective price fixing. Under the antitrust laws, competitors are rarely permitted to set prices collectively. Although interchange fees survived two antitrust challenges in the mid-1980s, many of the factual underpinnings for those decisions have changed substantially. Moreover, in other countries and on the Internet, transactions are conducted without interchange fees. Thus, it is an appropriate time for both regulators and the bank card associations—Mastercard and Visa—to reassess the role of interchange fees, their impact on competition and consumers, and whether they remain appropriate and consistent with sound anti-trust law and policy.

This article describes the basis for the early decisions permitting interchange fees. It then analyses whether the basis for these decisions is still valid. It sets out the competitive problems that arise in the use of interchange fees in the credit, ATM and debit environment. Interchange fees may frequently be unnecessary and should be prohibited. Where they are necessary the article closes with several suggestions about how regulators can reduce the anti-competitive impact of these fees.

Background

Interchange fees are the banking industry's billion dollar secret. They are set by credit card and ATM networks, supposedly based on their internal "confidential" assessment of cost. In the United States, typical credit card and debit card interchange fees are around 1.3 per cent of the transaction amount, paid by the merchant's bank to the card issuer's bank, while ATM interchange fees are about 50 cents per transaction, paid by the consumer's bank to the ATM terminal owner. In the world of electronic payment systems these small fees can add up to substantial sums. In the United States, credit card interchange fees exceed $10 billion, ATM interchange fees exceed $5 billion, and debit card interchange fees exceed $2 billion each year. Because they appear to be simply a transfer between banks, one might assume they have little economic impact. But the way credit and debit card interchange fees are structured ensures that they are passed on to merchants, and thus to consumers. ATM interchange fees are also paid by consumers, through "foreign fees" which banks charge their own customers for using another bank's ATM.

The problem posed by interchange fees is illustrated by the seemingly paradoxical way that competition seems to result in higher, not lower prices. In the world of offline debit Visa is more than three

David A. Balto, Assistant Director of the Office of Policy and Evaluation at the Federal Trade Commission. This article represents his views and not necessarily the views of the Commission or any of its Commissioners.

1 John R. Wilke, "Retailers' Suit Names Visa, MasterCard": Wall Street Journal A3 (January 25, 2000).

2 Don Cruickshank, *Competition in UK Banking: A Report to the Chancellor of the Exchequer* (March 2000) ("Cruickshank report"). "Payment Fees Anticompetitive According to U.K. Retailers", *Cards International* 8 (October 18, 1999) (British Retail Consortium testified before U.K. treasury commission that banks received over $811 million in unjustified fees).

3 "Australian Inquiry Launched on Credit, Debit Cards Fees", *Retail Banker International* 7 (September 30, 1999).

times as large as Mastercard. Yet it initiated a price war. In 1998, Visa announced that it would increase its offline debit card interchange fee by about 20 per cent effective April 1999.[4] In response, Mastercard announced that it would increase its interchange fees by 9 per cent. Following Mastercard's announcement, Visa increased its fee by an additional 5 per cent. Mastercard responded with still another increase. Visa and Mastercard engaged in an aggressive bidding war, increasing prices even before the initial price change took effect. At the end of the process, overall interchange fees had increased by over $300 million per year.[5]

Why did interchange fees increase? The associations claimed the reasons were "increased cost" and the need to foster "appropriate incentives for issuers and merchants".[6] But the basis for those claims was cloaked in secrecy. Data communications and processing costs continue to plummet throughout the economy. Meanwhile, debit card volumes have been increasing at a dramatic rate. One might logically expect costs per transaction to be decreasing. Moreover, industry observers noted that the profitability of off-line debit was skyrocketing.[7] To put it bluntly, the bidding war seemed to provide incentives solely for issuers.

In a competitive market, consumers can turn to alternatives when faced with anti-competitive price increases. But in these payment markets, merchants have no choice. As one merchant processor put it, "because Visa and Mastercard have control of the market, they can do what they want and get away with it.[8] One might ask what, if anything, might deter the degree of price increases by the card associations? Because merchants must accept offline debit as a condition of accepting credit cards, a merchant's only option is to discontinue accepting all debit and credit cards—not a viable solution for most merchants.

Did the ultimate consumer benefit from this price war? Typically in payment systems consumers are concerned about cost, security, and speed. Online debit, which runs through the regional ATM networks, is more secure and faster (because transactions are instantaneous). Moreover, online debit is less than one-fifth of the cost of offline debit. Higher interchange fees led banks to prefer offline debit to online debit. To secure higher offline interchange many banks have begun to charge consumers if they make online transactions.[9] So consumers were driven to offline debit, which cost merchants more and was less secure and timely. Ultimately, because of interchange fees the less efficient payment system prospered.

The Legal Setting

The antitrust laws clearly and appropriately prevent collective price fixing. That is because, as the Supreme Court has said, price setting is part of the "central nervous system" of the economy. A fundamental tenet of antitrust is a preference for individual price and quality decisions, which is the bedrock of a free market system. After all, if a group of banks decided to collectively set the fees charged to consumers, such as current account or annual credit card fees, it would be condemned with little need for analysis.

The antitrust laws, however, recognise that collective price setting can be permitted where it is "reasonably necessary" to the successful function of a joint venture. Thus, where certain efficiencies of the venture might be lost, or a venture might not be formed in the first place, such price setting might be permissible. During the last quarter of the twentieth century, various courts and the antitrust enforcement agencies (the Federal Trade Commission and the Antitrust Division of the Department of Justice) showed a much greater degree of sympathy towards the need for collective price setting in the limited cases where price setting was deemed "reasonably necessary".

4 "Mastercard Counters Visa in an Emerging Interchange War," *Debit Card News* 5 (February 16, 1999); "Visa Raises Interchange fees," 14 *Card News* (February 15, 1999); "Visa, Mastercard Give Debit Issuers a Big Raise," *Debit Card News* 1 (January 29, 1999); Jeffrey Green, "Bracing for an Interchange Fight," Credit Card Management (August 1998).

5 A similar price war has occurred for the last two years in credit card interchange fees, resulting in 5% increase in both 1998 and 1999. Pete Hisey, "How High Can You Go?," *Credit Card Management* (April, 1999); "Economics: Double Whammy; Associations Raise Interchange Again," *Credit Card News* (Feb. 1, 1999); "New Visa Interchange Rates Upset Merchant Segment," *Card News* (June 22, 1998).

6 "Economics: Double Whammy", n. 5 above.

7 "Visa Fees Going Up Again: Action Reflects Market Power,"22 EFT Report (February 10, 1999).

8 "Visa, Mastercard Give Debit Issuers a Big Raise," *Debit Card News* 3 (January 29, 1999).

9 "Issuers Turn up Online POS Fees to Raise their Offline Volumes," *Debit Card News* (June 15, 1999) (describing how banks surcharge consumers for online transactions "to encourage customers to use their offline debit cards to generate more interchange revenue"); "Interchange Rate Creep Beginning to Set in", *Bank Network News* (April 12, 1999).

Interchange and Credit Card Networks

When Bank Americard, the forerunner of Visa, was formed in the early 1970s, interchange fees were adopted to provide prospective members with some sense of the costs of participating in the system. Banks could be induced to participate in the venture only with some sense of what their costs would be and that they would be recoverable. The controversy over interchange fees came to a head in the mid-1980s with litigation between NaBanco, a large merchant processor, and Visa.[10] At the time interchange fees were initiated, both card issuance and merchant processing were performed almost exclusively by banks. Because most banks performed both tasks, the interchange fee was seen by many observers as simply a neutral transfer payment. NaBanco, one of the first non-bank merchant credit card transaction processors, alleged on the other hand that the interchange fee was illegal price fixing and asked the court to enjoin its use.

The court rejected NaBanco's argument for four reasons.

1. *The need to recover costs.* The court held that the interchange fee was intended to compensate card issuing banks for certain costs that might not be otherwise be recovered. Those costs included the risk of fraud and loss, the float and the costs of card issuance. At the time, various regulations prevented card issuing banks from recovering many of these costs directly from the card holder.

2. *A regulatory means of determining costs.* Moreover, the court felt a certain degree of security that the interchange fee was not anti-competitive, because the level of the fee appeared to be supported by an independent accounting firm's analysis of costs associated with credit card issuing and merchant processing.

3. *No less restrictive alternative.* The court found that no less restrictive alternative to interchange was available. At the time, card issuing banks were prohibited from charging various fees to consumers, which seemed to strengthen their argument for collecting fees instead from merchants.

Could there have been individual negotiations between merchant banks and card issuing banks for these fees rather than collective price setting? The court carefully analyzed the potential for bilateral negotiations, but rejected it as impractical because there were between 10 and 15 thousand members in Visa, and therefore the transaction costs of negotiations between pairs of merchant and card issuing banks would be so substantial that they would be prohibitive. Moreover, if some of these negotiations failed, a merchant might accept some Visa cards and not others, and thus the universal acceptance of the card would be diminished.

Finally, if there were no pre-established interchange fee a merchant bank might face a problem of "hold up" by the card issuing bank. Once the merchant accepted the transaction it would face only a single card issuing bank, which could charge whatever it wanted. Thus, a preset interchange fee prevented opportunistic behaviour by the card issuing banks.

4. *Impact on competition.* The court held that the actual impact of the interchange fee on competition would be slight, for two reasons. First, it defined the relevant market as containing all payment systems, including credit cards, ATMs, cheques and cash. The implication of this finding was that if Visa increased the interchange fee to an anti-competitive level, merchants or merchants' banks could turn to a variety of payment alternatives. Secondly, the court decided that the interchange fee was not truly "mandatory" because individual banks could enter into alternative arrangements. That is, they could bypass the Visa interchange fee system, and a large portion of transaction, perhaps as many as one-third, did bypass Visa through bilateral agreements.

5. *Interchange was simply a "transfer payment" that would not be used strategically.* The court characterized interchange fees as a "transfer payment" that equilibrated the costs and benefits between the merchant and card-issuing sides of the business. Most banks, including practically all of the Visa board members, participated in both the card issuing and merchant signing aspects of the business. For these banks interchange was just a transfer payment, not a profit centre. Thus, it seemed unlikely that the banks would use the interchange fee strategically, *e.g.* by inflating costs or attempting to extract supracompetitive profits, since as direct payers of interchange fees they would be harming themselves to some extent. Moreover, the Visa board that set the fee had strong representatives of both card issuing and merchant processing interests. Thus, the court concluded "VISA has every incentive to set [interchange] at a level which establishes an equilibrium between the issuer and merchant sides of

10 *National Bancard Corp. ("NaBanco") v. Visa U.S.A., Inc.*, 596 F. Supp. 1231 (S.D. Fla. 1984), aff'd, 779 F.2d 592 (11th Cir.), *cert. denied*, 479 U.S. 923 (1986). For an economic analysis underlying the decision, see William F. Baxter, "Bank Interchange of Transactional Paper: Legal Perspectives," 26 *Journal of Law and Economics* 541 (1983).

the business" and this degree of equilibrium diminished concerns over anti-competitive conduct.

Interchange and ATM Networks

NaBanco in effect established a quasi-regulatory model for avoiding the competitive risks of interchange fees. When ATM networks were formed they followed the teachings of *NaBanco* but with less clear results. In the ATM network environment, card-issuing banks pay ATM owners an interchange fee to compensate them for the costs of deploying ATMs. Like Visa, these networks believed they could find an antitrust safety zone by basing the fees on costs determined by independent accountants. These fees raised little concerns (in fact, since most banks issued cards and deployed ATMs, few saw interchange as a potential profit centre). That changed in the late 1980s in Texas, when First Texas, a member of PULSE, began to deploy many low volume, off-premise ATMs. That action drove up average ATM costs and suggested the need for a substantial inter-change fee increase. But the PULSE board responded instead by trying to decrease the interchange fee, perhaps based on a sense that their customers were subsidising one member's overly aggressive deployment strategy.

First Texas turned to antitrust litigation, alleging that the proposed reduction in the interchange fee was the illegal action of a card-issuing cartel intended to harm a major ATM deployer.[11] As to the role of interchange fees, First Texas asserted that any interchange fees constituted illegal price fixing. It suggested that interchange be eliminated altogether and replaced by a "free market" system in which ATM owners charged consumers directly. The antitrust arbitrator came extremely close to declaring interchange fees illegal: "where the benefits of a competitive market can be obtained without a substantial impairment of efficiency, the restraint cannot be viewed as reasonable."[12] He noted that the collectively set interchange fee may have been necessary and permissible at the inception of the network, but that justification was lost as the network attained dominance and the market matured.

The arbitrator chose not to condemn interchange fees altogether because it seemed that a free market system might cause consumer confusion and increase search costs, and result in possible price gouging, substantial technical conversion costs, an ability to interconnect with other networks, or the need for additional customer education.

The arbitrator found that the specific proposed reductions in the interchange fees violated the antitrust laws. After an extensive critical review of the mechanism of the cost studies, he found they did not support the board's actions. The problem was that the cost studies suggested that the interchange fees should increase, not decrease. Moreover, the imbalance between card issuers and ATM owners in PULSE suggested that the members of the board had acted opportunistically.

Time to Reassess NaBanco and First Texas

In short, even when they were issued, *NaBanco* and *First Texas* provided less than an unequivocal legal endorsement of collectively set interchange fees. Each decision recognized the preference of the antitrust laws for individual decision making. In *First Texas*, more than *NaBanco*, the arbitrator recognized how interchange fees could be used anti-competitively. But in both cases we should reassess how changes in the marketplace might alter our assessment of competition and the legality of the fees.

Consider the foundation of the *NaBanco* decision.

1. *The need to recover costs.* Much has changed since the decision. At the time of the litigation, credit card transactions were typically paper-based. Several days would elapse between the time of the transaction at the point of sale and the receipt of the transaction charge slip by the card issuing bank. The relative amount of risk and float in the system were thus far more substantial than they are today. In the early 1980s both card issuing and merchant processing were very unconcentrated markets. A merchant's relationship was probably with its local bank, and transactions with distant banks were relatively infrequent and potentially more risky.

A critical linchpin to the *NaBanco* analysis is the court's finding that significant costs are borne by the card issuing bank, primarily the risk of loss and the float. But those costs have changed substantially. The risk of loss is far less substantial in credit cards than it was decades ago. Electronic transactions and authorisation means that the card issuing bank knows almost instantly whether or not a transaction is valid. Electronic processing has significantly reduced the float, and, in any event, there are far fewer regulatory

11 *In re Arbitration between First Texas Sav. Ass'n & Financial Interchange, Inc.*, 55 Antitrust & Trade Reg. Rep. (BNA) 340, 350 (August 25, 1988).

12 *ibid.*, n. 11, above.

barriers preventing card issuing banks from recovering these costs directly from consumers. Finally, there is no float and far less risk of loss in the ATM and online debit card setting, where transactions are done almost instantaneously.

The U.K. banking study found that the cost justification for interchange fees was lacking in many respects. For example, it found that the sums recovered for fraud were substantially larger than the actual losses, which are often borne by the retailer or merchant acquirer. The report concluded that factors other than cost are involved in settling interchange rates, and that interchange fees "are substantially higher than can be justified by legitimate cost recover. In all cases, the process by which these fees are set is extremely opaque to end users and subject to abuse.[13]

2. *A regulatory means of determining cost. NaBanco* is practically unique in antitrust jurisprudence for approving the setting of a price based on a purported accounting of costs. Antitrust courts and enforcement agencies rarely, if ever, accept promises that price setting will be "cost based" as a reason to permit collective price fixing. There are several sound policy reasons for this. First, how can an antitrust court or regulator effectively regulate price setting? Who would monitor the price setting? Which costs would be selected? Such issues are the reasons why antitrust invariably prefers competition rather than collective price setting based on a promise that the collectively set price is the "right" price. The U.K. banking study found that the private setting of interchange was less efficient than either regulation or competition. See Cruickshank report, *supra*, note 2 at 3.105.

Moreover, as decades of unsuccessful government regulation have demonstrated, setting price based on cost often creates the wrong incentives for the market. If price is based on cost, there may be insufficient incentive for the venture or its members to attempt to reduce costs, because they know that at the end of the day all of those costs will be recovered. For example, in Texas the cost-based interchange fee structure gave First Texas the incentive to deploy "unprofitable" ATMs under the assumption that eventually ATM fees based on their costs would increase. The U.K. banking study observed that allowing issuers to recover costs through interchange "weakens the incentives to cut costs through greater efficiency. Inflated interchange fees can help protect inefficient suppliers from the full force of competition." See Cruickshank report, *supra*, note 2 at 3.116.

The history of interchange fees illustrates the problems associated with a cost-based mechanism. As one might expect with any type of "regulated" price setting, interchange fees primarily have only increased. Interchange fees may create incentives for the creation and expansion of a payment system network. Once the network of merchants or ATMs has been established, however, they are effectively locked in; thus there is relatively little incentive for the network to reduce interchange fees even in response to reduced costs. As suggested by the PULSE litigation, this problem is exacerbated where the network is effectively controlled by the card issuing banks, which increasingly see interchange as an important source of revenue.

3. *Less restrictive alternative.* The critical linchpin is that interchange is reasonably necessary because of the costs of any less restrictive alternative such as bilateral negotiations. What of the transaction costs argument? First, in countries where there are relatively few firms in a market the savings in transactions costs will not be substantial and the argument can not support interchange fees.

Secondly, even where there are a larger number of firms there may be greater opportunity for interchange fees to be replaced by bilateral negotiations. In the U.S. credit card market both merchant processing and card issuing are far more concentrated than they were 20 years ago. At present, 10 banks issue more than 60 per cent of bank credit cards, and one entity accounts for over 35 per cent of merchant processing. Although this does not suggest that transaction costs are trivial, they are far less substantial than in the past. Advances in data communications have reduced the once significant cost advantages of a centralized payment clearinghouse.

The transactions cost argument might still sound like the strongest remaining pillar of the *NaBanco* foundation. Alan Frankel, a noted economic expert on interchange fees, has observed however that this argument is premised on the assumption that some interchange fee is necessary for the efficient operation of the network. "If each financial institution party to the transaction can recover costs directly from customers, then exchange fees probably are not necessary at all for efficiency.[14] Perhaps the examples of the Internet and other payment systems suggest that many different types of firms are able to overcome these transactions

13 See Cruickshank report, *supra*, note 2 at 3.114.

14 Alan S. Frankel, "Monopoly and Competition in the Supply and Exchange of Money," 66 *Antitrust Law Journal* 313 (1998).

costs problems without resort to an interchange fee mechanism. Even if bilateral negotiations were required for efficiency, there is no reason why every bank would need to negotiate with each other bank. Rather, a logical alternative would be a system of correspondent banking relationships, with only a small fraction of banks actually connected directly to a significant number of other institutions.

4. *The potential for competition.* The *NaBanco* decision was fundamentally based on a view that credit card networks could not exercise market power because they participated in an "all payment system" market that was highly competitive, with different payment systems actively competing for use by merchants and consumers. While that might have seemed true during the 1980s (when credit cards were still an emerging market), it is clearly not true today. VISA and Mastercard have over 70 per cent of the market in the U.S.[15] Credit cards are a predominant form of payment, and consumers and merchants will not easily turn to other alternatives because of higher interchange fees. Successful network entry is rare and barriers to new networks are substantial. The prevailing use of credit cards in the burgeoning Internet commerce merely reinforces this existing marketplace reality.

From an antitrust perspective, the question is whether merchants, in response to an increase in interchange fees, could effectively defeat or deter the increase by trying to drive consumers to cheques or cash. There is little evidence that these alternatives limit the ability of the associations to increase prices. In fact, even if merchants were inclined to do so, their ability to steer customers to lower cost payment systems are often curtailed by contractual restrictions imposed by the credit card associations that prevent merchants from steering consumers to other payment methods or networks.

The offline debit example, described earlier, provides compelling evidence of Visa's ability to exercise market power. Under the U.S. antitrust laws, the ability of a firm to profitably increase prices by more than 5 per cent is treated as evidence of market power. The fact that Visa could increase its offline debit interchange fee by well over 10 per cent without losing substantial volume demonstrates both that debit is a separate market and that Visa possesses market power in that market.

The court in *NaBanco* also relied on the possibility that banks or merchants which were dissatisfied with the level of Visa's interchange fee could bypass Visa and enter into separate arrangements with other banks. In other words, if Visa charged an anti-competitive interchange fee, individual members could negotiate around the fee. Bypass is an important element in all joint venture arrangements, and where it is present and is used on a regular basis, it can be an important safeguard against the exercise of market power.

Although that argument sounded good in theory, these alternatives have proven to be non-existent in reality. There are several reasons why few banks engage in interchange bypass. First, there may be other rules of the card associations that make bypass far less than a practical alternative. For example, the associations can charge a separate fee for bypassed transactions that may equal or approximate the interchange fee, thus reducing the incentive to engage in bypass. In addition, if a card issuing bank realizes that it is securing a very lucrative interchange fee, it will have little incentive to bargain against itself and enter into a bypass arrangement. The issuer agreeing to receive less interchange revenue will gain no additional business as a result of its price cut, because its customers will get no price break from merchants compared to customers of banks receiving the standard, higher interchange fee.

The antitrust agencies apply a much more realistic standard on the issue of bypass.[16] They permit collective price setting, where there may be a threat of the use of market power, only where firms actually successfully engage in bypass and bypass exercises a competitive restraint on the market. Under that standard, interchange fees would fail to pass antitrust scrutiny.

5. *A "neutral transfer payment"?* Today many factors suggest that interchange has changed from a neutral transfer payment or an "equilibriating mechanism", to a potential substantial profit centre for banks seeking wealth transfers from merchants and consumers. Most banks have withdrawn from merchant processing, the vast majority of which is now performed by independent merchant processors. As a result, there is now generally far less balance or representation of the interests of merchants in the setting of

15 The U.K. report concluded that VISA, Europay and Switch all have significant market power. See Cruickshank report, *supra*, note 2 at 3.212, D3.16.

16 See David A. Balto, "Networks and Exclusivity: Antitrust Analysis to Promote Network Competition," 7 *George Mason L. Rev.* 523, 561-563 (Spring 1999) (discussing government standards in analysing exclusivity).

the interchange fee.[17] The potential for opportunistic conduct, such as the type described in the *First Texas* decision, is far more significant.

Since most banks now participate primarily in card-issuing, they have far greater incentives to increase the fee as much as possible and extract the highest revenue from merchants and consumers. Competition is distorted in favour of the network with an artificially high interchange fee. Moreover, without clearer involvement of merchants in the setting of the fee there is a greater ability to manipulate costs to increase the fee.

Impact on Consumers

Why should any of this matter to consumers? The reason is that credit card interchange fees comprise over 90 per cent of the merchant discount—the fee netted out and withheld from merchants when banks credit merchants' accounts for the amount of credit card charges. The merchant discount is a cost that is passed on to consumers in the form of higher retail prices. While this may appear fair for these costs to be passed on to customers who use credit cards, effectively non-credit customers (those who use cheques and cash) are subsidizing the costs of credit, as nearly all merchants find it too cumbersome (or are prevented by card association rules) to charge different prices to cash and credit customers. Moreover, for new payment mechanisms such as online debit, the collection of interchange fees may actually slow the growth of the network. Some merchants will likely be unwilling to undertake the costs of the network (*e.g.* terminal deployment) knowing that they will then have to pay an interchange fee when consumers present debit cards.[18]

Interchange fees have increased because there is little pressure to decrease them. In fact, the card associations have a perverse incentive to compete for card issuing members by raising the interchange fees they will permit those members to collect from merchants. Thus, although most costs have fallen, Visa and Mastercard have consistently increased interchange fees. In contrast, the non-interchange fee portion of merchant processing costs has fallen dramatically. That is because the merchant processing market is competitive and merchants can choose between numerous firms willing to provide service on increasingly razor-thin margins. But the situation now is such that most merchant transaction acquiring costs are unavoidable interchange fees, and the average merchant discount has thus increased even though merchant processing has become far more efficient.

ATM Interchange Fees

A reassessment of the ATM environment suggests an even more fragile foundation for interchange fees. In the *First Texas* case the arbitrator did not strike down the fees because PULSE argued that Armageddon would result if ATM owners charged consumers. Over ninety per cent of U.S. banks impose surcharges and each of the concerns—consumer confusion, price gouging, etc.—appear significantly overstated. The network costs of permitting surcharges were about one-tenth of the estimates. Surcharges exist and flourish and the problems identified by PULSE are relatively minor. In fact, PULSE is now one of the leading proponents of the use of surcharges.

ATM interchange fees also survived antitrust condemnation because they were necessary to compensate the ATM owners for deploying ATMs. Now that the vast majority of ATMs receive surcharges this justification seems wanting. Under surcharging the amount of ATM deployment has been breathtaking. Moreover, ATM interchange fees appear inefficient, and the fee setting mechanism is in paralysis. Although the costs of ATM deployment, communications costs and terminal costs, etc. have decreased over the past decade, ATM interchange fees have not changed. While ATM networks have decreased their switch fees by about 18 per cent over the last four years in response to lower costs, the fact that ATM interchange fees have not decreased seems like a disturbing anomaly.

Rather than decreasing interchange fees, because surcharges provide sufficient compensation for ATM deployment, the ATM networks appear to be ready to replicate the interchange war of the credit card networks. Many ATM networks have considered increas-

17 In the U.K. retailers have objected to interchange fees because they are excluded from the fee setting process. See "U.K. Retailers Attack Excessive Payments fees," *Electronic Payments International* 1 (September 30, 1999).

18 The U.K. banking study found that inflated interchange fees raised the cost to retailers of card payments, reduced the utilisation of credit and debit cards, raised retail prices to all consumers, and discouraged e-commerce. See Cruickshank report, *supra*, note 2 at 3.115. It also found that interchange fees harm less affluent and less sophisticated consumers who may not have credit cards. *Ibid.* at 3.117.

ing ATM interchange fees in order to secure more transactions.[19]

Currently in the United States ATM owners collect over $5 billion in interchange fees and $3 billion in surcharges. These double charges have greatly increased the costs of ATM transactions. From an economic point of view, having both surcharges and ATM interchange fees seems redundant at best, and inefficient at worst. When two firms set a price they both try to secure as high a margin as possible. Typically, the combined price will be higher than if only one firm sets the price. This problem is called "double marginalisation" because two firms try to set the same margin. From an economic perspective the most efficient result would be for one firm, either the ATM owner or the ATM network, to set the price.

Debit Interchange Fees

Interchange fees for online debit also seem to have a fragile basis. Since the transactions are instantaneous, the need for interchange seems far more tenuous. For several years online debit interchange fees clearly deterred the development of this payment system in the United States. Neither merchants nor card issuers could agree over who bore which costs and who should receive an interchange fee and in what amount. Merchants claimed they should receive the interchange because of the costs of terminal deployment. Card issuers argued they should receive the interchange because of the costs of card issuance. The amount of interchange fees varied, and frequently merchants declined to deploy point of sale terminals because of that cost.

The experience in other countries suggests that the claimed justifications for interchange fees were greatly overstated. In Canada, for example, the dominant debit card network was established and continues to exist without interchange fees.[20] Because the costs to merchants are less, the network grew far more rapidly than its U.S. counterparts. In fact, terminal deployment, merchant acceptance, and the use of online debit cards is far more significant in Canada than it is in the United States.[21] The costs of these transactions are funded by consumers, yet these costs do not appear to deter the growth of online debit.

In contrast, in the United States we observe the perverse marketplace phenomenon in which merchants pay more in interchange for a less efficient and valuable payment system—offline debit—than they do for its online counterpart, and find it difficult to induce customers to use the online system due in part to association rules.[22]

Summary

Interchange fees create an effective tax on merchants, and ultimately consumers, that often seems unresponsive to either competition or other economic forces. There are three reasons for this problem. First, the *NaBanco* decision approved a regulatory price-setting function which appears to result simply in increases in interchange fees. Because interchange fees are set solely by banks, there is no force to restrain the ventures from increasing interchange fees or to compel them to lower costs. The fact that interchange fees tend not to decrease, in spite of decreasing costs and reduced risk of loss, is particularly troubling.

Secondly, *NaBanco's* reliance on an assumed broad relevant product market comprised of all payment methods is misguided. Merchants have few if any alternatives in response to an interchange fee increase. Thus, converting consumers to cash or cheque transaction is not an effective deterrent to increases in the interchange fee.

Thirdly, consumers are unaware of the costs of various payment mechanisms, and have no incentive at the point of sale to use a payment method that imposes lower costs on merchants. Because interchange fees are buried in the level of retail prices, all consumers, including cash payers, fund the fees. Interchange fees are thus regressive, hitting relatively poor consumes who lack credit cards just as hard as relatively well-off credit card holders.

Alternatives and Questions

Are interchange fees necessary for interchange relationships to survive? In the United States, both cheque

19 Donald Davis, "The Forgotten ATM Fees," *Financial Service Online* (July/August 1988).

20 Many European countries, including Denmark, Holland, Belgium and Austria also do not have online debit interchange fees. Richard Rolfe, "Out of Sight, But Not Out of Mind," *Credit Card Management* (July 1998).

21 "Interac Sets the On-Line Pace," *Credit Card Management* 59 (February 1997).

22 Similarly retailers in the U.K. have objected that they pay more than twice as much for electronically processed debit transactions than the less efficient check transactions they are intended to replace. *Cards International*, n. 2 above.

clearing and various Internet relationships are performed without interchange fees. These examples suggest that setting a price is not a necessary requirement for establishing a network and sharing transactions. How would such an arrangement, eliminating interchange fees (or, equivalently, setting an interchange fee of zero) change payment systems in the United States?

A No Interchange Alternative

Card issuers and merchants will have to recover their costs internally. This may mean higher direct costs for consumers for credit cards and debit cards. But again, these prices will be transparent and in that fashion consumers can choose between banks offering the lowest cost product and this will force banks to compete more aggressively on these different cost factors. Ultimately it will force banks to attempt to reduce the costs that are currently compensated by the interchange fee: card issuance and risk of loss. This will provide even greater incentives for banks to drive for efficiency.

In order for a no interchange fee system to function effectively, merchants must be able to send accurate price signals to consumers. Thus any network rules that prevent those type of price signals, such as non-discrimination rules preventing different prices or treatment for customers who use different card brands, should be eliminated.

Of course, the crux to an interchange fee system involves the concerns over transaction costs. Where those concerns are not present because there are relatively few banks, the justification for such fees is lacking. The transaction fee justification seems to be the strongest remaining aspect of the *NaBanco* decision, and if that justification is absent the rationale for interchange seems far more tenuous.

Permitting Interchange Fees—A Regulatory Approach

In some situations, interchange fees may be deemed necessary. Where this is true, what should regulators do to reduce the potential for anticompetitive effects?

Permit interchange fees for a limited period only at the formation of the network. One lesson from the *NaBanco* and *First Texas* examples is that interchange fees may have been necessary at the beginning of the network where some members must make significant investments that may go uncompensated. Thus, an interchange fee may assist a network in being formed by ensuring cost recovery. Once the network has been established this justification diminishes. Thus, one approach may be to permit interchange fees only through the network formation stage.

Carefully regulate interchange fees with full disclosure of costs and balanced decision making. Where antitrust regulators choose to permit collective setting of interchange fees, those regulators should accept the mantle of cost regulation, while facilitating competitive bypass arrangements where possible. Regulators must establish a system in which they receive full information about each of the costs involved and the rationale for interchange fee changes. Moreover, in such a setting one approach would be to have the fee setting mechanism open to all interested parties including merchants and consumers.[23] This is an approach taken by some ATM networks in the United States. The U.K. banking study recommended that the setting of interchange fees should be transparent to merchants and consumers and based on "legitimate costs and should anticipate achievable cost reductions." It recommended that the methodology for the fees and aggregate returns be publicly disclosed.[24] By permitting merchants to actually participate in the fee setting mechanism and having all the costs transparent there is at least some potential for sending more appropriate price signals through the interchange fee.

Regulate which "costs" are used in calculating interchange. If a cost basis is used to set interchange fees, banking regulators should determine which costs are used to provide the most efficient price signals to the market. The approach of the U.K. banking study provides a useful model. It recommended that recovery be limited to certain well defined services provided by issuers to retailers, that the cost of the float be excluded, and that different interchange fees be set to provide incentives for retailers to reduce costs such as fraud. In addition, it suggested the use of a "forward looking element" to the cost structure to provide incentives for issuers to reduce costs.[25]

23 Merchants in the U.S. have asked for similar disclosure from the card associations. Charles Keenan, "Merchants Seeking Input on Interchange fees," *American Banker* 10 (March 19, 1999).
24 See Cruickshank report, *supra* note 2 at 3.199, 3.213.
25 See Cruickshank report, *supra* note 2 at 3.213.

Limit debit card interchange to a per transaction rather than an ad valorem fee. Interchange fees based on the value of the transaction are only appropriate where there is a significant risk of loss. In situations, such as debit, where the risk of loss is not substantial interchange should be limited to a flat per transaction fee.

Why is the difference important? Merchants are sensitive to the cost of handling these transactions. *Ad valorem* fees may discourage some merchants from accepting cards that they might accept if only a flat fee was used.[26]

Clearly permit bypass. Interchange fees should never be mandatory. Banks should be permitted to bypass the network and enter into bilateral agreements. The network should be prohibited from adopting other rules, especially additional fees, that might inhibit bypass.[27]

Prevent other price fixing. Other forms of price fixing, such as setting consumer or merchant fees, should be clearly prohibited.

Eliminate non-discrimination rules. The actual costs of different payment systems are hidden from consumers. Non-discrimination rules can exacerbate this problem by preventing merchants from "steering" consumers to less costly payment mechanisms. Any scheme that permits interchange fees should eliminate non-discrimination rules so merchants can provide incentives for consumers to use less costly payment systems. This in turn will enhance payment system competition.

The most egregious form of non-discrimination rule is one that requires a merchant to accept a card because the merchant accepts another product from the network—known as an "honour all cards" rule. For example, a group of U.S. merchants has challenged Visa's honour all cards rule because it requires them to accept Visa's expensive offline debit card as a condition of accepting Visa's credit card. These rules prevent merchants from refusing to accept these cards which in turn would force Visa to compete more aggressively for merchant acceptance.

Ultimately, the real solution to interchange fees is active competition between networks.[28] Only where networks truly compete for both sides of the equation, card issuing banks and merchants, and merchants have the right and ability to use lower cost networks to route transactions to card issuers, can consumers be assured that interchange fees are not just a hidden tax from consumers to banks. Interchange fees provide important incentives: but the question is whether those incentives are beneficial to the public, and whether a twentieth-century quasi-regulatory mechanism provides the correct incentives for the challenges of electronic commerce in the twenty-first century.

26 In the U.K. retailers have suggested that all *ad valorem* interchange fees be replaced by flat fees.

27 For a description of the types of arrangements that may restrict bypass and raise antitrust concerns see David A. Balto, "Routing Rules of ATM Networks: The Antitrust Risks in Backbones of Electronic Commerce," 20 *Journal of Retail Banking Services* 57 (1998).

28 As one merchant in the U.S. observed, "The more networks we have the more competition we have. The networks assure that both the issuer and merchant sides' interests in a transaction are covered." Jeffrey Kutler, "Retailers Threatening a Rebellion over Higher Card-Acceptance Fees," *American Banker* 1 (March 17, 1999).

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