

€-KONOMICA'S NEWSLETTER #7

APRIL 2005

The Spanish Tribunal rejects bank commissions on credit cards.

Juan Briones.

On 11th April, the Spanish Tribunal for the Defence of Competition (TDC) has rejected the authorization asked by Spanish banks for the collective fixing of interchange fees (IF) the issuing bank charges to the merchant bank for processing a credit card transaction.

The decision is unique in the EU, since VISA International obtained clearance from the Commission for cross border transactions with credit cards, and banks have obtained clearance for domestic IF charges in a number of national jurisdictions.

The IF rate sets a floor for the commission the merchant bank will charge the commerce¹ for a sale paid for with a credit card.

The economic interests at stake are obvious: according to the TDC decisions, the transaction volumes with credit cards is estimated at 10% of aggregate private consumption in Spain, and well over 6% of GDP.

This means that if total yearly household consumption is 563 billion euros in Spain, **the annual transfer of funds from consumers and the commercial sector to the financial sector can be conservatively estimated in the range 500-1500 million euros. This is without taking into account commissions charged to consumers for the issuing of the credit cards and for interests charged on delayed payments.**

The European Commission authorised VISA INTERNATIONAL an IF rate of 0,7% of the value of the purchase, on the consideration that this amount reflects actual costs incurred to process a cross border transaction with a credit card. In Spain, IF rates have been within a range of

¹ E-konomica advised commercial establishments and their associations in this procedure.

a minimum of 0.85% and a maximum of 2,75% of the value of the purchase. Bearing in mind that generally, international financial services are more expensive than the equivalent domestic service, the surcharge that the collective fixing of the IF has imposed on consumers and on the commerce in Spain is measured in thousands of million euros.

¿Why has the Spanish TDC reject the bank's application for clearance and request them to refrain from applying collectively fixed rates as from July 15th?

The economic reasoning of the TDC.

The text of the decisions of the TDC are extremely interesting because of their detailed economic reasoning and because the TDC makes explicit its assessment of the different economic studies presented by each side, identifying them by name (NERA, Ernst & Young y AT Kearney on the bank's side and E-konomica on the side of commercial establishments and their associations).

The theory of bilateral markets.

The advisors to the banks had put forward that four-party payment systems constitute so called bilateral markets, in which an IF cannot be considered a price of a banking commission, but just an efficient economic mechanism to assign a higher proportion of costs to the more inelastic side of demand (i.e. the commerce). Thereby, the usage of credit cards is maximized.

The TDC emphatically rejects the application of the bilateral market theory to the case at stake. The TDC argues that the collective fixing of a price (bank commission) is such a serious restriction of competition that it can only be authorised on the basis of efficiency considerations if the price adequately reflects costs.

The TDC draws a distinction between the mere existence and invocation of an economic theoretical model and the conditions under which it may be applied to analyse a particular competition case. The burden of proof to show the relevance of the model to the case lies on the parties.

The formula to reduce the IF rates in the next years.

The banks had proposed to reduce progressively the IF rates in the next years according to a mathematical formula purported to be objective and transparent in so far as it was a mathematical one.

The TDC has nevertheless considered that the formula was not objective or transparent, in as much as it contained a logarithmic element designed to minimize the impact of the rate reduction on total banking income from credit cards.

A close examination of the formula revealed that the only the rates applied to the smallest commercial establishments in terms of turnover would be reduced to any significant extent. The rates applied to the largest establishments would in fact remain at the same level. Thus, it was difficult, as e-konomica argued, to link the rate reduction to actual reduction in costs.

VISA's 0,7% IF rate.

VISA INTERNATIONAL presented evidence to show that the cost of processing a cross border credit card transaction represented 0,7% of the value of the purchase. This constitutes naturally a reference or benchmark for the cost of any domestic transaction. The banks argued that international credit card transactions are not a valid reference because they only constitute "marginal" operations.

But quite naturally, any individual operation with a credit card is marginal, in the sense that it constitutes an operation at the margin, independently of the way individual operations are grouped over a year according to different concepts.

The TDC emphatically rejects the argument, and retains the 0,7% rate as a valid reference for estimating costs. It even tends to consider the 0,7% as a ceiling on any domestic rate, since international banking services are as a rule more expensive than their domestic equivalent, and in particular bank transfers².

Cost calculation and incentives for inefficiency.

Two studies carried out by accountancy firms showed that the IF rates applied by Spanish banks were cost oriented. Costs were in both studies calculated as average cost for an anonymous sample of banks for identified categories of cost components.

Firstly, the TDC rejects the pertinence of ex-post cost studies to justify a particular level of the IF rate. Logically, the TDC considers that only cost studies carried out before the rates were fixed, and precisely in order to ascertain a proper cost measure to fix the IF rate.

Secondly, the reported costs show a very high variance across banks. Therefore, to calculate costs by reference to the sample average, even if weighted by volume of transactions or other appropriate variable, necessarily includes an element to remunerate bank cost inefficiency that the TDC does not accept. It would indeed lead to more cost efficient rates to remove from the sample those banks with the highest costs for each cost concept. These banks "inflate" the average cost, and if prices are

² E-konomica presented a statistical study based on a representative sample of Spanish banks for a representative basket of bank services to prove the point.

fixed by reference to the average cost, cost inefficiency is somehow artificially remunerated.

Conclusion.

The decisions of the TDC are of highest interest, not only because of the importance of the economic stakes or because it deviates from the usual practice in the EU.

The decisions also deal at length with the type of assessment the TDC carries out with respect to economic studies and economic argumentation, and it is crystal clear on a number of points, in particular with regard to the evidence it considers inadmissible.

You may download previous issues of this newsletter from www.e-konomica.net,