



The Mexican Experience on Interchange Fees



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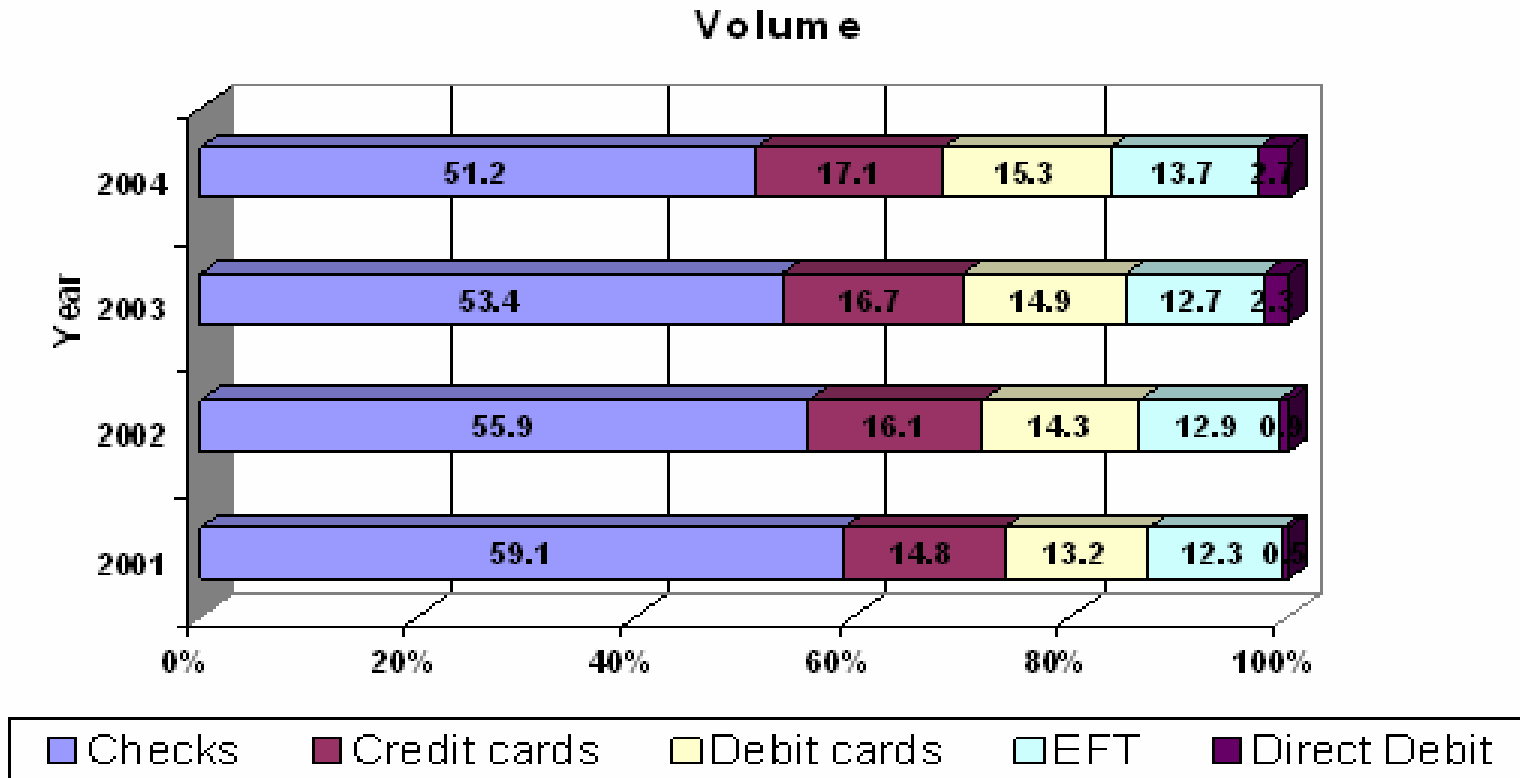
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Background: Functions of Banco de México

- Promoting the proper functioning of the payment systems is one of the main functions of Banco de México.
- Traditionally involved in large value payment systems (RTGS, Securities Settlement).
- New Law in 2004: For Transparency and Orderly Financial Services (*Ley para la Transparencia y Ordenamiento de los Servicios Financieros*, LTOSF).
- The new law gives the central bank explicit power to regulate retail payments systems (Interchange Fees - IF, in particular).

Background: Structure of retail payments

Structure of Non Cash Payments, Excluding Cash Withdrawals in Mexico, 2001-2004

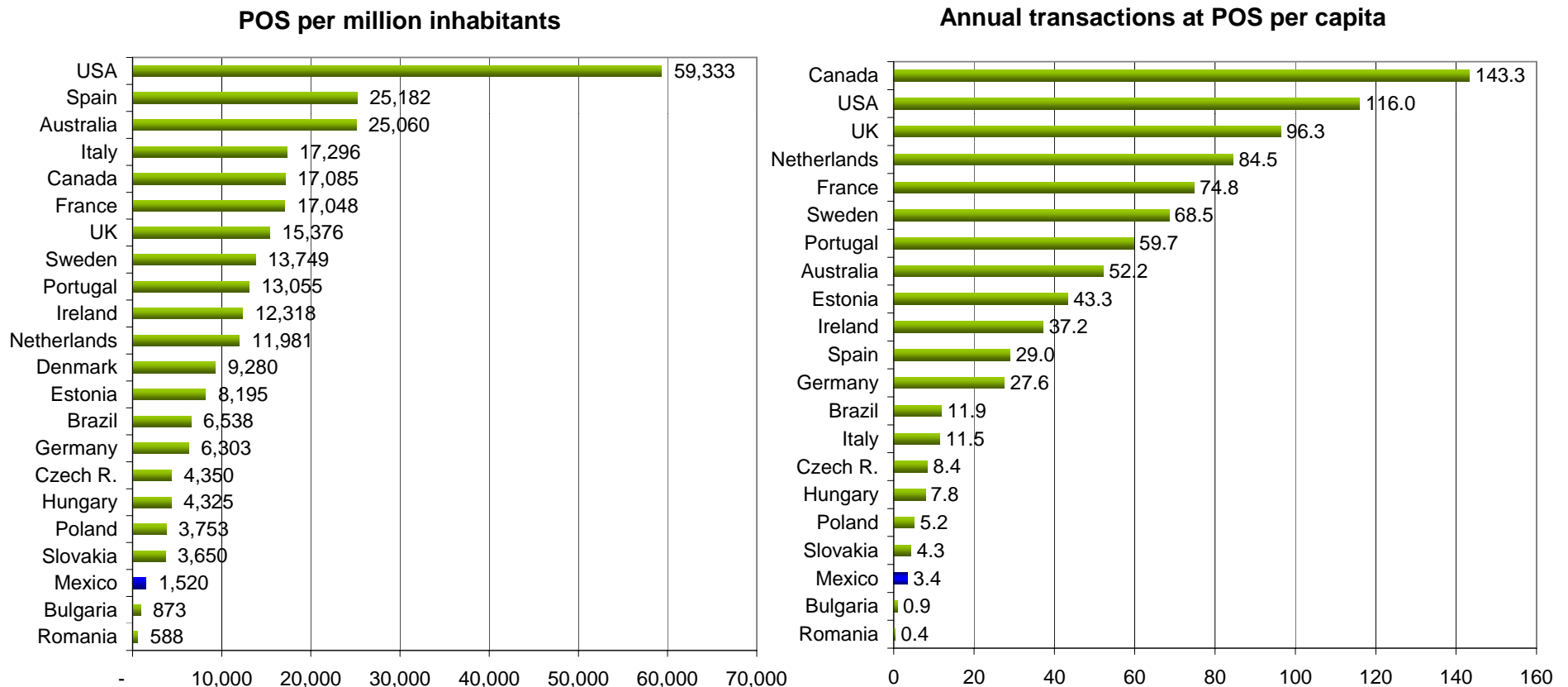


Source: Payment System Statistics, Banco de México.

Background: Structure of retail payments

- The number of POS and of transactions at POS was limited, specially when compared with countries of similar development.

POS and Transactions at POS for several countries, 2004



Source: European Countries: Blue Book Addendum. European Central Bank, March 2006. Non-European countries other than Mexico: Statistics on Payment and Settlement Systems for Selected Countries, Bank for International Settlements, March 2006. Mexico: Payment System Statistics, Banco de México.

Background: Reform of the retail payment systems

- In June 2004, Banxico launched a reform process of the retail payment systems, to encourage the use of the most efficient payment systems and foster banking competition.
- In particular Interchange Fees (IF) at point of sales (POS) were identified as a likely cause for the reduced use of payment cards, and thus the Banxico became interested in the mechanism banks use to set these interchange fees.

Background: IF for payments with credit and debit cards

- Banks used to set IF for the four party system. The IF scheme that was in place in 2004:
 1. Dated from 1993 and had remained almost unchanged.
 2. Both credit and debit card transactions had the same IF scale
 3. IF set according to the value of transactions performed at each merchant.

ABM's Scheme of Interchange Fees in place in 2004

| Category | Merchant's monthly transaction value | | Interchange Fee |
|----------|--------------------------------------|-----------------|-----------------|
| | From | To | |
| 1 | MX\$300,000,001 | Above | 2% |
| 2 | MX\$100,000,001 | MX\$300,000,000 | 2.40% |
| 3 | Mx\$10,000,001 | MX\$100,000,000 | 2.75% |
| 4 | MX\$200,001 | MX\$10,000,000 | 3.00% |
| 5 | Mx\$0.00 | MX\$200,000 | 3.50% |

Source: Banco de México.

Background: The IF for payments with credit and debit cards

- IF's dependence on merchants' transaction value seemed unsuitable to promote the POS network development in Mexico, because small commerce and service establishments predominate.
- Charging equal fees for credit and debit operations does not seem appropriate either: for credit cards, issuers incur in the costs of a free financing period for many users and have generous reward programs.
- IF seemed high when compared to international standards.
- Hence, although the scheme facilitated the interconnection among all system participants, Banxico asked the banks to propose a new mechanism to set IF.

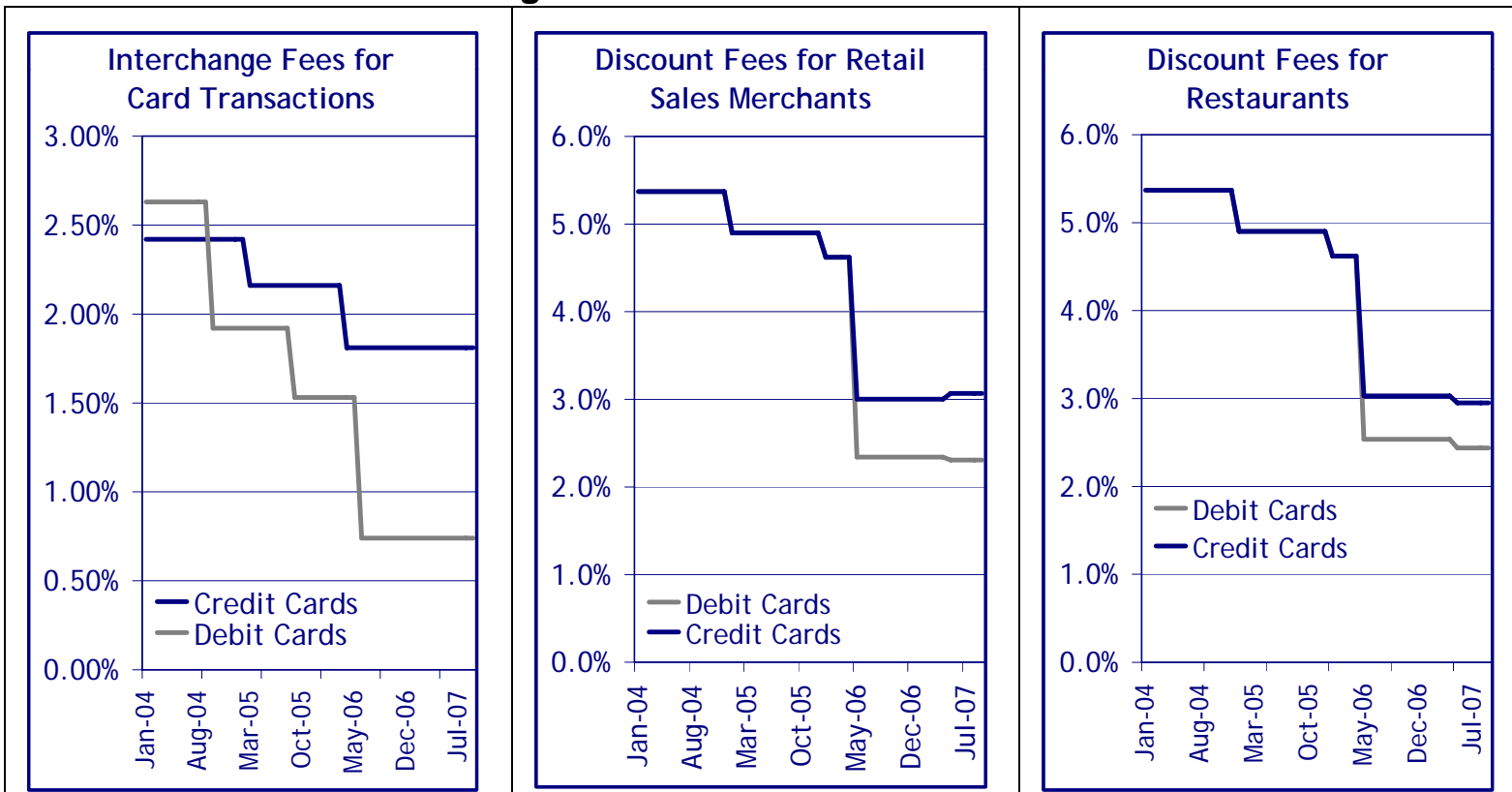
Banks' new methodology to set IF: The 2005 proposal

- On October 2005, a new methodology, based on a model that balanced the issuing and acquiring banks' profits through the IF (in the spirit of Visa's methodology) was determined.
 - Reduction on IF
 - Lower IF for debit and cap of 13.50 pesos
 - IF depend on type of merchant instead of its value of transactions

Recent trends of the bank payment cards market

- The decrease of IF has been followed by decreases of maximum MSF. Fees for small businesses, such as restaurants and retail stores, have dropped to almost half their levels of 2004.

Interchange Fees and Merchant Service Fees



Source: Banco de México.

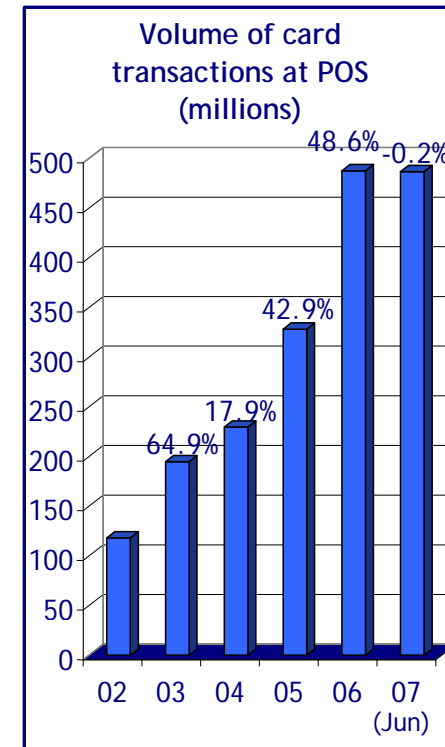
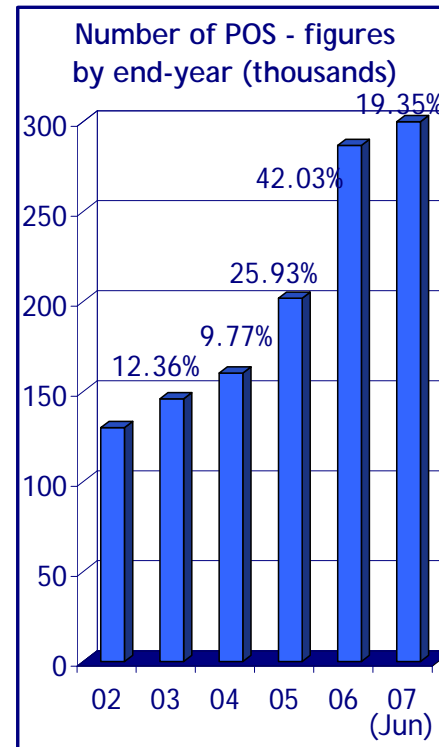
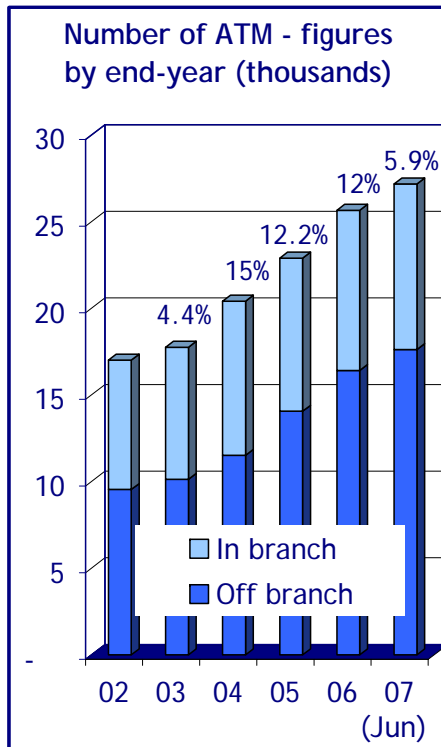
Recent trends of the bank payment cards market

- Since 2004, card payments have increased faster than before. But it is very difficult to attribute this development to IF changes, since other measures that Banxico promoted came into effect at about the same time.
- Besides, in November 2004, the Federal Government set the Electronic Payments Infrastructure Fund (*Fondo de Infraestructura de Medios de Pago Electrónicos*, FIMPE).
 - FIMPE is a private, non-profit-making trust fund formed by card acquirers.
 - It aims to promote and extend access to the electronic payment network among small and middle size business, as well as to increase consumers usage of them.
 - As part of the program, the Mexican Government granted a 3,100 million MXP fiscal incentive for installing POS terminals between 2005 and 2007.
 - FIMPE's programs include banking card usage promotion and first time free POS installation on commercial and service business.

Recent trends of the bank payment cards market

- By June 2007, the number of ATM and POS installed was 27,178 and 342,157, respectively. Operations at POS will probably exceed 500 millions by the end of 2007.

Number of ATM, POS and payment card operations

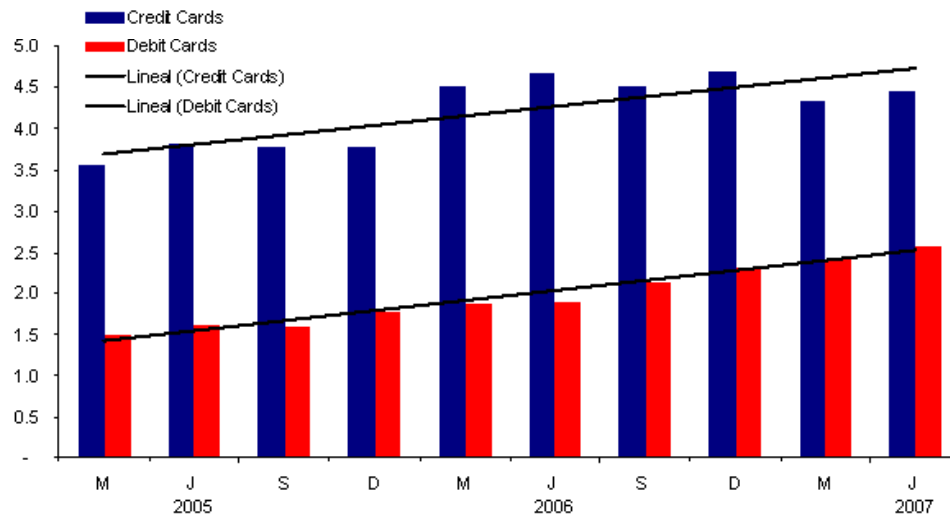


Source: Payment System Statistics, Banco de México.

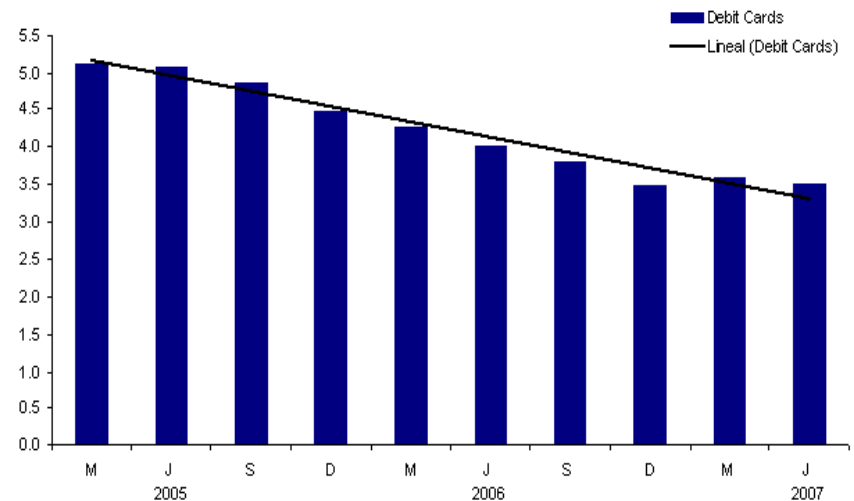
Recent trends of the bank payment cards market

- In addition, transactions per card have increased for both credit and debit cards and debit cards are also being used more to pay at merchant POS than to withdraw cash from ATM.

Ratio of number of transactions at POS to number of cards



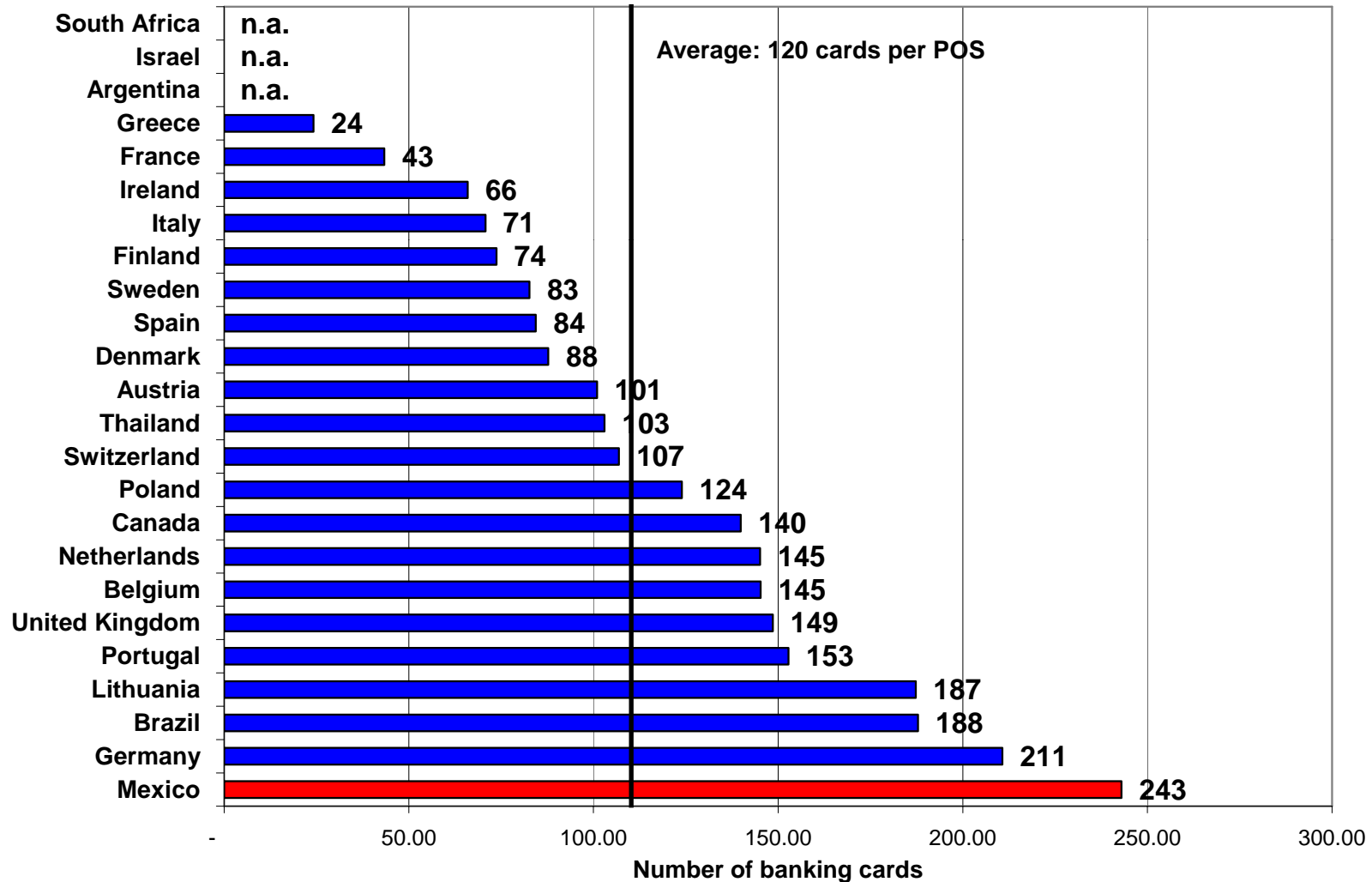
Ratio of number withdrawals with debit cards at ATM to payments with debit cards at POS



Source: Payment System Statistics, Banco de México.

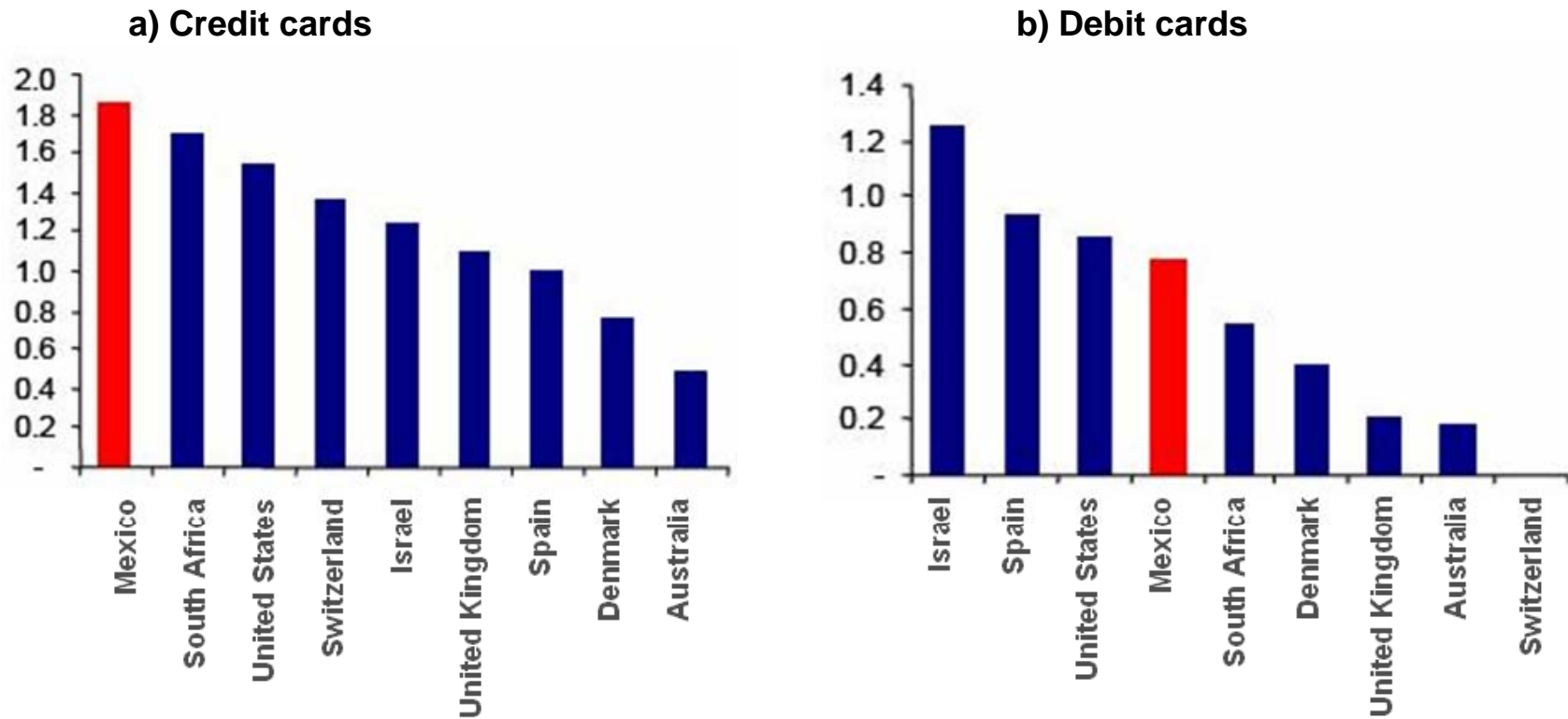
However...

Number of banking cards per POS in several countries



However...

Interchange Fee levels for several countries



Source: Banco de México and central banks from other countries. IF levels for Mexico are those prevailing on 2006 and for the other countries are those prevailing in 2005.

Next steps and open methodological questions

- In view of this evidence, the central bank asked for a further reduction of the IF levels. Last September, banks proposed the following:
 - The IF structure for credit card transactions will be adjusted so that the implicit IF diminishes to 1.61%.
 - The IF structure for debit card transactions will not change, but the maximum charge per transaction will decrease from MX\$13.50 to MX\$9.50.
 - The new IF will become effective on January 2008, and remain unchanged until April 2009.
 - During this time, the banks will continue improving the methodology to set IF.

Next steps and open methodological questions

- The Mexican experience regarding the setting of IF leaves a number of open questions on the approach that has been followed so far:
 - In the absence of a theoretical standard to set the level of IF, can practical “rules of thumb” be developed to decide how much and how often should IF be adjusted?
 - What are the consequences of setting price ceilings for IF charges? Can a floor on the debit IF charge can improve market efficiency?
 - Are there other mechanisms to transmit IF reductions into MSF and cardholder benefits?
 - Will further IF reductions be transmitted to consumers as higher prices for other financial services or lower interest rates on deposits?
 - Does the reduction of IF in the four party system provide an unfair advantage to the three party system (American Express)?
 - Since IF reductions hit small issuers harder than large issuers, how large is the adverse effect on the competition in that side of the market?