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In this note, I offer a few brief observations on the European Commission's recent decision with respect to MasterCard's policy of setting default values for Intra-EEA and Single Euro Payments Area (SEPA) interchange fees, which apply in the absence of bilateral agreements between issuers and acquirers.[1]

The fundamental logic of the European Commission's approach was the following: MasterCard's setting of default interchange rates constitutes a price-fixing agreement by or on behalf of MasterCard member banks ("the banks … 'outsourced' the co-ordination of their competitive behaviour to an independent body"[2]) that "restricts competition between acquiring banks by inflating the base on which acquiring banks set

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[1] Commission Decision 19/XII/2007 of 19 December 2007, Cases COMP/34.579 MasterCard, COMP/36.518 EuroCommerce, and COMP/38.580 Commercial Cards (not yet reported) [hereinafter Commission MC Decision], *available at* http://ec.europa.eu/comm/competition/antitrust/cases/decisions/34579/provisional_nc_decision.pdf (provisional non-confidential version). My review of this matter consists solely of reading this version and is not intended to be comprehensive.

[2] *Id.* at para. 99.

charges to merchants."[3] Because it constitutes a price-fixing agreement, the conduct must be shown by MasterCard to satisfy four conditions in order not to be found illegal.[4] The Commission found that MasterCard failed to meet its evidentiary burdens with respect to any of the first three conditions and, thus, that its policy of setting interchange fees is illegal.

Before addressing the core of this argument, I observe in passing that the Commission's characterization of the harm to competition is, on its face, a bit surprising. One might have expected the Commission to conclude that the default interchange rates restricted competition among card-issuing banks in bargaining with acquiring banks. Perhaps the Commission was concerned that card issuing banks do not compete with one another in reaching agreements with acquiring banks because—as discussed in the pages that follow—under MasterCard's rules an acquirer cannot choose to transact with some MasterCard issuers but not others. Or perhaps the Commission was concerned that it would have found it difficult to establish that most acquirers were harmed by the process.[5] There are conditions under which acquiring banks' customers are harmed by issuer price-fixing even if the acquirers are not, but this framing of the problem would have given prominence to the fact that the acquiring banks supported the policy, which

[3] *Id.* at para. 2.

[4] The legal process and standards are briefly summarized at *id.* at paras. 666-67.

[5] *See id.* at §7.2.5.1 stating that acquiring banks supported increases in the default interchange rates. The Decision identifies the reason as being that: "Acquirers expect that some issuers 'invest' a portion of their revenues from the [default interchange fee] in promoting further card usage which in turn may lead to some increases of transaction volume at merchant outlets." (*Id.* at para. 499.)

suggests that it made the relevant payment networks more attractive to merchants and increased system transaction volume.[6]

Turning to the central argument, consider the question of whether MasterCard's setting of default interchange fees constituted price-fixing. A first issue is whether or how setting *default* rates can fix prices. One reason might be that the default levels serve as focal points or coordination devices for issuers engaged in bargaining with acquirers. However, to the extent that issuers and acquirers have the option of privately or secretly negotiating bilateral agreements, one would typically expect coordination to break down because it would be difficult for issuers to monitor one another's compliance with the implicit agreement to maintain interchange fees at their default levels.

The presence of the honor-all-issuers rule provides a more plausible explanation of the power of default rates. The MasterCard system imposes the Honor All Cards Rule, which "obliges merchants to accept all valid MasterCard and Maestro branded cards and transactions equally and without discrimination according to the type of card used and the bank issuing the card."[7] Call the requirement that the merchant accept all issuers' cards equally the "honor-all-issuers" rule. In the presence of this rule, an issuer may have little

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[6] The Commission also concluded that the default interchange policy could disadvantage entrant acquiring banks in certain circumstances. (*Id.* at para. 415.) However, the mechanism for harm appears to be that incumbent issuers and acquirers may through bilateral negotiations reach terms that are more favorable to the incumbent acquirers than those a new acquirer would be able to negotiate. Specifically, the Commission assumes the entrant would have to pay the default rate. The differential bargaining abilities would seem to be as much a problem with bilateral negotiations as with alleged price-fixing.

An alternative theory would be that acquiring banks benefited from interchange fee increases because these banks then raised their charges to merchants by more than 100 percent of the interchange fee increases. This theory was not raised by the Commission and does not appear to be supported by the factual record summarized in the decision. (*See id.* at §7.2.3.1.3 [incorrectly numbered in the original document as 7.3.2.1.3] parts (a) through (e) for the limited data available.)

[7] *Id.* at 8 (Glossary).

incentive to agree to an interchange rate below the default level because an acquirer must either accept that issuer's cards (even absent a bilateral agreement) or forgo acquiring any MasterCard transaction.[8,9]

A second issue in determining whether MasterCard was engaged in price-fixing is what effect the organizational structure of MasterCard has on the analysis. The Commission concluded that, even though MasterCard has become a publicly traded, for-profit corporation, MasterCard's interchange fee setting constitutes a "collective exercise of market power by member banks."[10] Although member banks have retained governance rights beyond those possessed by a typical supplier's customers,[11] the existence of those governance rights does not appear to lie at the heart of the Commission's concern. Instead, the Commission stated that:

> MasterCard's member banks still share a common interest as regards the [default interchange rate] because it yields guaranteed revenues for their issuing business. […] In setting interchange fee rates the Global Board cannot ignore the commercial interests of the banks without whom the system would not function, because it yields guaranteed revenues for their issuing business.[12]

This statement merits three comments. First, to the extent that different banks are engaged in issuing and acquiring activities to differing degrees, these banks have a common interest in the overall success of the payment network, but they also have conflicting interests, with issuers likely preferring higher interchange fees than acquirers,

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[8] This is not to say that an issuer has no incentive to negotiate. There may be other dimensions of the issuer-acquirer relationship that create opportunities for mutually beneficial give-and-take.

[9] MasterCard itself identifies the honor-all-issuers rule as giving issuing banks a very strong bargaining position. (Commission MC Decision, *supra* note 1, at para. 536.)

[10] *Id.* at para. 523.

[11] MasterCard's member banks choose three of the 12 voting directors on MasterCard Incorporated's Global Board. (*Id.* at para. 72.)

[12] *Id.* at para. 3.

ceteris paribus. Second, the fact that its Global Board has to take into account the commercial interests of its customers does nothing to distinguish MasterCard from *any* economically rational supplier. Third, and related, there is a lack of a limiting principle. If this quotation indeed summarizes the Commission's basis for its conclusion, then the Commission should also conclude, for example, that every newspaper is engaged in price-fixing that restricts competition in the industries whose suppliers purchase advertising from that newspaper. This conclusion would follow, in part, on the grounds that: (a) readers have a common interest in high advertising rates because such rates lower the equilibrium subscription price; and (b) the newspaper cannot afford to ignore the commercial interests of its readers.[13]

To explore further the question of whether a payment network's determining interchange fees constitutes price-fixing when the network is not directly governed by the issuing and acquiring banks, it is helpful to introduce a few pieces of notation. Let t denote the interchange fee, measured as the flow of money from the acquirer to the issuer. Let w_A denote the (switch) fee that the payment network charges an acquirer when the network processes a transaction involving that institution. And let w_I denote the (switch) fee that the payment network charges an issuer when the network processes a transaction involving that institution. The net price paid by an acquirer for a transaction over this network is then $w_A + t$, and the net price paid by an issuer for a transaction is

[13] Perhaps the quotation does not do the Commission analysis justice. Unfortunately, almost all of the discussion of the evidence that led the Commission to reach its conclusion regarding the relationship between MasterCard and its member banks has been redacted from the public version of the decision. (*See id.* at §2.1.4.)

$w_I - t$.[14] Fundamental economic logic indicates that network transaction volume, the prices charged by issuers and acquirers to their customers, and network profits all can be expressed as functions of the *net* prices to acquirers and issuers, ceteris paribus.

The table below illustrates the important fact that, in general, knowing the value of *t* alone tells one nothing about the net prices acquirers and issuers face for using a network. As shown by the first two rows, identical interchange fees can be associated with very different net prices. And, as shown by the first and third rows, a positive interchange fee and a zero interchange fee can give rise to identical net acquirer and issuer fees.

w_A	t	w_I	Net price to acquirers	Net price to issuers
0.5%	1.0%	0.5%	1.5%	–0.5%
1.0%	1.0%	0.0%	2.0%	–1.0%
1.5%	0.0%	–0.5%	1.5%	–0.5%

More generally, if the network is free to choose its issuer and acquirer switch fees, then the level of the interchange fee is irrelevant in the sense that, for any value of *t,* the network can set w_A and w_I to obtain any pair of net prices desired and the same resulting

[14] In practice, interchange fees and switch fees are calculated as various combinations of flat per-transaction fees and fees levied as percentages of the transaction value. Allowing for more realistic situations would complicate the notation but would not change the fundamental point that switch fees can act as substitutes for interchange fees.

network revenue per transaction.[15] Hence, to be consistent, the Commission would have to consider a network's setting prices such as those in the third row of the table to be price-fixing.[16]

Would there be a principled basis for reaching such a conclusion? If the network also imposed a rule that banned issuing and acquiring banks from bargaining over payments between one another, then one might reach such a conclusion because the network would be explicitly restricting the competitive actions of issuing and acquiring banks in dealing with one another. But MasterCard's current interchange policy sets a default interchange rate, which is equivalent to setting the issuer and acquirer fees to replicate the effects of the default interchange rate and then allowing issuers and acquirers to engage in bilateral negotiations over their own interchange rates. However, MasterCard imposes an honor-all-issuers rule, which implies that an issuer would have little incentive to agree to pay an interchange fee to an acquirer, which is what would be necessary to undo the effects of issuer and acquirer switch fees that were set at levels that replicate current interchange arrangements.

Thus, there might be concern that, in practice, the effective interchange rate would be set by the network rather than through bilateral bargaining between issuers and acquirers. That said, public policy would have to allow the network to set at least some

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[15] Given interchange level t and desired net prices α and β, the network can always solve $w_A + t = \alpha$ and $w_I - t = \beta$ and earn revenues of $\alpha + \beta$ per transaction.

[16] One might try to argue that, rather than price-fixing, negative switch fees constitute predatory pricing. One would then have to answer the question: predatory against whom? The most natural candidates would be rival payment networks, but it would make no sense to evaluate the predatory effects of below-cost pricing to one side of the market without evaluating the effects on the other side of the market. To do otherwise would be to assert that all advertising-supported media, for example, are engaged in predatory pricing.

fees at non-zero levels, if for no other reason than that it would go out of business if unable to cover its costs. And difficult issues arise in determining where to draw the line between price-fixing and competitive network pricing in response to rivalry from other payment networks. Would the payment network in question be engaged in price-fixing whenever one side of the market was charged a fee that was negative or below some measure of cost? Such a policy would run counter to the fundamental lessons learned from the economics of two-sided markets.[17] Or would a network only be found guilty of fixing prices for one side of the market if it charged prices to the other side of the market that were above a threshold determined by an, as yet, unidentified principle?

A central piece of reasoning underlying the Commission's conclusion that MasterCard's fee-setting constituted price-fixing was the claim that, if MasterCard did not set default interchange rates, then interchange rates would be lower (indeed, falling to zero in the long run) and acquirers would lower their charges to merchants.[18] In the presence of the honor-all-issuers rule, there are strong reasons to doubt this assertion if the but-for world is one of bilateral negotiations between issuers and acquirers.[19]

The following hypothetical illustrates why. Suppose that there were no default interchange rates, but the honor-all-issuers rule remained in effect. Suppose further that an issuing bank with relatively few cardholders made the following speech to an acquiring bank:

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[17] For an overview of the relevant literature, *see* J.-C. Rochet & J. Tirole, *Two-Sided Markets: A Progress Report*, 37(3) RAND J. ECON. 645-67 (2006).

[18] *See, e.g.,* Commission MC Decision, *supra* note 1, at paras. 448 & 460.

[19] There are also reasons to doubt that interchange fees would fall to zero in the long run even if there was not an honor-all-issuers rule.

> We have a small customer base, so you will almost never encounter one of our customers. When you do, however, you have to agree to pay us a very high interchange fee for the transaction. If you don't agree to deal with us, you will be in violation of the honor-all-issuers rule and, consequently, will be thrown out of the network entirely. Because we are such a small part of the total, it is worth paying this money to us rather than being thrown out of the system.

If many issuers successfully argue this way, the average interchange fee could rise above the existing level.

The Commission recognized this concern and, at one point in the decision, provides a more complete specification of its but-for world:

> [T]he possibility that some issuing banks might hold up acquirers who are bound by the [honor-all-issuers rule] could be solved by a network rule that is less restrictive of competition than MasterCard's current solution that, by default, a certain level of interchange fee applies. The alternative solution would be a rule that imposes a prohibition on ex-post pricing on the banks in the absence of a bilateral agreement between them. The rule would oblige the creditor bank to accept any payment validly entered into the system by a debtor bank while prohibiting each bank from charging the other bank in the absence of a bilateral agreement on the level of such charges.[20]

In other words, the Commission's but-for world contains a solution that, by default, a certain level of interchange fee applies. The difference from MasterCard's current solution is that the default level is zero. To the extent that MasterCard's current policy constitutes a restriction of competition, so does the Commission's proposed policy.[21] Despite the identical forms of the two solutions, the decision asserts that the Commission's solution is somehow "less restrictive of competition."[22]

It seems, then, that the Commission's objection is not to network price-fixing, but to a positive interchange fee. This view is reinforced by the fact that the decision

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[20] Commission MC Decision, *supra* note 1, at para. 554 (footnote omitted).

[21] This point was put to the Commission by MasterCard. (*Id.* at para. 539.)

[22] *Id.* at para. 554.

expresses concern that "MasterCard's [setting of an interchange fee] has become an "(artificial) element of inter-system competition."[23] Elsewhere, the decision states that the interchange fee is "artificial" because it provides incentives for issuers to promote use of the network.[24] One could, however, imagine reaching the very different conclusion that pricing to promote the sale of one's product or service is the essence of competition. Although is does not say so explicitly, the Commission apparently does not accept the fundamental workings of two-sided markets and appears to be against competition if it raises merchant fees regardless of the fact that that competition benefit cardholders.

Now, consider the Commission's finding with respect to whether MasterCard's interchange agreement satisfies the first three of the four exemption conditions. The Commission's treatment of two of the conditions was closely related, and I will focus on those conditions.[25] The conditions were "that the agreement (a) contributes to improving the production or distribution of goods or to promoting technical or economic progress (b) while allowing consumers a fair share of the benefits."[26] The Commission interpreted condition (b) as a requirement that MasterCard prove that both merchants and households benefit from the restrictive agreement. The Commission apparently accepted that card users benefit but not that merchants (and, presumably, non-card-using consumers) do.

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[23] *Id.* at para. 486.

[24] *Id.* at para. 494.

[25] The third condition was that the agreement not impose restrictions unless they are indispensable to attainment of the agreement's objectives. (*Id.* at para. 666.) The Commission found that "MasterCard has not proven to the requisite standard that its current [interchange fee] is indeed indispensable to maximize system output and to achieve any related objective efficiencies." (*Id.* at para. 751.) This position is a bit odd given that elsewhere the decision expressed concern that MasterCard's network is displacing other networks *because* of MasterCard's interchange fees. (*Id.* at §7.2.4.3.)

[26] *Id.* at para. 666.

Observe the following implication of the fact that the Commission believes the restrictive agreement benefits card users: eliminating the restrictive agreement will harm consumers. So if the sole element of the logic is that a change must benefit everyone, one could argue against removing the restrictive agreement. Stated another way, neither situation Pareto dominates the other.

Of course, in comparing the situations with and without the restrictive agreement, a standard response is to apply an overarching principle by which more-competitive outcomes are preferred to less-competitive outcomes. There are, however, at least two issues with relying on this (generally sound) principle to justify the Commission's decision in this matter. First, as just described, the Commission's own but-for world entails MasterCard's setting prices in a way that, by the Commission's logic, restricts competition. Second, the decision repeatedly expresses doubts about the efficacy of competition in credit and debit card markets. Specifically, the decision repeatedly voices concern that inter-system competition raises interchange rates.[27]

Given that neither outcome Pareto dominates the other nor can be said to be less restrictive than the other, one might reasonably—at least from a social welfare, if not legal, perspective—ask which outcome promotes greater total or consumer surplus. Although the Commission apparently favors an interchange rate of zero, there is no economic theorem implying that such a level is preferable to the fee currently set by

[27] *See id.* at §7.2.4.

MasterCard. Two sets of findings from the theoretical literature on interchange fees are relevant.[28]

First, the network switch fees and interchange rates that maximize total surplus depend on demand conditions as well as costs. Moreover, even with constant unit costs, the prices that maximize total surplus generally are below cost. This set of findings indicates that it is difficult to identify and/or implement socially optimal prices.

The second set of findings concern whether privately owned payment networks have economic incentives to set efficient prices. The theoretical literature demonstrates that the prices that maximize either network profits or a weighted average of acquirer and issuer profits generally diverge from the total-surplus-maximizing prices, and the explicit or implicit interchange rate may be higher or lower than is socially optimal. That said, there are reasons to believe that privately set interchange rates will tend to be socially excessive and to encourage excessive card use.[29]

The Commission itself summarized this state of affairs as follows: "whether [an interchange fee] should be paid by acquirers to issuers or *vice versa,* and whether it should be set at a certain amount or zero, cannot be determined in a general manner by economic *theory* alone."[30] (emphasis added)

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[28] Summaries of significant papers in the earlier literature are provided by M. Katz, Reform of Credit Card Schemes in Australia II, Report commissioned by the Reserve Bank of Australia (2001); and J.-C. Rochet, *The Theory of Interchange Fees: A Synthesis of Recent Contributions*, **2**(2) REV. NETWORK ECON. 97-124 (2003). *See also* J. Wright, *The Determinants of Optimal Interchange Fees in Payment Systems*, 52(1) J. INDUS. ECON. 1-26 (2004).

[29] *See* M. Katz, *What Do We Know about Interchange Fees and What Does It Mean for Public Policy?*" *in* INTERCHANGE FEES IN CREDIT AND DEBIT CARD INDUSTRIES: WHAT ROLE FOR PUBLIC AUTHORITIES? (Kansas City: Kansas City Federal Reserve, 2005).

[30] Commission MC Decision, *supra* note 1, at para. 690 (footnote omitted).

The decision does not provide empirical evidence indicating that an interchange rate of zero would be more efficient or more beneficial to merchants and consumers overall than would the default interchange rates that had been set by MasterCard. Similarly, at least as the record is characterized in the decision, MasterCard failed to demonstrate that the present interchange rates are superior to clearing at par. Thus, at least based on the record as summarized in the Commission's decision, it appears to be an open question whether setting the default rates at zero will raise or lower consumer welfare.