Intrepid Ventures

Market Rather Than the State Should Determine What Payment Prices (Costs) Are and Who Bears Them

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"Payments Pricing: Who Bears the Costs?"

* View's expressed are strictly the author's.

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There are two sharply contrasted though often not clearly disclosed views on how the retail payments industry should be organized and resources allocated.

Market Model

- Prices set by profit-seeking firms in competitive free-markets at each stage in the value chain dynamically allocate resources
- Government is the night watchman
  - US while far from perfect is a reasonable and evolving example

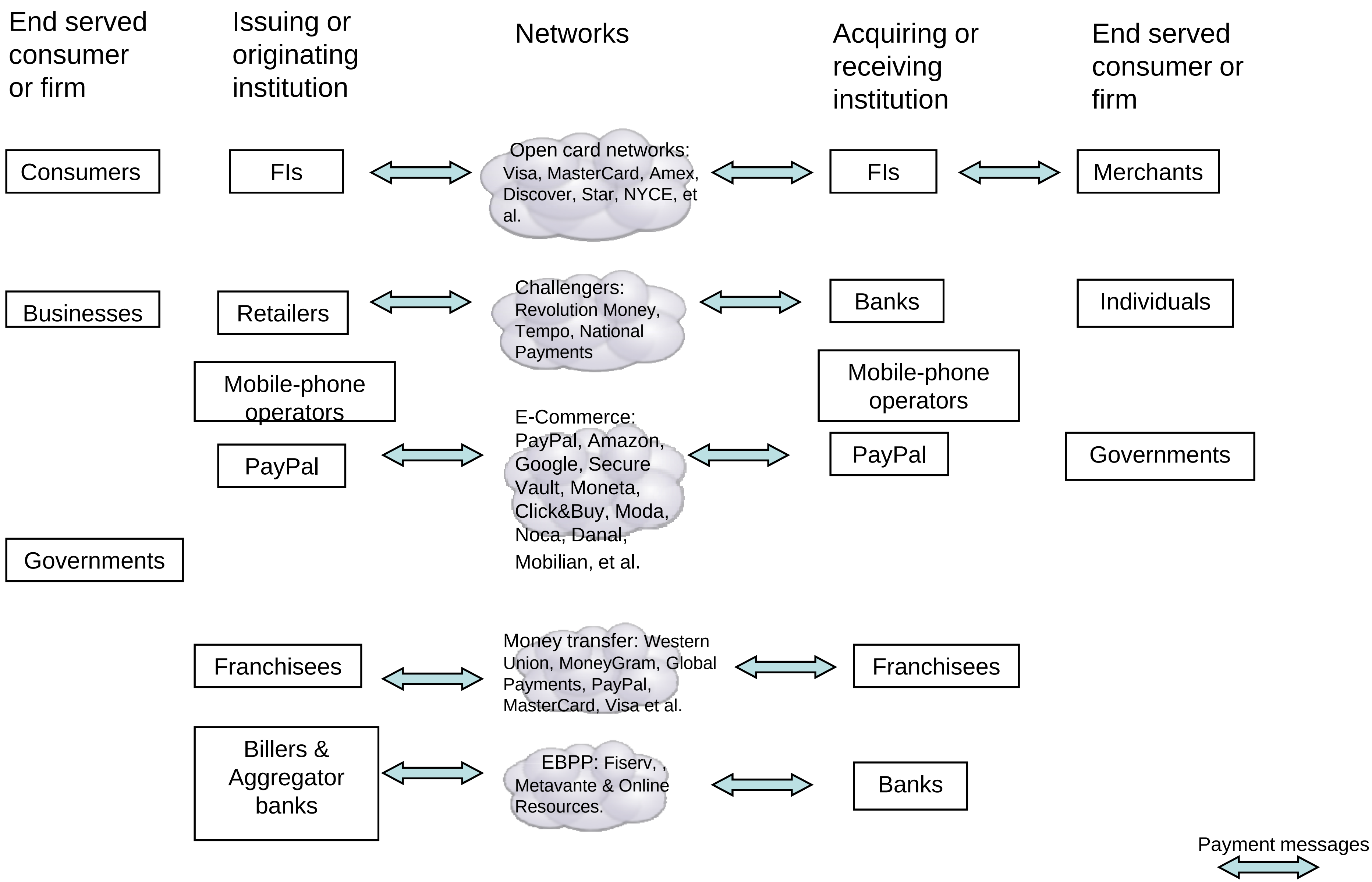
Public Utility Model

- Enlightened central planners or regulators determine optimal prices
  - "Credit Card Fair Fee Act of 2008" and the EU regulators bullying MasterCard to lower credit and debit interchange and rescind fees it charges its licensees are illustrative.
- Seek cost recovery rather than value framework for interchange.

Public Utility Model

- The merchant lobby and many regulators and politicians advocate greater government control of open, commercial retail payment system pricing and de facto to treat networks as utilities.
- While not ideologically hostile to free-markets, merchants seek through the political process to extract pricing concessions they can’t get in the market. Situational argument.
  - Retailers such as Wal-Mart and Overstock.com decry interchange yet reap interchange revenue from general-purpose credit cards they issue.
- Consumers vote in the market with each payment product and purchase decision. They take the systems’ benefits for granted.
- For regulators and politicians intervention is difficult to resist.
- A class of smart regulators can analyze at a point in time and in the value chain and by their compass try to determine and prescribe the right answer. However, neither Neelie Kroes nor any electronic payment system judge John Conyers and Dick Durbin would designate bring greater intelligence to bear than that embedded in the dynamic intelligence of billions of market decisions and the interplay of more than a dozen networks, thousands of FIs, millions of merchants and hundreds of millions of cardholders.

Retail Electronic Payment Networks Topography



The Spend Side of the Network

- Notwithstanding substantial US issuer consolidation, credit and prepay cards remain fiercely competitive, debit however much less so.
- What would enhance issuer competition and therefore innovation and value delivered?
- Nontraditional issuers participating more directly, which is in the interest of the networks, if not retail banks
  – Retailers
  – Mobile-phone operators have enormous reach and can enhance both issuance and for small merchants acceptance convenience, near-term particularly in emerging markets abroad.
  – Insurance carriers
- Decoupled debit is potentially a game changer creating genuine debit competition.
- Card # portability à la mobile-phones and/or greater use of email and phone # aliases linked to underlying payment accounts.
- Enabling cardholders to route transactions to different accounts within an issuer and across issuers.

The Acceptance Side of the Network

- Provision of payment card acceptance in the US is hypercompetitive. At the high-end of the market it's a commodity.
- The industry continues however to profitably extend acceptance to ever smaller and nontraditional merchants.
- Distinction between a "merchant" and individual will blur as networks enable tiny firms and individuals to participate on both sides of the network.

Networks: the Heart of the Payments Ecosystem

- There are markets such as France (for the moment) and China with monopoly, bank-owned, not-for-profit retail general-purpose card-payment networks.
- In stark contrast, the US retail card payment networks market is vigorously competitive. Banks are paramount customers.
- Four full-suite card payment networks (Amex, Discover, MasterCard and Visa), national debit networks such as Star and NYCE, ecommerce network PayPal, and a host of challengers compete.
- Discover closing acceptance gap by opening up.
- Traditional card network competition intensifying.
- Some e-commerce payment networks will extend to the physical POS.
- Boundaries between traditional money transfer and electronic P2P networks including global card payment networks likely to blur.

⇨ There is no market failure. At every stage in the US electronic retail card payments value chain competition is fierce.

So what's the problem? Asymmetric Pricing?

- Many two-sided networks price asymmetrically to maximize total network value.
- Asymmetric pricing is not immediately intuitive and therefore has been easy to demagogue against.
- The merchant lobby prefers the cost-recovery utility to the pay-for-value framework.
- For payment networks interchange flows both ways.
  - For ATMs from cardholders and issuers to ATM owners including merchants
  - For purchases, from merchants to issuers to cardholders
- Interchange fuels issuer innovation.
  - A range of prepay products, credit & debit rewards, decoupled debit, etc.
- Many two-sided network markets charge one side of the network more than the other.
  - Client/server software. Internet browsers, Adobe clients, etc.
  - Content – on and offline, advertisers subsidize readers
  - Bars often discount drinks for women but not men.

Framing Thinking About Intervention

- Most effective legal and regulatory interventions are discrete and aim to systematically enhance competition by fixing governance or structural problems.
  - 1998 DOJ suit forced bankcard associations MasterCard and Visa to permit US banks to participate in Amex and Discover, thereby increasing network competition.
  - Merchant interchange antitrust suits had the unintended positive consequence of banks spinning off MasterCard and Visa
- It is very unclear anything is broken in the US retail payments market, other than increasing politicization of credit card fees and practices.
- In contrast there are markets abroad where there may indeed be a case for a systematic fix.
- In Brazil Redecard and VisaNet enjoy MasterCard and Visa merchant acquiring monopolies respectively, which is in nobody's interest except their owners'. If and when an Elavon, a First Data or a Global Payments enters the market, it would want to provide MasterCard and Visa, acceptance – a superior merchant value proposition, immediately causing Redecard and VisaNet to go dual igniting competition.
- Notwithstanding China's WTO commitment to open up its domestic payment card market at the end of 2006, China UnionPay continues to be a protected monopoly.
- In Europe except for MasterCard, the major general-purpose payment networks are bank associations. Could jawbone banks to spin off Visa EU and national networks such as Cartes Bancaires, Girocard, PagoBancomat and PIN.

Price controls suppress value creation, always!

- Innovation occurs in the least regulated domain.
- Mandating lower credit-card fees diminishes revolving credit availability.
- Cutting acceptance fees ex interchange diminishes card acceptance.
- Suppressing interchange reduces value cardholders receive.

⇨ Market prices are the most effective system of allocating resources to where they are most highly valued, better than any system yet devised by central planners and regulators.

- Unfortunately, for those who see payment networks (and often other sectors) as public utilities, the current political climate in Brussels and Washington is propitious – hostile to the payments industry and highly politicized.
- In 2008 the Fed bowed to Capitol Hill implementing Barney Frank's credit-card issuer restrictions via regulatory diktat.
- Congress entertained imposing card acceptance and interchange fee caps.
- President Obama seeks political points railing against the credit card industry and calling for more stringent regulation.

⇨ The danger of price controls to the payments industry and consumer welfare has never been greater.