Interim Report on Payment Cards and Payment Systems

The Norwegian Ministry of Finance finds your interim report dated April 12th 2006 on Payment Cards interesting. Both your analysis and your conclusions are in line with our own findings based on a Norwegian report from 2004. Below we briefly address some of the main obstacles to workable competition in the markets for Visa and Mastercards. We also point to some alternative public measures. We look forward to your final report by the end of 2006.

In Norway the high fees paid by merchants and the high profitability for the banking system from international cards, contrasts to the low fees and profitability from the domestic debit card scheme BankAxept. Even though the international systems involves both cross boarder transactions and the extension of credit, the differences in fees and profitability from domestic schemes seem striking.

The use of international cards as a means of payment is largely decided by the cardholders. They decide what cards to hold and when to use them rather than for example cash or national debit cards. From a welfare perspective it is not only important that the overall level of fees and profitability is kept low. It is also important that the relative costs of different means of payment are reflected in the relative prices paid by card users. It would therefore be useful to discuss the public regulation of a (low) cap on fees paid by merchants (or interchange fees paid from acquiring banks to issuing banks). Any additional fees would then have to be charged directly to cardholders.

The competition seems to be workable between banks issuing international cards to card users. As noted in your report, the acquiring side is however much more concentrated. Also in Norway this side of the market is dominated by a bank owned joint venture that handles both Visa and Mastercard.

Adding to the problem with concentration, the collectively determined interchange fee that must be paid from the acquirer to the issuer, represent a threshold to the fees that can be offered to merchants. Even if “outside” acquirers (owned by non-banks or foreign banks) were to compete fiercely for merchants, the effect on the merchant fees would therefore be limited.

Given that interchange fees are needed, it does seem reasonable that they are set collectively. The transaction costs would be prohibitive if every possible pair of issuing and acquiring banks should enter into bilateral agreements. At least this seems to be the case with respect to cross boarder use of cards. *However*, as noted in your report acquiring banks in most countries cover their costs even without the interchange fee. If the interchange fees were to be reduced or eliminated one should expect the loss of revenue for the banking system to be *partly* offset by an increase in fees charged by card issuers to card users.

As in other industries where the suppliers simultaneously compete for end users and exchange network services between each other, the pricing of “interchange” will strongly influence the price paid by end users. When allowed to set interchange fees collectively and unregulated, one should therefore expect high fees unless there are competing networks or schemes. The reason why the interchange fees flows from acquirers to issuers of cards rather than the other way, is mainly because it is easier to pass on the cost of the interchange fee to merchants than to card user. The high revenues from the interchange fees do probably to some extent strengthen the competition for card users, but obviously without dissipating much of the profits in the issuing business.

Competition between card schemes could in principle have disciplined the setting of interchange fees within each scheme. In practise such interbrand competition seems to be seriously hampered by the fact that most banks issues both Visa and Mastercard (and often other cards as well), and that the bank owned joint ventures acquires the same two brands. The incentive for competition between schemes seems almost negligible, and this is supported by the observation of widespread *blending* where the fees for MasterCard and Visa are set at (more or less) identical and high levels.

The so called non-discrimination rule (NDR) prevents merchants from passing on their fees to card users. An argument for allowing the use of NDR seems to be that very little passing on would be likely to occur anyway. But if this is the case, then there should also be little need for the NDR. We submit that if NDR were abolished and the banking system perceived the risk of merchants passing their fees on to card users as real, this could dampen the incentive for the banking system to set high interchange fees. The reason is that card users are more sensitive to fees than merchants. We encourage the Commission to look deeper into this possible alternative to direct regulation of the interchange fee (possibly to zero).

We also encourage the Commission to look closer at structural impediments to interbrand competition. MasterCard and Visa seems to be close substitutes both for card users and merchants, and it is therefore not obvious why any single issuer or acquirer should need to offer both cards to its customers. A market structure where both issuers and acquirers dealt with one brand only, and where for example Visa issuers had ownership stakes in Visa acquirers only, may be more favourable to interbrand competition. Also reserving the acquiring business for non-banks may be an alternative that deserves to be explored.

Finally we invite the Commission to bring the existence of three party systems such as American Express more explicitly in to the analysis. This scheme may in principle exert strong competitive pressure one both Visa and Mastercard. For similar reasons as explained above, the actual competition may however be seriously limited.

Yours H:\Direction-D\D-1_forum\Sector Enquiry\Payment Cards\INTERIM REPORT - replies\Norway\E-post til Kommisjonen.docsincerely

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