

MasterCard interchange fees

Preliminary conclusions

February 2003

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SUMMARY

- The Office of Fair Trading (the OFT) has reached a preliminary conclusion that an agreement between MasterCard's UK members on a common fee charged on transactions made in the UK by credit and charge cards infringes the Competition Act 1998.
- In particular, the OFT believes that the agreement leads to an unjustifiably high fee being paid to card issuing banks on every transaction made by a MasterCard credit or charge card in the UK. The cost of these fees is borne initially by retailers' banks, but is passed on to retailers and, in turn, to consumers through higher retail prices. In effect, these fees act like a tax on retail transactions that is paid by all consumers in shops that accept credit cards. This results in higher retail prices for UK consumers.
- The OFT is giving MasterCard a further opportunity either to justify the existing agreement, or to come forward with changes to the agreement so that it will meet the conditions for an exemption under the Competition Act. If MasterCard fails to do either, the OFT expects that it will take a decision in the spring of 2003 that will require MasterCard to bring its infringement of the Competition Act to an end.

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1 INTRODUCTION

- 1.1 The OFT has today issued a Notice to MasterCard UK Members Forum Limited,¹ setting out its preliminary conclusion that an agreement between MasterCard members on a common fee charged on transactions made in the UK by credit and charge cards infringes the Competition Act 1998. The agreement concerns a fee known as the 'multilateral interchange fee' (or 'MIF').
- 1.2 This paper explains what a multilateral interchange fee is, outlines the reasons for the OFT's preliminary conclusion and sets out the possible next steps in this case.²

¹ Formerly known as MasterCard/Europay UK Limited.

² Sections 55 and 56 of the Competition Act place limits on the information that can be included in this paper.

2 THE MULTILATERAL INTERCHANGE FEE

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

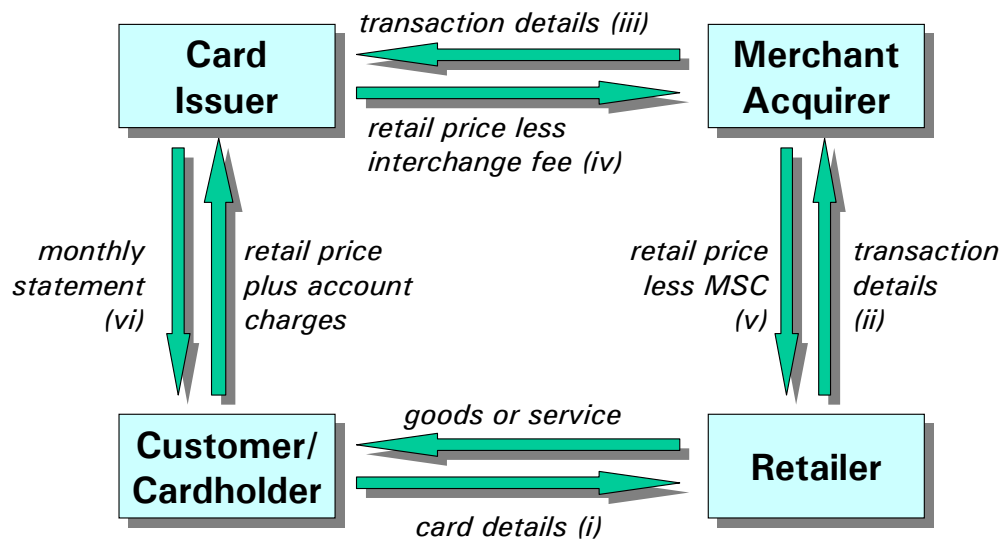
- the customer/cardholder
- the retailer
- the bank that issued the credit or charge card, known as the 'card issuer', and
- the bank that acts for the retailer, known as the 'merchant acquirer'.

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

- 1 the cardholder agrees to pay the retailer for the relevant good or service, the card details are checked and the transaction authorised
- 2 the retailer sends transaction details to the merchant acquirer
- 3 the merchant acquirer in turn forwards transaction details to the card issuer
- 4 the card issuer pays the merchant acquirer the retail price less an **interchange fee**
- 5 the merchant acquirer pays the retailer the retail price less the **merchant service charge (MSC)**, and
- 6 the card issuer debits the retail price to the cardholder's account.

DIAGRAM 2.1

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 retailer's bank, bank R, receives information from the retailer which it passes to bank J. Bank J pays to Bank R £1,000, less the interchange fee. Bank R then pays to the retailer the price less its MSC. For the purposes of illustration, if the interchange fee was one per cent and the MSC was two per cent, Bank R would receive £990 (the price less the interchange fee) and the retailer 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** between members of the MasterCard scheme (effectively all the major UK financial institutions) on the level of a **multilateral interchange fee** (the 'MIF'). The MIF is a fallback level for the interchange fee that applies when members fail to agree on the level of the fee bilaterally. However, in the UK, bilateral arrangements are rare and the interchange fee used is nearly always the MIF.³
- 2.5 The sums at stake are very significant. In 2001, purchases in the UK paid for using credit and charge cards were worth £94 billion, with £30 billion spent using MasterCard branded cards.⁴
- 2.6 According to the Cruickshank report published in 2000, the average MIF for MasterCard credit and charge card transactions was 1.1 per cent of the transaction value.⁵

³ It has been estimated that the MIF applies in over 90 per cent of transactions, see *Competition in UK Banking*, ('the Cruickshank report'), HM Treasury, March 2000, paragraph D3.48.

⁴ APACS, *Plastic Card Review 2002*, Table 4B.

⁵ *Competition in UK Banking*, Table D3.6.

3 THE OFT'S POSITION

The legal test OFT must apply

3.1 The OFT has considered whether the MIF agreement infringes the prohibition on anti-competitive agreements contained in Section 2 of the Competition Act (known as the 'Chapter I prohibition'). In deciding whether the MIF agreement infringes this prohibition, the OFT has had to consider two principal questions:

- whether the agreement creates an appreciable restriction of competition within the UK, and
- if it does, whether it nevertheless meets the conditions for an exemption from the prohibition.

3.2 An exemption can be granted if the agreement contributes to improving production or distribution, or to promoting technical or economic progress, and it allows consumers a fair share of the resulting benefit. Any restrictions created by the agreement must be indispensable to the attainment of those objectives, and the overall agreement must not afford the possibility of eliminating competition in a substantial part of the products concerned.

OFT's preliminary conclusions

COMPETITION

3.3 On the first question above, the OFT's preliminary conclusion is that the MIF agreement creates an appreciable restriction of competition. It removes incentives for the parties to enter into bilateral agreements, which can be expected to mean that there will be little or no competition between them over the level of the interchange fee.⁶

3.4 In addition, this fixed fee places a floor on the level of the MSC charged by merchant acquirers to retailers. The MSC has to cover the MIF in order for merchant acquirers to make a profit, so no merchant acquirer would be willing to reduce the level of its MSC below the MIF. The MIF

⁶ See also footnote 3 above.

is a significant proportion of the MSC charged to most retailers.⁷ Consequently, the MIF agreement significantly restricts the scope for merchant acquirers to compete on price by reducing the level of their MSCs. This leads to higher MSCs which will be passed on to consumers through higher retail prices.

POTENTIAL BENEFITS OF A MIF

- 3.5 On the second question at paragraph 3.1 above, the OFT recognises that having an agreement on a fallback level for the MIF can produce benefits for consumers.
- 3.6 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 MasterCard is that cardholders know that their cards will be accepted by any retailer that participates in the scheme. This universal acceptance makes MasterCard payment cards more useful to cardholders. However, it also means that retailers cannot select which issuers' cards they will accept, and so every merchant acquirer in the scheme must potentially deal with every card issuer. In the absence of a MIF agreement, any new card issuer or merchant acquirer joining the MasterCard scheme would have to agree an interchange fee with every existing merchant acquirer or issuer, which would be difficult and costly.
- 3.7 In particular, the new entrant would be in a very weak bargaining position, since it could not join the scheme unless it agrees an interchange fee with every potential counterparty. In the absence of an agreement on a fallback MIF, existing members would be able to exploit this bargaining power at the expense of potential new members, who might then be deterred from joining the scheme.
- 3.8 The fallback MIF, if set at an appropriate level, could therefore allow for more new entry and competition between members banks. This would benefit consumers, while at the same time allowing cardholders the certainty that their cards will be accepted by all participating retailers.

⁷ The MIF accounts for between 66 per cent and 80 per cent of the MSC according to Datamonitor, *The Future of Interchange*, (BFFS0156) October 2002, p.12.

3.9 For this reason, the OFT accepts that, in principle, an agreement on the level of the MIF could benefit consumers and qualify for an exemption from the Chapter I prohibition.

PRELIMINARY CONCLUSIONS ON THE MASTERCARD MIF

3.10 In order to grant an exemption, however, the OFT must be satisfied that the agreement meets all the tests set out in the Competition Act (see paragraph 3.2 above).

3.11 In order to meet these tests the OFT would need to be satisfied that the commonly agreed MIF has not been set at too high a level. If the MIF is set at too high a level it will fail these tests because:

- consumers will not receive a fair share of the benefits. This is because retailers will have to pay unduly high MSCs which will in turn be passed on to their customers who will face higher retail prices, and
- the agreement will create an unnecessary restriction of competition. The higher the MIF, the less scope there will be for merchant acquirers to compete by reducing the level of their MSCs (see paragraph 3.4 above).

3.12 The OFT's preliminary conclusion is that MasterCard has not justified the level at which it has set its MIF. The OFT accepts that the MIF could be justified if it was set at a level which covered the costs of the **payment system services** which issuers provide to merchant acquirers and retailers. These payment system costs would include the costs of processing transactions, for example. However, the MasterCard MIF has been set a level much higher than these costs.

3.13 MasterCard has in the past stated that the MIF has been set at a level that covers also the costs of:

- funding an interest-free period for those consumers who receive one (generally those who clear their balance at the end of the month), and
- providing a 'payment guarantee', where the card issuer guarantees to cover the costs of fraudulent use of credit cards.⁸

⁸ *Competition in UK Banking*, paragraphs D3.78 to D3.82.

3.14 The OFT considers that an agreement to charge a MIF designed to cover these costs would not qualify for exemption under the Competition Act because:

- the **interest-free period** is not part of the payment system services provided to retailers. Interest-free credit is a service provided by card issuers directly to individual cardholders. (In fact many cardholders do not receive this benefit: the large proportion of cardholders who do not clear their balances each month generally do not receive any interest-free credit.) If, rather than credit terms being a matter between issuers and cardholders, the cost of the interest-free period is instead included in the calculation of the MIF, this will lead to higher retail prices, which will be paid by all consumers, including the many customers who do not use credit cards or receive interest-free credit. These consumers should not be forced to subsidise the provision of interest-free credit to those who benefit from it.
- while retailers benefit from a **payment guarantee** against the costs of fraudulent use of credit cards, it is not clear why this service has to be bundled together with other payment system services. Retailers could be given a choice as to whether they purchase this guarantee from the scheme, purchase it from other potential providers, such as insurers, or self-insure against this risk. The bundling together of these services would appear to be an unnecessary restriction of competition.

4 THE IMPACT ON CONSUMERS

- 4.1 An unjustifiably high MIF results in a transfer of money from retailers to card issuers. Since retailers will have to recover this cost through higher retail prices, it is consumers who ultimately fund this transfer. In general, very few retailers charge different prices for transactions paid for using credit cards rather than other payment methods. So all consumers, whether they use credit cards or not, face the higher retail prices that result from an inflated MIF.
- 4.2 Certain consumers may to some extent benefit from this transfer of money, if card issuers use part of their income from the MIF to fund benefits such as interest-free credit on balances that are cleared at the end of the month. However, many consumers do not receive these benefits, but they are forced to subsidise those who do. In particular, consumers on lower incomes or with a poor credit history may lack access to credit cards, but still have to bear some of the costs of the MIF through higher retail prices.
- 4.3 In summary, the MIF acts like a tax on retail transactions that is paid by all consumers in shops that accept credit cards. This results in higher retail prices for UK consumers. Certain cardholders may benefit to some extent from the revenues generated, but virtually all consumers will face higher retail prices as a result.

5 RECENT EUROPEAN COMMISSION DECISION

- 5.1 The European Commission has recently published a decision⁹ on the agreement between members of Visa International on the MIF paid for **cross-border** transactions within the EEA (e.g. the MIF paid when a customer uses a card issued in Germany to purchase goods at a retailer in France). In that case the Commission has granted an exemption under Article 81 of the EC Treaty, the equivalent provision in European Community law to the Chapter I prohibition.
- 5.2 While there are some similarities between the two cases, and the OFT has studied carefully relevant parts of the Commission's decision, that decision relates solely to cross-border and not to domestic transactions. Consequently, much of the analysis and reasoning that led the Commission to grant an exemption is not relevant when examining a MIF for domestic transactions, such as the MasterCard MIF. In addition, Visa International made a number of changes to its MIF agreement which ensured that it qualifies for exemption. Nevertheless, there are many points where the OFT has reached preliminary conclusions which are similar to the Commission's. For example, both have concluded that MIF agreements create an appreciable restriction of competition, that competition from other payment methods (such as cheques) will not prevent the MIF from being set at an excessive level, and that these agreements can qualify for exemption only if the level of the MIF can be justified.

⁹ Case no. Comp/29.373 – **Visa International – Multilateral Interchange Fee**, decision of 24 July 2002; OJ L 318/17, 22.11.2002.

6 OFT'S FUTURE ROLE IN RELATION TO PAYMENT

SYSTEMS

- 6.1 In his November 2002 pre-budget report the Chancellor of the Exchequer confirmed that the government will introduce legislation to give the OFT new powers to promote effective competition in payment systems as soon as parliamentary time allows.
- 6.2 The exact scope of the OFT's new role has yet to be finalised, and will be determined by Parliament. However, the action the OFT is taking at present under the Competition Act is separate from any future role the OFT may acquire as payment systems regulator. The OFT is enforcing the existing law.

7 PROCESS AND NEXT STEPS

- 7.1 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 MIF agreement. On 1 September 2000, the British Retail Consortium¹⁰ made a complaint to the OFT against MasterCard and the other UK payment card schemes focusing in particular on the setting of the MIF.
- 7.2 On 25 September 2001, the OFT issued a first Notice to MasterCard setting out its initial findings on why the current MasterCard MIF agreement appears to infringe the Competition Act. At the beginning of 2002, MasterCard and other interested parties made representations (in writing and orally) to the OFT.
- 7.3 Subsequently, on 24 July 2002, the European Commission made its decision on its Visa International case, which was published on 22 November 2002, and which the OFT has studied carefully.
- 7.4 The Notice issued today takes into account the representations referred to at paragraph 7.2 above, all the subsequent submissions of the parties, and the European Commission's Visa International MIF decision, to the extent that it is relevant. MasterCard now has the opportunity to comment on this Notice before the OFT takes any final decision.
- 7.5 The OFT is at the same time inviting MasterCard to modify its agreement on the MIF to satisfy the conditions for exemption as set out in the Competition Act. If MasterCard proposes a modified MIF agreement which complies with the Competition Act by fulfilling the criteria for exemption, the OFT will consult publicly before issuing an exemption decision. In the absence of any such proposal or new justification for the existing agreement by MasterCard, the OFT intends to make an infringement decision that reflects its preliminary conclusions.
- 7.6 MasterCard and interested third parties have the right to challenge an OFT decision by bringing an appeal before the Competition Commission Appeal Tribunal.

¹⁰ 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.

8 CONCLUSION

- 8.1 The OFT has reached the preliminary conclusion that the existing agreement between MasterCard members to charge a common MIF infringes the Competition Act. In particular, the level at which the commonly agreed MIF is set results in UK consumers paying higher retail prices.
- 8.2 The OFT is inviting MasterCard to make further representations on the OFT's preliminary conclusions. It has the opportunity either to show that its existing agreement on the level of the MIF complies with the Competition Act, or to come forward with changes to the agreement so that it meets the conditions for an exemption under the Competition Act.
- 8.3 If MasterCard fails either to justify its agreement or to make necessary changes, the OFT expects that it will take a decision in the spring of 2003 that will require MasterCard to bring this infringement of the Competition Act to an end.