
The Regulation of Payment Cards: The Mexican Experience

José L. Negrin

Banco de México

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I. Objective

- This is a descriptive paper that presents the current situation of payment cards in Mexico.
- The analysis is restricted to general acceptance credit and debit cards issued in four party systems; it is also limited to card use at points of sale (POS). It excludes cards issued by merchants.
- The Mexican experience is relevant because there have been several instances of public intervention in this market.
- This description allows us to discuss some issues behind the functioning of the market and the role of financial authorities.

II. Some Background

- In Mexico a relatively small portion of the population has access to banking services.
- There is a widespread perception that banks' services are too expensive and banks' profits are too high.
- In January 2004, Congress passed the Law of Transparency and Restructuring of Financial Services (LTOSF).
- The LTOSF provided Banco de Mexico with powers to regulate banks' fees and commissions, including interchange fees.

II. Some Background

- Central Bank's Law states that one of its goals is "...promoting the sound development of the financial system and fostering the proper functioning of payment systems".
- Banco de Mexico had only been involved in large value payments (systemic risk).
- The LTOSF gave Banco de Mexico the opportunity to influence retail payments.

II. Main Issues

- Are there distortions in the Mexican payments' card market?
- If so, could public intervention mitigate the problem?
- Has past public intervention affected the market's development?
- We will look at evidence of market distortions:
 - General analysis: market development (coverage), market concentration and other indicators.
 - Particular to payment cards : imbalances from a two sided market perspective, the interchange fee, card associations' rules, etc.

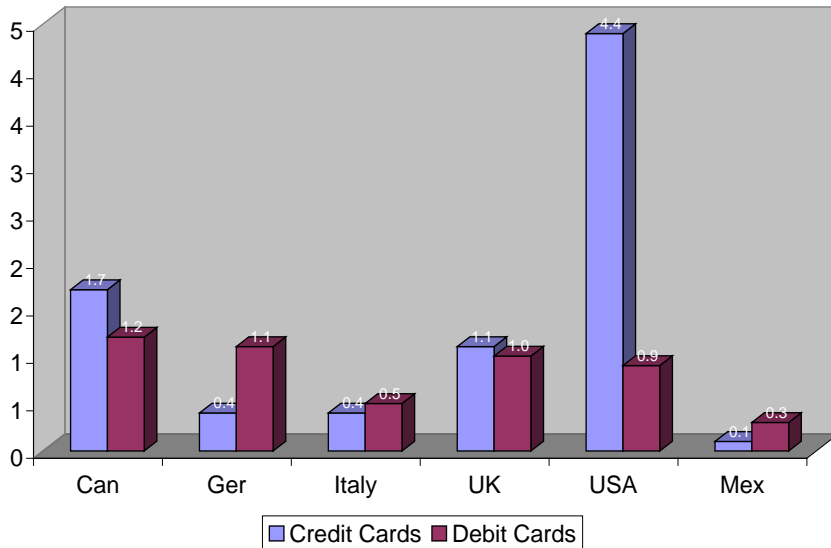
We will mention instances of public intervention along the way, before LTOSF was issued.

II. Background on Payment Cards

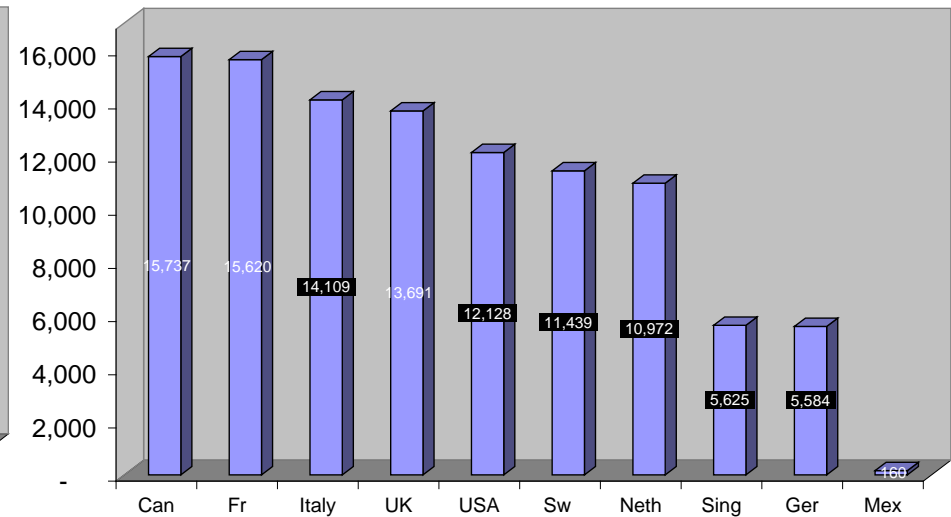
- In the Mexican banking industry cross subsidies and indirect practices are common. It is hard to isolate the costs and profitability of a single service.
- The banking system is characterized by its lack of transparency and by product differentiation. This limits consumers mobility.
- In terms of regulation, all chartered banks are allowed to issue general acceptance cards and to acquire (card associations, however, may set other barriers to entry).
- Payment cards travel along the same infrastructure.
- They are all signature based (PIN is only used at ATMs).

III. Market Development Indicators

Payment Cards Per Person
(2003)



POS per Million Inhabitants
(POS terminals that accept debit cards, 2002)

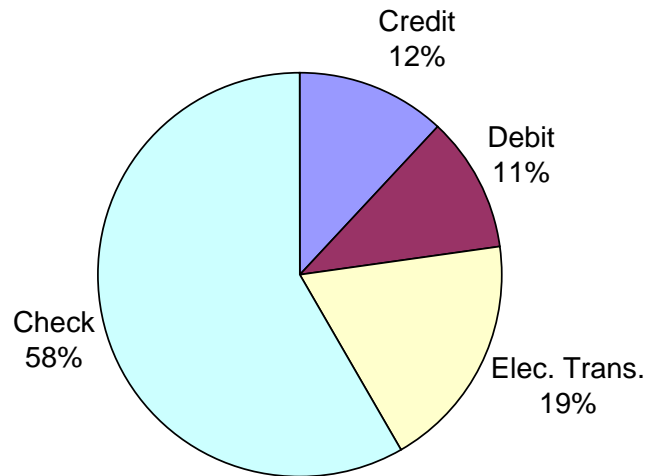


The market is rather underdeveloped:

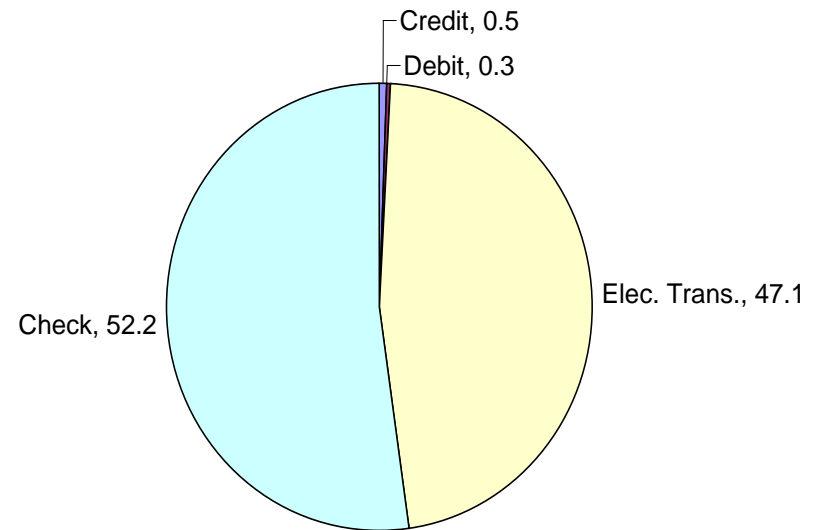
- The number of cards per person is very low (0.1 for credit and 0.3 for debit).
- The number of POS is very low.

III. Market Development Indicators

Structure of Non-Cash Retail Payments: Number of Transactions at POS (%)



Structure of Non-Cash Payments: Transactions Value at POS (%)



Importance of debit and credit card transactions within non-cash transactions at POS (excluding transactions performed at ATMs).

- Limited importance of credit and debit transactions
- In 2004, over 90% of debit transactions in Mexico was performed at ATMs.

IV-a) Indicators of Market Concentration

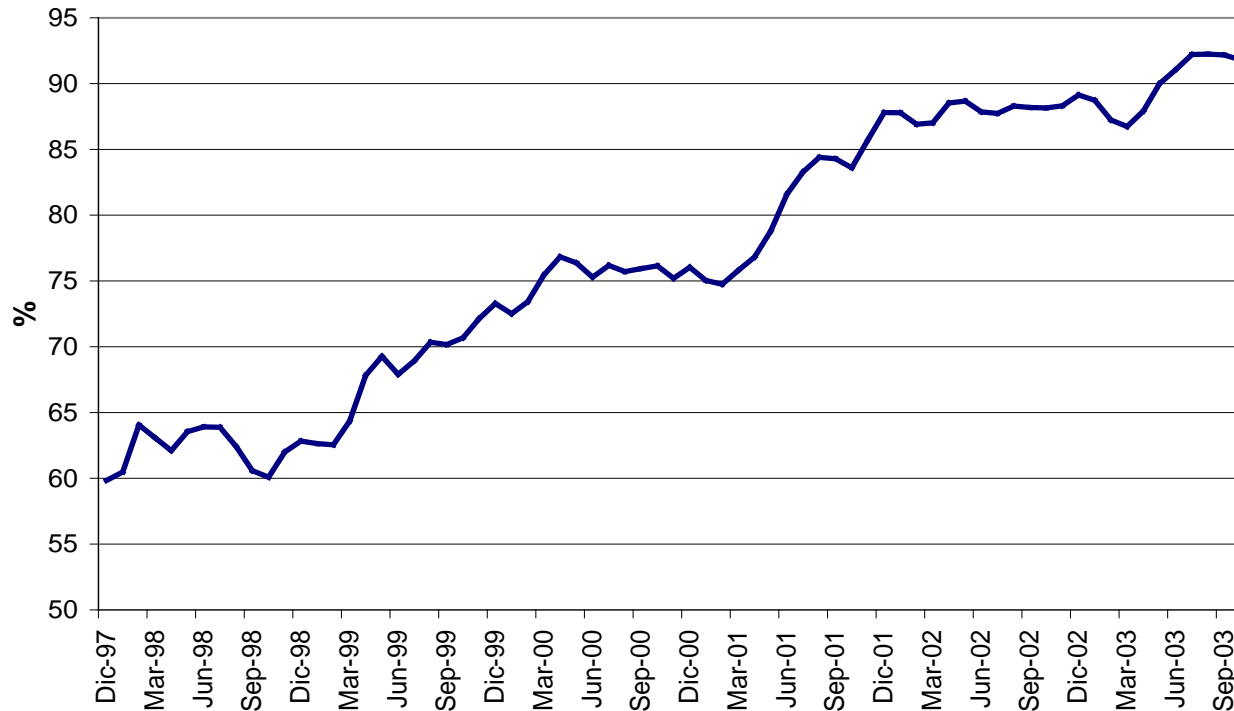
Cards' Issuing Concentration Indicators (2004)		
	Credit Card	Debit Card
Number of issuers	11	25
CR 2 (%)	72	46
CR 4 (%)	90	72
Herfindalh	2924	1683
1/Herfindahl	3.4	5.9
Source: original data from CNBV		

- Market is highly concentrated (based on contracts number).
- Situation is similar in the acquiring side of the market.
- Same banks control both sides of the market.

IV-a) Evidence of Market Distortions

Lerner Index for Classic Credit Cards: margins seem large.

Classic Credit Card Lerner Index (weighted by market share)

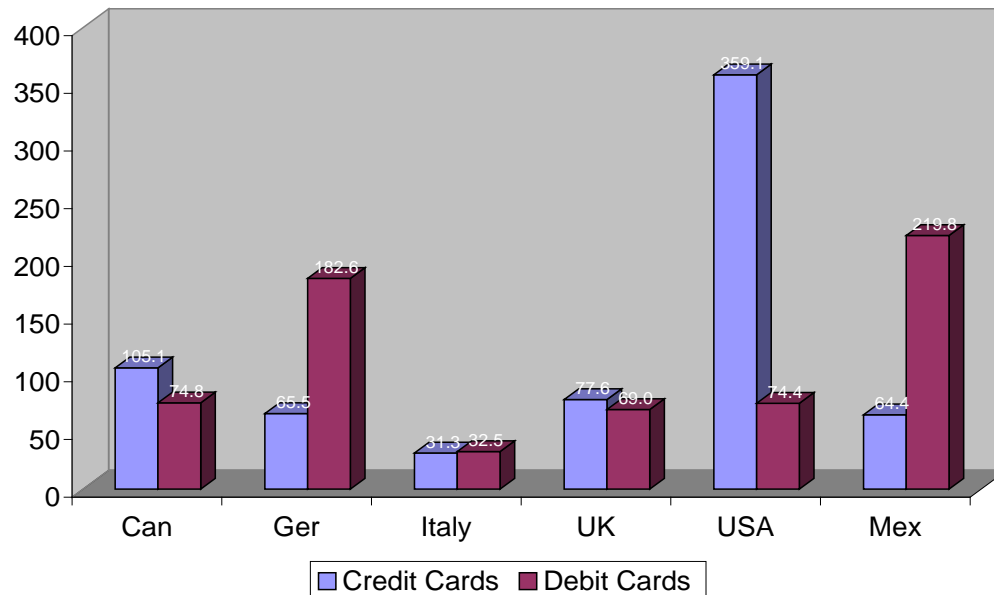


There is evidence of competition through product differentiation, rather than prices.

IV-b) Payment Card Market Imbalances

From a two sided market perspective, there should be a correspondence between cards and POS.

Number of Payment Cards per POS
(2003)

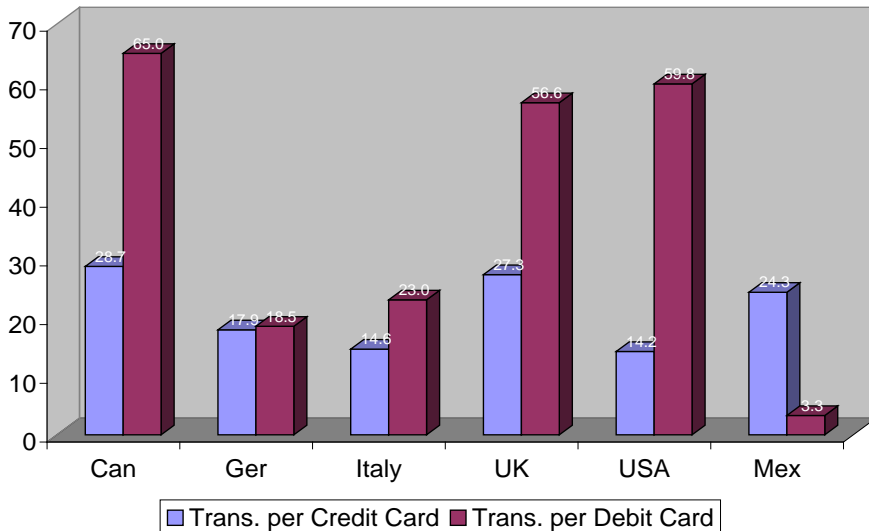


- The ratio of cards per POS is high.
- The number of debit cards seems too high given the number of POS.

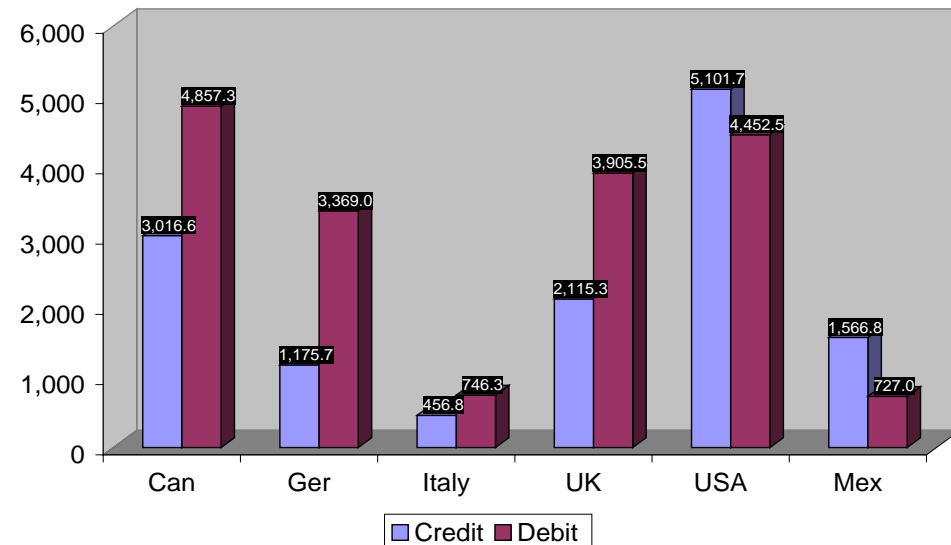
IV-b) Payment Card Market Imbalances

From a two sided market perspective, there should be a correspondence between both market sides.

Transactions per Payment Card
(2003)



Transactions per POS
(2003)



- The number of debit transactions per card is very low (3.3 a year).
- The number of debit transactions per POS is low considering the number of debit cards in the market.

IV-b) Distortions: Associations' Rules

- Honor all cards rule: usual shape before LTOSF.
- No surcharge rule: modified by the intervention of the Federal Competition Commission (CFC) in 1994. Discount for cash payments are allowed; surcharges for credit card payments are forbidden.
- Duality rule: modified by the intervention of the CFC in 1996. The same bank issues Visa and MasterCard cards, and even AMEX
- Only acquirer if issuer rule: still upheld.

Additionally, non-banks do not participate in the market:

- Only banks can connect to switches (regulation);
- Only institutions subject to similar prudential regulations as banks can issue cards (associations).

IV-b) Distortions: Interchange Fees

- The IF flows from issuer to acquirer.
- The role of card associations in setting the IF is limited. The IF schedule is the same for Visa and MasterCard.
- The Association of Mexican Banks (ABM) sets the IF. This mechanism was set up in 1995.
- All banks face the same IF schedule, but they are free to set discount rates (acquiring) and consumers' benefits (issuing).
- IF is set in a non transparent manner.

IV-b) Interchange fees in the Mexican Market

Before the LTOSF was passed, there were three IF schedules in Mexico:

Interchange Fee Schedules Prior to the LTOSF			
		Debit	
	Credit	Applied to Non-ANTAD Merchants	Applied to ANTAD Merchants
Average	2.73%	2.73%	0.04 US dlls.
Brackets	5	5	10
Main Feature	Proportional	Proportional	Fixed fees

- They reflect bargaining power; no efficiency content.
- They discriminate against small (non-ANTAD) merchants-debit transactions.
- Within a schedule, discrimination was based on volume only, no line of business consideration.
- IF had been constant for years: complex agreement to set them.
- Although international comparisons are not strictly correct, IF seems high with respect to other countries.

IV. Summary

- Market is rather underdeveloped;
- Market is concentrated and same banks dominate both sides;
- There are important imbalances:
 - The number of POS is very low; there seem to be constraints in the acquiring side;
 - Debit cards are not used for purchases at POS;
- There are barriers to entry both in issuing and acquiring;
- The IF schedules disfavor:
 - Small merchants;
 - Debit purchases at POS.

V. Who Regulates

- There are distortions that could justify public intervention;
- However, who should regulate?
 - The CFC has already intervened in the payment cards market, but
 - Banco de México has more powers and expertise to design the industry of retail payments;
- What are the right instruments to regulate?
 - The main regulatory instrument provided by the LTOSF is price fixing.
 - Price fixing is not the best instrument to promote the use of more efficient payment means but it provides a credible regulatory threat.

V. What has been done so far

After the LTOSF, Banco de Mexico has taken several steps:

- Transparency:
 - Inform clients of fees and commissions through Internet and other ways;
 - Contracts must specify clients' commissions;
 - Changes in commissions have to be notified to Banco de Mexico.
 - Banco de Mexico is making public comparisons of commissions between banks.
- Eliminating restrictions to participation:
 - Balance transfer for credit card payments is allowed;
 - Honor all cards rule has been modified: merchants can accept only credit, debit cards or both.
- The Interchange fee has not been regulated.

V. What has been done so far

- However, the ABM has adjusted the IF schedules down in several occasions after the LTOSF was issued:
 - The average credit card IF has fallen 43 basis points (bp).
 - The (proportional) average debit card IF has fallen 134 bp.
- This has led to lower IF for debit than credit.
- The ABM is promoting entry of non-covered segments through special IF categories: hospitals, fast foods, gas stations, etc. This should promote efficiency.
- Additionally: Treasury is funding POS readers' deployment.
- Reduction in IF, special rates and Treasury promotion should increase POS deployment and debit card use at POS.

VI. Final Comments

- Regulating prices in banking is complex and undesirable.
- In particular, regulating the IF may cause distortions because it is not clear what the ideal level is.
- Moreover, it is not clear to what extent changes in IF are translated to discount rates and consumer benefits.
- Nevertheless, the setting of the IF in Mexico seems to be the outcome of a bargaining process rather than the “delicate balancing act”.
- It is puzzling that banks were so willing to reduce IF:
 - Regulatory threat;
 - Same banks being dominant on both sides of the markets: lose on one side, win on the other;
 - Banks conviction that IF should be reduced to expand the network.

VI. Final Comments

- Before regulating prices, other policies should be attempted.
- It is desirable to introduce transparency at all levels: IF and commissions. This should increase consumer mobility and competition.
- It is important to eliminate barriers to entry: access to switches and to the acquiring markets should be eased.
- It is not clear if no-surcharge regulations imposed in the past have had a negative impact on market development.
- It is still too soon to evaluate regulations.