

Companion paper to decision

Investigation of the multilateral interchange fees provided for in the UK domestic rules of Mastercard UK Members Forum Ltd (formerly known as MasterCard/ Europay UK Limited)

Case CP/0090/00/S

6 September 2005

OFT 811

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This companion paper forms no part of the Decision but has been produced by the OFT to assist the public and other interested parties in understanding the Decision and the factual background to it. The full non-confidential text of the Decision will be published in due course on the OFT website at [www.of.gov.uk/Business/Competition+Act/Decisions/index](http://www.of.gov.uk/Business/Competition+Act/Decisions/index)

# 1 INTRODUCTION

- 1.1 The OFT has today issued a Decision concluding that a collective agreement between members of MasterCard UK Members Forum Limited<sup>1</sup> ('MMF')<sup>2</sup> setting the fallback multilateral interchange fee ('the MMF MIF') which applied to all transactions made in the UK using MasterCard branded consumer credit and charge cards<sup>3</sup> between 1 March 2000 and 18 November 2004 ('the MMF MIF agreement'), infringed the prohibition in Article 81 of the EC Treaty and the Chapter I prohibition of the Competition Act 1998.
- 1.2 The OFT has found that the MMF MIF agreement led to an unduly high interchange fee being paid to card issuing banks on every transaction made using a MasterCard credit or charge card in the UK. The cost of this fee was borne initially by merchants' banks ('acquirers'), but was passed on to merchants and generally passed on, in turn, to all consumers, by causing merchants to charge higher retail prices. In effect, therefore, this fee acted as a tax on retail transactions paid by all consumers in outlets that accepted MasterCard cards in the relevant period. This resulted in higher retail prices for UK consumers overall.
- 1.3 It has also found that the agreement did not meet all of the conditions for exemption from the prohibitions, contained in Article 81(3) of the EC Treaty and section 9 of the Competition Act.
- 1.4 The purpose of this paper is to assist the public and other interested parties in understanding the Decision and the factual background to it. It explains in simple terms what a multilateral interchange fee is, and the reasons for the conclusions reached in the OFT's Decision. It also outlines possible future action by the OFT.<sup>4</sup>

## Action preceding this Decision

- 1.5 On the date of entry into force of the Competition Act (1 March 2000), MasterCard notified to the OFT a set of agreements including the MMF MIF agreement. On 1 September 2000, the British Retail Consortium ('BRC')<sup>5</sup> made a complaint to the OFT against the MasterCard scheme and other UK payment card schemes focusing on the setting of multilateral interchange fees, including, in particular, the MMF MIF.

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<sup>1</sup> Formerly known as MasterCard/EuroPay UK Limited.

<sup>2</sup> MasterCard International Incorporated, MasterCard Europe SpA and UK MasterCard licensees, who were not MMF members, were also all parties to the agreement.

<sup>3</sup> The Decision only concerns UK domestic transactions made using MasterCard branded consumer credit and charge cards. It does not concern, and makes no findings, in respect of MasterCard branded business cards (corporate credit and charge cards).

<sup>4</sup> Part 9 of the Enterprise Act places limits on the information that can be included in this paper.

<sup>5</sup> The BRC is the trade association of the retail industry and represents more than 90 per cent of the total retail trade in the UK.

- 1.6 On 25 September 2001, the OFT issued a first notice to MasterCard setting out its objections to the MMF MIF agreement. Subsequent notices of OFT objections were sent on 11 February 2003 and 10 November 2004.
- 1.7 The OFT's Decision takes into account the representations and submissions made to the OFT throughout this matter (including representations from third parties). All have been carefully considered by the OFT in reaching its conclusions.

## 2 A MULTILATERAL INTERCHANGE FEE

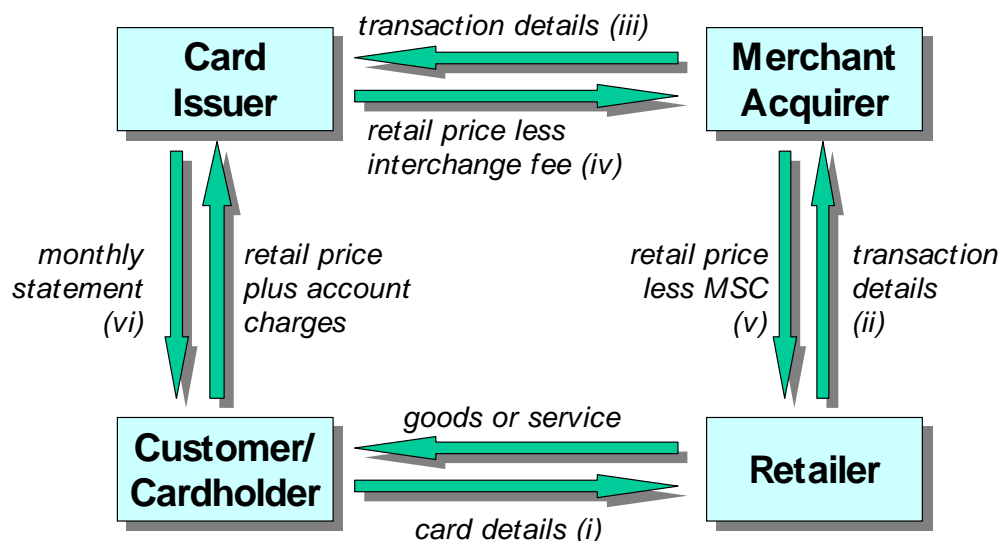
2.1 As illustrated in the diagram below, when a customer purchases goods or services using a credit or charge card, there are typically four parties involved:

- the customer/cardholder
- the merchant
- the bank that issued the credit or charge card, known as the 'issuer', and
- the bank that acts for the merchant, known as the 'acquirer'.

2.2 For each transaction the following steps will normally take place:

- (i) the cardholder agrees to pay the merchant for the relevant good or service, the card details are checked and the transaction authorised
- (ii) the merchant sends transaction details to the acquirer
- (iii) the acquirer in turn forwards transaction details to the issuer
- (iv) the issuer pays the acquirer the retail price less an *interchange fee*
- (v) the acquirer pays the merchant the retail price less a *merchant service charge (MSC)*, and
- (vi) the issuer debits the retail price to the cardholder's account.

## Typical Credit or Charge Card Transaction



- 2.3 In particular, the acquirer has to pay an *interchange fee* to the issuer for each transaction made using a credit or charge card. For example, suppose Mr Jones has a credit card issued by bank J. When he buys a TV set that costs £1,000, the merchant's bank, bank R, receives information from the merchant which it passes to bank J. Bank J pays to Bank R £1,000, less the interchange fee. Bank R then pays to the merchant the price less its MSC. For the purposes of illustration, if the interchange fee were 1 per cent and the MSC were 2 per cent, Bank R would receive £990 (the price less the interchange fee) and the merchant would receive £980 (the price less the MSC). The MSC would therefore be £20 of which £10 would be the interchange fee retained by Bank J.
- 2.4 This case concerns an *agreement* binding participants in the MasterCard scheme (including all the major UK financial institutions) on the level of a *multilateral interchange fee* (ie: the MMF MIF). The MMF MIF is a collectively agreed fallback interchange fee that applied when members otherwise failed to agree on the level of the fee bilaterally. Between 1 March 2000 and 18 November 2004, bilateral arrangements on interchange fees were virtually non-existent in the MasterCard scheme and the interchange fee which applied to MasterCard transactions was, almost without exception, the MMF MIF.
- 2.5 Interchange fees are among the most frequently paid prices in the UK economy. In 2004, purchases in the UK paid for using credit and charge cards were worth £122.8

billion, with £42.7 billion spent using MasterCard cards.<sup>6</sup> An interchange fee was charged on each of these transactions as a percentage of total transaction value. In practice, MasterCard cards are accepted by virtually all merchants that accept any variety of credit card.

- 2.6 MasterCard does not publish the MMF MIF and we do not consider that it would be appropriate for the OFT to do so, but the MasterCard European intra-regional MIFs are published on the MasterCard's website. For the most common category of transaction (non-chip electronic) the European intra-regional MIF is 0.95 per cent.

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<sup>6</sup> *APACS Plastic Card Review 2005*, Table 4B.

### 3 THE OFT'S POSITION

#### The legal test that the OFT has applied

3.1 The OFT's Decision has considered whether the MMF MIF agreement infringes the prohibition in Article 81 and the Chapter I prohibition. In deciding that the MMF MIF agreement does infringe these prohibitions, the OFT has considered two principal questions:

- does the agreement create an appreciable restriction of competition?
- if so, does it nevertheless meet all of the conditions, contained in Article 81(3) of the EC Treaty and section 9 of the Competition Act, for an exemption from the prohibitions?

3.2 The MMF MIF agreement will meet the Article 81(3) and section 9 exemption conditions only if:

- (i) it contributes to improving production or distribution, or to promoting technical or economic progress
- (ii) it allows consumers a fair share of the resulting benefit
- (iii) restrictions created by the agreement are indispensable to the attainment of those objectives, and
- (iv) the overall agreement does not afford the possibility of eliminating competition in a substantial part of the products concerned.

#### The OFT's conclusions

##### Competition

3.3 On the first question above, the OFT has concluded that the MMF MIF agreement created an appreciable restriction of competition in two ways.

3.4 First, it deterred Parties from entering bilateral agreements, meaning that there was little or no competition between them on the level of interchange fees while the MMF MIF agreement was in place. The MMF MIF acted as a price floor on the level of MSCs charged by acquirers to merchants (as a significant proportion of the MSC charged to most merchants<sup>7</sup>). In order for acquirers to make a profit on MasterCard

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<sup>7</sup> The OFT estimates that between 2001 and 2003, the MMF MIF, on average, accounted for 80 per cent of the level of the MSC.

transactions, MSCs must be set at a level which enables acquirers to recover the cost of the interchange fee applicable to that transaction from merchants. Accordingly, as long as the MMF MIF agreement was in place, no acquirer would set an MSC at less than the MMF MIF. Consequently, the MMF MIF agreement significantly restricted the scope for acquirers to compete on price by reducing the level of MSCs.

- 3.5 Secondly, the MMF MIF agreement resulted in parties recovering, through the MMF MIF, costs of services provided which are not integral to the operation of the MasterCard scheme as a viable payment transmission mechanism (such as the costs of providing an interest free period). The costs of these services are referred to in the Decision as 'extraneous costs'. Recovering extraneous costs through the MMF MIF resulted in acquirers paying a higher MMF MIF to issuers than would otherwise have been paid. This further distorted competition between acquirers by uniformly raising the common price floor for the MSCs charged by acquirers to merchants, thereby reducing their ability to compete on the amount that they charge to merchants. The higher MMF MIF was passed on by acquirers to merchants through higher MSCs. Merchants generally recouped these higher MSCs by increasing the retail prices charged to all consumers, including those consumers who did not use MasterCard cards. Therefore, the effect of a higher MMF MIF, caused by the recovery of extraneous costs, was ultimately like the imposition a 'tax' on merchants in the form of higher MSCs and on all consumers in the form of higher retail prices.
- 3.6 The recovery of extraneous costs through the MMF MIF generated extra interchange revenue for issuers (including major banks) each time a transaction was made using their cards, and gave them the incentive to fund inducements for cardholders (such as loyalty schemes and interest free-periods), to encourage cardholders to use MasterCard cards instead of other payment methods (such as cash or debit cards). Receipt of the additional revenue and the provision of inducements to cardholders distorted competition between the MasterCard scheme and other payment systems.
- 3.7 It also distorted competition between issuers within the MasterCard scheme in two ways. First, if MasterCard issuers had had to recover from cardholders the full costs of extending credit to them, rather than recovering some of those costs through the MMF MIF, then it is likely that they would have competed more in relation to the prices (eg: interest rates or annual fees) that they charged to cardholders. Secondly, the extra revenue from a higher MMF MIF meant that cardholders spending more on MasterCard cards, whether or not they used them for borrowing, were more attractive to issuers than would otherwise have been the case.

#### Potential benefits of a MIF

- 3.8 On the second question at paragraph 3.1 above, the OFT recognises that a collective agreement setting a multilateral interchange fee could produce benefits for consumers.

- 3.9 Payment card networks, such as the MasterCard scheme, provide a useful means of payment for consumers in the UK. An important feature of credit and charge card schemes, such as the MasterCard scheme, is that cardholders know that their cards will be accepted by any merchant that participates in the scheme. This universal acceptance makes MasterCard credit cards more useful to cardholders. However, it also means that merchants cannot select which issuers' cards they will accept. Therefore, every acquirer in the scheme must potentially deal with every issuer. In the absence of a MMF MIF agreement, any new issuer or acquirer joining the MasterCard scheme would have to agree an interchange fee with every existing acquirer or issuer, which although possible, would be relatively more difficult and costly.
- 3.10 In its Decision, the OFT accepts that the MMF MIF agreement would have increased the ease, and reduced the costs, of entry into the MasterCard scheme. This would benefit consumers, while at the same time allowing cardholders the certainty that their cards would be accepted by all participating merchants. The OFT accepts also that the MMF MIF agreement would have reduced transaction costs as compared to a situation where every acquirer and issuer had to come to agreements on interchange fees bilaterally.
- 3.11 The OFT accepts that, in principle, a collective agreement on the level of a multilateral interchange fee could benefit consumers and satisfy all exemption conditions *if* set at an appropriate level. The MMF MIF could have satisfied all exemption conditions if set at a level no greater than the costs of the *payment transmission* services (such as the costs of processing transactions) incurred by issuers.
- 3.12 However, because the MMF MIF was used as a vehicle for the recovery of *extraneous costs*, the Decision concludes that it was not set at an appropriate level and did not satisfy all exemption conditions.
- 3.13 Specifically, because the MMF MIF agreement resulted in the recovery of extraneous costs through the MMF MIF, this meant that the MMF MIF was set at a higher level than it would be *without* this agreement. Because of this:
- (i) Consumers did not receive a fair share of any benefits arising from the MMF MIF agreement. This is because merchants had to pay unduly high MSCs which were in turn recovered from their customers through higher retail prices.
  - (ii) The distortion of competition created by the inclusion of extraneous costs in the MMF MIF (see paragraph 3.5) was not necessary for the achievement of the benefits outlined in paragraph 3.7.

## 4 THE IMPACT ON CONSUMERS

- 4.1 Because the MMF MIF was unduly high between 1 March 2000 and 18 November 2004 this resulted in a transfer of money from merchants to issuers via acquirers. Since merchants generally had to recover the cost of higher MSCs arising from the MMF MIF through higher retail prices, consumers ultimately funded this transfer. In general, it is relatively rare for merchants to charge different prices for transactions paid for using credit cards rather than other payment methods. All consumers, regardless of whether they use MasterCard cards, faced higher retail prices resulting from an inflated MMF MIF.
  
- 4.2 Certain consumers may have benefited from this transfer of money to the extent that issuers used some of their income from the MMF MIF to fund benefits such as reward points and interest-free credit on balances that are cleared at the end of the month. However, many consumers do not receive such benefits, but were forced, as a result of the MMF MIF agreement, to subsidise those who do. In particular, consumers on lower incomes or with a poor credit history may lack access to credit cards, but would still have had to bear some of the costs of the MMF MIF through higher retail prices charged by merchants that accepted MasterCard cards.

## 5 CONCLUSION

### Consequences of, and next steps arising from, this Decision

- 5.1 Where the OFT decides that there has been an infringement of Article 81 or the Chapter I prohibition, it has the power to issue such directions as it considers appropriate to bring the infringement to an end<sup>8</sup> and to require undertakings party to the infringement to pay financial penalties.<sup>9</sup> Because the MMF MIF agreement, to which the OFT's Decision relates, has ended, the question of whether to give directions in respect of this agreement does not arise. In addition, having regard to all the circumstances of the case, the OFT has determined that it is not appropriate to impose a penalty on the parties to the MMF MIF agreement.
- 5.2 MasterCard and interested third parties have the right to challenge the OFT's Decision by bringing an appeal before the Competition Appeals Tribunal.<sup>10</sup>
- 5.3 From 18 November 2004, MasterCard introduced new arrangements for setting interchange fees that apply to UK MasterCard transactions. The OFT has concerns that under the new arrangements the interchange fee applying to UK transactions may still be set with reference to extraneous costs and used to recover these costs. The OFT expects to start an investigation into the new arrangements for setting the fallback interchange fee applying to UK MasterCard transactions unless this concern is addressed by MasterCard.

### Future action on credit markets

- 5.4 The OFT has identified credit markets as a key priority area on which it will focus particular attention in the 2005-06 to 2007-08 business years. Where the OFT applies competition law to other interchange fee arrangements, it expects to do so in a manner consistent with the OFT's Decision.
- 5.5 As part of its work in this area, the OFT is currently investigating the method of setting the interchange fee charged on transactions made in the UK using *Visa* cards. The OFT intends to reach its preliminary conclusions in this investigation shortly.

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<sup>8</sup> Section 32 of the Competition Act.

<sup>9</sup> Section 36(1) of the Competition Act.

<sup>10</sup> Sections 46 and 47 of the Competition Act.