The credit card industry in Israel

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Major Israeli banks and their credit card companies

Banks and market shares in 2004 in terms of deposits by the public	1998 – 2000	2000 – 2005
Bank Hapoalim - 29.8%	Isracard (100% owned): • Isracard (100%) • Mastercard (100%) • American Express (100%)	Isracard (100% owned): • Isracard (100%) • Mastercard (≈ 100%) • American Express (100%) • Visa (N/A)
Bank Leumi - 25.6%	CAL (65% owned): • Visa (84%)	Leumi Card (100% owned): • Visa Leumi (≈ 50%) • Mastercard (N/A)
Israel Discount Bank - 17.6%	CAL (35% owned)	CAL (51% owned): • Visa (≈ 50%) • Mastercard (N/A)
Bank Hamizrachi - 10.7%		
First Int'l Bank - 8.5%	Alpha Card (67% owned): • Visa (16%)	CAL (20% owned)

Credit cards and market shares in acquisition (most of the data is from 2001)

Credit card company	Cards	Number of cards (in millions)	Market share in acquiring
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 (2004)	Visa Leumi Mastercard	1.2 N/A	15.3%
Others			5.9%
Total active cards (2004)		3.8	

Number of active cards grew at an annual rate of 9.1% since 1982 (from 0.55 million)

Main features of Israeli credit cards

- Deferred debit cards; virtually no credit cards and no debit cards
- Credit cards are also ATM cards and in effect are tied with bank accounts (Bank Leumi's clients were unilaterally transferred from CAL).
- Credit is provided by the banks through overdrafts which are very common
- Very little competition on the issuing side (there is very little competition in the banking industry as well especially with regard to households)
- Credit cards are extremely popular:
  - 3.8 million active cards with 3.6 million adults of ages 25 and over
  - 34.1% of private consumption was paid for with credit cards
  - About 10 transactions per month on average
  - M1/GDP is extremely small in Israel (prob. legacy of hyperinflation in the early 1980’s

- Cards are used for:
  - Regular transactions
  - Interest-free installments (typically 3)
  - Credit transactions (up to 36 installments with interest)

- Cardholder fees:
  - Annual fee is waived if a minimum average number of transactions is made
  - Fixed processing and liability fees (introduced after Alpha's exit)
  - Extensive reward programs (most are actually direct marketing)
  - In-kind benefits (rather than cash rebates)

- Honor-all-cards is banned by the IAA

- The no-surcharge rule is banned by the IAA (yet there is no surcharging and cash discounts are rare)

- Few financial firms acquired credit transaction. Since 2001, most of them merged with the 3 credit card companies

The legal grounds for the Israeli Antitrust Authority's (IAA) intervention in the credit card market

- ❖ The ability to proclaim that a Isracard is a monopoly in the acquisition of Isracard/Mastercard allows the director of the IAA to regulate Isracard's activities and merchant fees

- ❖ The interchange agreement between Alpha card and CAL and later between CAL and Leumi card was considered a "restraint of trade" that has to be approved by the Court for trade restrictions

Proclamation of Isracard as a monopoly

- ❖ 2001: Consent decree has capped Isracard’s merchant fees at 2.6% (regular transactions) and 2.8% (credit transactions)

- ❖ 2002: A threat to declare Isracard as a monopoly in acquiring Isracards/Mastercards was used to force Isracard to relinquish its exclusive right to issue/acquire Mastercards

- ❖ 2005: Proclamation of Isracard as a monopoly (after competition in Mastercards did not take off) will enable the IAA to regulate Isracard’s activities (e.g., open up Isracard for competition, force Isracard to issue/acquire Visa cards)

The interchange agreement in the Visa system

- **1998:** IAA grants CAL and Alpha card a provisional exemption, but asks Visa Int'l to provide methodology and data for determining the interchange fee
- **2000:** Visa Int'l does not provide the methodology nor the data - IAA extends the provisional exemption
- **2001:** The agreement between CAL and Leumi card replaces the agreement between CAL and Alpha card
- **2001:** CAL and Leumi card deliver their own methodology and data, but the IAA finds their submission unconvincing

- **2001:** The interchange agreement between CAL and Leumi receives a temporary approval by the Court for Trade Restrictions. CAL and Leumi card are asked to submit their methodology and data for the court's approval

- **2002:** 5 large merchants appeal the temporary approval

- **2002:** CAL and Leumi submit their methodology to the court (but not the data). The court hears the merchants' objections, and decides for now to consider only the methodology

- **2003:** CAL and Leumi card threaten to move to a "split" regime. The court rejects the application. The parties submit their summaries

- **2005:** We are still waiting for the court's decision on the methodology...

Interchange fees in the Visa system as temporarily approved by the court for trade restrictions

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 table was meant to preserve the overall fee structure that prevailed in 2002
- ❖ The average fees were lowered

The methodology proposed by Visa's economic experts

- ❖Intended to "balance between cardholder fees and fees from merchants."
- ❖Sets an average fee but allows for different categories based on the merchants' elasticity of demand for payment services
- ❖The data analysis and calculations were performed by the Arthur Andersen Consulting Group in Israel
- ❖The recommended weighted average of the interchange fee across all categories was 1.8%.
- ❖Sensitivity analysis: A 95% ↑ in the cardholder fees will lower the average interchange fee to 1.6%, while a 20% ↓ in the issuer costs will lower it 1.36%.

❖ Demand-based, two-sided, approach:

$$IF = IR/V; \qquad IR = TC - (I + zN).$$

- TC – total issuer cost including everything
- I - Issuers' income from cardholder use, I (but not interest payment)
- z – cardholders' maximum willingness to pay for credit cards

❖ z was estimated by a major polling firm "Mutagim" using a survey

❖ The willingness of merchants to pay merchant fees was ignored because "merchant demand is virtually impossible to measure..."

❖ Since the recommended interchange fee was lower than the existing one this was not an issue

The merchants' and IAA's position

- ❖Ideally, the interchange fees should balance the cardholder and merchant fees, but such an approach cannot be implemented
- ❖Despite the lack of theoretical foundations, the only practical approach is cost-based

Why a demand-based approach not practical?

❖Mutagim's survey has revealed the following:

- 48% of cardholders are not willing to pay for having a credit card
- 30% are willing to pay only up to 50 NIS a year
- Only 22% are willing to pay above 50 NIS a year

❖After the survey was completed, the credit card companies introduced in early 2002 annual fixed processing and liability fees of about 90 NIS a year

❖Since 2002 active credit cards have increased from 3.5 million to 3.8 million...

- ❖Cardholders' willingness to pay cannot be estimated using surveys!
- ❖According to the Visa companies, merchants' willingness to pay cannot be estimated either
- ❖Without the ability to estimate the willingness to pay you cannot implement a demand-based approach!

Collusion on the acquiring side

- ❖ Interchange fees serve as price floors:
  - o "On them" – interchange fee is a cost
  - o "On us" – interchange fee is an alternative cost
- ❖ The acquiring side in the Israeli Visa market seems to be more competitive than the issuing side
- ❖ Credit card companies would rather earn profits on the issuing side
- ❖ The interchange fees allow CAL and Leumi card to support more collusive prices on the acquiring side. The profits are then transferred to the issuing side where they are kept due to weak competition for cardholders.

Additional objections

- ❖Due to merchant fees, credit cards are significantly more expensive than cash and checks.
- ❖Yet, merchants feel that they cannot refuse to accept credit cards because consumers have a strong preference for using them
- ❖This strong preference is due in part to the marketing efforts of the credit card companies (e.g., the extensive reward programs)
- ❖Ironic that the interchange fee should be based on all issuers' costs, including marketing costs that might be excessive from the merchants' point of view.

- ❖The proposed methodology takes all issuers' costs into account – even if they are excessive and inefficient (cost-plus problems)
- ❖Issuers' profits were ignored: the IR will have to financed solely from merchant fees.
- ❖But banks will be willing to finance IR from their profits to ensure that the volume of credit card usage is large
- ❖Credit cards are less costly to handle than checks - banks can save costs by inducing consumers to switch from checks to credit cards - these cost savings should be factored into the computation of the interchange fee

Checks

- ❖It is argued that without interchange fees, issuers will charge higher fees and we will have too little usage
- ❖There are no interchange fees in checks and generally there isn't a feeling that checks are underused
- ❖The Federal Reserve Board in the US has eliminated the "exchange charges" on checks since 1913
- ❖The par clearance controversy in the 1910's-1920's was similar to the debate about interchange fees
- ❖Why are credit cards different?

Conclusion

- The Israeli credit cards market is heavily regulated by the IAA
  - Credit card companies were forced to offer cards they did not want to offer
  - The IAA dictates the terms at which Isracard will license CAL and Leumi card the right to issue Israecards
  - Isracard's merchant fees are regulated
  - The interchange fees in the Visa system was fixed by the Court of Trade Restrctions
  - The court is going to determine the methodology and then the appropriate interchange fee in the Visa system
  - The same interchange fee will be also implemented in the Mastercard system

- ❖No evidence yet of any success in the regulatory intervention:
  - No competition in issuing
  - Few Mastercards issued by CAL and Leumi card and few Visa cards issued by Isracard
  - The court case regarding the methodology for setting the interchange fee is still pending (the case started in 1998!)
  - No data was ever released by the credit card companies regarding their costs, number of cards, usage, etc.

- ❖The interchange fees in Israel are probably not neutral:
  - Merchants do not surcharge
  - Rebates to cardholders are in-kind rather than in cash.

- ❖Demand for credit cards is probably very inelastic (few distortions are expected)

- ❖Demand-based approach seems impractical

- ❖The IAA is advocating cost-based approach