Credit Cards and Interchange Fees: The Israeli Competition Case

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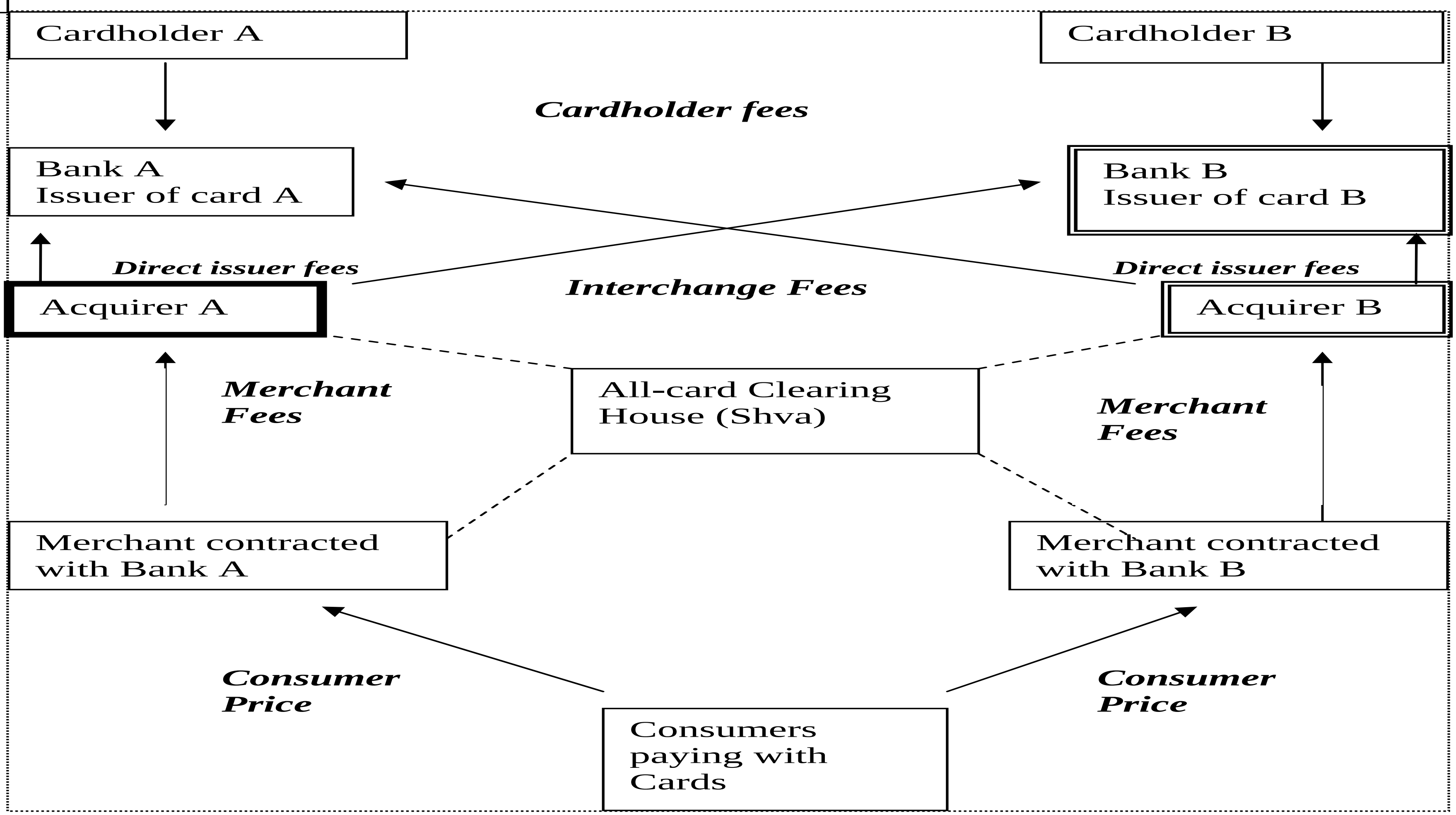
Background

- By 2002 Card issuers were owned by the largest banks. Each issuer was also an acquirer (Israeli case)

- Issuer: Issues brand-name cards to cardholds (mostly to bank account holders, combined with ATM cards). Debit consumers' bank accounts according to transactions' value

- Acquirer: Process charges received from merchants and transfers them to issuers

- Interchange fee (IF): Acquirer of one card pays an issuer of a different card (per transaction)


Cardholder A
Cardholder B
Cardholder fees
Bank A
Issuer of card A
Bank B
Issuer of card B
Direct issuer fees
Direct issuer fees
Acquirer A
Interchange Fees
Acquirer B
Merchant Fees
All-card Clearing House (Shva)
Merchant Fees
Merchant contracted with Bank A
Merchant contracted with Bank B
Consumer Price
Consumer Price
Consumers paying with Cards

Issuers' Petition to the Court (Antitrust Tribunal)

During September 2001, the issuing and owning banks asked the Israeli Antitrust Tribunal to approve the following arrangement:

Coordination: Issuers would be allowed to coordinate their interchange fees at rate levels that are mutually agreed among all card issuers

Categories: Interchange fees will be set according to industry types (fee discrimination, in the range of 1.2% to 1.6% of the transaction value)

My 3 Arguments Against This Arrangement

1. Interchange fees, if any, should adhere to the basic economic principle of marginal cost pricing (a few cents associated with the electronic/manual procedure plus a few cents for merchants' payment guaranty insurance)

2. Marginal cost pricing implies that there is no room for discrimination according to industry type and transaction type

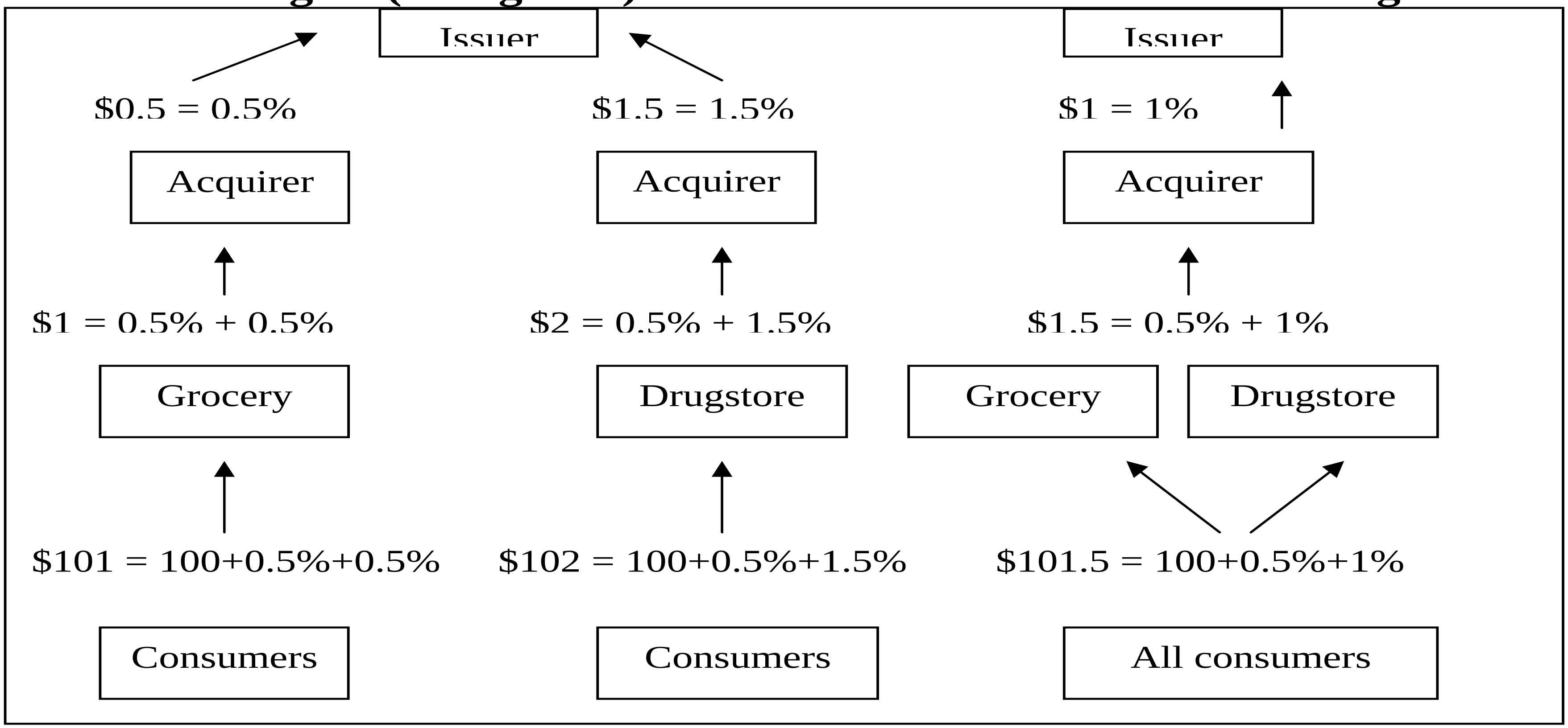
3. The issuers' threat to stop processing transactions using competing cards (split) is a bluff, and should be ignored! Proof: The European EC card has very low or no IF fees!

Why Discriminating IF (by categories) Damage Competition? The Market for Diapers

Deviation from marginal cost pricing: Refueling gas at a gas station and purchasing tomatoes using a card generates the same cost (if any) to issuers. See also Reserve Bank of Australia (2002)

Price distortion: Categories will raise the price of diapers in pharmacies relative to grocery stores, thereby reducing competition in the market for diapers

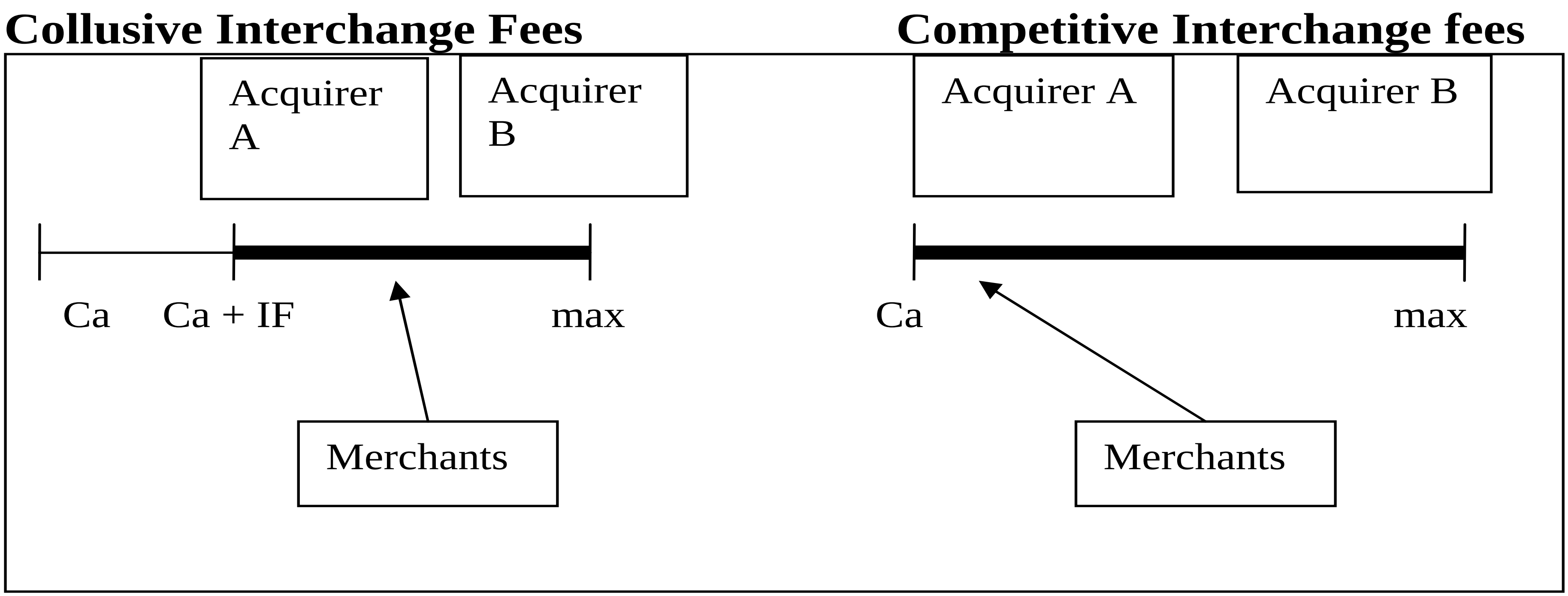
Discriminating IF (Categories) **Uniform Interchange Fees**



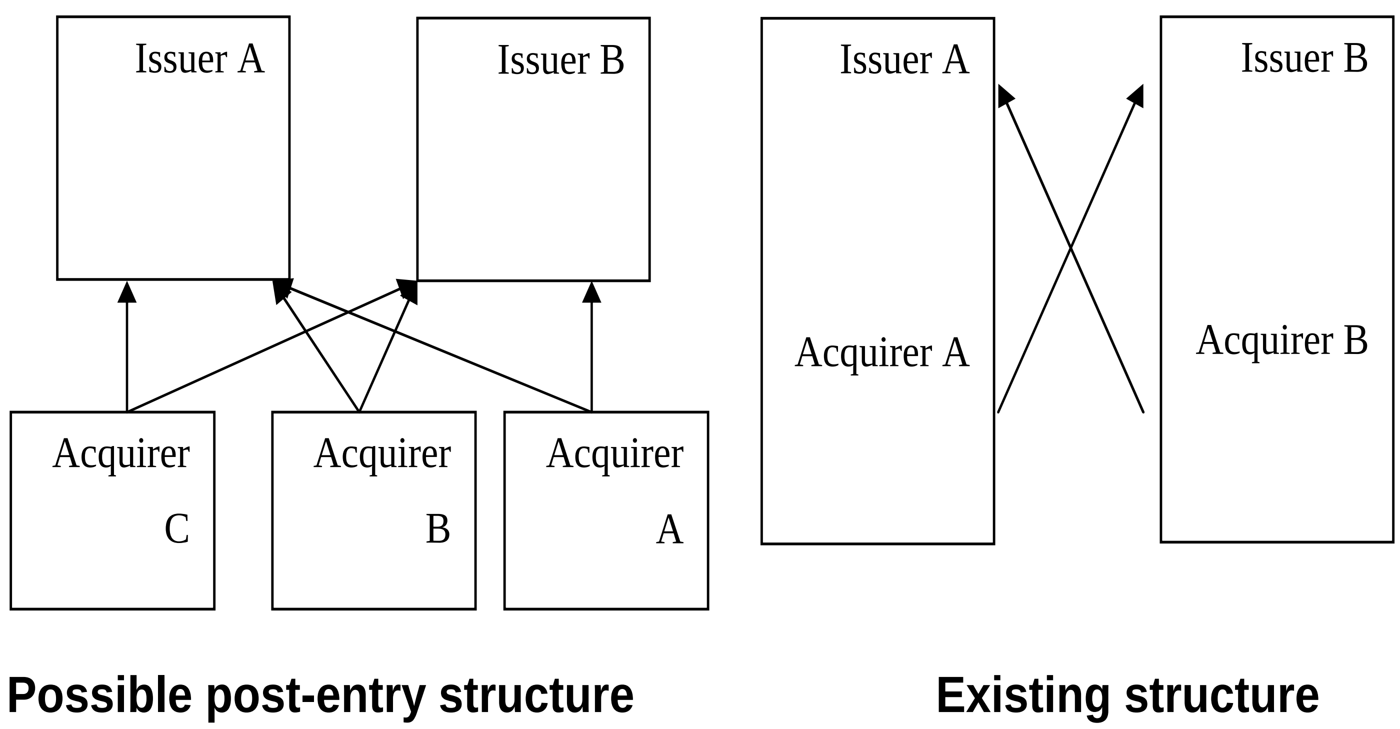
Why Coordination on IF Above MC is anticompetitive?

1. Reduces the room for competition among acquirers
2. Increases entry barriers of new acquirers and new issuers
3. Most importantly, high IF are rolled onto consumer prices, and...
4. raise prices also for those who pay cash and by checks (via the implicitly imposed no-surcharge rule)

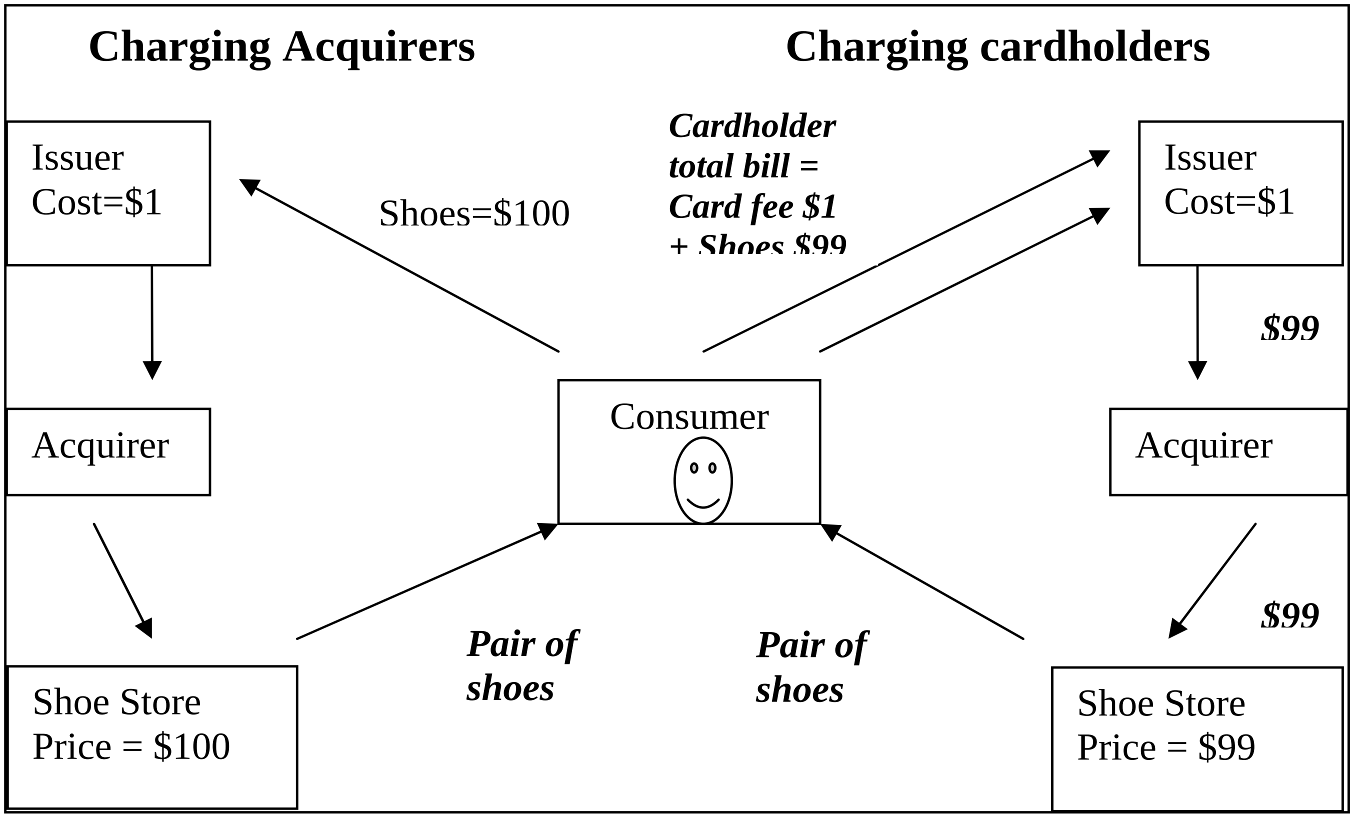
Reduced Competition Among Acquirers



Entry Barriers Resulting from Coordination on Interchange Fees Above Marginal Cost



Why Issuers Should Charge Cardholders Directly Instead of Acquirers?



Misinterpretation of the 2-sided Market Theory

- Some argue that the theory of 2-sided markets imply that merchants should subsidize cardholders via (above MC) IF

- Some, rely on Rochet & Tirole (Rand J., 2003) as a justification, However, they often forget to mention that:

- *Proposition 3b*: "the interchange fee set by a payment card association controlled by issuers may lead, under a certain condition, to an overprovision of payment card services"

- Conclusion: Welfare effects are ambiguous !!!

Conclusions

High (above MC) interchange fee distort the payment market in the following ways:

1. Raise consumer (shelf) prices
2. Raise prices non-uniformly, (if categories are being used)
3. Cause buyers to overutilize credit cards (making consumers believe that credit card transactions are free)
4. "Tax" consumers who don't pay by credit cards