

"Remarks on Interchange Fees: Central Bank Perspectives and Options".

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Let me first say that I am delighted to be participating in this conference. Let me tell you a few things about the payments system and the question of interchange fees in Mexico. Mexico is a relevant case, not because the market is so big – and I am going to give you some numbers regarding the size and the characteristics of the market – but because I believe we are the first emerging market to actively be involved in the analysis of payment card regulation . Of course, the precedent of what we do will be important and this has attracted a great deal of interest on the part of the industry.

First, let me go through telling you how we got involved into this question. Then, I will make a diagnosis of how things are developing, I will talk about the steps we have taken so far, and finally, I will mention some of the preliminary lessons we have learned.

One of the Banco de México's mandates is to seek the proper functioning of payments systems like many other central banks, so we initially got involved in the development of high-value payments systems. In fact, we played a central role in developing an electronic large value payment system, a delivery versus payment clearing mechanisms and a nationwide clearing house for checks.

Regarding retail payments, our participation until recently was concentrated in developing a retail electronic system to allow payments in real time between bank account holders¹. Now we have developed a platform, which is big and powerful enough to do low-value payments at very, very small cost in real time. In fact, we are starting with this already.

The reason why we became more involved into other aspects of retail payments systems is that the Mexican congress passed a law² last year in reaction to continuous complaints about the level of bank commissions, particularly those related to retail payment systems. There is a widespread public perception that banks' commissions are too high. Those commissions not only pertain to fees charged on checks, payments, and so on, but also regarding credit card fees. Of course, interchange fees play a very important role here.

Let me give you just a few numbers and tell you about the situation in the payments card industry in Mexico. The main thing is that Mexico is still a very *undercarded* country. Of course, most retail payments are still done with cash and checks. Now that we have this platform for electronic transfers at very low cost we expect this to change rapidly. Nevertheless, the total number of cards in Mexico, although small, has been growing extremely fast. The number of credit cards has doubled

¹ SPEI.

² Law for the transparency and reordering of the financial services (*Ley para la Transparencia y Ordenamiento de los Servicios Financieros*), issued in January of 2004.

from 2001 to 2004 and debit cards are increasing over 20 percent per year in the last few years. Despite this, the use cards at POS is limited when compared with countries of similar development.

I don't want to go into a lot of detail with the numbers, but there are two or three basic things that we have noticed in looking at international comparisons.

One is that debit cards in Mexico are mostly utilized for ATMs, just for drawing cash. Also, the number of point of sale is low and the number of payment card transactions at POS is relatively limited. We have a general perception that the level of interchange fees in Mexico is high when you do international comparisons – even though I know it is very difficult to perform such comparisons. So we suspect that the high level of interchange fees has something to do with this situation.

Additionally, there are important barriers to entry for nonbanks in the payments card industry. Card associations are not allowing nonissuers to participate in the acquiring business and only banks are allowed to join the switches. The problem that we face goes much beyond the narrow question of interchange fees. It is a question of market structure, which is heavily concentrated in Mexico, both on the issuing and acquiring sides. It is a question of transparency. And it is a question of competition.

We look at this question of interchange fees as one aspect of the whole problem of developing a more competitive banking sector.

Through interchange fees, all banks are interconnected for the provision of card-payment services. This is organized around interchange fees charged on many different services, including credit and debit cards.

It is worth mentioning that interchange fees in Mexico are not determined by a platform of card associations, as in the majority of countries, but rather by banks through the Mexican banking association. The mechanism followed by banks to set interchange fees is only known to them. All banks are subject to the same interchange fee structure, but they are free to set their own merchant discount rates. Issuers are also free to set cardholders' benefits and commissions.

Until very recently, the interchange fee structure in Mexico³ was characterized by the same proportional interchange fee schedule for credit and debit card transactions at small merchants, which of course is very odd because there is a lot of risk associated with credit cards that is not involved in debit card purchases.

The same interchange fee schedule applies for all platforms. Therefore, there is no competition between them in terms of interchange fees.

³ Regarding transactions carried out at points of sale, there were and still are 2 interchange fee schedules for debit transactions and one for credit. In the case of transactions performed with credit cards, the scale is proportional (*ad valorem*). In the case of debit transactions, the first scale is proportional and was exactly the same used for credit sales; this is applied to transactions carried out at rather small merchants that do not belong to the Associations of Self Service and Department Stores (ANTAD). The second debit scale is a set of fixed fees (non-proportional), only applied to transactions performed at ANTAD merchants.

Also, interchange fees are based on merchants' volume of sales, rather than on the line of business. There is a strong discrimination of merchants that lack bargaining power.

The general perception was that the level of interchange fees was high for international standards, in particular those applied to debit transactions carried out by small merchants.

Finally, interchange fees had remained fixed for the last five years, despite the huge increase in the volume of transactions and the clear evidence that cost related to issuing had come down quite sharply in the last years.

From this very brief overview, it can be inferred that there is a general perception that consumers' commissions are high, that the card market is very concentrated at both issuing and acquiring, and despite its recent growth in electronic payments – including debit and credit cards – are still underdeveloped. There is also an imbalance, as I mentioned before, between the number of points of sale and the number of cards and between their number of debit cards and their use at points of sale.

When the laws were passed last year, we at the bank saw an opportunity to launch a real reform of the retail payment system. The general goal should be, of course, to increase disclosure and transparency in order to foster competition and to encourage the use of more efficient payments systems.

A point was made this morning regarding competition and regulation, which authority should do what, and what the role of the central bank should be in this matter. Congress took a very pragmatic approach, because it gave the Bank of México the power to regulate all payments systems, including interchange fees. Of course, the competition commission is ultimately charged with determining whether the system is competitive or not. The competition commission can act on its own behalf if there are complaints regarding the structure of competition. But we can proceed on our own, if we perceive that the payment system is not operating efficiently.

Let me tell you what we have been doing so far. I repeat, the objectives of the regulation are increasing transparency in order to foster competition and encouraging the use of more efficient payments systems.

Some strange things occur in Mexico. When we get together with the banks, they say, “Well, we are on the same wavelength as you are. We also want to encourage the use of more efficient payments systems.”

But if you look at the fees’ structure in one specific market segment, for instance checks versus electronic payments, the price structure that was prevailing was not encouraging the use of electronic transfers at all. So we got together with the banks’ association, we told them what we saw and they recognize that there was something wrong there; hence, they have agreed to revise their fee schedules. Despite these imbalances

in fee schedules, the more general point – and I will come to that later – is that we are not keen to regulate prices at the Bank of México.

Getting back to what we have done, we got together with the banks and made a general proposal to them to overhaul the retail payment systems, which included the regulation of some prices. Of course, we got a very strong reaction from the banks and the industry. So we went back and said, “Let’s analyze each retail payment independently. Let’s analyze, electronic transfers, ATMs, debit cards, and credit cards, and take each a step at a time.”

Then we asked a commission from the IMF, comprised of experts from Australia, the Netherlands, and so on, to come to advise us. We had a first diagnosis of the retail payments system in Mexico and then we have started a dialogue with the banks that has already produced some tangible results. It was mentioned before that in Australia this *voluntary* approach was not paying off. In our case, this *induced* voluntary approach is having a better reaction on the part of the industry.

As a consequence of this interaction, in the middle of 2004, we issued regulations to improve transparency and competition. The regulation required banks to disclose their fees to customers and to inform Banco de México in advance of any changes in their commissions. We also made it compulsory for banks to allow the

payments of credit balances through electronic transfers from any other bank.

We are studying additional measures to promote competition. Among them, we are analyzing eliminating restrictions to banks and nonbanks to enter the acquiring market. This is something quite important that the IMF mission pointed out to us.

We realize that it is not only the structure of fees, but the competitive structure what is lacking there. We need more industry participants. We need more participants on the acquiring side, hopefully non-banks, and we also need more participants on the issuers side, hopefully also non-banks. We are looking at these issues right now.

In order to enhance the use of more efficient systems, Banco de México made the honor-all-cards rule more flexible to allow the possibility of merchants accepting only debit cards. We are also promoting very, very keenly the adoption of chip-nip technology, to hamper fraud and thus further reduce interchange fees.

A related issue is that we are coordinating with the Ministry of Finance, which is engaged in a large program to subsidize the installment of points of sale, for tax transparency purposes. So the adoption of this chip-nip technology together with the effort of the treasury to have most of the transactions done by cards are our goals for a potentially very large development, particularly of debit cards.

Let me tell you what has happened since we took the steps that I mentioned. We have been having meetings with the industry regularly and have agreed to form a working group in which the banks will disclose, first, the mechanism of setting the interchange fees and they will provide the Bank of México a detailed cost structure, which are two elements of course that are important for this discussion.

Second, the banks have agreed unilaterally to reduce substantially interbank fees. They have already decreased the interchange fees for credit card by 43 basis points and 134 basis points for debit cards, making debit cheaper, as it should be. Additionally, the banks' association eliminated the highest bracket for proportional interchange fees and introduced several special categories based on retailers' line of business, increasing the system efficiency.

The Australian experience made evident that interchange fee reductions may not translate entirely into discount fees. This is a problem we are looking at. It also showed that cardholders' benefits may go down when a reduction in exchange fees takes place. It is too recent to judge the impact of these first steps in Mexico, but the banks have pretty much agreed together that the reduction of interchange fees will actually translate into an equivalent reduction in discount rates.

Let me conclude by telling you briefly some of the lessons that we have learned. The lessons, of course, are very much in the spirit of what we have heard this morning.

One is that interchange fee regulation is very complex, particularly because it is not obvious what the socially optimal fee should be.

Secondly, once financial authorities are convinced that interchange fees have to be shifted in a particular direction, it is better to do so through cooperation with industry participants. However, having a credible regulatory threat helps to keep all participants honest.

Thirdly, for interchange fee reduction to have an impact, authorities must have a mechanism to make sure that such reductions will be translated to discount rates.

Fourthly, central banks need to increase the resources directed to these areas, given their growing importance and complexity. In particular we should devote resources to empirical research.

Finally, authorities have to be aware that promoting and improving efficiency in retail payment systems is a long run continuous process.

Allow me to tell you that this has been a fascinating experience. I hadn't read any microeconomic texts for ages. I have been mostly worried about inflation targeting, monetary policy, and things like that. So when reading some of the papers for this conference, I became interested, and took my micro books out to learn about two-sided markets. So thank you again for giving me the opportunity to refresh some of my microeconomics. Intellectually, it is a pretty fascinating topic as an economist. Since we are combining the role of regulator now, I had better sharpen my skills in this.

As Tom was saying, we don't have to wait for an economic theory to produce general results that are applicable to policy decisions on a general basis. If we know, or we have high suspicions, that the industry is heavily concentrated, that there are barriers to entry, that commissions are too high, etc., without fixing prices, we can move in the right direction. We don't know exactly what the level of fees should be, but we know they should probably be lower just by looking at the data.

So we tell the banks, "I hate writing regulations. It is one of the most boring things that a central banker can do. If you don't want me to write these things, you do it on your own. You go back to the table and look at your own fee structures. These are the objectives that we have and we want to do it on cooperative basis. If you don't come up with something that makes sense to us, then we will have to sit down and write all these regulations, which puts us in a very mad mood, right?"

Let me conclude by thanking Tom again for all the reasons I have mentioned. It has been a privilege attending this conference. Of course, I never thought that people would get very excited about interchange fees until I had this experience. Thank you very much.