

# Conference Overview: Issues to be Raised

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A number of issues will be covered during this conference: the definition of interchange fee, the market parties involved, and the role of public authorities.

## **DEFINITION OF INTERCHANGE FEES**

Interchange fees have been the focus of much debate recently. To stimulate and enhance the discussion on the subject, I will start with highlighting the basic concept of interchange fees. Conceptual clarification is needed because for countries and market parties involved, definitions and perceptions may be different. Roughly speaking, the interchange fee is between issuer and acquirer, in either direction, for compensation of cost incurred while providing payment services to the client of the other.

The interesting point about interchange fees is they are not directly paid by the end user of the payment service, but between competitors. This leads to a number of questions.

A crucial question is whether the interchange fee influences behavior of the end user. In general, the two-sided market theory provides a framework to analyze this. In the literature, a two-sided market is defined as a market in which one intermediary deals directly with two involved customer groups. In this case, those two customer groups are cardholders and merchants. The intermediary can be, for example, a credit card company. The choice of which payment instrument to use in a certain transaction depends on both merchant and cardholder. In theory, both parties calculate costs and benefits of different alternatives to pay and choose that payment instrument where the benefit outweighs the cost. Cardholders pay fixed fees and/or transaction fees, while their benefits are, roughly speaking, of a qualitative nature. Their benefits include safety, availability, and ease of use. For merchants the costs are fixed investments, fixed periodic fees, and transaction fees. The benefits for merchants also include

whether a payment is guaranteed or not and a strategic motive that accepting cards may lead to additional sales and customers.

When for one side of the transaction the benefits do not outweigh the costs, it is possible to influence this situation by lowering the fee or improving the service level. An interchange fee can be used for this purpose. So, in theory, in a two-sided market, the total cost can be distributed over two sides. This means that the volume of transactions not only depends on the level of total cost but also on the *distribution of cost* over the two sides. A message of the theory of two-sided markets is that the socially optimal transaction volume may not be realized without an interchange fee.

In practice, it is hard for consumers to make this cost-benefit calculation. In this respect, it is interesting to note that a consumer survey conducted by a Dutch retailer association revealed that consumers seem to be relatively insensitive to the surcharging of debit card payments done by some retailers in the Netherlands. On the other hand, Dutch consumers do not seem to be aware of the payments costs, because they only pay a fixed annual fee for their debit card. As a consequence, consumers are not interested in costs and benefits at the level of an individual transaction. Would knowledge of the costs for merchants and other parties involved change cardholders' payment behavior? Or are other factors, for instance national payment culture and institutional traditions, more important?

## **MARKET PARTIES INVOLVED**

Another topic where practice is even more complex than theory about interchange fees is the involvement of other market parties. In addition to the payer, merchant, issuer, and acquirer bank, there are other parties (for example, network operators) on regional, national, and international levels, and other parties such as independent ATM deployers and suppliers of equipment used, for instance providers of terminals. All these market parties have an interest in realizing a smooth and safe payment process besides profit maximization or cost saving. That another distribution of costs can change a loss into a profit is shown in the example of the U.K.'s Halifax Bank of Scotland. For almost a decade, the majority of banks in western Europe have been struggling to squeeze any profit from their ATM activities, and many are running them at cost at best. Recently, the Halifax Bank of Scotland sold its "non-core" ATMs to Cardpoint, a U.K.-based independent ATM deployer. Cardpoint said it will introduce direct charges to the cardholder to make this service profitable.

In order to decide whether interchange fees can be used as an instrument by banks and nonbanks, their incentives must be structured correctly. In this light, the question can be raised whether and how nonbanks' participation in the payments system can contribute to overall efficiency. Also, attention could be paid to the possible effects of the technological developments in the payments sector on interchange fees, for example, the introduction of the Windows-based control software for ATMs or a future coupling of ATMs to public networks such as the Internet. To answer these questions, more empirical data on the specific market structure and parties is needed.

### **ROLE FOR PUBLIC AUTHORITIES**

I now come to my third issue. What is or should be the role for public authorities with regard to interchange fees? This is a topical but difficult and sensitive question. In each country, there are several public policy objectives. One public policy objective is promoting competition. Another is safe and smooth operating payments system. Ideally, the right balance of these objectives would be struck.

In this perspective, the Dutch case is interesting. On April 28, 2004, the Dutch competition authority fined Interpay and its shareholders, eight Dutch banks, for violation of the Dutch Competition Law. Interpay is the Dutch automated clearinghouse for retail payments that also operates the network for switching debit card transactions. Interpay was fined 30 million for excessive charging of network services for online debit card transactions. The shareholder banks were fined 17 million for cooperation in acquiring through Interpay and thereby eliminating competition in acquiring. Interpay and the banks have appealed against this ruling because, in their minds, the interchange fee is only one of the components of the total costs of a payment.

The Dutch central bank, DNB, is convinced that cooperation between banks in providing payment services remains necessary to some extent. The Netherlands disposes a relatively cost-efficient payments system, which can, at least in part, be attributed to successful cooperation between banks. In a two-sided market, cooperation up to some level can be beneficial and may lead to an increased efficiency and optimal social cost. It does not seem desirable, for instance, that all banks develop their own payment infrastructures and instruments that are not interoperable. That may well be detrimental to both the consumer and the merchant because network externalities and economies of scale may then be lost. In the end, the objective is to

reduce social cost and improve efficiency of the payments system. An incorporation of this objective in the approach of the competition authorities also may contribute. In the Netherlands, efficiency is included in the mandate of the competition authority. The issue is what kind of criteria should be used to assess efficiency. At the moment, the competition authority and the central bank are engaged in a constructive and open dialogue in order to reach an agreement on how to work toward this common objective.

## **CONCLUSION**

The issues of interchange fees are complex, and there are a lot of parties involved—all with their own interests. On top of that, defining and promoting the public interest is not easy. This conference will address the objectives of the public authorities and may lead to answers on questions of which situations they can or should interfere in and how this can be done best. In organizing this conference, the Federal Reserve Bank of Kansas City has brought the various parties involved together in an environment where views can be exchanged. I look forward to a fruitful discussion.