The Credit Card Industry in Israel

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Abstract

This paper reviews the Israeli credit card industry and discusses in detail the ongoing attempts by the Israeli Antitrust Authority (IAA) to promote competition in the industry. Currently, these attempts had only limited success: there is still little competition both on the issuing and the acquiring sides of the market.

1 Introduction

Until 1998, there were two main players in the Israeli credit card 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 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 Mizrahi 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 card transactions.

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[1] As of December 31, 2004, the respective market shares of Bank Hapoalim, Bank Leumi, Israel Discount Bank, United Mizrahi 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 19 additional 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

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 systems, Visa and Mastercard. 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 (Licensing) which states that banks cannot jointly own auxiliary corporations.[3] Following this order, IDB bought Bank Leumi's share in CAL in 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 credit card companies in the Israeli market: Isracard, CAL, and Leumi Card.

In March 2001, the director of the IAA instructed CAL and Leumi Card to start issuing their own brands of Mastercards no later than August 1, 2001, and to start acquiring Mastercard transactions 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 November 2005 however, this agreement is still pending in the Court for Trade Restrictions). Meanwhile, Isracard has 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 and the Mastercard systems are formally open systems, which, at least in principle, have three issuers and three acquirers operating in each system. In practice, however, Isracard is effectively active only in the Isracard/Mastercard market, while CAL and Leumi Card are active only in the Visa market.

The IAA played a key role in bringing about the structural change in the Israeli credit card industry. In this paper, we 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

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[2] It is estimated that in 1999, there were around 245 thousand Visa Alpha cards, compared with 1.3 million Visa CAL cards (see Business Data Israel, 2000). For a detailed case study regarding Alpha Card's entry into the market, see Aviram (2004).

[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 partnership 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.

Section 3 with a review of the current industry structure. In Sections 4 and 5 we discuss the IAA's ongoing intervention in the credit card industry.

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 to the director's proclamation of Isracard as a monopoly in acquiring Isracard and Mastercard transactions 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 in both 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, 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 credits and decide each month how much 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. PIN-based debit cards are not offered in Israel.

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). The credit in this case is provided by the merchant. 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). 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 issuing bank rather than by the merchant.[5] 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 even encourage) their customers to have overdrafts: according to Bank of Israel data, the total overdraft in personal and commercial bank accounts in Israel amounted, as of July 2005, to 56.5 billion NIS, of which 15.3 billion NIS were overdrafts that exceeded the official credit limits.[6] By comparison, the total credit extended by Israeli banks to the public amounted in the same period to 552 billion NIS.[7] Second, ATM cards and credit cards in Israel are tied – the same plastic card is used for both functions. Moreover, once a customer opens a bank account, he almost automatically receives a credit card from the same bank. Although the director of the IAA has issued in September 2001 an order that prohibits banks from tying bank accounts and credit cards, it appears that it is still 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, it sent an official letter to all of its clients, who until then held Visa CAL cards, to inform them that their Visa CAL cards have been cancelled and they are requested to go to their branch to pick up their new Leumi credit/ATM cards.[8]

Together, these features of the Israeli banking industry imply that, effectively, most Israeli cardholders do receive credit services when they use their cards, although these services are provided by the banks themselves through the cardholders' overdrafts rather than directly by the credit card companies.[9] From the perspective of a bank that owns a credit card company, however, the card is equivalent to a credit card only when the cardholder maintains his checking account in the same bank. Otherwise (for example, the cardholder has a Visa Leumi Card but a checking account in United Mizrahi Bank), the credit service is provided by a different bank.

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[5] For example, an Isracard holder whose card was issued by Bank Hapoalim receives credit from Bank Hapoalim rather than Isracard, while a Visa CAL holder whose card was issued by IDB receives credit from IDB rather than CAL. The credit card companies provide credit for credit transactions only in those (still rare) cases in which the cardholder is not a client of a bank which is authorized to issue the credit card (for example, a client of IDB who holds an Isracard).

[6] See Dorit Bar, "Israelis exceed their overdrafts by 15 billion NIS," YNET, October 2, 2005, http://www.ynet.co.il/articles/0,7340,L-3150132,00.html.

[7] See Table A-2.1, Non-Direct Bank Credit to the Public, Bank of Israel – Research Department, Main Israeli Economic Data, http://www.bankisrael.gov.il/deptdata/mehkar/indic/eng_a2_1.htm

[8] An application to approve a class action was filed against Bank Leumi on April 2001, alleging that the bank misled its clients and tied bank accounts and credit cards. See Bank Leumi Financial Statements for March 31, 2002.

[9] On January 1, 2006, a new Bank of Israel directive, which requires banks to enforce the credit limits of their customers, will go into effect with a six-month "adjustment period" (see Shlomy Golovinski, "Central Bank bowls to unrest, grants 6 months to adjust to overdraft reform", Haaretz, December 7, 2005). Since currently 39% of Israeli bank account holders regularly exceed their credit limits (see Ronit Harel, "Anticipating black January: Fasten your belt and think positively", Haaretz, November 2, 2005), it is likely that the new directive will lead to lower overdrafts and an increased demand for traditional credit cards, like Leumi card's Multicard and CAL's Active card, that were recently introduced into the Israeli market.

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 virtually no cash rebates however). In addition, cardholders receive with their monthly bills an advertising booklet that offers various products and services at a discount. Bank of Israel directive No. 470 allows the revenue from the sale of advertising space in the advertising booklet to cover the operating cost of mailing the monthly statement to customers, but not to exceed it.

There is some evidence that the demand of cardholders 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.[10] This number has continued to grow 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 processing and liability fees of around 90 NIS annually, irrespective of card usage.[11] Despite this fact, the number of active cards and the volume of credit card transactions have continued to grow since 2002 (Bank of Israel, 2004, Ch. 6).

On the merchants' side, it seems that merchants are not willing or able to refuse to honor credit cards or even try to divert consumers from credit cards to other means of payments. Moreover, following a complaint by the association of travel agents, the "no-surcharge" rule was held by the director of the IAA as an illegal restraint of trade under the Israeli antitrust law in 1993 (see IAA, 1993). Yet, casual observation suggests that merchants do not impose surcharges on credit card transactions, and, except for a few deep discount retail chains, they do not give cash discounts either. In addition, although the merchant fees of supermarket chains have almost doubled in May 2002 following regulatory intervention by the IAA, supermarket chains did not try to dissuade consumers from using credit cards (IAA, 2005).

Finally, it appears that the IAA's position is that the "honor-all-cards" rule is an illegal restraint of trade. One indication for this is a consent decree between the director of the IAA and Isracard under Section 50(b) of the Israeli Antitrust Act that was submitted for the approval of the Court of Trade Restrictions on August 2002. Among other things, the decree stipulated that Isracard will not be allowed to tie the acquisition of either Isracard or Mastercard transactions with the acquisition of transactions made with other credit cards.[12]

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[10] 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 and Judy Maltz, "Isracard – the leading credit card company in Israel," Globes, December 28, 1999.

[11] Apart from the processing and liability 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 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.

[12] See publication number 3015226 at
http://www.etype.co.il/anti1/?cmd=4&text=1511,1489,1493,1510,1514,32,1508,1493,1506,1500,1497,1501
It should be pointed out, however, that the director has recently decided to remove his request to approve the consent decree, claiming that some of the decree's provisions, and particularly the opening of the Mastercard market to competition, have not yet occurred despite the fact that three years have passed since the consent decree was submitted to the Court's approval (see IAA, 2005).

3 Industry structure

As of December 2004, there were 3.8 million active credit cards in Israel as of December 2004 (that is, 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 number of merchants that receive acquiring services from each company:

Credit card company	Cards	Number of cards (in millions) *	Number of merchants receiving acquiring services **
Isracard	Isracard Mastercard American Express Visa	1.1 0.3 0.15 N/A	90,000
CAL	Visa CAL Mastercard Diners card	1.1 N/A 0.16	45,000
Leumi Card	Visa Leumi Mastercard	1.2 N/A	36,000

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

Notes: * 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. ** Taken from the websites of Isracard, CAL, and Leumi Card. According to Business Data Israel (2001), as of November 2001, the market shares of Isracard, CAL, and Leumi Card, in acquiring were, 47%, 31.8%, 15.3%, respectively.

A few comments about Table 1 are in order. First, the numbers in the table do not necessarily reflect active cards. Second, the table does not show the number of Visa cards issued by Isracard and the number of Mastercards issued by CAL and by Leumi Card, casual observation suggests that these numbers are still quite small. One reason for this is that, currently, these cards cannot be used for interest-free installment transactions and credit transactions, which account for a significant fraction of all credit card transactions. 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, 2005).[13]

Fourth, until recently, a few independent financial firms specialized in acquiring interest-free installment transactions (that is, pay the merchants the full amount with a

[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#).

discount and then collect the cardholders' installment payments from the issuers). By 2001, the market share of these independent firms in acquiring has reached 5.9% (Business Data of Israel, 2001). Since then, however, three of these firms were acquired by the credit card companies; the only independent firm which is still active in this market segment is A.S Mimunim whose market share in acquiring credit transactions is 4%.[14]

To appreciate the number of credit cards in Israel, it should be noted that the average population 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 Israelis 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 months of 2004, 34.1% of the expenditure on private consumption in Israel was 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 was about 10.[17]

International comparison reveals that credit cards are more common in Israel than in other developed economies. Table 2 shows the importance of payments by cards relative to all cashless payment instruments, including checks and credit and debit transfers, in 1998.

Not surprisingly, the number of businesses that accept credit cards is also quite large in Israel. It is estimated that in 2000, about 50-60 thousand Israeli merchants accepted credit cards. This number ranks Israel third in Europe in terms of the proportion of businesses that accept credit cards (Business Data Israel, 2000). Since then, however, the number has grown substantially, as is evident from Table 1.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, M1 as a proportion of GDP is much smaller in Israel than in the U.S., Europe, and Japan.[18]

Casual observation suggests that there is still relatively little competition on the issuing side. For instance, direct marketing of credit cards, which is extremely common in the credit card market in the U.S., is generally absent in Israel. Moreover, as noted earlier, credit cards in Israel are perceived to be a service provided by banks to their clients, so that

[14] In 2001, Isracard merged with Tzameret, which had a market share of 4% in the acquiring of credit transactions. 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 acquiring of credit transactions, merged with the second largest firm in this segment, Yatzil, which had a market share of 33%. See Dafna Tzuker, "Strum conditioned the merger between CAL 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

[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 million active cards, this implies that on average, each credit card used in 2004 in 118.4 annual transactions, or 9.8 monthly transactions.

[18] 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 6.8% of Israeli GDP. The corresponding numbers for the U.S., France, Germany, Italy, and Japan, were 12.8%, 23.4%, 27.4%, 34.7%, and 43.4%.

most Israeli cardholders hold credit cards from the bank in which they maintain their checking accounts. Consequently, the lack of competition on the issuing side reflects the fact that the Israeli banking industry is not very competitive in general, especially in the household market. For example, the Hirschman-Herfindahl concentration index in the Israeli banking industry is 2,280, compared with an average of 1,770 for a group of comparable countries (Ruthenberg, 2005).[19] Moreover, the average price-cost margin (that is, "Lerner index") in the household market is over 0.65 (see Bank of Israel, 2003, Ch 2).

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%

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

Source: 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.

While there seems to be little competition on the issuing side of the market, there does seem to be growing competition between CAL and Leumi Card for the acquiring of Visa transactions. This competition seems to also affect the behaviour of Isracard in the Isracard/Mastercard market. For instance, until 2001, the credit card companies used to pay merchants once a month for the transactions made during the last month. Since 2001 however, Isracard offers merchants advanced payments of up to 80% of future credits in regular transactions and 60% in the case of credit transactions. 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). The fact that competition on the acquiring side is stronger than on the issuing side is consistent with the observation that competition between Israeli banks in the business market is stronger than in the households market: for example at the end of 2003, the average Lerner index in the business market was slightly over 0.5, compared with over 0.65 in the household market (see Bank of Israel, 2003, Ch 2).

[19] The countries are Belgium, Denmark, Finland, Greece, Ireland, Norway, New Zealand, Portugal, and South Africa.

4 The proclamation of Isracard as a monopoly

As mentioned in the Introduction, the IAA plays a key role 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.

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 to the public. The director's threat to proclaim Isracard as a monopoly allowed him to reach a consent decree with Isracard under Section 50(b) of the Israeli Antitrust Act. The decree that was submitted to the Court of Trade Restriction for approval back in August 2002, requires Isracard to relinquish its exclusive right to issue and acquire Mastercards in Israel.[20] In other words, the director of the IAA has used its power to force Isracard to open up its proprietary system for competition.

Thus far, however, only minor competition has evolved between Isracard, CAL, and Leumi Card (see IAA, 2005). A main obstacle for competition between the three companies is the fact that all three retain exclusivity over both interest-free installment transactions and credit transactions made with their own cards. As mentioned in Section 2, these transactions account for a substantial fraction of all credit card transactions in Israel. Given this state of affairs, the director has recently backed off from the proposed consent decree with Isracard before it was approved by the Court of Trade Restrictions, and, in May 2005, proclaimed Isracard as a monopolist in acquiring Isracard and Mastercard transactions (IAA, 2005).

4.1 The grounds for the proclamation

Since Isracard is still virtually the sole acquirer of Isracard and Mastercard transactions, 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 Israelis carry credit cards issued by 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 argued that other means of payments are not sufficiently close substitutes for credit cards because many customers have a strong preference for credit cards. This strong 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 due to the various reward programs that the credit card companies offer their cardholders. The director argued that a refusal of merchants to honor credit cards will lead to a large loss of sales. He therefore concluded that merchants cannot afford to refuse to honor credit cards despite the fact that due to merchant fees, they are significantly more expensive for the merchants than other means of

[20] See Shmuel Deklo, "Bank Hapoalim and Isracard ask the Court of Trade Restrictions to force Strum to honor the Mastercard decree," Globes, July 3, 2005.

payment. The director also pointed out that although the merchant fees on transactions made in supermarket chains have almost doubled in May 2002 following regulatory intervention by the IAA that raised the interchange fee for Visa transactions made in supermarket chains from 0.55% to 1.00%, supermarket chains did not try to dissuade consumers from using credit cards.[21] 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.[22]

Third, the director argued that credit cards issued by CAL and by Leumi Card are not sufficiently close substitutes for credit cards issued by Isracard. This argument was supported by the observation that as of May 2003, both Isracards/Mastercards (issued by Isracard) and Visa cards (issued by CAL and Leumi Card) were directly debited in 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, following 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%.[23]

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 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 itself to acquire Visa card transactions. 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 those that the Court of Trade Restrictions will set for Visa card transactions.[24]

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[21] Although the IAA intervened only in the Visa market, Isracard also raised its merchant fees for supermarket chains at about the same time from 0.72% to 1.03% on Isracard transactions and from 0.71% to 1.04% on Mastercard transactions.

[22] 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).

[23] It should be noted however that the merchant fees of all three 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, while part of the decline in Isracard's merchant fees was ordered by a consent decree reached between the IAA and Isracard.

[24] As of November 2005, the interchange agreement between CAL and Leumi Card, as well as the system of interchange fees, is still pending in the Court of Trade Restrictions. This is despite the fact that the agreement

Any other agreements between Isracard and the other acquirers will be subject to approval by the director of the IAA or the Court of Trade Restrictions. 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 Isracard transactions will stipulate that CAL and Leumi Card will be able to acquire Isracard transactions only after each of them has issued at least 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 Isracard transactions. 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 Isracard transactions 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 Isracard transactions, in the hope that Isracard will reciprocate and will not attempt to compete in the acquisition of Visa card transactions.

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 mentioned earlier 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 credit transactions, unless new acquirers will enter the Isracard/Mastercard market. Isracard has lowered its fees accordingly, even though eventually, the director has decided to back off from the consent decree and in May 2005, proclaimed Isracard as a monopoly in acquiring Isracard and Mastercard transactions.[25]

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 (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.[26] 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 credit 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

was first submitted for the court’s approval back in March 2001 and most of the court hearings took place in 2002.

[25] See Shmuel Deklo, “Bank Hapoalim and Isracard ask the Court of Trade Restrictions to force Strum to honor the Mastercard decree,” Globes July 3, 2005.

[26] The director can exempt the parties from the obligation to obtain the Court's approval if he believes that the fees do not substantially harm competition.

following its proclamation as a monopoly in acquiring Isracard and Mastercard transactions.

5 The interchange agreement between CAL and Leumi Card

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. 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 such an interchange agreement is a restraint of trade, which, under the Israeli law, has to be approved by the Court for Trade Restrictions. The Court may approve a restraint of trade if it finds that the benefits to the public outweigh the 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 to lower 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 stated that during the 18 months extension period, Visa International should complete the required cost study and 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 earlier promises, Visa International has once again failed to complete the required 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 for setting 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 Mastercard transactions 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:

Category	**September 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%

Table 3: Interchange fees in the Israeli Visa market

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 and reducing the gap between the interchange fees in the various categories. It should be noted that since the interchange agreement between CAL and Leumi Card is still pending in the Court for Trade Restrictions, the temporary interchange fees stated 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 against them and in favour of 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 on the ground that, although the temporary agreement has substantially lowered the interchange fees across the board, large supermarket chains were moved, starting from May 2002, from the lowest category in which the interchange fee is 0.55%, to the second lowest category in which 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 on Visa transactions almost doubled and rose to more than 1%.[27] By comparison, Supersol's CFO has testified in the Court for Trade Restrictions that since the 1980's, Supersol's merchant fees on Visa transactions were around 0.55%. It should be pointed out that at the same time, Isracard raised its merchant fees for supermarket chains from 0.72% to about 1.03% on Isracard transactions and from 0.71% to about 1.04% on Mastercard transactions (see IAA, 2005). The reason for moving large supermarket chains from the lowest to the second lowest category was 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 to promote competition in the 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, both 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 much larger so that overall, the average merchant fees paid by supermarkets will increase following the approval of the temporary interchange agreement.

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[27] 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.

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 decided by the Court.[28] As mentioned earlier, as of November 2005, the case is still awaiting a final decision by the Court. 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 be also implemented in 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 University, 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 stated goal of the proposed methodology was to set interchange fees that "provide a balance between cardholder fees and fees from merchants", in the spirit of the theoretical models of Baxter (1983), Rochet and Tirole (2002, 2003), and Schmalensee (2002). 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 should be set at 1.8%.[29] 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 starts with the computation of an "Interchange Requirement", IR, which is given by

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

where TC is the total issuing costs, I is the issuers' income from cardholder use, z is the cardholders' maximum willingness to pay for credit cards, and N is the number of cardholders.[30] IR represents a deficit on the issuing side that must be recovered from

[28] In January 2003, CAL and Leumi Card have requested the Court for Trade Restrictions to withdraw their application to approve their interchange agreement, thereby moving in effect to a "split" regime in which 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 based on a well-founded methodology benefits the public at large.

[29] It should be noted however that both the data, as well as the actual calculations, were not disclosed due to confidentiality granted by the court.

[30] According to the proposal, the total issuing costs would be identified using a methodology developed by Visa International. This methodology (which was not presented to the court) is intended to allocate the total

acquirers. The interchange fee then should be set so as to cover the IR. 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" (Fershtman and Gandal, 2002, Section 0, p.3). The average interchange fee is then simply given by IR/V, where V is the average volume of card transactions across all categories.

It should be noted that the proposed methodology does not explicitly take into account the willingness of merchants to pay the merchant fees that are necessary to cover IR, because "merchant demand is virtually impossible to measure even if one uses survey methods" (Fershtman and Gandal, 2002, Section 4, p.2). Instead, Fershtman and Gandal note that since their proposed methodology will lead to a reduction in the merchants' fees, the merchants' willingness 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, along with the issuers' income from cardholder use, determines the size of issuers' costs that can be recovered from cardholders. To determine z, a professional survey was commissioned from a major polling firm "Mutagim". The main findings of the survey were as follows:

(1) 48% of the population holds one card and another 21% hold two or more cards,

(2) 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.

(3) Only 22% are willing to pay above 50 NIS a year for having a credit card.

(4) 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 indicated that 48% of cardholders will drop out of the system as a result, Fershtman and Gandal have assumed that the churn would only be 10%. Since 21% of all individuals hold two cards or more, they estimated a decrease of 15.4% in the total number of cards. Given this figure, they estimated that the total cardholders' fees will be

$$50 \times (100\% - 15.4\%) \times N \times 1.1,$$

where N is the number of cardholders before imposing a cardholder fee of 50 NIS and the 1.1 figure 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, submitted to the Court economic expert opinions on their behalf.[31] For the

costs of the credit card companies and the respective owner banks (which are co-issuers) into issuing and acquiring components. Moreover, according to the proposal, 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, but not interest income on overdrafts. The proposal asserted that the latter should not be included because the overdrafts of cardholders are independent of the means of payment.

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

most part, these 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 lacking theoretical foundations, is relatively straightforward to apply.

Of course, the fact that a cost-based approach can be applied is not, in and of itself, a reason for applying it. However, the Court of Trade Restrictions had to choose a methodology for setting the interchange fee. The two alternatives are a demand-based methodology that takes the willingness of consumers and merchants to pay into account, and a cost-based methodology that does not take the willingness to pay into account. Unfortunately, the Israeli case demonstrated that a demand-based methodology is simply impractical. The reasons for this are as follows.

First, as mentioned above, Fershtman and Gandal argue that "merchant demand is virtually impossible to measure". Indeed, their methodology does not explicitly take the merchants' willingness to pay into account.

Second, currently there are still no good econometric techniques for estimating demand functions in two-sided markets. Moreover, it is not obvious that we have enough price variation in the Israeli credit card market to estimate such demand functions even if we had the right econometric techniques. Hence, the only way to estimate the willingness of cardholders to pay for credit cards is by relying on survey results. However, the Israeli court case provided a vivid example that it is virtually impossible to measure the willingness of cardholders to pay for credit cards using survey results. 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 but before it was presented in court, the credit card companies have began charging processing and liability 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. This leaves us with a cost-based methodology, despite its theoretical shortcomings.

The merchants also made few other arguments regarding the interchange fees. First, merchants' testimonies at the court have 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 due to the strong preference of consumers 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 of consumers for credit cards is due, in part, to the marketing efforts of the credit card companies (for example, the extensive reward programs that the companies offer and which are often tied to credit card usage). This implies in turn that merchants may be better off if the credit cards companies scale back their marketing efforts. The merchants argued that it is ironic to base the interchange fee on all of the issuers' costs, including marketing costs that might very well be excessive from their point of view. Moreover, they pointed out that the methodology proposed by

Fershtman and Gandal does not provide the credit card companies with any incentive to minimize their costs on the issuing side since all of these costs are supposed to be recovered from merchants through interchange fees. Hence, their proposed methodology may lead to inefficiencies on the issuing side.

Second, the merchants pointed out that an implicit assumption in Fershtman and Gandal's proposed methodology is that the interchange requirement should be financed solely from merchant fees. This is of course unavoidable if the credit card market is perfectly competitive and the banks earn zero profits from credit cards. In Israel, however, there are only three credit card companies and there is little competition between them. Not surprisingly then, credit cards are quite profitable. For example, Leumi Card was profitable even in its first year of operation. It should be noted that the profits of the credit card companies understate the banks' overall profits from credit cards since part of these profits accrue to the banks directly (for example, the interest revenue from overdrafts). It is therefore clear that the banks' profits could serve as another source for covering the interchange requirement. After all, credit cards in Israel are tied to bank accounts and are viewed by account holders as part of the overall service that banks provide. Hence, the banks have a strong incentive to ensure that credit cards are used, and moreover, have the financial means to ensure that this is the case.

Third, the merchants argued that it is conceivable that the widespread use of credit cards allows banks to save costs by inducing their clients to increase their credit cards usage at the expense of checks and cash.[32] Moreover, the widespread usage of credit cards may also help the banks to reduce the number of bank branches and ATMs, which is quite small by international comparison.[33] These cost savings should be factored into the computation of the interchange requirement. Of course, it could be argued that the credit card companies bear various costs on the issuing side such as the cost of processing, the cost of bad debts by cardholders, and the cost of float, which must be covered by the acquirers. However, the merchants claimed that the processing and liability fees that the credit card companies have started charging in February 2002 are specifically intended to cover the cost of processing as well as the cost of liability. Moreover, since credit cards in Israel are deferred debit cards, the risk of non-payment lies with the banks rather than with their credit card subsidiaries. The interest on overdraft already covers these risks. As for the cost of float, 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 typically pay merchants twice a month. Hence, the merchants argued that a large fraction of the float is in fact borne by the merchants rather than by the credit card companies or the issuing banks.

5.3 The IAA's position

The IAA also supported the idea that the interchange fee should be cost-based. In particular, the IAA's position was that since payment guarantee is at the core of what credit card systems provide, the interchange fee should be based only on the issuers' costs

[32] For instance, some estimates suggest that banks' costs due to credit card transactions are three times smaller than the costs of transactions made with checks (see for example, Humphrey and Berger, 1990; and Robinson and Flatraaker, 1995).

[33] 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).

of providing payment guarantees to merchants. Accordingly, the IAA proposed an interchange fee that would be based on the cost of fraud and fraud prevention, the cost of bad debts, the cost of authorization of credit card transactions, and the cost of processing interchange transactions (that is, acquisition of transactions made with cards issued by another company), but not on items like marketing costs and the cost of various promotions and reward programs which are not related to payment guarantees. The IAA noted that its proposed methodology is consistent with the methodology that was determined in 2002 by the Reserve Bank of Australia and by the European Commission in the case of cross-boarder transactions. Moreover, the IAA's position was that, unless there are differences in the cost of providing payment guarantees (for example, there are differences in the incidence of fraud between different merchants), the interchange fee should be uniform across merchants.

The IAA also maintained that after the court would determine the appropriate methodology, the actual interchange fee would be determined by an independent and objective entity that would be approved by the court. This entity would audit and report the relevant issuers' cost that would serve as the basis for setting the interchange fee. Moreover, the IAA maintained that for the sake of transparency, the credit card companies would publicly reveal the interchange fees that would be eventually set by the court and that these fees will be gradually applied in order to minimize the risk of large shocks to the system.

5.4 Key features of the Israeli credit card industry which are important for determining the interchange fees

There are several features of the Israeli credit card market that seem to be particularly important for the determination of interchange fees:

First, in Israel, credit cards are widely held and widely used by consumers and are almost universally accepted by merchants. Hence, it appears that there is no need for an interchange fee (positive or negative) to bring cardholders and merchants on board: they are already on board. Moreover, as mentioned in Section 2, it appears that the demand of cardholders for credit cards and the willingness of merchants to accept them are both inelastic. Hence, changes in the interchange fee are unlikely to cause major changes in the usage of credit cards.

Second, the issuers' costs are probably quite small in Israel due to the fact that cardholders hold their checking accounts in the same bank that issues them a credit card. This ensures that banks already have substantial data on cardholders. Moreover, virtually all cards in Israel are deferred debit cards, so the risk, if any, lies with the banks rather than the credit card companies. And, as noted earlier, credit card transactions replace the more costly checks transactions and may well promote private consumption and, hence, the banks' revenues from interest income on overdrafts. The fact that the issuing costs are small is important because it weakens the argument of CAL and Leumi card that there is a deficit on the issuing side, which has to be covered by a positive interchange fee imposed on the acquiring side.

Third, the acquiring side of the market is probably much more competitive in Israel than the issuing side. Therefore one might suspect that the credit card companies would have an incentive to set a high interchange fee in order to prevent competition from bringing about lower merchant fees. The interchange fees then transfer the resulting supracompetitive profits to the less competitive issuing side, where there is no competitive pressure on the credit cards companies to pass on these revenues to cardholders through cash rebates. Indeed, the extensive reward programs that the Israeli credit card companies offer are all in-kind rather than in the form of cash, and moreover, many of these programs seem more like direct marketing programs that may very well generate additional profits rather than merely raise costs.

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.[34] 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 and setting different merchant fees for different merchants (for example, pharmacies and supermarkets). 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.

The district court approved the class action based on the excessive pricing and restraint of trade claims, holding that these claims have a reasonable probability of being decided in favor of the plaintiff. The Supreme Court, however, reversed this decision. 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 reinforces 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.

As to the claim that the joint ownership of CAL by IDB and Bank Leumi was a restraint of trade, the Supreme Court held that the damages caused by this restraint were computed by the plaintiff according to the 2% merchant fee benchmark charged by Alpha Card. Since the Court found that this benchmark is inappropriate, this claim was not approved as well. The Court also pointed out that even if the 2% benchmark was

[34] See BSH"A 106462/98 Howard Rice v. CAL.

appropriate, the plaintiff's claim does not cope with the fact that some of the harm caused by the supposedly excessive acquiring fees was passed on to consumers, and was not borne by plaintiffs.

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

What are the main lessons that can be drawn from the Israeli experience? First, it appears that so far, the IAA had only limited success in trying to promote competition in the Israeli credit card industry: despite its heavy regulatory intervention, Isracard is still effectively active only in the Isracard/Mastercard market, while CAL and Leumi Card are still effectively active only in the Visa market. It therefore appears that merely ordering firms to offer products that they do not wish to offer is a poor structural remedy. Although formally Isracard offers Visa cards and CAL and Leumi Card offer Mastercards, casual observation suggests that none of these firms makes a real attempt to promote these cards. Moreover, these cards are limited in their usage since they cannot be used to make interest-free installment transactions or credit transactions, both of which account for a substantial fraction of all credit card transactions in Israel. On the other hand, the IAA did manage to introduce competition into the Visa system by requiring Bank Leumi and IDB to end their joint ownership in CAL. This intervention has led Bank Leumi to establish Leumi Card and enter the Visa market following Alpha card's exit in 2000. It is quite likely that without this intervention, we would have today only one player in the Visa market.

Second, it seems that so long as credit cards are tied to bank accounts, there is very little hope of having meaningful competition between the credit card companies on the issuing side. This is especially true given the lack of vigorous competition between Israeli banks in the household market. It therefore seems that the best hope for competition is on the acquiring side. The IAA's continuing attempts to open the acquisition of Isracard/Mastercard transactions for competition from CAL and Leumi Card and its attempts to facilitate Isracard's entry into the acquisition of Visa transactions may play an important role in promoting such competition. Needless to say, whether competition on the acquiring side will lead to lower merchant fees will depend to a large extent on the interchange fees, which effectively serve as price floors for the merchant fees. It is therefore obvious that the ongoing court case regarding the appropriate methodology for determining the interchange fee in the Visa system is going to have a crucial effect on competition in the credit card industry, especially given the intention of the director of the IAA to also apply the same methodology in the Isracard and Mastercard systems.

Third, although the interchange agreement in the Visa market was first reviewed by the IAA back in 1998, the agreement is still pending at the Court for Trade Restrictions. In fact, the Court has not yet completed even the first step of the process, which is to determine the right methodology for setting interchange fees. Once this step will be completed, the Court will have to consider the data and determine the actual interchange fee. It is therefore not obvious when the process will end. To make things worse, up to now, CAL and Leumi Card have not presented any data about the number of cards they issue, the usage of cards, their costs, their revenues, or even the precise contractual arrangements between them, the owner banks, and Visa International. The latter is important because it affects the nature of the relationship that would prevail between CAL and Leumi Card should the Court decide not to approve the interchange agreement between them (although such an outcome seems highly unlikely). This information has been kept confidential, implying for instance that the merchants who have appealed to the Court of Trade Restrictions were never able to base their appeals on any concrete data, nor were they able to verify the precise nature of the data on which the credit card companies have based their proposal to set the average interchange fee at 1.8%. In fact, CAL and Leumi Card did not even specify clearly which items they have included in the issuers' costs and issuers' income, both of which were part of the computation of the interchange requirement that the interchange fees are supposed to cover.

Fourth, the entire court case suffered from the lack of transparency: instead of having an open process whereby all potentially affected parties can raise their concerns and participate in the determination of the interchange fees, the court case has only involved CAL, Leumi Card, and Visa International, on one side, and the IAA and five merchants, on the other side. However, the five merchants who appealed the interchange agreement are all very large and therefore hardly representative of the entire population of merchants who accept credit cards in Israel. As a result, the Court for Trade Restrictions never had any input from small or medium merchants regarding their preferences and their cost of handling various means of payments. In fact, even Isracard was not part of the process: its request to join the process has been denied by the Court on the grounds that so long as Isracard has not reached an interchange agreement with CAL and Leumi Card, it is not an affected party.

It therefore seems that the adversarial court procedure that took place (and in fact is not over yet) is not an ideal mechanism for determining a highly complicated and technical issue like how to set interchange fees. This is all the more so given that the literature on interchange fees is still in its infancy, so it is far from clear what is the best methodology for determining the interchange fees and what are the implications of using alternative methodologies. It would seem that a more open process with wide participation by cardholders and merchants that would have allowed the parties to discuss the issues more openly and exchange views could have been much better suited for this purpose.

Finally, although it could be argued that the decision regarding the interchange fees is irrelevant since interchange fees are neutral (Gans and King, 2003), 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 (that is, merchants have effectively adopted a voluntary no surcharge rule) 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 credit card transactions account for about a third of all private consumption in Israel, these effects might be quite large.

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