The Israeli credit card's case – Supersol's view

Yossi Spiegel

Tel Aviv University

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Some background

- Supersol is the largest supermarket chain in Israel with about 25% of the food market
- Supersol's merchant fees:
  - 0.75% until 1998
  - 0.55% from 1998 to 2001
  - > 1% after 2001 (IF was set at 1%)
- The temporary approval of the interchange agreement on Sep. 2001 more than doubled Supersol's merchant fee on Visa transactions
- The IAA is generally concerned with food retailing – raising the IF on supermarket transactions was meant to reduce the gap between the costs of large supermarkets and smaller food stores

⇒ The IAA "hijacked" the credit cards case to deal with the food retailing sector (by raising the cost of supermarkets!)

The main points from Supersol's view

- Vis-a-vis the Visa companies:
  - The "demand-based" methodology advocated by the Visa companies cannot be implemented
  - Only a "cost-based" methodology (despite the lack of theoretical foundations) is practical
  - The IF is an instrument for collusion on the acquiring side
- Vis-a-vis Superpharm and the IAA:
  - Categories are a good idea
- A general point
  - The court is a bad place to set the IF

Point 1a: The proposal of the VISA companies

- The Visa companies argued that their methodology is intended to "provide a balance between cardholder fees and fees from merchants"
- In principle such a methodology makes a lot of sense (e.g., Schmalensee, *JIE* 2002, and Rochet-Tirole, *RJE* 2002)
- In reality, they proposed the following the following formula:

$$IF = (TC - I - zN)/V$$

  - TC – total issuer cost including everything
  - I - Issuers' income from cardholder use (but not interest payment)
  - z – cardholders' max. WTP for credit cards

- The merchants WTP merchant fees was totally ignored because "merchant demand is virtually impossible to measure..."
- The Visa companies argued that since the recommended av. IF was lower than the existing av. IF, existing merchants will be better off (but what about merchants who still do not accept cards?)

Point 1b: Why a demand-based approach is not practical?

- To examine z (the WTP of cardholders), the Visa companies hired a large Israeli polling company “Mutagim”

- Mutagim’s survey has revealed the following:
  - 48% of cardholders have z = 0 (unwilling to pay for having cards)
  - 30% of cardholders have z ≤ 50 NIS per year
  - 22% of cardholders have z > 50 NIS per year

- After the survey was completed (but before it was introduced in court), the credit card companies introduced in early 2002 annual fixed processing and liability fees of about 90 NIS a year

- Since 2002 active credit cards have increased from 3.5 million to 3.8 million...

- z cannot be estimated using a survey and we have no data to empirically estimate z (even if we knew how to estimate it)

⇒ Since the Visa companies argue that merchants’ WTP cannot be estimated at all, it’s clear that a “demand-based” approach that “provides a balance between cardholder fees and fees from merchants” cannot be implemented!

Point 1c: Why the IF should be based on a cost-based approach

- Only a “cost-based” methodology (despite the lack of theoretical foundations) is practical
- IF should cover issuer costs that benefit merchants (to prevent “free-rider problem)
- A cost-based IF in Israel should be very small:
  - Credit cards save banks costs (e.g. fewer “expensive” checks and fewer branches and ATMs) $\Rightarrow$ banks should also finance the issuing side
  - Cardholders already pay processing and liability fees $\Rightarrow$ no need for merchants to cover these costs all over again
  - The risk of non-payment lies mostly with the banks since actual credit is given through overdrafts – the interest rate on overdrafts covers this cost
  - The cost of float in Israel is negligible:
    - Issuers pay acquirers only once a month $\Rightarrow$ the cost of float is borne by the acquirers, not the issuers!
    - Acquirers typically pay merchants twice a month $\Rightarrow$ a large fraction of the float is borne by the merchants rather than the Visa companies

Point 1d: Collusion on the acquiring side

- IF serves as a price floor:
  - "On them" – IF is a cost
  - "On us" – IF is an alternative cost

- The acquiring side in Israel seems to be more competitive than the issuing side:
  - Credit cards are also ATM cards and effectively tied with bank accounts (Credit is provided by the banks through overdrafts; credit cards are simply a mechanism for extending credit)
  - Very little competition in the Israeli banking industry, especially with regard to households

- Credit card companies would rather earn profits on the less competitive issuing side than on the more competitive acquiring side

- The IF allows CAL and Leumi card to support more collusive merchant fees and then shift the resulting profits to the less competitive issuing side where they can keep these profits due to weak competition for cardholders

Point 2: Categories

- IF > 0 is a tax imposed on merchants in order to subsidize cardholders
- It is efficient to finance the tax according to the Ramsey principle (tax according to the relative elasticities)
- The relative welfare maximizing Ramsey prices are the same as the relative prices under 3rd degree price discrimination

⇒ Let the Visa companies set the relative IF (and hence the merchant fees) but ensure that the av. IF (and hence av. merchant fees) is low!

Point 3: The legal process

- Unreasonable delays:
  - The court case started in 1998 and the first part (what's the right methodology) was decided only in 2006
  - The case regarding the actual IF will be decided by bargaining among the Visa companies and the IAA
- Complete lack of transparency:
  - No data was ever released by the credit card companies regarding their costs, number of cards, usage, etc.
  - Merchants had to argue on the basis of speculation with major facts being heavily disputed
  - Small merchants did not participate at all

Point 3: The legal process

- The adversarial process seems to be a poor process to figure out the right methodology or indeed to reach any sort of agreement
- The parties make extreme arguments and disagree completely even on the most minor facts
- No constructive exchange of information and ideas
- Most of the facts before the court are based on conflicting evidence and vague depositions (e.g., what is the cost of handling checks or cash? What the benefit that merchants obtain from credit cards? What is the division of profits between the banks and their credit card subsidiaries? Does Visa Int'l allows CAL and Leumi to adopt a split regime)
- This is especially so given that the theory on how to set IF and what are the competitive effects of the IF is still in its infancy (in 2002, the first papers on IF started appearing in journals)

Appendix: Some main features of Israeli credit cards

- Deferred debit cards; virtually no credit cards and no debit cards
- Credit cards are also ATM cards and effectively tied with bank accounts (e.g., Bank Leumi's clients were unilaterally transferred from CAL)
- Credit is provided by the banks through overdrafts
  - Credit cards and a way to give credit
  - The income from credit is captured by the banks
- Until January 2007, overdrafts are encouraged by banks
- Very little competition on the issuing side (there is little competition in the banking industry in general, especially with regard to households)
- Credit cards are extremely popular:
  - 3.8 million active cards with 3.6 million adults of ages 25 and over
  - 34.1% of private consumption was paid for with credit cards
  - About 10 transactions per month on average