Preserving interchange: from explicit to implicit MIF

A bold concept to resolve the current impasse over interchange

The collective setting of interchange fees is interpreted by many competition authorities as collective price fixing. It is argued that the collectively set interchange fee is used to set a minimum price on the acquiring side of the market.

By Malte Krueger and Christoph Strauch

These concerns have led to regulatory regimes which favour a kind of cost-based interchange, implying in practice a reduction in interchange rates. Examples are the decisions by Spanish regulators and by the Reserve Bank of Australia. The recent MasterCard ruling by the European Commission, however, seems to be more serious threat against interchange in general.

The Commission sees interchange as a price for services rendered by issuers to acquirers. This price could be, in theory, negotiated bilaterally. If it is fixed collectively for all issuers and acquirers, this does, indeed, look like a "restrictive business practice," in violation of Article 81 of the Treaty of Rome.

It is well known, however, that this argument is not accepted by everybody. In particular, there is a large body of theoretical literature which suggests that interchange should not be interpreted as a price. The Commission apparently rejects these arguments in favour of a focus on the economic outcome of interchange, namely a "floor under the MSC."

Since the non-confidential version of the MasterCard decision has not yet been published, the Commission's precise arguments are not known. Judging from the first explanations given, it will be very difficult indeed, to meet the conditions for an exemption as set out in Article 81 (3) of the Treaty of Rome, provided, of course, the ruling is approved by the European Court of Justice.

So, what can be done to save MIF – or at least the desirable effect of a MIF, namely to bring both market sides in balance to an efficient outcome? We propose a method of setting a MIF which should be in accordance with the principles of the Treaty of Rome – no collective price setting and thus no violation of Article 81 – and which will hopefully provide a better outcome by increasing competition.

We propose calling this new type of MIF "implicit MIF" in contrast to the current explicitly-changed MIF. We argue neither that current MIFs are optimally set nor that the methodology currently employed by the card organizations is the best possible.

The implicit MIF is introduced through implementation of the new role of an 'interchange trader' which undertakes commercial responsibility for negotiating individual fees with each issuer and acquirer, and receives income from the spread. The respective fees paid by acquirers and paid to issuers may be considered as an 'implicit interchange,' although there will be no direct flow of fees from an acquirer to an issuer and the fees are not uniformly set.

Moving from an explicit to an implicit interchange fee would make it much easier to defend the principle of interchange against anti-trust concerns. With the implementation of the role of an interchange trader, the traditional 4-party card schemes are transformed into 5-party schemes. In the following, we will argue that current 4-party payment systems already can be interpreted as 5-party systems and that a
few alterations in their organization would make their 5-party character more explicit.

**Implicit MIF In 5-party schemes**

Card payment systems are usually classified as 3-party or 4-party systems. In 3-party systems, a single institution serves as issuer and acquirer. In 4-party systems, a large number of institutions serve as issuers and/or acquirers. Some systems may require participants to be active on both sides of the market. However, this is not an essential ingredient of 4-party systems. MasterCard and Visa include institutions which offer only acquiring services, whereas others offer only issuing services and some are active as issuers and acquirers.

In addition to the four parties mentioned, 4-party systems are employing a fifth party with responsibility for:
- licensing and management of the brand;
- setting and supervision of the rules, and
- provision of central switching, clearing and settlement services.

In order to be able to perform these functions, the card organization levies charges on issuers and acquirers, including membership, assessment and processing fees. The card organization does not, however, pay or receive interchange fees. The term ‘4-party system’ reflects the fact that the fifth party is only providing the platform but is not commercially involved in delivery of payment services through the platform.

These interchange fees are typically paid from acquirers to issuers. As a rule, interchange fees are set by the card organization, collectively by its members. The collectively set interchange fees apply to all issuers and all acquirers. This is interpreted by the Commission, and other authorities, as setting a common floor for merchant service charges. Thus, according to this view, a minimum price is fixed collectively.

Competition authorities are believed to have no issues with a fee paid from acquirers to issuers, provided that the fee is bilaterally negotiated between each pair of issuers and acquirers.

Clearly, it is not practical to negotiate individual interchange fees bilaterally between each pair of issuers and acquirers because of the large number of bilateral relationships – and it would also be inefficient, given the small bilateral volumes. The straightforward way to overcome such an ugly constellation is to bundle volumes via the use of ‘traders.’

To implement the role of a trader would mean to introduce a player which negotiates ‘interchange fees’ separately on both sides with full commercial responsibility. More explicitly, the ‘interchange trader’ would, on the one side of the market, negotiate an individual price with each acquirer for presenting transactions and, on the other side, negotiate a remuneration with each issuer individually for honouring all presented transactions. As usual, the trader would earn revenue from the spread between average prices on both sides.

Naturally, but not necessarily, the role of the trader would be taken over by the card organizations. This would transform the traditional 4-party systems into 5-party systems, where the fifth party is really participating in the business rather than only providing a platform. Of course, this model will require some changes in the commercial relationships between issuers, the card scheme and acquirers and the commercial structure of entire systems.

Some straightforward implications are that acquirers would no longer pay an interchange fee directly to the issuer for handling transactions. They just would pay the agreed fee to the trader, who might be the card organization. On the other side, issuers would receive the agreed fee from the trader for honouring all presented transactions.

In this case, there no longer would be an explicit flow based on a uniform interchange fee. There simply would be two prices, one paid by acquirers and one paid to issuers. Of course, the business model includes an implicit interchange fee: the part of the acquiring fee that the card organization passes on to issuers.

A fraction of the acquiring fee, the ‘spread,’ is retained by the card organization. Note that the card organization is not primarily interested in the level of interchange but in spread income (i.e. spread times volume). Accordingly, there would be plenty of room for the interchange trader to develop the market further through negotiating special rates to provide incentives for particular sectors, countries, or technologies. On the other side, issuers and acquirers would compete with each other to produce the best value for the system in order to get the most attractive rates from the trader.

To what extent changes in existing structures are required – for example, liabilities and provision of the payment guarantee – or whether the commercial model can be implemented based on changes in the fee structure only is believed to be of no relevance with regard to the anti-trust concerns. For ease of implementation we would prefer a pure commercial solution.

**Business consequences**

Under the new set-up, it would be much more difficult to argue that implicit interchange constitutes a restrictive business practice. After all, one company, on behalf of its role as interchange trader, simply sets a price for its services and another price for its inputs – just as a manufacturer of shoes charges wholesalers a price X per shoe and pays suppliers a price Y for leather.

Of course, it could still be the case that this company has market power. However, the proper indicator of market power would be the spread, and
the profits it implied, not the level of interchange.

Such a re-organization of business models may provide a way for card schemes to retain the desired economic effect of interchange.

One should, however, not make the mistake of seeing this move as merely cosmetic. Once the schemes, as interchange traders, are the commercially responsible counterparty for issuers and acquirers – receiving the entire acquirer fee and paying out the entire issuer fee, there will be incentives for negotiating differentiated rates and maximizing the profit potential of the spread.

It can be expected that very large issuers will get better deals than small issuers and very large acquirers will get better deals than small ones. In fact, schemes may be tempted to contract with large merchants directly – opening the way for 'self-acquiring'.

Thus a range of acquirer fees and a range of issuer fees would emerge. In this case, the implicit interchange fee will be a weighted average of all fees.

A vision only?

Some of these trends can already be observed: this approach can hardly be implemented in interbank organizations where customers are also shareholders. Also, this approach is in obvious conflict with the traditional 'not for profit' basis of card organizations. But incorporation of the card schemes helps fulfill the basic prerequisites. Thus, the explicit move towards a 5-party system would only accelerate tendencies which gained momentum with the incorporation of MasterCard in 2006.

As an incorporated company, MasterCard has already become a more active ‘5th party.’ Its strong capital base allows it to lure issuers with special incentives or large merchants or entire sectors with lower rates.

It can also be observed that a 3-party scheme like American Express is issuing cards through bank partners. Even if these cards legally are issued by Amex and the bank only serves as distribution partner, the commercial model is not far from the one mentioned above because the bank gets a volume-based commission from Amex.

The 3-party organizations are in a position to take the direct way to a 5-party system, not needing the detour through the 4-party model as BankAmericard did with Visa and regional American banks did with the Interbank Card Association, now MasterCard.

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