Towards a Competitive Card Payments Marketplace

Alan S. Frankel, Ph.D.
afrankel@lexecon.com

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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
Plus 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 solve (internalize) the usage externality, or create and exploit it?
Efficient Pricing When Merchant Costs Are Lower For Cards
(No Other Transaction Costs - No Interchange Fee)
Theoretically Efficient Interchange Fee
If Cards Cost Less But Merchants Must Charge 1 Price

(Accomplishes efficient discount for card use)
Efficient (Negative) Interchange Fee
If Cards Cost Merchants More Than Cash

(Accomplishes efficient surcharge for card use)

"Negative" IF Collected From Cardholder, Paid To Merchant
• “[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?

Merchant Cost

Merchant cash cost

Price to Everyone With Interchange Fee

Price to Everyone With No Interchange Fee

Interchange Fee: Little Rebated to Cardholder

Merchant card cost
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

- **Two networks** can be accessed from a 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

- Amex did not take over market.
- Differential surcharging constrains Amex, Diners.

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

Interchange Fee

-0.45%

Visa, MC Merchant Service Charge

-0.57%

Higher Card Fees by Issuers

0.16%

"Two-sided Price Level"

-0.41%

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 exploit 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

Alan S. Frankel, Ph.D.
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