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CENTER FOR ADVANCED STUDIES

ON THE REGULATION OF THE NATIONAL FINANCIAL SYSTEM

NEASF

10th MEETING OF THE CENTER FOR ADVANCED STUDIES ON THE REGULATION OF THE NATIONAL FINANCIAL SYSTEM

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OPENING REMARKS

On March 19, 2021, the 10th meeting of the Center for Advanced Studies on Regulation of the National Financial System (NEASF) was held by the Center for Research in Law and Economics (CPDE), part of Fundação Getulio Vargas' Rio de Janeiro Law School. The meeting was exceptionally held online.

NEASF's main objective is to contribute to better regulation of the national financial system through research and analysis that make it possible to diagnose problems and identify opportunities to improve Brazil's financial sector.

NEASF is a multi-stakeholder organization involving representatives of academia, the market and government. Through debates and roundtable discussions, its members discuss topics related to regulation of the national financial system, contributing to broader understanding of the sector, trends, risks, any regulatory gaps and their implications.

The chosen subject of NEASF's 10th meeting was "Challenges Involved in Interest-Free Credit Card Installments." The meeting was held in a single session, in which the subject was analyzed from the following angles:

(i) The perspective of payment processors, consumer protection and banking regulation regarding interest-free credit card installments; and
(ii) The impact of interest-free installments on the credit card market in general and on issuing institutions in particular.

CONTEXT OF MEETING AND RELEVANCE OF DEBATE

NEASF's 10th meeting looked at "Challenges Involved in Interest-Free Credit Card Installments." The meeting took place during the Sars-CoV-2 (COVID-19) virus pandemic. A study carried out in the first half of 2021 by the National Confederation for Trade in Goods, Services and Tourism (CNC) found that 66.6% of Brazilian families have debts, and credit cards are the main vehicle for taking on debt[1]. Hence the relevance of the topic chosen for NEASF's 10th meeting.

Interest-free credit card installments are a time-deferred payment method offered directly by retailers to their end customers. In this installment option, the transaction amount is the division, into fixed installments, of the final price of the good or service, to be paid on credit card bills in the months following the purchase date. The term "interest-free" results from the sum of all installments resulting in an amount equal to that which would be charged in the case of payment in cash. Thus, even if the consumer takes several months to make the full payment, in theory, there is no explicit or implicit interest charge. Therefore, through interest-free credit card installments, the card issuer is at risk of default on the installments, but without defining the essential characteristics of the credit operation (payment period and remuneration of credit granted).

Although this form of deferred payment to acquire goods and services in the Brazilian retail market dates back to the 1980s,[2] this type of installment payment[3] has recently been criticized for generating inefficiency in the credit card market. This is because credit card issuing institutions cannot influence the credit term and remuneration granted to the customer, so their remuneration is not aligned with the risk of credit operations. Consequently, this impossibility would in theory result in an increase in the interest charged by card issuing institutions, in the event that they may influence the term and remuneration of credit, especially in revolving credit modalities[4] or through direct loans take out by the customer with the credit card's issuing financial institution.

[1] Source: https://www.portaldocomercio.org.br/publicacoes/pesquisa-de-endividamento-e-inadimplencia-do-consumidor-peic-junho-de-2021/363192. Accessed on July 8, 2021.
[2] At that time, the use of checks as a means of payment was more widespread than credit cards, so several post-dated checks were used to pay in installments for products and services. Over time, credit cards replaced checks as the preferred means of payment in Brazilian retail. As a result, the commercial practice of splitting the price of products and services into several installments (represented by post-dated checks of equal value) was transferred to the credit card market.
[3] Also referred to by payment market participants in Brazil as "retail postpaid plans."
[4] The expression "revolving credit" refers to cases in which customers fail to pay, on the due date, the full amount of their monthly credit card bill and the debit balance is added to the amounts of the next bills until the customer pays the debit balance in full.

INTEREST-FREE CREDIT CARD INSTALLMENTS FROM THE PERSPECTIVE OF PAYMENT PROCESSORS

One of the first subjects addressed in this session was the positive impact of Law 13,455 of 2017, for having authorized commercial establishments to charge different prices for the same product in line with the means of payment used. In 2018, for example, 46.4% of surveyed establishments reported having granted a discount to customers paying in cash or with a debit card rather than with a credit card.[5]

The meeting's participants discussed the benefits of interest-free installment payments on credit cards offered by retailers ("retail postpaid plans"), such as the fact that the merchant receives a payment guarantee upon receipt of the transaction, even if the credit card holder defaults. Accordingly, they discussed the independence and incommunicability of credit rights generated through transactions carried out by means of credit cards, divided between the issuer's credit right to the cardholder, the payment processor's credit right to the issuer and the establishment's credit right to the purchaser. Mention was made of new guidelines on the registration and trading of receivables from payment arrangements (Brazilian Central Bank Resolution 72 of February 12, 2021, and National Monetary Council Resolution 4,888 of February 12, 2021) and how, based on them, registration of an establishment's receivables can be used in a more efficient and competitive environment for granting credit.

The financial disintermediation generated by the direct granting of financing by retailers to final consumers, through a credit card, was also mentioned. It was noted that this is a remnant of the dysfunctional absence of competition and high-inflation environment. In other words, as establishments needed to create means of sale and consumption, consumers were induced to use their credit cards.

The importance of installment payments to consumers during the pandemic was also addressed, as only 16% of credit card users would be able to purchase a durable good if payment were made in cash. This type of payment was used by 75% of credit card users in the period analyzed.[6]

One of the meeting's participants argued that the concept of interest-free installment payments on credit cards generates cross-subsidies is fallacious, since the revenues generated by card users, without including revolving interest, are already significant for issuers.

The concept of cross-subsidy in the structure of the credit card market was presented. Consumers who pay in cash are said to be partially financing the purchases of those who opt for interest-free installments and, as a result, there is a need to redistribute risks, which would be offset by an increase in revolving interest rates. However, it was observed that every transaction made with

[5] For more information, see https://www.bcb.gov.br/htms/relinf/port/2018/03/ri201803P.pdf. Accessed on March 23, 2021.
[6] For more information, see https://economia.uol.com.br/noticias/redacao/2021/02/11/compras-parceladas-cartao-de-credito-datafolha.htm. Accessed on March 23, 2021.

credit or debit cards remunerates the issuer through the incremental interchange fee and, in particular, for the capital allocated for the granting of credit and part of the default risk.

As for the similarity between revolving credit and overdrafts, it was mentioned that, despite being banking services on which the incidence of cross-subsidies is discussed, the use of credit card is already remunerated through the interchange fee and annuity. This is different from what occurred to overdrafts prior to National Monetary Council Resolution 4,765 of 2019. For this reason, the charging of high interest in installments was justified by the need to remunerate the allocated capital. Along these lines, it was also said that demand for revolving credit card has low interest elasticity.

Regarding high interest rates on revolving credit, it was commented that the concentration of the credit market for individuals was one of the reasons for its existence, as around 80% of this market is composed of the five largest financial institutions operating in the national financial system. Thus, it was argued that given the existence of market power, this price results from the elasticity of demand, and in competitive markets, the price is determined to a large extent by the actual marginal cost.

Thus, it was argued that high revolving credit card interest does not result from a cross-subsidy generated by merchants through installments, but rather from the combination of market power and demand inelasticity.

With regard to the possibility of exchanging retail postpaid plans with a model in which consumers obtain credit from financial institutions, it was said that this change would greatly increase the cost of consumption because of the average rates practiced in the market for non-payroll loan personal credit and prepayment of receivables. It was also recalled that the average interest rate applied to non-payroll loan personal credit is approximately 10 times higher than the interest rate applied to prepayment of receivables.

It was said that retail postpaid plans are extremely important for Brazilian retail and that the high interest rates charged by financial institutions make it impossible for this to be the fundamental source of financing for consumer goods, or there would be a sharp drop in sales.

Regarding solutions to deal with the issue of retail postpaid plans, the meeting's participants discussed the need to encourage competition through the entry of new players as a way to reduce market power and facilitate credit portability to allow customers to take their credit lines to new institutions that offer more attractive rates.

It was said that credit portability flow is still slow, the terms are long and noncompliance by institutions, combined with the charging of reimbursement for operating costs and the possibility of renegotiation with the institution originating the credit, would end up discouraging the supply of portability options. The importance of the Central Bank's role in encouraging the entry of new agents into the card market was also commented on, including the BC+ and BC# agendas, PIX, open banking and regulatory sandboxes.

It was argued that the regulation of bank locks in the card receivables agenda contained in Brazilian Central Bank Resolution 72 of 2021 and CMN Resolution 4,888 of 2021 would have a direct impact on retail postpaid plans, as the registration of receivables and their ownership would ensure that there are no ways of reversing credit guarantees, thus allowing a reduction of rates for prepayment of receivables.

It was argued that the inefficiency of retail postpaid plans, regarding non-discrimination of the spot price of installments, will tend to be reduced or eliminated in highly competitive markets. The impact that the fourth phase of the Central Bank's regulation on open banking may have on the card market was cited as an example. This regulation provides for the sharing of data on financial services, such as investments, insurance, foreign currency transactions, open pension funds and other information on fees and rates charged by each institution, which can therefore make this market more competitive. In this sense, the need to create mechanisms for opening up the market and building infrastructure that facilitates access to information and greater ease in credit portability was noted, as measures capable of reducing these inefficiencies.

It was said that between 2010 and 2020, revolving credit defaults ranged between 30% and 35%, while defaults on retail postpaid plans have been 2.5% on average. However, large variations in the interest rates applied to the revolving system in that decade did not substantially affect the default rate.

Finally, the risk faced by acquiring institutions in prepayments of receivables to retailers was discussed. There is a possibility of credit card transactions being cancelled, especially in transactions carried out online. It was said that this risk rises mainly as a result of fraud in transactions carried out with credit cards, especially in transactions carried out over the internet.

INTEREST-FREE CREDIT CARD INSTALLMENTS FROM THE PERSPECTIVE OF CONSUMER PROTECTION AND BANKING REGULATION

To analyze the topic from this angle, some basic premises were initially discussed before delving deeper into subject of interest-free installment payments, including pricing freedom, which in our system is guaranteed by the principle of free price setting, assuming that participants in payment arrangements have the freedom to negotiate – as far as possible from the regulatory perspective – to establish the collection and payment flows carried out between them.

Thus, it is worth clarifying that in typical credit card market structures, the participants in these arrangements[7] (especially issuers, acquires and credit card brands) may establish fees among themselves in return for the provision of certain services, such as the merchant discount rate, which is the amount the acquirer charges the merchant, corresponding to a percentage of sales made using credit cards, and the so-called interchange fee, which the issuer charges the acquirer to transfer the payment from the consumer.

[7] Payment arrangements are the set of rules and procedures that govern the provision of a certain payment service to the public accepted by more than one recipient institution. The participants in these arrangements, which process and settle transactions, are the following: issuing banks or issuing payment institutions, sub-acquiring or issuing institutions, and credit card brands, in addition to settling and domicile banks and institutions.

It was argued that this topic should be discussed from two perspectives: one of merit, in relation to the production chain and how the participants in payment arrangements price risks (credit, default, etc.) throughout payment operations; and the other a direct external projection to the consumer, in which there is a more current discussion about giving consumers the possibility of making use of interest-free installments, which occurs when the value of a transaction is divided into more than one installment , to be charged on subsequent invoices.

In this context, there are some costs to be considered, such as the payment method offered. In this regard, emphasis was placed on the wording given to item I of article 54-C to be included in the Consumer Protection Code (Law 8,078 of 1990) by Bill 3,515 of 2015 which among other things expressly or implicitly prohibits the offer of credit, whether through advertising or not, related to "interest-free credit" or "free credit." An exception to this ban for credit card payments is allowed at the beginning of this article.[8]

It was said that the rule of the device has a generic character, "whether or not advertising the supply of credit." According to the meeting's participant in question, this reference could lead to an interpretation that this "supply" not only covers products and services, which can be paid for in interest-free installments, but also everything that occurs before payment. We should seek to protect correct information for consumers but not a ban on offering interest-free installment payments. It was said that such an interpretation could remove a less costly form of financing from consumers, which did not seem to have been lawmakers' intention. The importance of preserving the autonomy and freedom of parties in pricing the distribution of risks within payment structures was also reiterated.

THE IMPACT OF INTEREST-FREE INSTALLMENTS ON THE CARD MARKET

To analyze the impact of retail postpaid plans on the card market, three aspects related to interest-free credit card installment payments were initially considered: i) bills in progress to reduce revolving interest rates on credit cards; ii) trends in interest rates and volumes of credit granted in the last decade; and iii) the personal characteristics and the level of schooling of revolving credit borrowers.

On the first topic, two bills currently under way in Congress were discussed, aimed at reducing interest rates on revolving credit and preventing over-indebtedness. The first bill discussed was Senate Bill 283 of 2012,[9] designed to regulate consumer credit (credit in general, not just related to credit cards), seeking to make commercial establishments more responsible and transparent in dealings with consumers.

[8] Note: Following NEASF's 10th meeting, Bill 3,515 of 2015 was approved by the House of Representatives and Senate and signed into law by the president of the Republic, and then converted into Law 14,181 of July 1, 2021. This law was approved with some vetoes, so that the new article 54-C was introduced into the Consumer Protection Code without part I and the first paragraph. For more information, see http://www.planalto.gov.br/ccivil_03/_Ato2019-2022/2021/Lei/L14181.htm (text in the approved law) and http://www.planalto.gov.br/ccivil_03/_Ato2019-2022/2021/Msg/VEP/VEP-314.htm (veto message). Accessed on July 8, 2021.

[9] Senate number for bill that proceeded through the House of Representatives under number 3,515 of 2015.

Another objective of this bill is to prevent consumers from becoming over-indebted, so they can meet their minimum daily needs, by providing forms of conciliation in these cases and prohibiting the offer of interest-free credit (apart from in card credit sales, as stated above, in article 54-C of Bill 3,515 of 2015). According to this bill, borrowers may only commit the equivalent of 30% of their monthly net salary to pay off their loans.

The second bill that was mentioned in the meeting is Bill 1,166 of 2020,[10] aimed at restricting the interest rate applicable to revolving credit and overdrafts to 30% per year during the state of emergency arising from the novel coronavirus pandemic declared on March 11, 2020 by the World Health Organization. It was noted that at the moment, interest on revolving credit and overdrafts is approximately 280% and 150% per year, respectively.

It was also said that between 2011 and 2020, the interest rates applied in Brazil and the amount of revolving credit granted to individuals (in Brazilian reais) behaved very similarly. It was said that in the event of a reduction in interest rates, credit grantors could increase the interchange fee to compensate for losses in profit margins and so there would be a possible redistribution in the credit card market's pricing.

Still on the subject of trends in recent years, another graph was shown that plotted revolving credit, installments and cash payments between February 2012 and October 2020. It was said that although the share of each type of credit varied, there was a notable increase in the amount of credit in general issued every year in Brazil. Public data provided by the Brazilian Central Bank, relating borrowers' level of schooling to each type of payment (cash, direct installments, regular rotating and irregular rotating),[11] was also presented and discussed. This data shows that the lower the level of education, the higher the average debt through regular revolving credit lines and installments, and the higher the level of schooling, the greater the use of cash credit and the less the use of revolving credit.

Finally, the importance of financial education to lessen the impact of default and maintain consumers' ability to pay their everyday expenses was stressed.

THE IMPACT OF INTEREST-FREE CREDIT CARD INSTALLMENTS ON CARD ISSUING INSTITUTIONS

From the perspective of credit card issuing institutions, the topic of interest-free credit card installments was analyzed from two angles: i) the historical context of the Brazilian payments market; and ii) possible problems and solutions.

[10] See https://www25.senado.leg.br/web/atividade/materias/-/materia/141297. Accessed on July 8, 2021.
[11] Source: Brazilian Central Bank. Special Study 90 of 2020. "Sensibilidade da demanda à taxa de juros e poder de mercado em modalidades de crédito pessoal com recursos livres." Available at https://www.bcb.gov.br/conteudo/relatorioinflacao/EstudosEspeciais/EE090_Sensibilidade_da_demanda_a_taxa_de_juros_e_poder_de_mercado_em_modalidades_de_credito_pessoal_com_recursos_livres.pdf. Accessed on July 8, 2021.

Regarding the historical context, it was noted that Brazilian society has a history of entering into informal contracts, such as "post-dated" checks. It was said that although this form of payment does not offer the parties (establishment and consumer) any formal contract or guarantee of payment, stores nevertheless chose to carry out sales based on credit, with payment deferred in time. It was said that consultations with credit rating agencies were often the only indicator as to whether consumers were good payers, and this influenced the confidence that credit granted would be paid back. As a counterpoint, it was mentioned that any other modalities of granting credit, such as those carried out by financial institutions, would require formalization of the act.

Also with regard to the historical context, it was said that as a result of Brazil's period of hyperinflation, especially in the 1980s, it became difficult to incorporate losses related to the inflationary cost of the period between the purchase and the receipt of the transfers made by acquirers. In order to adapt the remuneration model to inflationary reality, the possibility for acquirers to be remunerated in the 30-day float (D+30) was created. This process, known as banking float, concerns the time difference between the date on which the amounts are made available to the acquirer and the date on which it clears these amounts to commercial establishments. During the 30-day period, in order for acquirers to offset the values of establishments' sales, it financially invests the volume of resources that it will have to pay to the commercial establishments.

The high degree of impatience in Brazilian society was also mentioned as another element that influences adherence to interest-free installments. This high impatience rate is reflected in the preference of immediate consumption over future consumption and it is manifested in the population's lower willingness to save.

In this sense, it was said that in Brazil, the private savings rate of families is still less than 20% of GDP. This percentage is considered low in relation to other economies with more developed markets.

The low level of financial education was also mentioned as one possible reason for the emergence of interest-free installments in Brazil, as consumption preference is often dictated by the value of each installment to be paid on credit cards, not the total price of goods or services. Accordingly, the high rate of impatience of the Brazilian population combined with low education could have led to the growing use of interest-free credit card installments in Brazil.

It was said that the history of high interest rates in the country also influences interest-free installments. Brazilian society is used to paying high interest rates, so the issue of the discount rate at the spot price is less important to consumers.

Finally, it was said that low competition in the payment market favored the lack of discussion about revolving interest rates on credit cards or interest-free installments themselves.

Regarding the problems posed by the existence of interest-free installments, it was said that it was necessary for spot prices to offer an attractive discount to consumers, to result in lower prices for cash payment. In fact, this price differentiation movement ought to be adopted by shopkeepers in general. In the consumption chain, retailers offer cash prices well below those offered for deferred payments or through retail postpaid plans, but this only accounts for a mere fraction of the broader consumption system.

Another point raised was the maintenance of spot or deferred prices when installments are the same or very similar amounts. In practice, this results in equal treatment of good and bad payers, as the interest implicit

in installments would be the same for both consumers. Thus, if there was differentiation between prices and we could identify the amount of interest charged on installments, good payer could opt, for example, for a loan with lower interest rates than that practiced by the merchant when paying in credit card installments.

The impact of cross-subsidies on the card market and how they affect the price of products was also discussed. It was said that cash transactions finance those made through credit card installments, and that the interest applied to regular revolving credit also finances interest-free installments and consumers' default in the payment of their respective bills.

In the area of cross-subsidies, it was said that having no difference between spot and installment prices causes many card users to take out credit unnecessarily, and this can affect the stock of credit made available to those who really need it. It was said that price differentiation could occur through those who hold market power, in order to reduce these inefficiencies.

"Dead weight" loss[12] was also mentioned as a relevant issue. It was explained that it can occur through the distinction between the cash value and the amount paid in installments on credit cards, since, given the high interest rates charged on products, the final value offered to consumers would tend to differ from the ideal value that would be practiced in a balanced market situation.

In this context, the advantages obtained by all those who are part of the credit card market structure were discussed. As an example, issuers' remuneration from charging an annuity fee and enrollment in rewards programs was mentioned, in addition to the interchange fee and interest rate applied to revolving credit.

It was also said that acquirers are remunerated by discount rates applied to the amount transacted for the prepayment of future flows, while merchants are remunerated from the possibility of higher value transactions. Finally, consumers benefit from purchases in installments on their credit card as they can prepay the purchase of a product or consumer good through a less bureaucratic credit channel, with a period to pay for their purchase.

Possible ways to get more people to pay in cash and possible alternatives to credit card installments were also discussed. Issues were raised such as mandatory price differentiation for cash and installment payments. The inclusion of interest in the price of product when consumers opt for installments was mentioned. However, it was said that both the regulator and establishments are reluctant to do this.

The meeting's participants also said that greater competition – both in the credit card market and in the retail sector – and financial education could help encourage more Brazilians to pay in cash. It was said that the highest rates of cash payments are found in people in formal employment and with higher levels of education, who choose to pay in cash or through retail postpaid plans and rarely use revolving credit.

It was also said that around 80% of credit card transactions occur through retail postpaid plans, which hinders the operation of the credit market, whose guidelines determine that the inclusion of interest be made explicit.

[12] The term "dead weight" is used to designate market inefficiencies, that is, imbalances between supply and demand for the products and services offered.

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