Towards a Competitive Card Payments Marketplace

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Regulation Unwarranted?

- "The agreements that are in place between card systems, merchants, and cardholders are consensual, not the product of force or fraud. **It is hard to imagine how intervention in the form of price regulation could possibly improve matters**." – Tim Muris

Who Has Been Regulating?

"Let me say up front that **I am a firm believer in self-regulation. So is Visa**…" – Visa's Bruce Mansfield

The **scheme** acts as **"price regulator," "licensing authority,"** and **"competition authority"** – Rochet & Tirole

If price regulation does not "improve matters," then why should ***card schemes*** established by banks regulate bank fees?

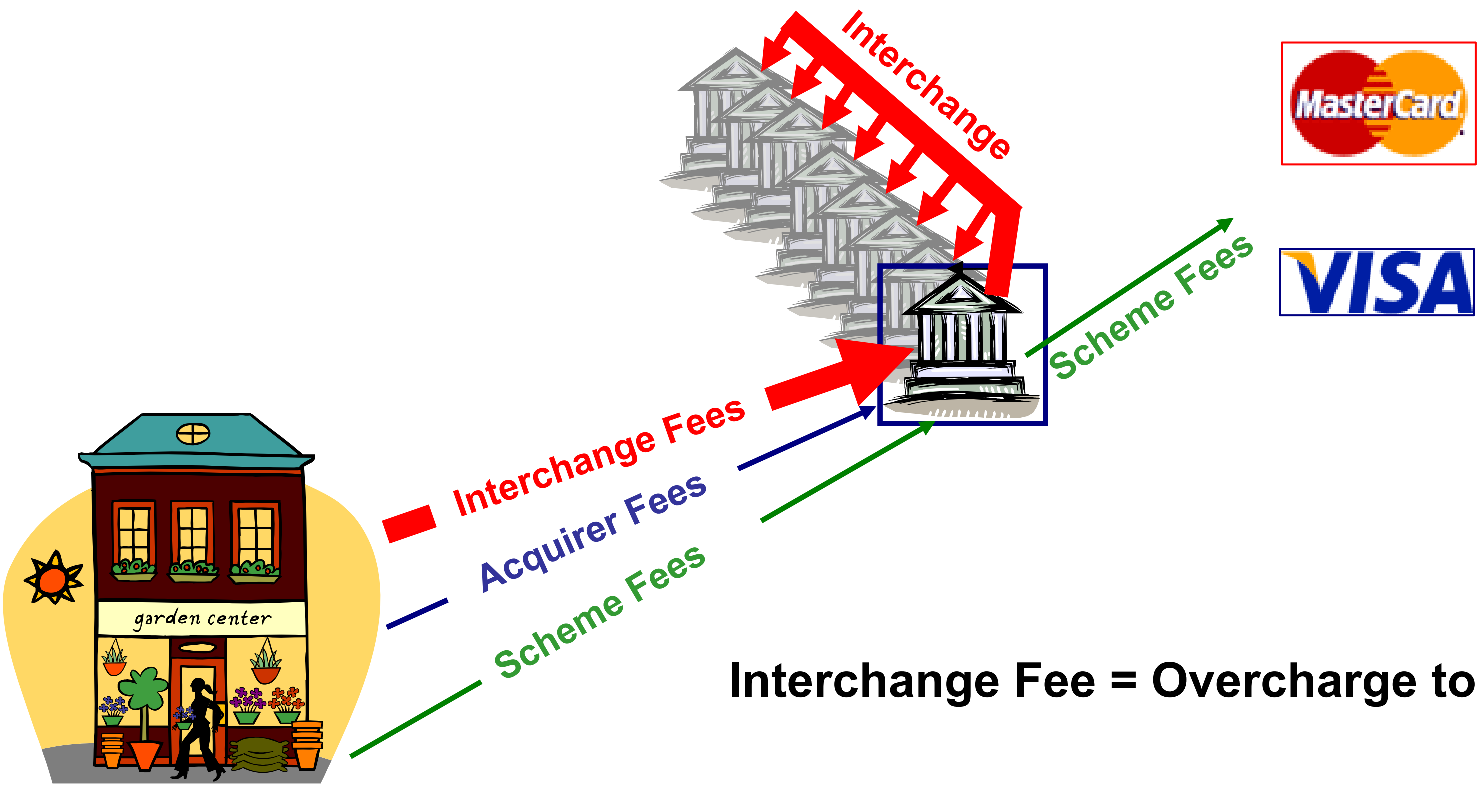
What is Going on Here?

- “Over the last two years, the PIN debit networks have waged **fierce interchange fee competition, spurred by steep increases** in Interlink, Visa's PIN debit network.”
- “Being **more attractive for issuers and cardholders than merchants** is the best route to maximizing network value.”
  - From *American Banker*

Inelastic Merchant Demand

- **Created** collectively, not exogenous:
  - – Design of market.
  - – Restrictions on merchants.
  - – Restrictions on banks.
    - → **Single-homing cardholder behaviour.**
    - → **Multi-homing merchants.**
- **Exploited** collectively:
  - – Interchange fee.
  - – Price discrimination.

Merchant Pays Its Own Bank <u>Plus</u> Other Scheme Members



Interchange Fee = Overcharge to Merchants

No Support for Interchange Fees From "Network Externalities"

- **"This network externality becomes less and less important as the network matures, when virtually all potential users have joined."** – Rochet
- **"[N]etwork externalities can decrease as a network grows and can reach zero at some point… [W]here national coverage of a joint venture is valuable, as in payment systems, attainment of such coverage may exhaust network economies."** – Evans & Schmalensee
- Australia is a "relatively mature" credit card market in which **"the importance of these [network] externalities may be difficult to quantify…"** – Network Economics Consulting Group
- "Australia is a relatively mature market." – Visa's Rupert Keeley

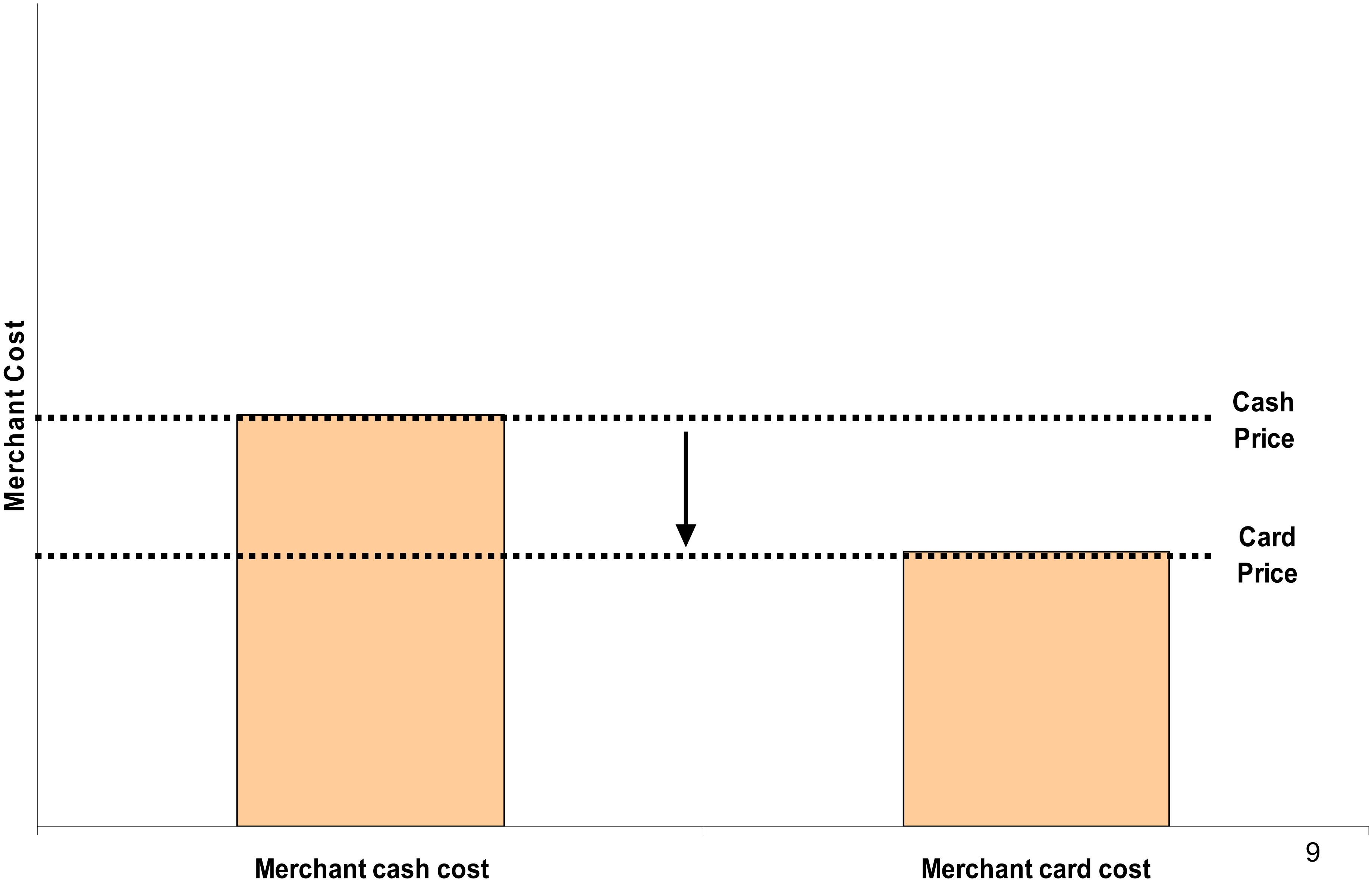
The "Usage Externality" Persists

- The **"fundamental externality… remains important: the choice of the payment instrument is ultimately a decision of the buyer, that impacts the net costs of the seller."**

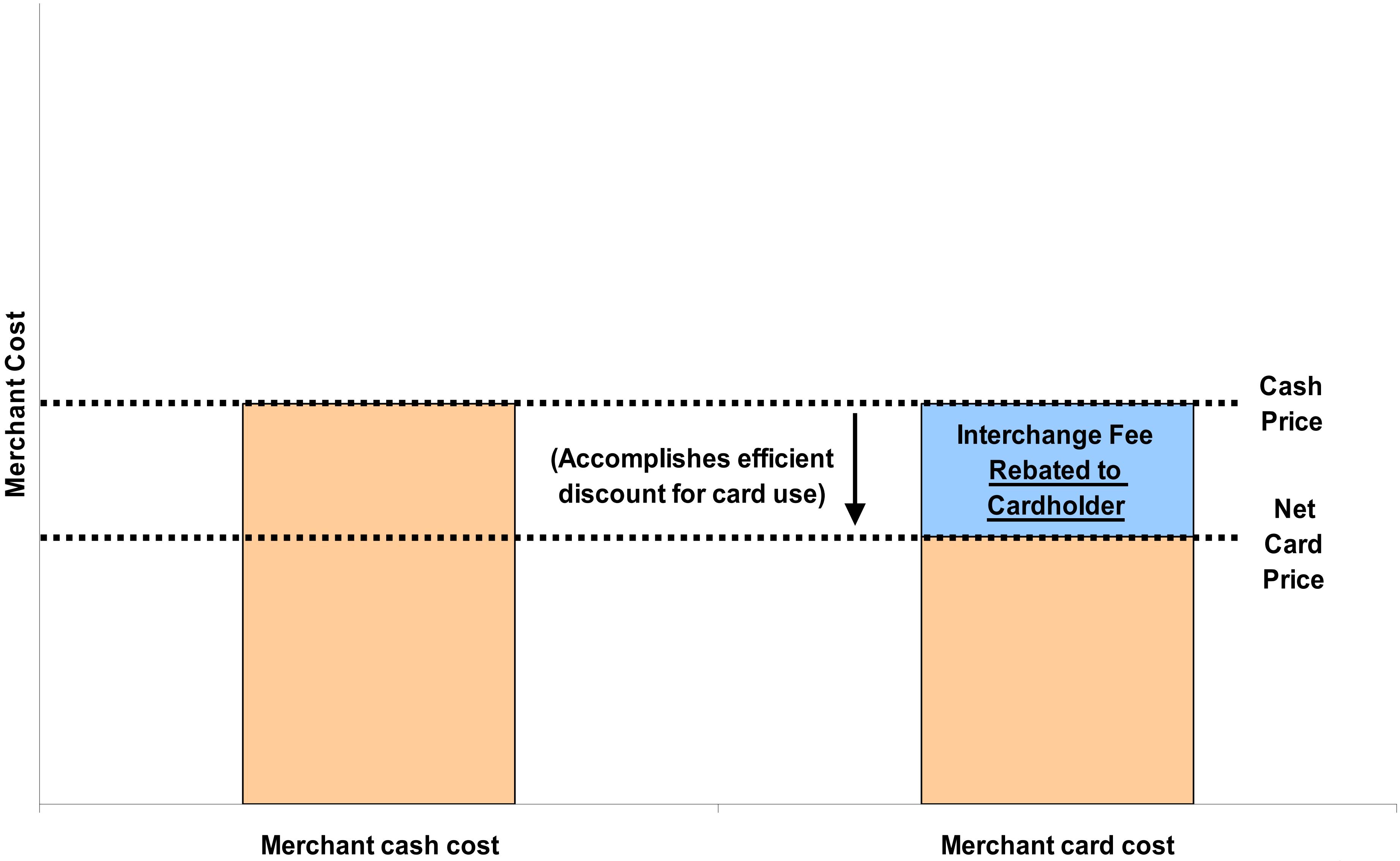
  – Jean-Charles Rochet

- Question: ***do the schemes use rules and interchange fees to <u>solve</u> (internalize) the usage externality, or <u>create and exploit</u> it?***

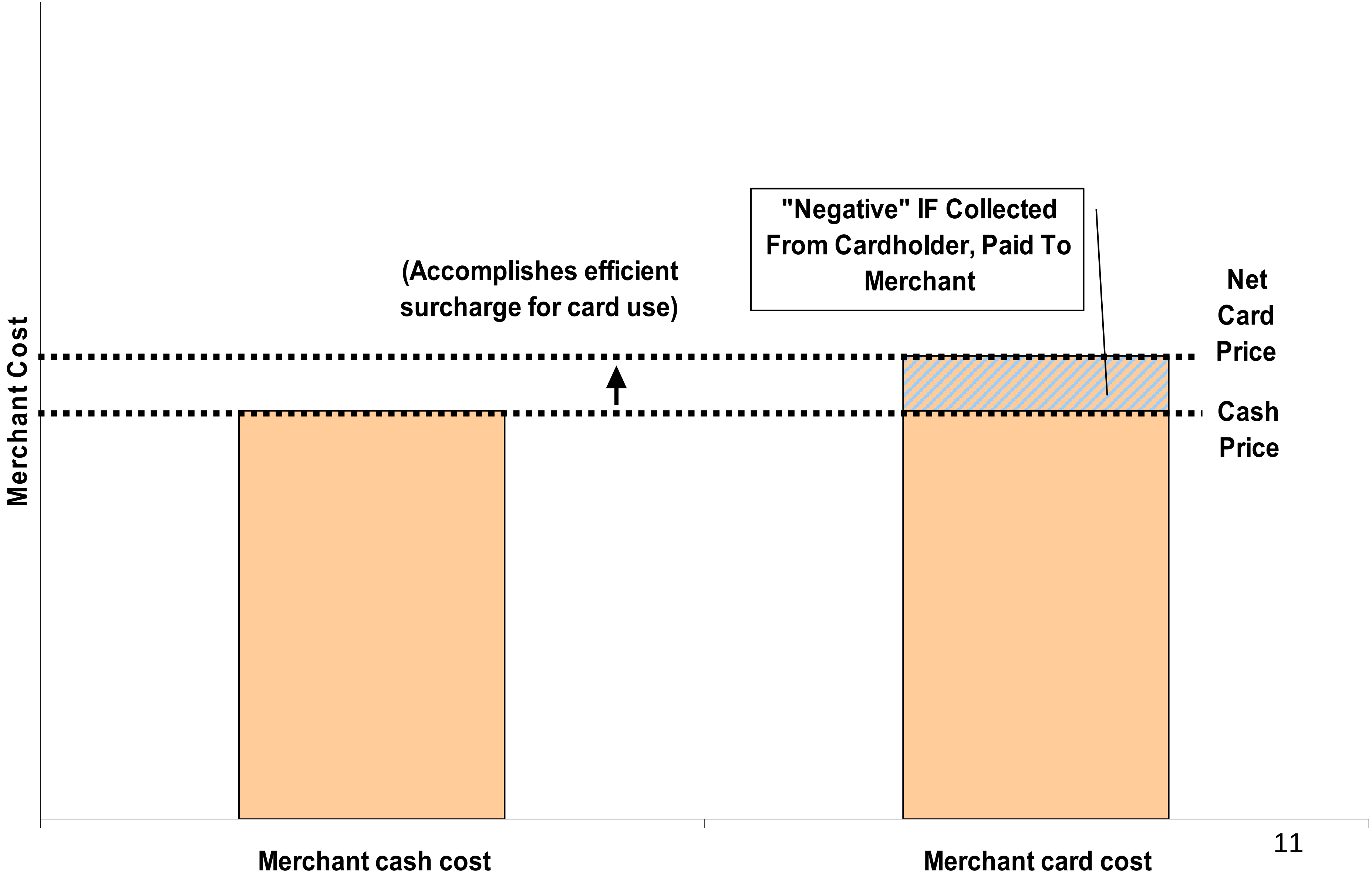
Efficient Pricing When Merchant Costs Are <u>Lower</u> For Cards (No Other Transaction Costs - No Interchange Fee)



Theoretically Efficient Interchange Fee
If Cards Cost Less But Merchants Must Charge 1 Price



Efficient (Negative) Interchange Fee
If Cards Cost Merchants More Than Cash

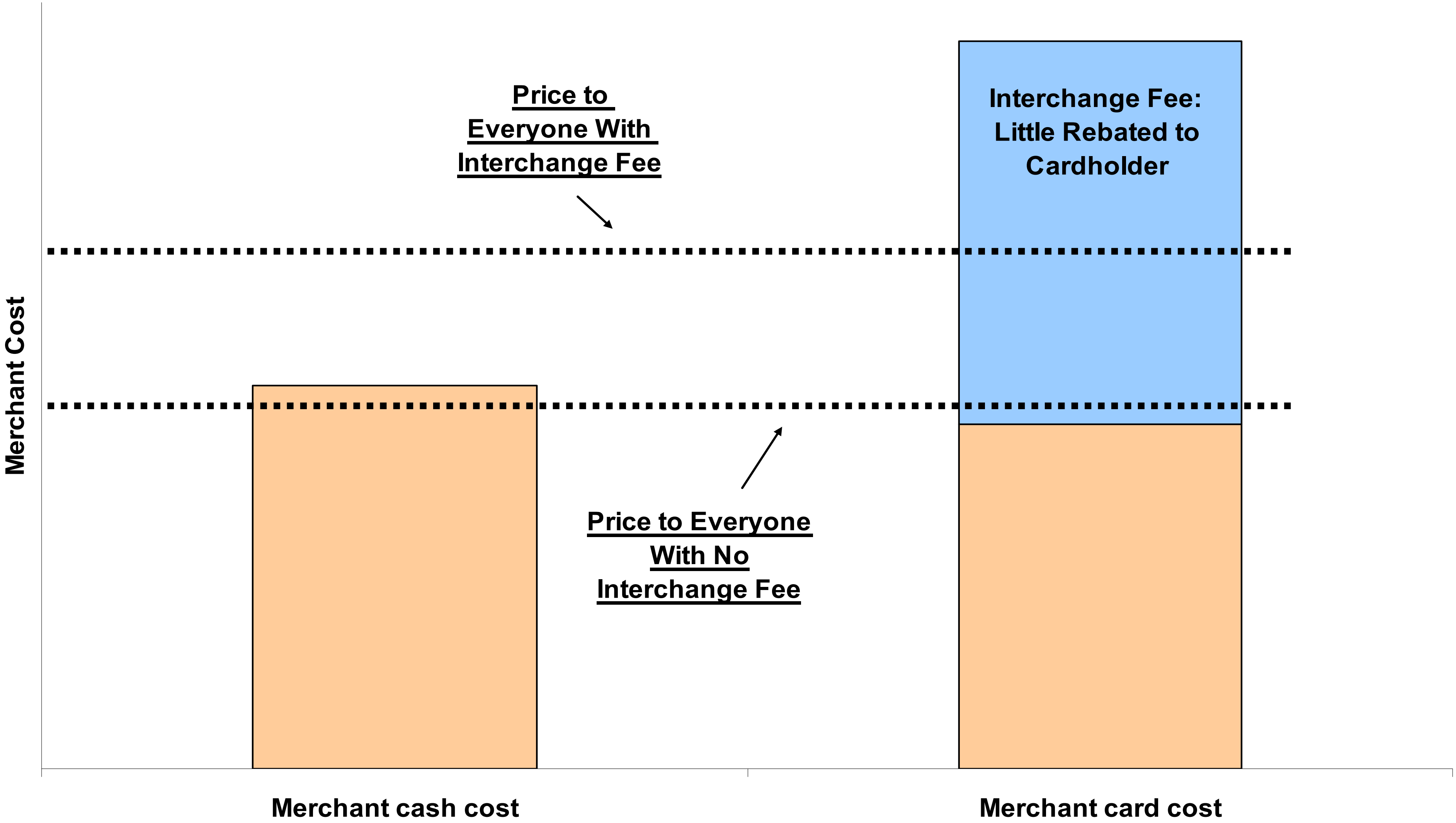


- **“[W]hen the optimal IF… is close to zero, the implementation costs that the network would have to incur for negotiating a non-zero IF and implementing the associated interbank payments could exceed the benefits generated by the internalization of usage externalities.”** – Jean-Charles Rochet

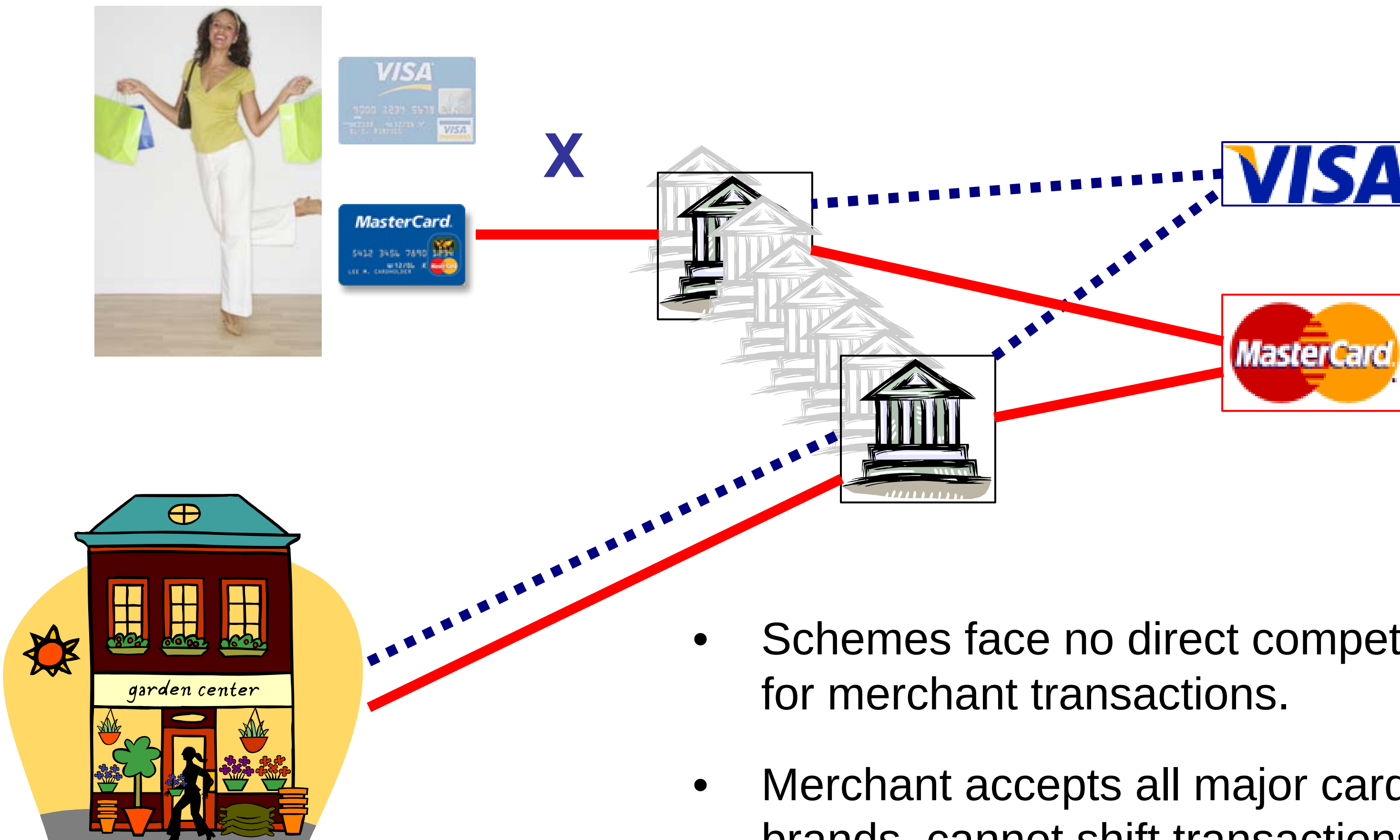
- Also “implementation costs” to the merchant if the network is not omniscient.

- Is optimal fee “close to zero?”

But What if This Happens?

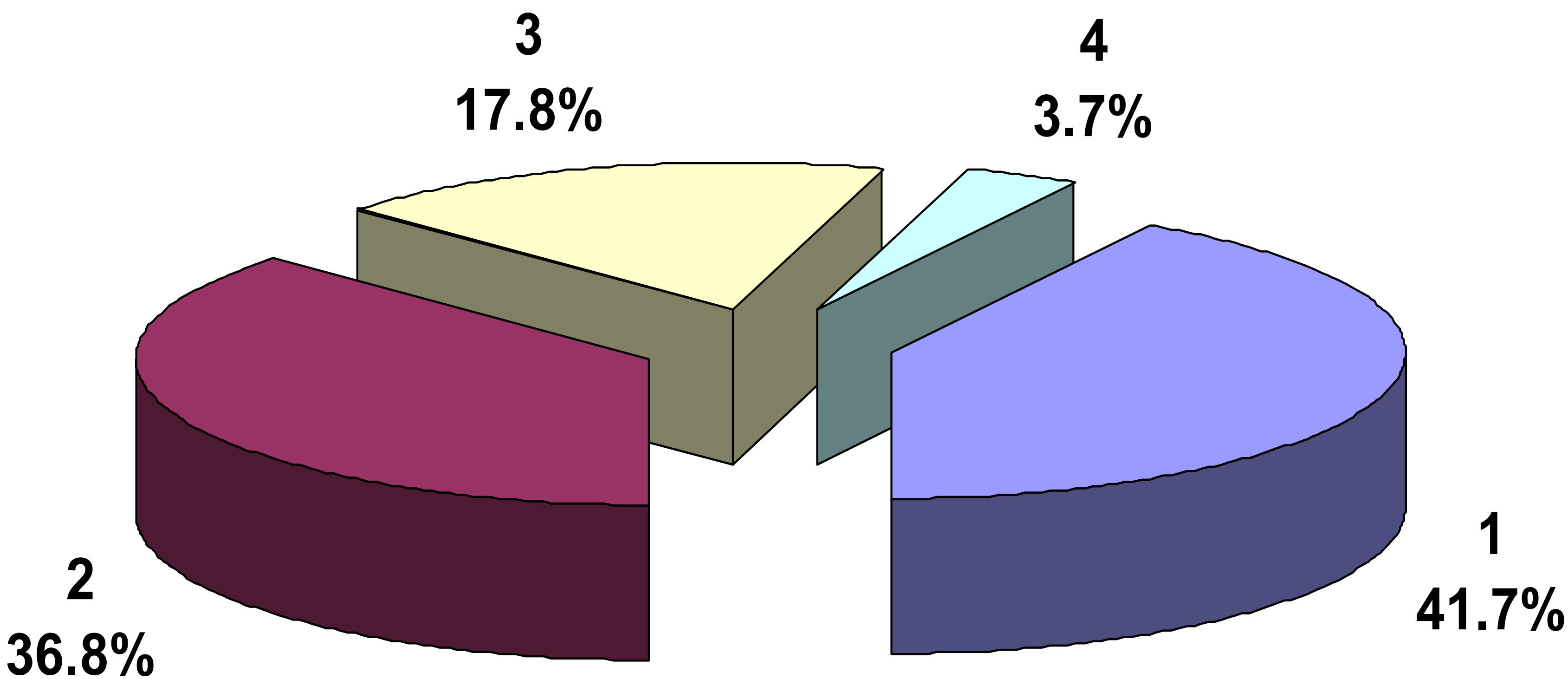


Cardholders “Single-Home;” Schemes Divide Market



- Schemes face no direct competition for merchant transactions.
- Merchant accepts all major card brands, cannot shift transactions to scheme with lower interchange fee.

Card Brands Carried: U.S. Cardholders



Source: Rysman (2007), Table V.

“Must-Take” Cards

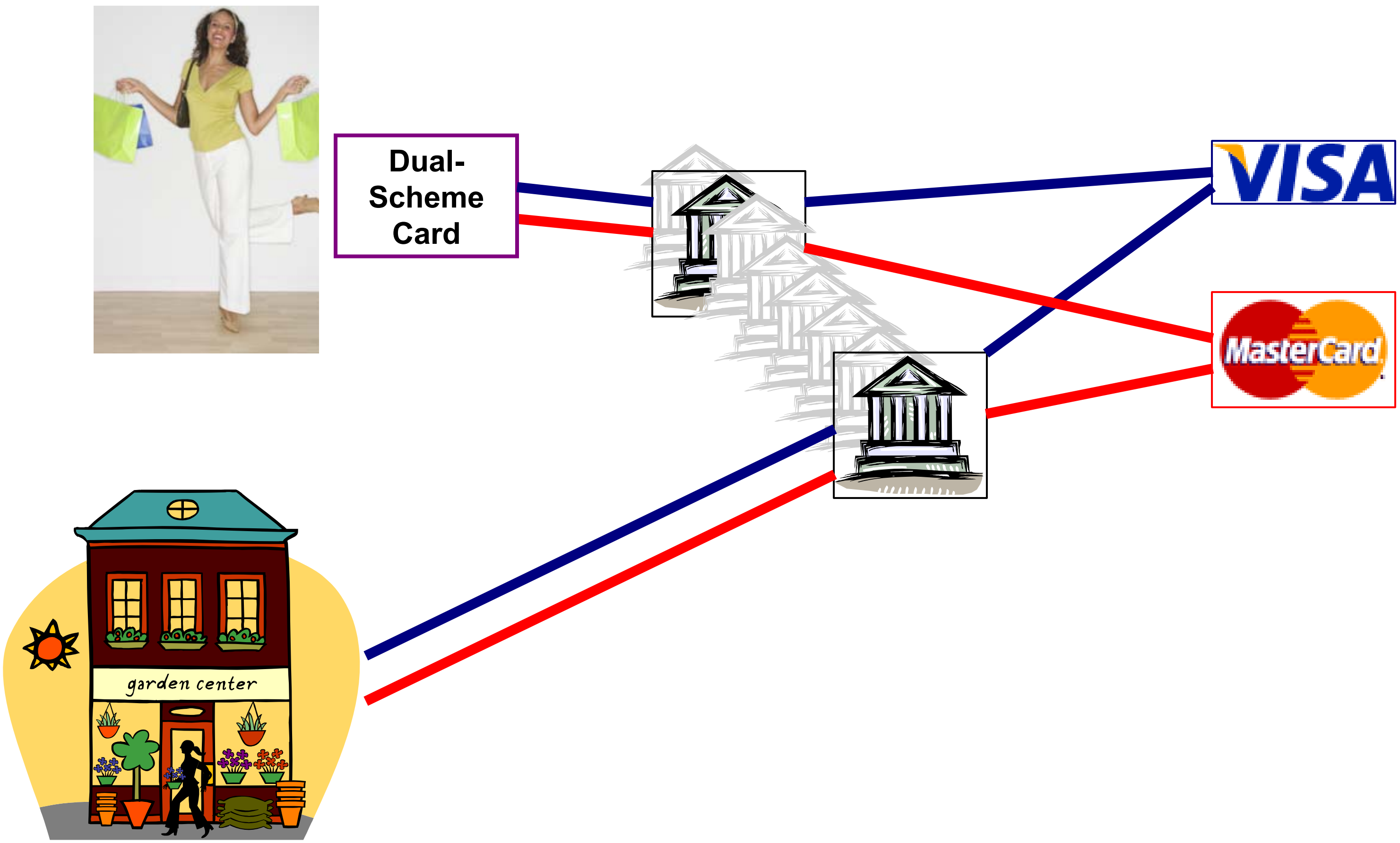
- **“Most merchants… cannot accept just one major card because they are likely to lose profitable incremental sales if they do not take the major payment cards.”**

  – Tim Muris

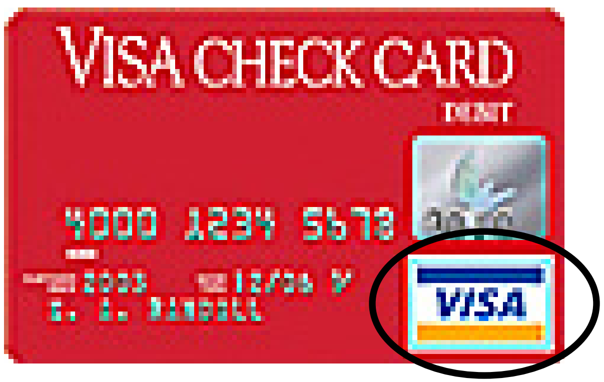
Anti-Steering Rules

- No multiple network cards
- “Honour all cards”
- No surcharges
- Regulation of price promotions
- No discrimination
- No “suppression”
- No minimum purchase for card use

Interoperable Card Can Enhance Inter-Network Competition



Example: Multi-Network Cards



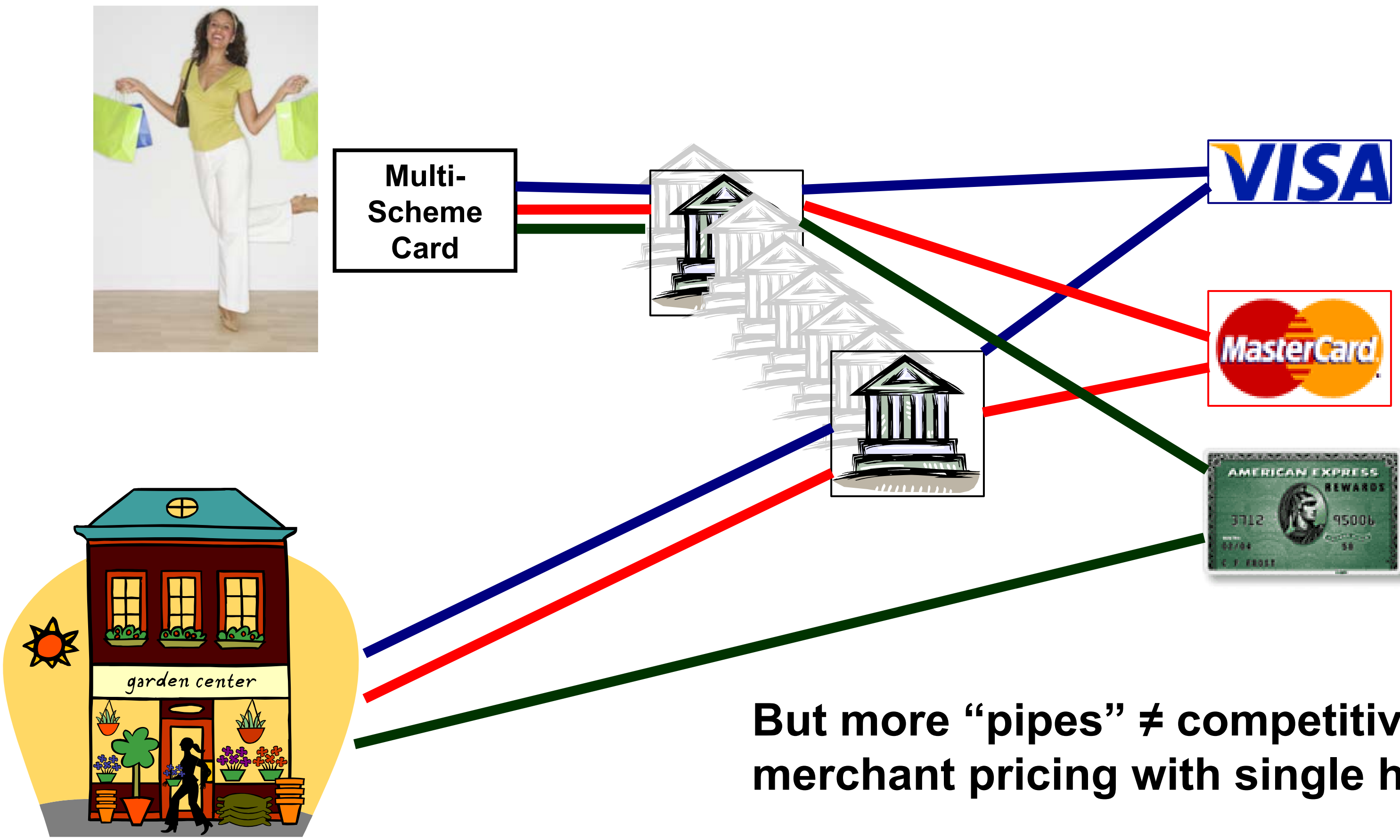
Front of card

STAR

On Reverse

- **<u>Two networks</u>** can be accessed from single debit card at P.O.S.
- More “multi-homing” characteristics by cardholders.
- Technology has helped steer to PIN debit cards; 85-90% success in U.S. when merchants “PIN-prompt.”

Interoperable Card Could Enhance Inter-Network Competition



But more "pipes" ≠ competitive merchant pricing with single homing.

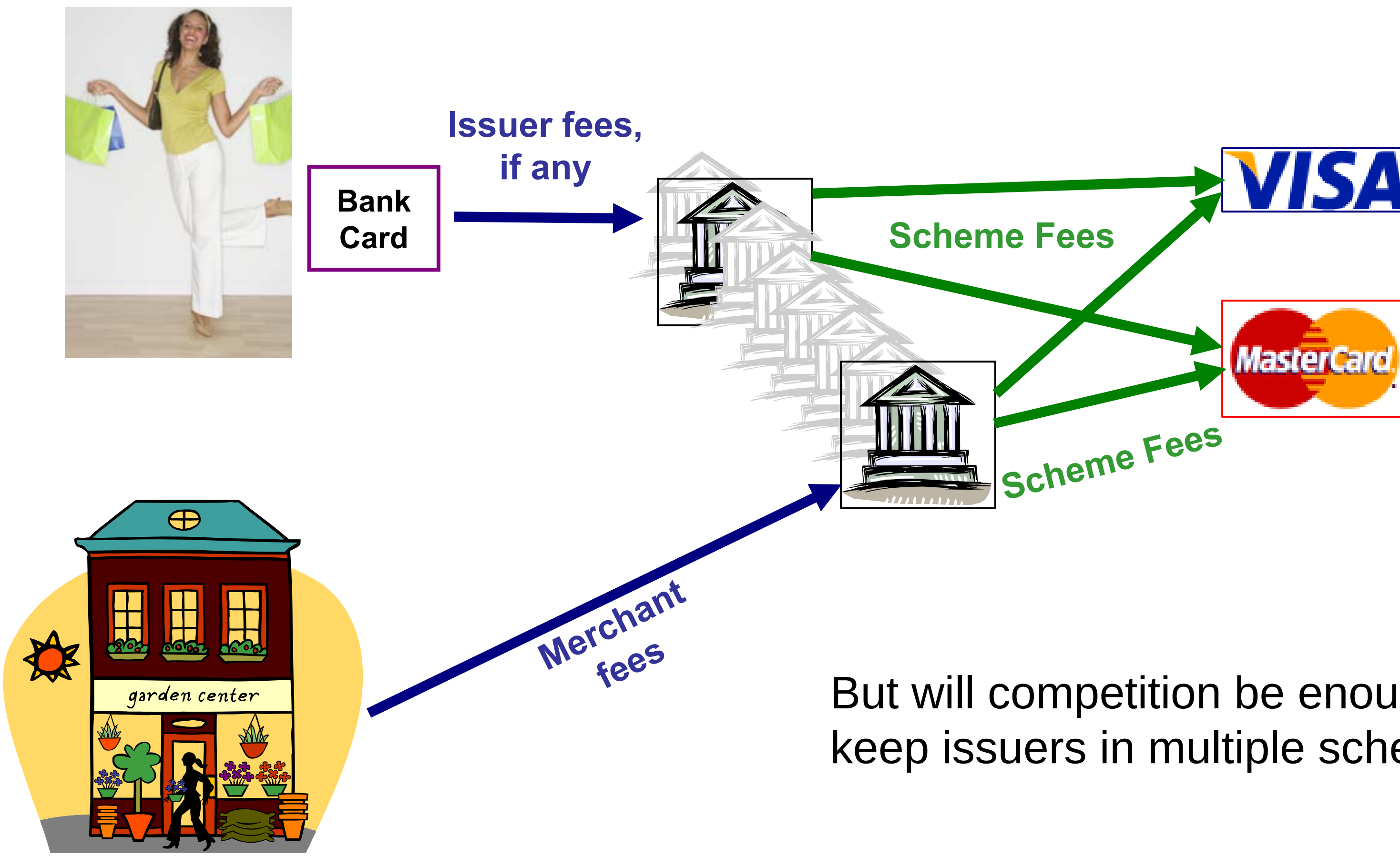
Can the Usage Externality Be Solved Competitively?

- Let each merchant decide whether to pay an interchange fee, and how much.
  - Have the amount appear as a direct credit to the cardholder.
- Eliminate mandatory interchange fees.
- Eliminate vertical restrictions.

Par Settlement

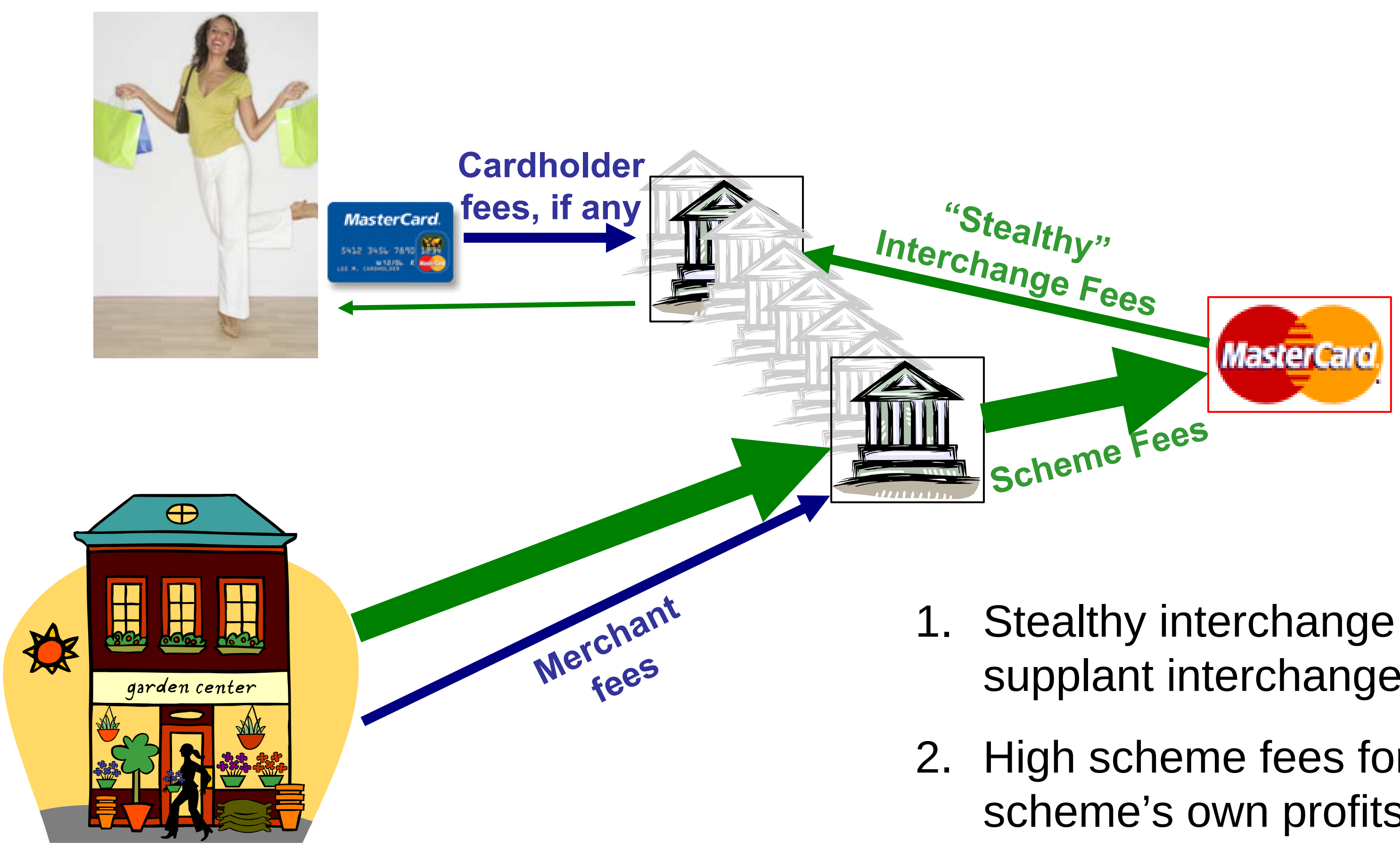
- Is not: arbitrarily “regulating the price to zero.”
- Is:
  - Declining to regulate prices.
  - Eliminating the collective *overcharge*.
  - Letting competition determine merchant fees.
  - Letting competition determine cardholder fees.
  - Letting each merchant steer customers.
  - Consistent with history and other successful card networks.

Competitive Pricing, Competing Banks and Clearinghouses



But will competition be enough to keep issuers in multiple schemes?

For-Profit Scheme Structure: Risks



1. Stealthy interchange fees supplant interchange fees.
2. High scheme fees for scheme's own profits supplant interchange fees.

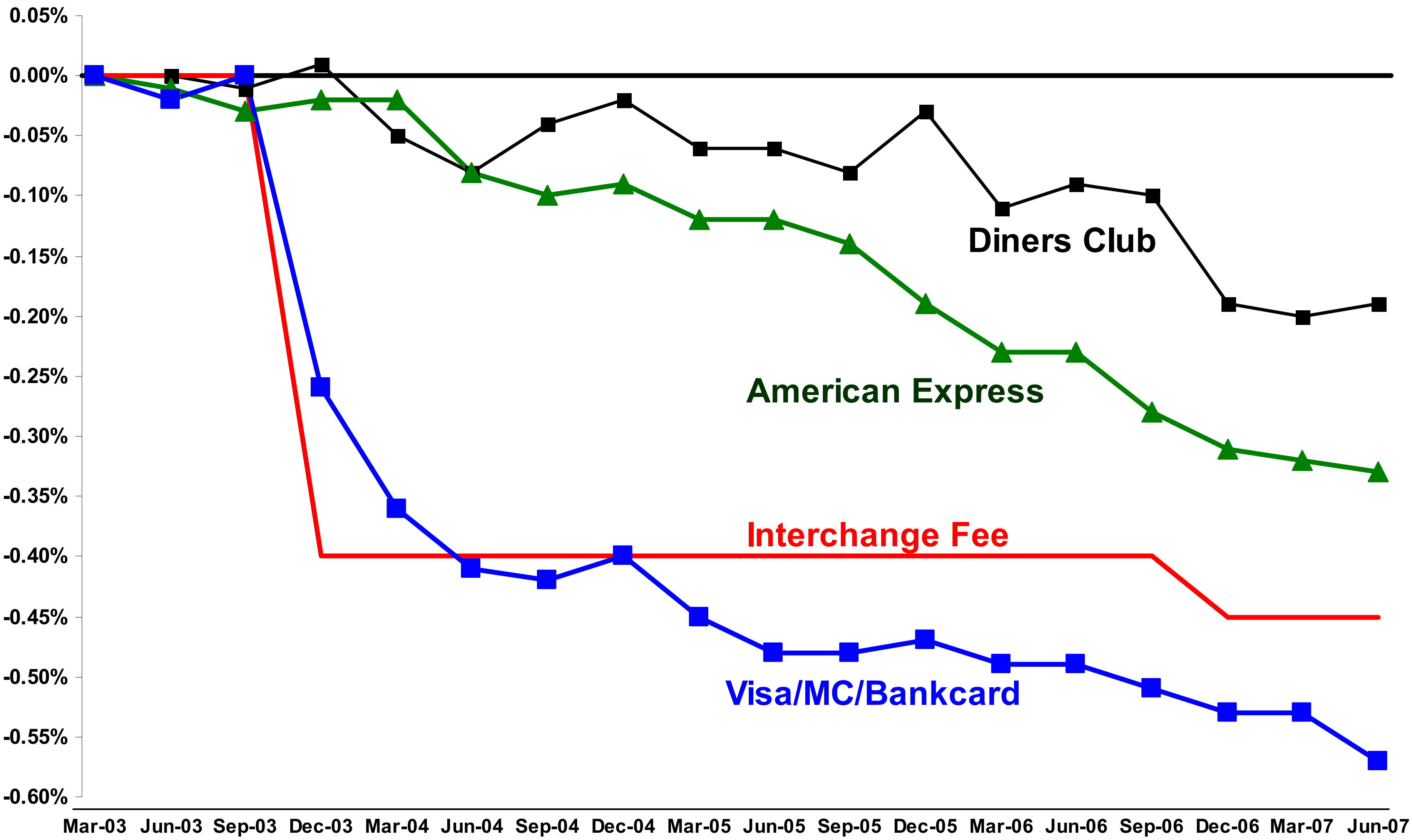
Removal of Merchant Restraints is Not Enough

- Merchant steering is helpful, but not a panacea.
- Interchange fees still fix bank prices;
  - Don’t become competitive or beneficial just because they face *some* constraints from merchant steering.

Designing Competitive Payments Markets

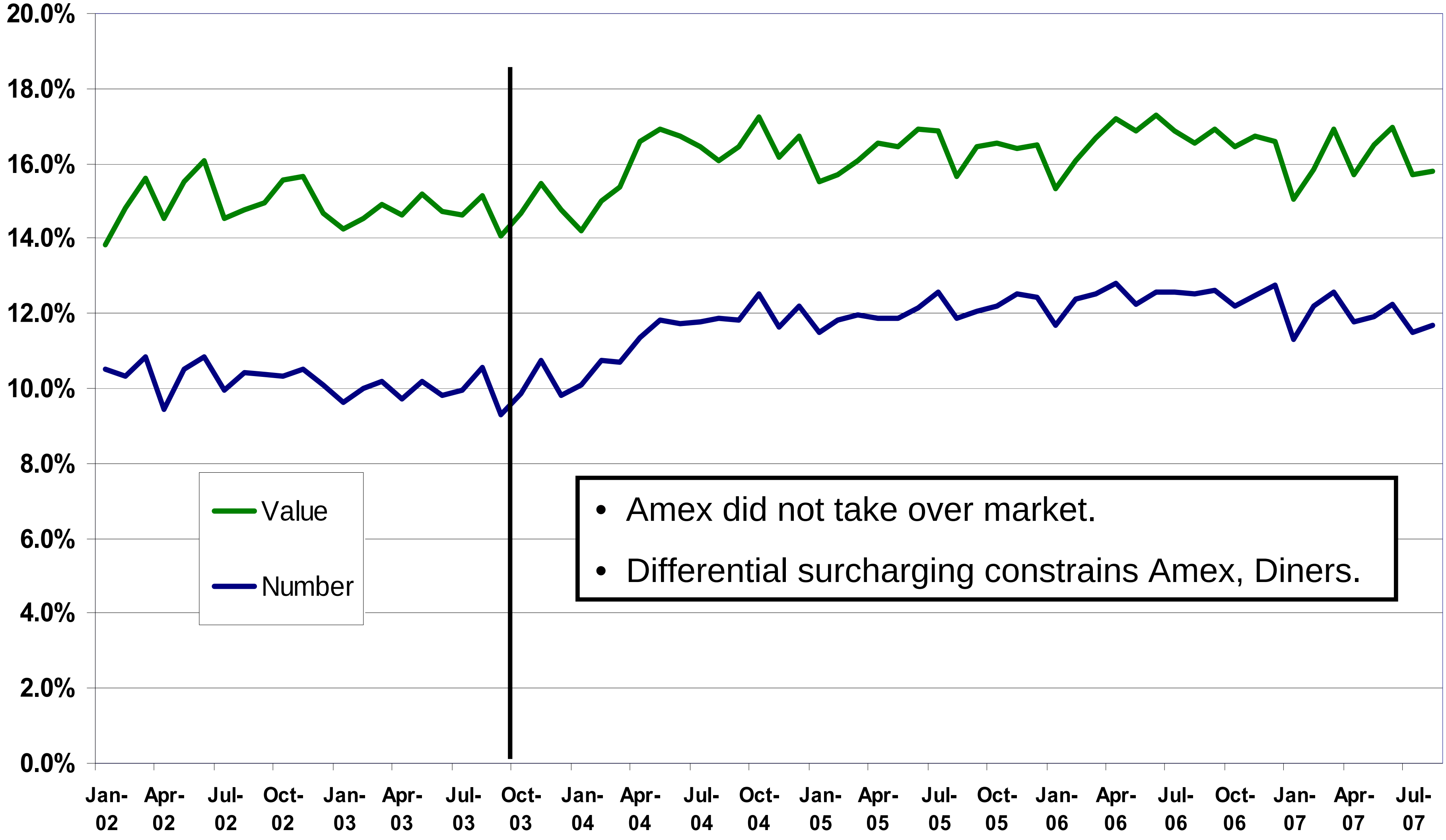
- Choices and competition at every stage:
  - Issuing, Acquiring, Clearinghouse, Processing.
- No mandatory interchange fees.
- Merchant competition, not scheme restrictions, determines POS payment terms and options.
- Network competition – consider:
  - Separate clearinghouse from standard setting, rulemaking?
  - What is best competitive network structure for the future?

Change in Merchant Fees After RBA Interchange Fee Intervention



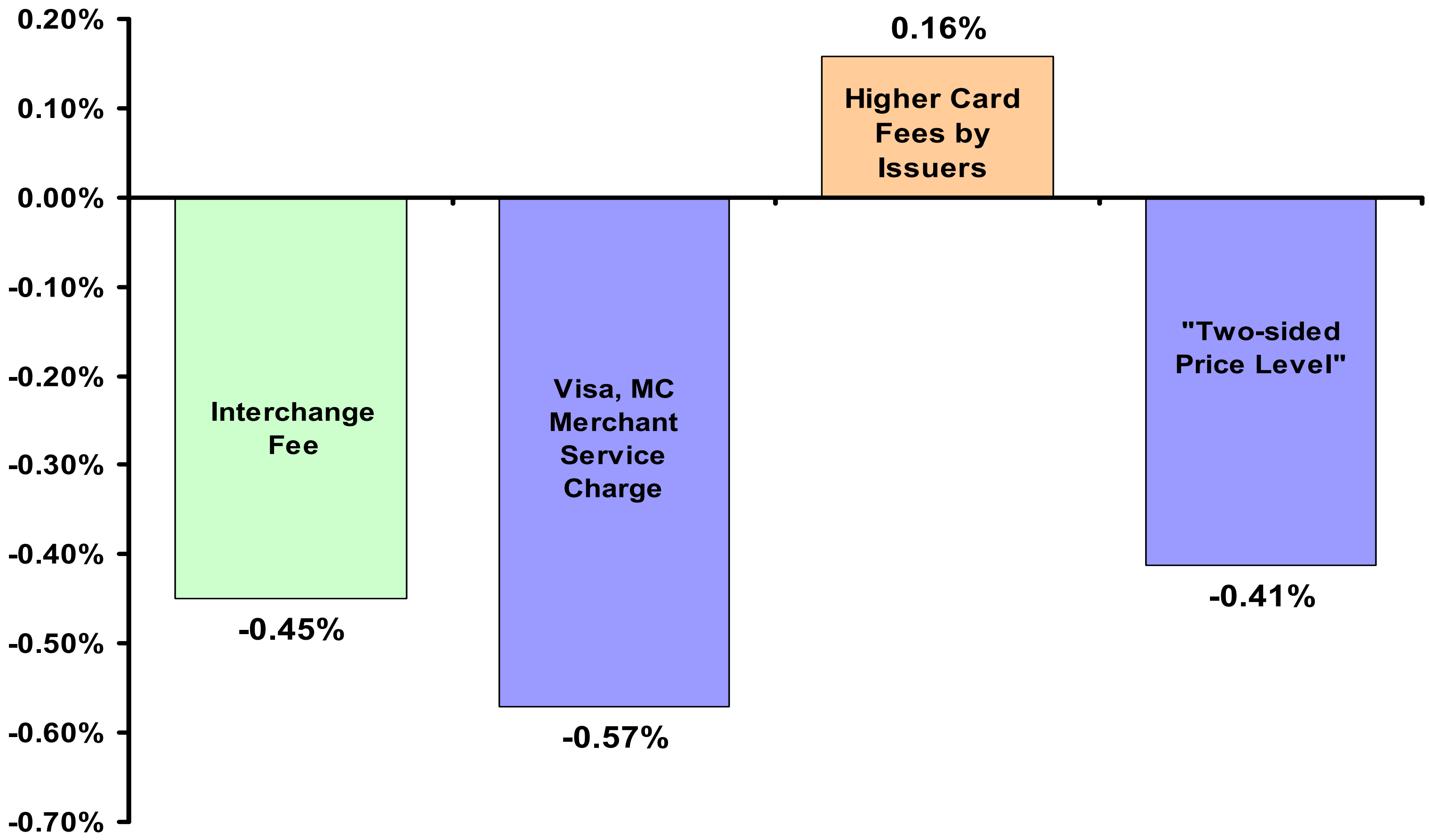
Source: RBA Statistical Bulletin Series C-3

American Express/Diners Club Share of Credit and Charge Transactions



Source: RBA Statistical Bulletin Series C-2.

“Two-Sided” Visa/MasterCard Price in Australia Following RBA Reforms



Source: RBA Statistical Bulletin C-3 and Chang, et al. (2005). (Note: uses midpoint of Chang, et al. estimates of increase in cardholder fees.)

Will Merchants Keep MIF Reductions For Themselves?

- MasterCard: Merchants "pocket" the savings.
  - ➔Not credible. Merchant sector is generally competitive.

- **Rochet & Tirole:**
  - **"Merchants are likely to pass through cost increases into the retail price."**
  - **"Merchants are likely to pass the extra costs, if any, of card transactions through to consumers in general, that is to cardholders and cash payers altogether."**

Conclusion

- Interchange fees <u>exploit</u> externalities.
- Scheme rules reduce merchant elasticity of demand, intensify externalities and market power.
- Competitive payment markets:
  – No mandatory interchange fees.
  – No competitive restrictions on merchants.
  – Competing clearinghouses.
- RBA Reforms: effective and should be extended.

For a copy of my paper, see
www.RBA.gov.au

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