Preliminary and incomplete

The credit card industry in Israel

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Abstract: Since 1998, the Israeli credit card industry was transformed from a duopoly with two credit card companies which offer proprietary cards to a triopoly with two large open systems, Visa and Mastercard, which are issued and acquired by each of the three credit card companies. Regulatory intervention by the Israeli Antitrust Authority (IAA) played a key role in bringing about this structural change. In this paper we first review the Israeli credit card industry and then discuss in detail the regulatory intervention by the IAA.

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1. A brief history of the credit card industry in Israel

Until 1998, there were two main players in the Israeli credit cards industry: Isracard, which was established in 1975 and is 100% owned by the largest bank in Israel, Bank Hapoalim, and CAL which was established in 1978 and was jointly owned at the time by the second largest bank in Israel, Bank Leumi (65%), and the third largest bank, Israel Discount Bank (35%). Isracard issued its own brand of credit card, called Isracard, for domestic use in Israel, and Mastercard and American express card for use in Israel and abroad, while CAL issued both Visa cards, under the brand name Visa CAL, and Diners Club cards. Apart from the three largest banks, there are two additional large banks in Israel, United Mizrachi Bank and First International Bank of Israel (FIBI).[1] Both banks, as well as some other smaller banks, were authorized to issue Visa CAL cards to their clients, although Visa CAL was the sole acquirer of Visa cards.

Since 1998, the Israeli credit card industry was transformed from a duopoly with two credit card companies which offer proprietary cards to a triopoly with two large open systems, Visa and Mastercard, which are issued and acquired by each of the three credit card companies. The changes began when FIBI established a new credit card company, Alpha card, together with a large investment group (Aurek). Alpha Card started operating in July 1998 and offered its own brand of Visa card, called Visa Alpha. Despite reaching a market share of around 16% in the Visa market by the end of 1999, the new company incurred large losses and decided to exit the market in 2000.[2] Meanwhile, the supervisor of banks and the director of the Israeli Antitrust Authority (IAA) ordered Bank Leumi and the Israel Discount Bank (IDB) to dissolve their joint ownership of CAL, following Amendment No. 11 of the Israeli Bank Law

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[1] As of December 31, 2004, the respective market shares of Bank Hapoalim, Bank Leumi, Israel Discount Bank, United Mizrachi Bank, and FIBI, were 32.2%, 20.8%, 13.7%, 11.2%, and 7.8% in terms of credit to the public, and 29.8%, 25.6%, 17.6%, 10.7%, and 8.5%, in terms of deposits of the public. Apart from these five banks, there are additional 19 commercial banks in Israel with a combined market share of 14.3% in terms of credit to the public and 8.4% in terms of deposits of the public. For more details, see "Data on Israeli Banking System, Main Data on Banks for 31.12.04," http://www.bankisrael.gov.il/publeng/6-9eng/htm

[2] It is estimated that in 1999, there were around 245 thousand Visa Alpha cards, compared with 1.3 million Visa CAL

regarding the control of auxiliary corporations by banks.[3] Following this order, IDB bought Bank Leumi's share in CAL at February 2000 and shortly afterwards, brought new partners to CAL, including FIBI which acquired 20% of the shares of CAL. Currently, IDB's ownership share in CAL is 51%. The remaining 29% are held by a large investment group, the Fishman group (24%), and an insurance company, Harel Hamishmar (5%). Bank Leumi in turn established its own fully owned credit card company, Leumi card, and bought Alpha card's operational infrastructure. Alpha card's clients were sold to CAL. Leumi card began offering its brand of Visa cards, Visa Leumi, in 2001. Following these changes, there are currently three large credit card companies in the Israeli market: Isracard, CAL, and Leumi card.

In March 2001, the director of the IAA has instructed CAL and Leumi card to start issuing their own brands of Mastercards no later than August 1, 2001, and to start acquiring Mastercards no later than October 1, 2001. This instruction was one of the director's conditions for approving the interchange agreement between CAL and Leumi card regarding the acquisition of one another's Visa card transactions (as of September 2005 however, this agreement is still pending in the Court for Trade Restrictions). Meanwhile, Isracard has voluntarily decided to issue Visa cards as a means of coping with the entry of CAL and Leumi card into the Mastercard market.[4] As a result of these events, both the Visa

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cards (see Business Data Israel, 2000).

[3] In July 1998, the director of the IAA notified Bank Leumi and IDB that they should dissolve their joint ownership of CAL by the end of 1999, otherwise he would open an investigation. The director's claim was that the joint ownership was an illegal restraint of trade under Section 2 of the Israeli Antitrust Act (see Ora Koren, "Tadmor to Bank Leumi and Discount: You must dissolve the partership in Visa CAL by the end of 99'," Globes July 8, 1998 and Keren Tzuriel, "Banking sources: Tadmor threatened an investigation if the Visa CAL partnership is not dissolved," Globes, January, 18, 2001.

[4] See Dafna Tzuker and Smadar Hirsh, "Leumi Card and ICC issue Mastercard; Isracard began to issue Visa Cards," Globes, August 28, 2001; Judy Maltz, "Isracard is examining the issuing of Visa cards – in order to maintain its market position," Globes, January 16, 2000.

and the Mastercard systems became open systems which, at least in principle, have three issures and three acquirers operating in each system.

The IAA played a key role in bringing about the structural change in the Israeli credit card industry. In this paper we shall discuss this regulatory intervention in detail. We begin in Section 2 by reviewing the main characteristics of credit cards in Israel. We then proceed in Section 3 with a review of the current industry structure. In Section 4 we review the legal background for the structural changes that occurred in the credit card industry over the last few years.

There are two main legal grounds for the IAA's ability to force structural changes in the credit card industry. First, the Israeli antitrust law allows the director of the IAA to proclaim that a single firm will be seen as a monopolist. This proclamation allows the director to regulate this firm by imposing various restrictions on its activities or by issuing directives that are deemed necessary to prevent probable harm to competition or the public. In Section 4 we discuss the events that led the to the director’s proclamation of Isracard as a monopoly in acquiring the Isracard and Mastercard brands and the director’s justification for this proclamation. We also discuss the directives that the director intends to issue in order to ensure the opening of the Isracard and Mastercard brands to competition both in terms of issuing and acquiring.

The second legal ground for regulatory intervention in the Israeli credit card industry comes from the fact that interchange agreements are considered by the IAA as a restraint of trade, which according to the Israeli antitrust law, must be approved by the Court of Trade Restrictions or by the director of the IAA. In Section 5 of the paper we describe the legal process that took place before the Court of Trade Restrictions regarding the interchange agreement between the Visa companies.

In addition to the IAA’s ability to intervene in the credit card market by proclamation of monopoly and by imposing various restrictions as a condition for approving interchange agreements, there is a third legal ground for antitrust intervention in the credit card market. According to Section 29(a)(b)(1) of the Antitrust Act, a firm with a monopoly position is not allowed to charge unfair prices.

In Section 6 of the paper, we describe a class action of over 1 billion NIS that was brought against CAL, Leumi card, and Isracard, based mainly on this provision. Although the Supreme Court has eventually decided not to approve the class action, it left open the possibility that Section 29(a)(b)(1) will be used in the future to deal with excessive merchant fees.

2. The main characteristics of credit cards in Israel

Until recently, all credit cards in Israel were a hybrid of deferred debit cards and credit cards. Traditional credit cards that allow customers to maintain revolving credit and decide each month how mach to repay the credit card company were first launched in Israel only at the beginning of 2005 by Leumi card (Multi card) and by CAL (Active card). It is still too early to tell how successful these cards are going to be.

Other than the Multi card and the Active card, credit cards in Israel are used in three different ways. First, unless the cardholder explicitly requests otherwise, all charges are debited to the cardholder’s bank account once a month, exactly as in the case of deferred debit cards. Second, many merchants allow cardholders to pay for specific transactions through interest-free installments (typically three installments). It is estimated that out of 50-60 thousand Israeli merchants who accepted credit cards in 2001, about 20-25 thousands offered this payment scheme to their customers. The value of these installment payments in 2000 was estimated at 20-25 billion NIS, out of total credit card transactions of 80-85 billion NIS (Business Data Israel, 2001). Unlike in the case of credit cards, the credit in the case of interest-free installment payments is provided by the merchant. Third, cardholders can ask merchants to register specific transactions as “credit transactions,” in which case the cardholder pays for the transaction through installment payments (between 3 and 36 installments according to the cardholder’s choice); the unpaid portion of the charge carries in this case an interest which is roughly similar to the interest rate charged by banks for bank overdraft. Unlike in the case of interest-free installments, here the credit is provided by the credit card company rather than the merchant. If cardholders choose the “credit transactions” option, then their cards essentially function like credit cards, although unlike with traditional credit cards, here the cardholder needs to choose the number of installments in advance when making the transaction rather than decide at the end of each month how much to repay the credit card company.

Although the default is that cards in Israel function as deferred debit cards, it might be argued that in fact they function more like credit cards. The reason for this is due to two important features of the banking industry in Israel. First, Israeli banks allow (and in general even encourage) their customers to have overdrafts. Casual observation suggests that many, if not most, Israeli households have large overdrafts, for at least part of the month. Second, casual observation also suggests that the most Israelies hold credit cards from the same bank in which their checking account is held. In fact, ATM cards and credit cards in Israel are tied - the same plastic card is used for both functions. Once a customer opens a bank account, he automatically receives a credit card from the same bank (e.g., an Isracard if the individual opens a bank account in Bank Hapoalim and Visa Leumi if the individual opens an account in Bank Leumi). Although in September 2001 the director of the IAA issued an order that prohibits banks from tying bank accounts and credit cards, it appears that it is still very rare for individuals to have a credit card from a bank in which they do no hold a checking account. One indication for the close link between a customer's checking account and credit card is the fact that when Leumi card launched its Visa card in early 2001, all Bank Leumi's clients, which until then held Visa CAL cards, received official letters from their banks in which they were told that their Visa CAL cards have been cancelled and they are requested to go to their branch to pick up their new credit/ATM cards.[5]

Together, these features of the Israeli banking industry imply that, effectively, most households in Israel receive credit from their banks, although the credit service is provided by the bank itself through

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[5] An application to approve a class action was filed against Bank Leumi on April 2001, alleging that the bank misled

the household's overdraft rather than by the bank's credit card company. In fact, from a cardholder's point of view, the card still provides a credit service even if the cardholder's checking account is held in a different bank (e.g., the cardholder has a Visa Leumi card but a checking account in United Mizrachi Bank). From the perspective of the bank which owns the credit card company, however, the card is no longer equivalent to a credit card in this case because the credit service is provided by a different bank (the cardholder's bank).

Credit cards in Israel offer cardholders many rewards, including travel insurance and points which are proportional to card usage and can be exchanged for various presents or discounts on particular products and services (there are no cash rebates however). In addition, cardholders receive with their monthly bills various offers to buy products and services at deep discounts. The cardholders' monthly bills serve, in effect, as a vehicle for direct marketing and it appears that they are actually an additional revenue source for the credit card companies.

There is some evidence that the demand for credit cards in Israel is inelastic. First, following Alpha card's entry to the market in July 1998, substantial membership fees collected from cardholders were eliminated. Yet, the number of Visa cards has increased only moderately from 1.3 million cards before Visa Alpha's entry to 1.5 million afterwards.[6,7] This number has grown at about the same rate to 1.545 million Visa cards in 2000, and to 1.85 million in 2001 (Business Data Israel, 2000, p. 7 and Business Data Israel, 2001, p. 12). Furthermore, starting on February 2002, credit card companies in Israel began charging administrative fee of around 90 NIS annually, irrespective of card usage.[8] Despite

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its clients and tied bank accounts and credit cards. See Bank Leumi Financial Statements for March 31, 2002.

[6] See Zehava Dovrat, "Nielsen Israel Data: The market share of the Visa group: 52.5%; Isracard's market share: 46.5%," Globes, August 30, 1998..

[7] See Judy Maltz, "Isracard - the leading credit card company in Israel," Globes, December 28, 1999.

[8] Apart from the administrative fees, there are also annual membership fees. Cardholders however can avoid paying annual membership fees provided that the average monthly number of transactions they make exceeds a certain

this fact, the number of active cards and the volume of credit card transactions has continued to grow since 2002 (Bank of Israel, 2004, Ch. 6).

From the perspective of banks, the main sources of revenue from credit cards are merchant fees and the cardholders' overdrafts, which generate revenues for the banks from interest payments. It could also be argued that the widespread use of credit cards allows banks to lower the costs of handling checks and also helps them reduce the number of bank branches and ATMs, which is quite small by international comparison.[9]

Due to regulatory intervention by the director of the IAA, credit cards companies in Israel are not allowed to impose the "no-surcharge" and the "honor-all-cards" rules. Following a complaint by the association of travel agents, the director of the IAA issued in May 1993 a formal decision that held that the "no-surcharge" rule is an illegal restraint of trade under the Israeli antitrust law. Despite this decision, it appears, however, that merchants are reluctant to surcharge credit card transactions. Moreover, casual observation suggests that apart from few deep discount retailers who offer cash discounts, merchants charge uniform prices which are independent of the means of payment.

As for the "honor-all-cards" rule, a consent decree between the director of the IAA and Isracard under Section 50(b) of the Israeli Antitrust Act, submitted for the approval of the Court of Trade Restrictions on August 2002, stipulated that Isracard will not be allowed to tie the acquisition of Isracards with the acquisition of other credit cards, including Mastercards, and likewise will not be allowed to tie the acquisition of Mastercards with the acquisition of other cards, including Isracards.[10] The director recently decided, however, to remove his request to approve the consent decree, claiming

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threshold. This threshold is not very large: for instance, in the case of Visa Leumi, this threshold is 6 transactions a month. The Israeli average is about 10 monthly transactions.

[9] The average population per bank branch in Israel is 6,722 compared with 3,048 in G-10 countries and the average population per ATM is 4,878 compared with 1,037 in G-10 countries (see Bank of Israel, 2004, Ch. 6).

[10] See publication number 3015226 at

that despite the fact that almost three years have passed, some of the provisions of the decree, and particularly the opening of the Mastercard market to competition, have not yet occurred (see IAA, 2005). Accordingly, the "honor all cards" prohibition included in the consent decree no longer applies, and the IAA is counting on the opening of the Isracard and Mastercards markets to competition instead.

3. Industry structure

According to the Bank of Israel, there were 3.8 million active credit cards in Israel as of December 2004 (i.e., cards that were used at least once every quarter), an increase from 3.6 million active cards as of December 2003 and 3.5 million active cards as of December 2002 (Bank of Israel, 2004, Ch. 6). The following table provides an estimate of the number of cards of each kind and the market shares of the credit card companies in acquisition:

http://www.etype.co.il/anti1/?cmd=4&text=1511,1489,1493,1510,1514,32,1508,1493,1506,1500,1497,1501.

Table 1: Number of credit cards and market shares in acquisition

Credit card company	Cards	Number of cards (in millions) [11]	Market share in acquiring[12]
Isracard	Isracard Mastercard American Express Visa	1.1 0.3 0.15 N/A	47%
CAL	Visa CAL Mastercard Diners card	1.1 N/A 0.16	31.8%
Leumi Card	Visa Leumi Mastercard	1.2 N/A	15.3%
Non banks			5.9%

Few comments about Table 1 are in order. First, the cards in the table are not necessarily active cards so the total number of cards need not sum up to 3.8 million which is the total number of cards reported by the Bank of Israel. Second, Isracard has started offering Visa cards and CAL and Leumi card have started offering Mastercards only after a heavy regulatory intervention by the director of the IAA. Casual observation suggests that the number of Visa cards issued by Isracard and the number of Mastercards issued by CAL and by Leumi card is still quite small. Third, according to the IAA, as of August 2004, over 20% of all credit cards in Israel were Isracards and slightly less than 20% were Isracard Mastercards. Moreover, over 20% of the total volume of credit card transactions were made with Isracard Mastercards (IAA,

[11] The numbers of cards issued by Isracard and by CAL are taken from Business Data Israel (2001), except for the number of Diner cards issued by CAL which is taken from IAA (2002). According to IAA (2002), Isracard has issued 1.4 million Isracards and Mastercards combined by November 2002. According to CAL's website, CAL has issued a total of 1.2 credit cards by September 2005. The number of cards issued by Leumi card is taken from Leumi card's website. Most of these cards are probably Visa cards since to date, Leumi card has probably issued only a few Mastercards.

[12] Taken from Business Data Israel (2001). According to the webpages of Isracard, CAL, and Leumi card, the companies provide acquiring services for 90,000, 45,000 and 36,000 businesses, respectively.

2005).[13]

Fourth, the non banks mentioned in the table are financial firms that specialize in acquiring transactions paid through interest-free installments: they pay the merchants the full amount with a discount and then collect the cardholders' installment payments from the issuer. The size of this secondary clearing market increases rapidly as the option of offering customers installment payments became increasingly popular in Israel and many merchants prefer to get the full amount quickly. Since 2001 however there were three mergers between credit card companies and non banks. In 2001, Isracard merged with Tzameret, which had a market share of 4% in the secondary market. In 2003, Leumi Card merged with the largest firm in this segment, Gama, which had a market share of 49%, while CAL, which had a 10% market share in the secondary market, merged with the second largest firm in this segment, Yatzil, which had a market share of 33%. The only independent non bank that is still active in the secondary market is A.S Mimunim with a market share of 4%.[14]

To appreciate the number of credit cards in Israel, it should be noted that the average population in Israel in 2000 was 4.705 million for ages 15 and above, 4.141 million for ages 20 and above, and 3.602 million for ages 25 and above.[15] Since most Israelies serve in the army until age 21 for men and 20 for women (and do not earn a salary during this time), it might be argued that the potential size of the market for credit cards is around 4 million. With 3.8 million active cards, the Israeli market seems to be nearly saturated. During the first 9 month of 2004, 34.1% of the expenditure on private consumption in Israel was

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[13] According to euromonitor, in 2003, the market shares of Isracard, CAL, and Leumi card in issuing were 44%, 33%, and 23%, respectively (see http://www.euromonitor.com/Financial_Cards_in_Israel#).

[14] See Dafna Tzuker, "Strum conditioned the merger between C.A.L and Yatzil: All discount companies will be able to perform discounting for CAL cards," Globes, November 20, 2003; Dafna Tzuker, "Leumi Card is following CAL and Isracard's footsteps: It is entering the market for discounting of credit card vouchers," Globes, February, 6, 2003.

[15] These numbers are taken from Table 2.19 in the Statistical abstract of Israel, 2004 (http://www.cbs.gov.il/shnaton55/st02_19x.pdf

paid for with credit cards.[16] The average value of a credit card transaction in the same period was 55.6 USD with 35% of all transactions having an average value of over 233.6 USD (Bank of Israel, 2004, Ch. 6). The average number of monthly transactions per card is about 10.[17]

International comparisons reveal that credit cards are more common in Israel than in other developed economies. The following table shows the importance of payments by cards relative to all cashless payment instruments, including checks and credit and debit transfers, in 1998.

Table 2: The importance of payments by cards relative to all cashless payment instruments, in 1998[18]

Country	Percentage of total volume of cashless transactions	Percentage of total value of cashless transactions
Israel	40.2%	41.9%
U.S.	24.3%	0.2%
U.K.	33.1%	0.3%
France	18.2%	0.1%
Germany	5.1%	0.04%
Italy	14.2%	0.07%

Not surprisingly, the number of businesses that accept credit cards is also quite large in Israel. It is estimated that about 50-60 thousand Israeli merchants accept credit cards. This number ranks Israel third in Europe in terms of the proportion of businesses that accept credit cards (Business Data Israel,

[16] See http://www.bankisrael.gov.il/press/heb/041222/041222a.htm (in Hebrew).

[17] The total number of credit card transactions in 2004 was 450 million (Bank of Israel 2004, Ch. 6). With 3.8 active cards, this implies that on average, each credit card used in 2004 in 118.4 annual transactions, or 9.8 monthly transactions.

[18] The numbers are taken from Tables 8 and 9 in Bank for International Settlements (2000). The numbers for Israel (which do not appear in the tables) were computed by subtracting the percentage use of other cashless payment instruments from 100.

2000).

One reason why credit cards are so common in Israel might be due to the legacy of the hyperinflation that Israel has experienced at the beginning of the 80's until the stabilization policy of 1985. Due to this hyperinflation, the Israeli public opted to hold as little means of payment (M1) as possible. Consequently, M1 as a proportion of GDP in Israel is much smaller than in the U.S., Europe, and Japan.[19]

Casual observation suggests that there is relatively little competition on the issuing side. For instance, direct marketing, which is extremely common in the credit card market in the U.S., is generally absent in Israel. Moreover, the credit card companies have only recently launched advertising campaigns to promote their new cards (i.e., Isracard in the case of Visa cards and CAL and Leumi card in the case of Mastercards).

While there seems to be little competition on the issuing side of the market, there does seem to be growing competition in acquiring. This competition led credit card companies to lower their merchant fees and offer merchants new payment plans. Until 2001, acquirers used to pay merchants once a month for the transactions made during the last month. Since 2001 however, the credit card companies began offering merchants alternative arrangements. For instance, Isracard offers merchants advanced payments of up to 80% of future credits in regular transactions and 60% in the case of installment payments. Another plan that the company offers is to credit the merchant in full a few days after the transaction was made. Leumi card offers similar plans (Business Data Israel, 2001).

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[19] See Bank for International Settlements (2000, p. 1). Table 1 in the same report indicates that notes and coins in circulation in 1998 in Israel were 46.9% of M1 and 3.2% of GDP. Hence, M1 in 1998 was 0.068% of Israeli GDP. The corresponding numbers for the U.S., France, Germany, Italy, and Japan, were 0.128%, 0.234%, 0.274%, 0.347%, and 0.434%.

4. Proclamation of Isracard as a monopoly

As we mentioned in the Introduction, the IAA played a key role in bringing about the structural change in the Israeli credit card industry. In this section and the next we discuss the two main legal grounds for this regulatory intervention. We begin in this section by discussing the proclamation of Isracard as a monopoly which allows the IAA's ability to regulate Isracard's activities.

According to Sections 26(a) and 26(d) of the Israeli antitrust law, the director of the IAA can proclaim that a single firm or a group of firms (a "Concentration Group"), respectively, will be seen as a monopolist, if the firm's market share (or concentration group's market share) in the relevant market exceeds 50%. This proclamation allows the director to impose restrictions on the activities of these firms or issue directives that are deemed necessary to prevent probable harm to competition or the public. The director's threat to proclaim Isracard as a monopoly back in 2002 allowed him to reach a consent decree with Isracard in August 2002 that requires Isracard to relinquish its exclusive right to issue and acquire Mastercards in Israel, and also requires it to begin issuing and acquiring Visa cards.[20] In other words, the director of the IAA has used its power to force the owner of a proprietary credit card (Isracard) to open up its system for competition, and forced the same firm to offer cards that belong to a rival system.

Although some minor competition has evolved between Isracard, CAL, and Leumi card, such competition remains crippled however, since all three companies retain exclusivity over installment transactions made with their own cards (e.g., only Isracard is able to acquire installment transactions made with Isracards and Isracard Mastercards). As mentioned in Section 2, the value of these transactions is about a quarter of the total value of all credit card transactions in Israel.

Given this state of affairs, the director has recently backed off from the above-mentioned consent decree with Isracard, before it was approved by the Court of Trade Restrictions, and, in May 2005

[20] See Shmuel Deklo, "Bank Hapoalim and Isracard Ask the Court of Trade Restrictions to Make Force Strum to

proclaimed Isracard as a monopolist in acquiring Isracard and Mastercard transactions (IAA, 2005).

4.1 The grounds for the procalamation

Since Isracard acquires nearly all Isracards and Mastercards, it is obvious that in order to establish its monopoly position, the director only had to show that the acquisition of Isracard and Mastercard transactions is a relevant antitrust market. To this end, the director first pointed out that nearly 50% of all Israelies carry Isracards and over 40% of all credit cards in Israel are issued by Isracard. The director concluded that given this dominant position, merchants simply cannot afford not to honor credit cards issued by Isracard.

Second, the director held that acquiring Isracards and Isracard Mastercards is a relevant antitrust market. The director supported his position by arguing that other means of payments are not sufficiently close substitutes for credit cards, due to the strong preference of many customers for credit cards. This preference is due to the convenience of using credit cards, the fact that customers do not need to carry cash, the fact that the cards can be used for making transactions over the phone or the internet, and the various reward programs that the credit card companies offer their cardholders. The director argued that a merchant's refusal to honor credit cards will lead to a large loss of sales. He therefore concluded that despite the fact that merchant fees make credit cards significantly costlier than other means of payment from the merchants' point of view, merchants cannot afford not to honor credit cards. The director also pointed out that although the interchange fee for Visa transactions made in supermarket chains has increased from 0.55% to 1.00% following regulatory intervention by the IAA in 2001, and although Isracard raised the supermarket chains merchant fees from 0.71% to 1.03% for Isracard transactions and from 0.71% to 1.02% for Mastercard transactions at about the same time, supermarket chains did not try to dissuade consumers

Honor the Mastercard Decree," Globes July 3, 2005.

from using credit cards. This observation, he argued, is another indication that credit cards and other means of payments are not sufficiently close substitutes. The director also quoted court cases from the US and Europe that have reached similar conclusions.[21]

The director went on to argue that credit cards issued by Isracard are not sufficiently close substitutes for other credit cards. This argument was supported by the observation that as of May 2003, Isracards/Mastercards (issued by Isracard) and Visa cards (issued by CAL and Leumi card) were directly debited to only 3% of all bank accounts in Israel. Since credit cards in Israel are deferred debit cards, this is a strong indication that very few households in Israel hold both Isracard/Mastercards and Visa cards. Hence, in response to a small increase in Isracard's merchant fees, merchants would be unable to divert customers from credit cards issued by Isracard to credit cards issued by CAL and Leumi card. Moreover, the director noted that among all merchants who own credit card processing terminals less than 3% honor only Visa cards. Furthermore, the director found that although the average merchant fees of CAL and Isracard were both around 1.9% in April 1998, just prior to Alpha card's entry into the credit card market, the merchant fees on Visa cards have substantially declined since then to around 1.4% by July 2004, while Isracard's merchant fees have seen a much more modest decline to slightly under 1.6%.[22]

4.2 Restructuring the Isracard/Mastercard market

Section 30 of the Israeli Antitrust Act allows the director to regulate a monopolist's activity in ways that are necessary to prevent potential harm to competition or the public. One of the director's intentions is to issue directives that would ensure that the Isracard and Mastercard markets will open up for competition

[21] United States v. Visa U.S.A. Inc., 163 F. Supp 2d 322 (2001), 336 and Commission Decision of 24 July 2002 (Case No Comp/29.373 - Visa International – Multilateral Interchange Fee OJ L 318 (2002), p. 17, para 46.

[22] It should be noted however that the merchants fees of all three credit cards companies were subject to heavy regulation by the IAA. In May 2000, the IAA has forced CAL and Leumi card to set an average interchange fee of 1.38% as a condition for a temporary approval of their interchange agreement and a certain decline in Isracard's

both on the issuing side and on the acquiring side. According to the proposed directives (which still did not go into effect), Isracard must allow other companies to acquire Isracard and Mastercard transactions and will be allowed to acquire Visa card transaction. The interchange agreements between Isracard and other acquirers will be similar to the interchange agreement between CAL and Leumi Card regarding the acquisition of Visa cards, and the interchange fees will be equal to the interchange fee that the Court of Restrictive Practices is going to set for Visa card transaction.[23] Any other agreements between Isracard and the other acquirers will be subject to approval by the director of the IAA or the Court of Restrictive Practices. The proposed directives also order Isracard to create the infrastructure necessary for the full implementation of the agreement.

The proposed directives also state that the licenses that Isracard will issue CAL and Leumi card in order to allow them to acquire Isracards will stipulate that CAL and Leumi card will be able to acquire Isracards only after each of them has issued 30,000 Isracards. Furthermore, the licenses will allow Isracard to charge CAL and Leumi a fee for every Isracard they issue as well as a certain percentage of their revenues from acquiring Isracards. Both fees will be determined by bargaining between the parties, but if the parties will fail to reach an agreement within 30 days from the day the licenses were issued, they will have to appoint an arbitrator whose identity shall be approved by the director of the IAA.

It should be noted that the proposed directives do not guarantee the emergence of competition in the acquiring of Isracards since CAL and Leumi card may intentionally refrain from issuing 30,000 Isracards, which is the threshold above which they will be allowed to acquire Isracards in the hope that Isracard will reciprocate and will not attempt to compete in the acquiring of Visa card transactions.

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acquiring fees was ordered by a consent decree reached between the IAA and Bank Hapoalim in 2001.

[23] The interchange agreement between CAL and Leumi card (and the determination of the interchange fee) is still pending in the Court of Restrictive Practices.

4.3 Isracard's Merchant fees and interchange fees in the Mastercard market

Apart from using his power to restructure the Israeli credit card market, the director of the IAA has also used his power to regulate Isracard's merchant fees. The proposed consent decree between the director and Isracard under Section 50(b) of the Israeli Antitrust Act has stipulated that starting on November 1, 2001, Isracard will gradually lower its merchant fees (except on American Express cards). According to the consent decree, by May 1, 2002, Isracards' maximal fees will not exceed 2.60% on regular transactions and 2.80% on installment transaction and these fees will remain in effect even when new acquirers enter the market. Isracard has lowered its fees accordingly even though eventually, the director has decided to back off from the consent decree and proclaimed Isracard as a monopoly in acquiring Isracards and Mastercards.[24]

The consent decree also stipulated that, similarly to the Visa case, Isracard will provide the director with a detailed methodology and data for the determination of interchange fees for Mastercards. Mastercards (see Paragraph 14 in the decree). And, if the director will not be convinced that the proposed interchange fees are justified, Isracard and the entrants to the Mastercard market will file an application with the Court for Trade Restrictions to approve their interchange agreement.[25] However, as mentioned above, this course of action failed since competition in the Mastercard market remains crippled due to the inability of each credit card company to acquire installment transactions made with another company's cards. As a result, the director has recently proposed to implement the interchange agreement between Isracard and the Visa Companies through his authority to issue Isracard directives following its proclamation as a monopoly in acquiring Isracards and Mastercards.

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[24] See Shmuel Deklo, "Bank Hapoalim and Isracard Ask the Court of Trade Restrictions to Make Force Strum to Honor the Mastercard Decree," Globes July 3, 2005.

[25] The director can exempt the parties from the obligation to obtain the Court's approval if he believes that the fees are justified.

5. The interchange agreement between CAL and Leumi

A second legal ground for antitrust intervention in the credit card industry is the prohibition of restraints of trade under Section 2 of the Israeli Antitrust Act. The emergence of the Visa system in Israel as an open system with two issuers and two acquirers following Alpha card's entry into the Visa market in July 1998 created the need for an interchange agreement between CAL and Alpha card to deal with cases in which one company acquires transactions made with cards issued by the other company. The director of the IAA has determined that an interchange agreement is a restraint of trade, which, under the law, has to be approved by the Court for Trade Restrictions. The Court may approve a restraint of trade if its benefits to the public outweigh its harm to competition, although typically it gives an approval only subject to certain conditions that the director of the IAA proposes.

On July 1998, the director of the IAA granted CAL and Alpha Card a provisional exemption from the obligation to obtain an approval from the Court for Trade Restrictions for their interchange agreement under Section 14 of the Antitrust Act. This exemption was issued under the condition that Visa International will conduct a cost study that will serve as a basis for determining the appropriate interchange fees in the Israeli Visa market. The director of the IAA imposed a number of additional conditions, including a mechanism that will lead to the decrease in the merchant fees and a ban on exclusivity agreements between the Visa companies and merchants. The most important condition perhaps was that Bank Leumi and IDB will terminate their joint ownership of CAL by the end of 1999. As mentioned earlier, Bank Leumi eventually sold its share in CAL to IDB in February 2000 and established Leumi card which replaced Alpha card as the second Visa Company in the market after the latter exited the market in 2000.

By May 2000, the director decided to extend the exemption for a period of another 18 months following Visa international's failure to complete the cost study required by the director. The extension of the exemption stated that during this 18 month period, Visa International should complete the required cost study and will pass its recommendations regarding the appropriate structure of interchange fees to the director's approval.

Following Alpha card's exit and Leumi card's entry into the credit card market, the original interchange agreement between CAL and Alpha card was adopted by CAL and Leumi card. On March 2001, the two companies submitted their agreement to the IAA for exemption from the obligation to obtain an approval from the Court for Trade Restrictions. However, despite its earlier promises, Visa International has once again failed to complete the cost study and provide the director with a basis for its recommendation for the appropriate interchange fee that has to be set in the Israeli Visa market. This time, it appears that the director of the IAA, as well as CAL and Leumi card, have lost any hope of receiving the required data from Visa International (see IAA 2001). Consequently, CAL and Leumi card have asked the director for another extension and promised that during the extension period they will study the issue on their own and will provide the director with the required data that will be used to determine the appropriate interchange fee in the Israeli Visa market.

The director has agreed to extend the exemption given to the interchange agreement only under very restrictive conditions. Among other things, these conditions included a commitment by CAL and Leumi card to begin issuing Mastercards no later than August 1, 2001 and acquiring Mastercards no later than October 1, 2001, a substantial decrease in the interchange fees that will prevail while the exemption is in effect, and a reorganization of the entire structure of interchange fees. The reorganization was intended to shrink the gap between different categories of interchange fees. In addition, the director asked the Visa companies to submit a detailed methodology and a complete set of data needed to determine the interchange fee no later than May 1, 2001. He also informed CAL and Leumi card that the methodology for setting the interchange fees will be determined by the Court for Trade Restrictions. The fact that the Israeli law requires the Court to invite the director to express his position and arguments regarding the case at hand meant that the IAA would continue to be heavily involved in the determination of the interchange fee.

The proposed methodology that CAL and Leumi card submitted to the IAA called for setting up four different categories for interchange fees with an average fee of 1.25% and such that the fee in the highest category would be 3.4 times that in the lowest category. The director, however, found the proposed methodology unconvincing and also thought that the data that was provided was insufficient for supporting their proposal. He therefore decided to extend the deadline for the submission of the required methodology and data to September 1, 2001. Since Leumi card and CAL were unable to obtain an exemption from the director, they filed an application with the Court for Trade Restrictions to approve their interchange agreement. The Court granted a temporary approval for the agreement on September 9, 2001. The interchange fees in this temporary approval were divided into three categories that are specified in the following table:

Table 3: Interchange fees in the Israeli Visa market

Category	Sept. 2001 - April 2002	May 2002 -
Gasoline, payments to the government offices and municipalities, Bezeq (the Telecom monopoly), large supermarket chains (until May 2002)	< 1.8%	Online transactions: 0.55% Offline transactions: 0.8%
Large supermarket chains (until May 2002), Telecom services, Travel agencies, Insurance, Sick funds (health care), Natural gas, Cable TV	< 1.8%	Online transactions: 1% Offline transactions: 1.25%
Others	Online transactions: < 1.8% Offline transactions: < 1.8%	Online transactions: 1.6% Offline transactions: < 1.85%
Average	< 1.25%	< 1.25%

The interchange fees in the table were meant to preserve the overall fee structure that prevailed in the Israeli Visa market at the time of the approval, while significantly lowering the fees level. It should be noted that since the interchange agreement between CAL and Leumi card is still pending in the Court for

Trade Restrictions, the interchange fees in the table are still in effect today.

Following the temporary approval of the interchange agreement between CAL and Leumi card, four large merchants who were included in the highest category, Superpharm (a drugstore chain), Ace (a home improvement chain), Kitan (a linen and textile chain), and Golf (a clothing chain), have appealed to the Court on the grounds that the temporary agreement discriminates them against large supermarket chains which directly compete with them in many product lines and were included in the lowest category until May 2002.

Apart from these four merchants, a large supermarket chain, Supersol, has also appealed to the Court. The grounds for Supersol's appeal were that although the temporary agreement has substantially lowered the interchange fees across the board, starting from May 2002, large supermarket chains were moved from the lowest category, where the interchange fee is 0.55%, to the second lowest category, where the fee on online transactions is 1% (virtually all transactions in large supermarket chains are online). Since the interchange fee serves in effect as a price floor for the merchant fees, this meant that from May 2002 onward, the merchant fees paid by large supermarket chains were at least 1%.[26] These fees are almost double the historic fees that large supermarket chains paid. For example, Supersol's CFO has testified in the Court for Trade Restrictions that since the 1980's, Supersol's merchant fees were around 0.55%. Moreover, the merchant fee that Supersol paid Isracard at the time was merely 0.6%. The reason for doubling the interchange fees on transactions made in large supermarket chains seems to have been the desire of the director of the IAA to equalize the merchant fees paid by large supermarket chains and by small supermarkets. This desire was part of the director's agenda of promoting competition in the

[26] When a credit card company acquires transactions made with a card issued by another company, it has to pay that other company an interchange fee so its acquiring cost is at least as high as the interchange fee. If the credit card company acquires transactions made with its own cards, the interchange fee represents an alternative cost since the company could have earned an interchange fee had it allowed another credit card company to acquire the transaction.

supermarket industry. Until May 2002, small supermarkets were included in the second lowest category and their interchange fee was 1.7%. Thus after May 2002, small supermarkets, as well as large supermarket chains, were included in the same category and the interchange fee for both was 1%.

Supersol has argued that this move by the director of the IAA was not justified since it was based on the director's concerns with a different industry altogether. Moreover, Supersol argued that in his attempt to promote competition in the supermarket industry, the director has, in effect, forced the credit card companies to double the merchant fees of large supermarket chains and that as a result, supermarkets will be forced to raise their prices, thereby harming consumers who shop in large supermarket chains. Supersol has also argued that even though small supermarkets will pay lower merchant fees, the volume of credit card transactions in large supermarket chains is so large that overall, supermarkets (large and small) will end up paying higher merchants fees following the approval of the temporary interchange agreement.

Despite the appeals, the Court for Trade Restrictions has decided to approve the temporary interchange agreement until the methodology for setting the interchange fees and the fee structure will be finally decided by the court. As mentioned earlier, to date, the case is still awaiting a final decision by the court.[27] The remainder of this section is devoted to a discussion of the arguments of the various parties in the Court for Trade Restrictions regarding the right methodology for determining the appropriate interchange fee in the Israeli market. Although formally this interchange fee is supposed to be implemented in the Visa market, it appears that the director of the IAA is going to mandate in the directive that he plans to issue Isracard that the same interchange fee will also be implemented in

[27] In January 2003, CAL and Leumi card have requested the Court for Trade Restrictions to withdraw the application to approve their interchange agreement and in effect, move to a "split" regime whereby each company acquires transactions made with its owns cards. The Court however decided on February 5, 2003 to reject this request and ordered the two companies to continue with the court case on the grounds that an interchange agreement which is based on a well-founded methodology benefits the public at large.

Mastercard and Isracard markets.

5.1 The methodology proposed by Visa's economic experts

As mentioned earlier, CAL and Leumi card have proposed their own methodology for setting the interchange fees only after Visa International has repeatedly failed to do so. The director of the IAA, however, found the first methodology that CAL and Leumi proposed on May 2001 to be unconvincing and not well-founded. Consequently, CAL, Leumi card, and Visa International have hired two professors of Economics from Tel Aviv Unversity, Chaim Fershtman and Neil Gandal, to offer a new methodology, which was then submitted to the court's approval in the summer of 2002.

The proposed methodology was generally based on the theoretical models of Baxter (1983), Rochet and Tirole (2002, 2003), and Schmalensee (2002) and called for setting an interchange fee that "provide a balance between cardholder fees and fees from merchants." Moreover, based on the principle of Ramsey pricing, the proposed methodology recommended a "category-based system in which the interchange fees are inversely related to the merchants' elasticity of demand for payment services" (see Fershtman and Gandal, 2002, Section 0, p. 3). This methodology was then combined with data analysis and calculations that were performed by the Arthur Andersen Consulting Group in Israel, based on data provided by CAL, Leumi card, and their respective owner banks. The recommendation that came out of the proposed methodology and the data analysis and calculations was that a weighted average of the interchange fee across all categories should be set at 1.8%. Fershtman and Gandal have also provided a sensitivity analysis that indicated that a 95% increase in the cardholder fees will make it possible to lower the average interchange fee from 1.8% to 1.6%, while a 20% decrease in the issuer costs will make it possible to lower the average interchange fee from 1.8% to 1.36%.

Specifically, the proposed methodology was derived as follows: first, one has to compute an "Interchange Requirement," IR, which is equal to the gap between the total issuing costs, TC, and the issuers' income from cardholder use, I, and the maximal income that can be generated from cardholders' fees, zN, where z is the cardholders' maximum willingness to pay for credit cards, and N is the number of cardholders.[28] That is, the interchange requirement was computed as

$$IR = TC - (I + zN).$$

The interchange fee is then simply given by IR/V, where V is the volume of transactions made with the card. The idea behind this methodology is that the IR represents a deficit on the issuing side that must somehow be recovered from acquirers. Raising the cardholders' fees, it was argued, will cause some cardholders to drop from the system and this will lower the volume of transactions V. Hence the result might be that the interchange fee will only increase as a result.

It should be noted that the methodology completely ignores the willingness of merchants to pay merchant fees necessary to cover the interchange requirement. However, Fershtman and Gandal argue that "merchant demand is virtually impossible to measure even if one uses survey methods. This is because … of the difficulty in obtaining a representative sample of merchants" (see Fershtman and Gandal, 2002, Section 4, p. 2). Consequently, they have assumed that the merchants' willingness to pay is sufficiently high and supported this assumption by arguing that, so long as the eventual merchant fees will not increase, then the willingness of merchants to pay is not going to be a binding constraint.

A crucial component in the proposed methodology is z, the cardholders' maximum willingness to pay for credit cards. This component in turn determines the size of issuers' costs that can be recovered from cardholders. To determine z, a professional survey was commissioned from a marketing research firm "Mutagim." This survey was intended to estimate the willingness of Israeli cardholders to pay for cards. According to Mutagim's survey, 48% of the population holds one card and another 21% hold two or more

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[28] The total issuing costs would be identified using a methodology developed by Visa International that makes it possible to allocate the total costs of the credit card companies and the respective owner banks (which are co-issuers) into issuing and acquiring components. The issuers' income from cardholder use will consist of various income items such as replacement card fees, income from cash withdrawal abroad, and foreign exchange conversion fees.

cards. The survey found that 48% of all individuals who hold cards are not willing to pay for having a credit card, while 30% are willing to pay up to 50 NIS a year. Only 22% are willing to pay above 50 NIS a year for having a credit card. The overall average willingness to pay was estimated at 48.8 NIS. Based on the survey, Fershtman and Gandal chose z to be equal to 50 NIS. Although the survey has indicated that 48% of cardholders will drop out of the system as a result, Fershtman and Gandal have assumed that churn only be only 10%. Since 21% of all individuals hold two cards or more, they estimated a decrease of 15.4% in the total number of cards. They then estimated that the total cardholders' fees will be

$$50 \text{ x } (100 - 15.4\%) \text{ x } N \text{ x } 1.1,$$

where N is the number of cardholders before imposing a cardholder fee of 50 NIS and the 1.1 was meant to reflect the fact that it may be possible to charge some cardholders above 50 NIS.

5.2 The merchants' position

Two of the merchants that appealed to the Court for Trade Restrictions, Supersol and Superpharm, decided to submit to the court economic expert opinions on their behalf.[29] For the most part, these expert opinions accepted the principle that the interchange fees should ideally balance the cardholder and merchant fees, but argued that an interchange fee based on the willingness of consumers and merchants to pay is simply impractical. Hence, the expert opinions recommended a cost-based approach, which despite not having desired theoretical foundations is relatively straightforward to apply.

A main reason why an interchange fee that takes into account the willingness of consumers and merchants to pay is impractical is as follows. First, as mention above, Fershtman and Gandal argue that "merchant demand is virtually impossible to measure." Indeed, their methodology completely ignores the merchants' willingness to pay. Second, the Israeli court case provided a vivid example that it is also

[29] The economic expert opinion submitted by Supersol was written by us. The economic expert opinion submitted by Superpharm was written by Oz Shy.

virtually impossible to measure the willingness of cardholders to pay for credit cards. The survey conducted by "Mutagim" found that only 22% of all cardholders are willing to pay above 50 NIS a year for having a credit card. Yet, in February 2002, after the survey has been completed, the credit card companies have began charging administrative fees of about 90 NIS per year, irrespective of card usage. According to the survey, more than 78% of all cardholders should have stopped using credit cards. Needless to say none of that has happened: in fact, the number of active cards, as well as the volume of credit card transactions, have kept growing since 2002 (Bank of Israel, 2004, Ch. 6). Mutagim's survey was then a big fiasco and it indicates, we believe, the fundamental difficulties of assessing how much cardholders are willing to pay for credit card usage.

Of course, without the ability to assess the willingness of merchants and cardholders to pay it is impossible to use a demand-based methodology. The obvious alternative is to use a cost-based methodology, despite its theoretical shortcomings.

In the remainder of this section we would like to mention few other relevant points. First, merchants' testimonies at the court indicated that, due to merchant fees, credit cards are significantly more expensive for the merchants than cash and checks. Yet, merchants generally feel that they cannot afford to refuse credit cards because consumers have a strong preference for using them; hence a refusal to honor credit cards will lead to a large loss of sales. It is plausible that this strong preference is due in part to the marketing efforts of the credit card companies (e.g., the extensive reward programs that the companies offer, which are often tied to the credit card usage). This implies in turn that merchants may have been better-off had the credit cards companies scaled back their marketing efforts. It is therefore ironic to include in the computation of the interchange fee all issuers' costs, including marketing costs that might very well be excessive from the merchants' point of view.

Second, an implicit assumption in Fershtman and Gandal's proposed methodology was that the interchange requirement should be financed solely from merchant fees. This is of course unavoidable if the credit card market is competitive and the credit card companies make zero profits. In Israel however there are only three credit card companies and only two of them operate in the Visa market. Not surprisingly then the credit card companies are quite profitable. For example, Leumi card was profitable even in its first year of operation. It should be emphasized that the Bank Leumi's profits are even larger due to its interest revenue from overdraft that results from credit card usage. It is therefore clear that the banks' profits could serve as another source for covering the interchange requirement. After all, the banks too have a stake in ensuring that the volume of credit card usage is large and, at least in Israel, they have the means to ensure that this is the case.

Third, it is conceivable that the banks can save costs by inducing consumers to increase their usage of credit cards at the expense of cash and checks. This is because the cost for the banks of handling credit cards is lower than the cost of handling other means of payment. Of course, it could be argued that the credit card companies bear costs due to the cost of processing, the cost of bad debts by cardholders, and the cost of float. However, at least in Israel these arguments are doubtful. First, the administrative fees that the credit card companies have started charging in February 2002 are specifically intended to cover processing costs. It is highly likely that these fees well exceed the cost of processing. Second, the risk that cardholders will fail to cover the credit they get is minimal since virtually all Israeli credit cards are deferred debit cards. Hence, the risk of non-payment lies with the banks rather than with the issuers. The interest on overdraft should then cover these risks. Third, the interchange agreement between CAL and Leumi Card states that the issuer pays the acquirer only once a month. Hence, if anything, the cost of float is borne by the acquirer, not the issuer. Moreover, acquirers pay merchants twice a month. Hence, it appears that a large fraction of float is in fact borne by the merchants.

If indeed the banks save costs by inducing their customers to increase their credit cards usage (they need to have fewer branches, fewer ATMs, they handle fewer checks), then these cost savings should be factored into the computation of the interchange fee since they imply that banks would agree to finance the interchange requirement from their own sources even if the operations from credit cards generate accounting losses.

6. The class action against the credit cards companies

A third legal ground for antitrust intervention in the credit card industry is Section 29(a)(b)(1) of the Antitrust Act, which provides that a firm with a monopoly position abuses its dominant position if it charges “unfair prices.” A class action of over 1 billion NIS, based mainly on this provision, was approved by an Israeli District Court in January 2003.[30] The class action claimed that prior to Visa Alpha’s entry into the credit card market, CAL and Isracard were charging excessive, and therefore “unfair,” merchant fees. The claim was that any merchant fee above 2% is excessive and it was supported by two arguments. First, shortly after entering the market in 1998, Visa Alpha set merchant fees of approximately 2%. Hence, it was claimed that merchant fees above 2% are excessive. Second, before Visa Alpha’s entry in 1998, merchant fees in Israel were well above those in other countries.

The class action also claimed that CAL and Isracard have violated Section 29(a)(b)(3) of the Israeli Antitrust Act by engaging in price discrimination – according to the claim, CAL and Isracard have set different merchant fees for different merchants (e.g., pharmacies and gas stations). It was also claimed that price discrimination is another indication for “unfair” pricing.

Another ground for the class action was that Bank Leumi and IDB’s joint ownership of CAL constituted an illegal restraint of trade. As mentioned in the Introduction, this claim was the main reason for the ability of the director of the IAA to force Bank Leumi and IDB to dissolve their joint ownership of CAL in February 2000.

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[30] See BSH”A 106462/98 Howard Rice v. CAL.

The Supreme Court, however, reversed the district court's decision and did not approve the class. action. The court held that the merchant fee that Visa Alpha was charging could have been an introductory offer and therefore does not reflect the "fair" merchant fee that would have been charged in equilibrium. Moreover, the fact that CAL has responded by lowering its own merchant fees could have been an attempt to deter Visa Alpha's entry and hence again not a reflection of the equilibrium fees. The court also argued that Visa Alpha's collapse shortly after entering the market only reinforced the view that Visa Alpha's merchant fees could not have been equilibrium fees. Absent any other evidence to support the claim that the fees were "unfair," the Supreme Court concluded that the chances of the class action to prevail in court were too small and hence decided not to approve it.

It should be emphasized however that the Supreme Court's decision does leave the door open for the possibility that Section 29(a) of the Antitrust Act could be used in the future to bring class actions against the credit cards companies for charging excessive merchant fees. At the same time, the court's decision has set a very high standard for the evidence necessary to establish that the fees are excessive.

7. Conclusion

Currently, only Visa is effectively an open system in Israel with two large issuers and acquirers – CAL and Leumi card. It is expected however that Mastercard which is currently dominated by Isracard, will also become an open system with three large issuers and acquirers, and that Isracard will increase its presence in the Visa market. The interchange fees that will be set in both systems are going to be determined by the Court for Trade Restrictions. The court held its hearings back at the end of 2002 and the parties have submitted their summaries back in the end of 2003 and the beginning of 2004. Since then the parties are waiting for the court's decision regarding the appropriate methodology for determining the interchange fees as well as the fee structure.

Although it could be argued that the decision regarding the interchange fees is irrelevant since interchange fees are neutral (Gans and King, 2001), it appears that the conditions for neutrality do not hold in the Israeli market. This is because Israeli merchants have refrained from imposing surcharges on credit transactions (i.e., merchants have effectively adopted voluntary no surcharge rules) and because issuers give cardholders in-kind rebates instead of cash rebates. Furthermore, competition among issuers seems to be still fairly weak. Hence interchange fees are likely to have real effects on the Israeli economy. Given that about a third of all private consumption in Israel is paid for with credit cards, these effects might be quite large.

Several key features of the credit card market in Israel seem to be particularly important for the determination of interchange fees:

(i) There seems to be little consumer or merchant resistance to cards. Cards were widely used even when there was virtually no competition in issuing or acquiring.

(ii) The cost of issuers is likely to be small due to the fact that cardholders hold their checking accounts in the same bank (the extent of adverse selection is therefore greatly reduced) and that virtually all cards in Israel are deferred debit cards.

(iii) Acquiring is probably much more competitive in Israel than issuing. Therefore one might suspect that interchange fees will raise the merchant fees and the resulting revenues will be transferred to the less competitive issuing side, where there is no competitive pressure on credit cards companies to pass on these revenues to cardholders through cash rebates.

(iv) Given the (current) market shares of the credit card companies in issuing and acquiring, it seems that lowering the interchange fees is likely to hurt Isracard and Leumi card, which have larger market shares in issuing than in acquiring, but benefit CAL.

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