

DIRECTIVE 1/2006

Publishes Banco Central do Brasil's opinion on payment card industry.

The Banco Central do Brasil, as part of its mission to pursue both the stability of the national currency and a sound financial system, is in charge of promoting an efficient and safe national payment system, which is understood as a set of rules, institutions, markets, instruments and contracts that allow funds transfers among the economic agents.

2. Retail payments comprise mainly low value funds transfers related to good and service purchases.
3. Retail payment systems and related instruments have an important role regarding efficiency and economic welfare in a society, particularly with respect to aspects relating to the people's reliance on the currency, and the normal functioning of business and commercial relationships.
4. Cost reduction together with improvements in information technology have made possible and economically viable new electronic payment instruments as alternatives to paper-based instruments. The rapid development of these new payment instruments and the importance of the retail payment system have motivated the Banco Central do Brasil to act in this area.
5. In this context, the Banco Central do Brasil has published the "Report on the Brazilian retail payment system"¹ aiming to get determinants of the retail payment system modernization and to found the related policies and guidance. For the purposes of the aforementioned report, modernization means increment in the relative use of electronic payment instruments vis-à-vis paper-based instruments, which is justified in terms of social cost reduction in an amount that, according to studies carried out in some countries, has a potential to reach some 3% of the respective GDP.
6. Retail payment system modernization, as explained before, is aimed at maximizing economic efficiency so as to allow an enlargement of the social welfare.
7. As to retail payment service market, there are two distinct segments. The first directly provides services and payment instruments to customers, and the second offers infrastructures to capture, process, clear and settle retail payments.
8. In the first segment, competition has the potential to produce better results towards promoting economic efficiency, with its participants demanding access to networks in order to meet the users' needs through new products.
9. In the second segment, the use of shared arrangements to process, clear and settle payments has the potential to produce better results, since these arrangements take advantage of economies of scale and simultaneously favor the better exploitation of network externalities.
10. Payment cards have had an important role in the replacement of paper-based instruments. In Brazil, the use of payment cards increased some 29% a year in average from 1999 to 2005, and accounted for more than 45% of interbank non-cash payments. The corresponding value of transactions increased from some R\$ 41 billion to R\$ 190 billion over the same period.
11. The Banco Central do Brasil recognizes the payment card market's development as a positive factor, and considers that, as stated in the "Report on the Brazilian retail payment system", there is still room to augment their use with gains of efficiency and increased social welfare benefiting the final users, that is, both cardholders and commercial establishments. Thus:

The Banco Central do Brasil recommends that the payment card industry use all the potential stemming from cooperation regarding use of infrastructures so as to allow improvement in terms

¹ The report, which is available at www.bcb.gov.br, explains the rationale for this Directive.

of efficiency and social welfare, without prejudice to innovation, development of new products and services, and competition.

12. There are a number of payment cards such as credit cards, debit cards, e-money, retailer cards and charged cards. However, in the context of this Directive, only general-purpose payment cards, also called “universal cards”, namely credit cards, debit cards and e-money, are being considered.

13. Payment card industry comprises the entities in charge of issuing the payment cards, acquiring commercial establishments to participate in the network, and providing network infrastructures that process transactions carried out by the cardholders.

14. Payment cards are network goods and so they are subject to the effects of network externalities, critical mass and economies of scale. The analysis of these aspects is important so as to understand the motivation of this Directive.

15. Network externalities are characterized by the fact that the value of a good or service increases whenever a new user enters into the system. In payment card systems, networks externalities have an important role regarding efficiency and innovation.

16. The existence of a large number of consumers wishing to make their payments through cards stimulates merchants to accept them, and at the same time the existence of a large number of merchants accepting payment cards stimulates the users’ demand related to them. The value of a payment card for its user increases insofar as more merchants accept it and new users enter into the system. As to merchants, the increment in the number of potential buyers increases their interest in participating in the system.

17. The coexistence of multiple network infrastructures in the same market or industry functioning without cooperation among them reduces the positive effects of network externalities, which will in this case be restricted, at a lower level, to each individual network infrastructure. Where there is a cooperative arrangement, the benefits stemming from network externalities are potentially maximized for all market participants – cardholders, firms, issuers and acquires.

18. Critical mass of users and base already installed of merchants are crucial for developing a payment card network. In an initial stage, many potential users will not be interested in adhering to a service network because the installed base is too small and, at the same time, the installed base is too small because few users have already adhered to the network. Therefore, the inexistence of critical mass is a barrier to its development. The present size of the network depends on the expectation of the potential users regarding its future size. Furthermore, taking into account that payment card market is a two-sided market, it is important to have coordination of decisions and expectations regarding all relevant stakeholders.

19. In the infrastructure segment, there are activities that are subject to economies of scale because of the significant investment that is necessary to initiate operation, the high relative fixed costs and low marginal costs, that is fixed costs account for the largest share of the costs.

20. In this sense, cooperation is important to optimize investments in infrastructure. This means that the same result in terms of goods and services can be reached with a lower volume of productive resources, or still that with the same volume of productive resources it is possible to get a better result and gains of efficiency.

21. Infrastructure cooperative arrangements presenting clear and objective access criteria allow reduction of barriers to new entrants into the payment card service provider segment, insofar as sunk costs to initiate operation are reduced.

22. In sum, cooperation facilitates participants’ coordination of decisions and expectations aimed at maximizing benefits stemming from network externalities and reducing infrastructure fixed costs, exploiting all the potential of economies of scale, and, on the other hand, competition among payment service providers is stimulated.

23. Gains of efficiency and enlargement of social welfare can be gotten with the simultaneous existence of cooperative and competitive arrangements. Cooperation among infrastructure market participants does not have the aim

of eliminating competition. In fact, in this arrangement competition is focused on activities where it produces better results.

24. Apart from stimulating gains of economic efficiency by means of arrangements based on cooperation without prejudice to competition, the Banco Central do Brasil's expectation is that these gains be distributed among all participants in the payment chain, which would be benefited by both value aggregation and increased social welfare.

25. Innovation is essential for developing, creating and distributing new products and services in the payment card industry. Heterogeneity is part of the aim of increasing the social welfare, and diversity in terms of products and services benefits consumers since in this case they have more opportunities of choice. Cooperation regarding infrastructure should not represent impediment to innovation and to diversity of products and services.

26. Central banks and international organizations have been in favor of cooperation regarding infrastructure in the payment card industry. The Bank for International Settlements (BIS)² recommends the use of interoperability among networks processing transactions at the point of sale, especially in POS networks, so as to both expand the supply of available services and improve the infrastructure.

27. Another important issue is the criterion to access infrastructure arrangements, since open access helps to promote efficiency. However, in the context of cooperation highlighted in this Directive, the establishment of different criteria for future participants or to share networks may be acceptable so as to balance the differences among the participants, but these criteria should not be impeditive to acceptance of new participants, and they should be objective, clear and transparent.

28. The Banco Central do Brasil will oversee the payment card industry by means of qualitative and quantitative analyses so as to monitor aspects relating to efficiency, cooperation in infrastructure, competition in supply of services, and development of new products.

29. Should the Banco Central do Brasil identify market failures that result in reduction of welfare for cardholders and merchants in the present arrangement, it may propose some structural changes aimed at correcting them.

30. The exercise of either market power or practices hindering competition may lead the Banco Central do Brasil to carry out a joint initiative with competition authorities so as to establish a competitive environment in the market.

Brasilia, April 11, 2006.

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² See "General Guidance for Payment System Development" (2005), page 42.