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A conference summary

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Payments Pricing: Who Bears the Cost?—A conference summary

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As consumers and merchants increasingly adopt electronic payments, the pricing of these services has generated substantial scrutiny by public authorities around the world. To discuss these developments and related issues, the Federal Reserve Bank of Chicago hosted its ninth annual Payments Conference on May 14–15, 2009.

For some time now, merchants have spoken out about their inability to influence their customers' payment choice or to pass along the costs of payment instruments such as credit cards to their customers. The card networks, such as Visa and MasterCard, have received the brunt of the pricing criticism across the globe as public authorities seek to restructure payment costs. Yet, the networks argue that the fees they charge reflect the market value of their products. Consumer advocates often claim that consumers are unaware of the impact of their payment decisions and that *some* consumers end up subsidizing the payment choices of others. Adding to the mix, many nonbank payment providers are bringing innovative payment products to the market to satisfy changing consumer and merchant preferences and needs.

In an efficient market, prices and benefits are aligned in a way that provides all participants with proper incentives to maximize social welfare.[1] If the costs and benefits of the payments system are not aligned in such a way, will regulation be required to bring the system into the proper balance? Or will the market resolve the problem through innovation? In this *Chicago Fed Letter*, we summarize this year's Payments Conference, where the participants discussed these and related issues.

The current environment

In his keynote address, David Stewart, of McKinsey and Company, described how the weakened U.S. economy and growing regulatory pressures are influencing the payments landscape. Payments revenues saw a 5.9% compounded annual growth rate over the period 2002–07, according to Stewart, but in the next five years, this growth may slow to 1.3%. Such a decline might be expected in a sizeable downturn, but there are particular factors in play this time that suggest the impact might be felt differently by different players. Deposit balances were the highest ever in 2008, Stewart said, as people cut back on consumption; and the supply of credit also diminished greatly, since risk aversion increased throughout the market. Debit card usage was growing much more rapidly than credit card usage before the downturn, and current conditions may bolster this trend. Furthermore, with consumer spending weakening, merchants may attempt to reduce costs by steering consumers toward payment types with lower merchant fees.

In addition to such pressures, pricing practices for payment products are becoming increasingly scrutinized by public authorities globally. Financial institutions are now struggling to find pricing models that replace their reliance on traditional sources of revenue, such as interchange fees[2] from merchants and penalty fees from some consumers, including overdraft fees[3] and finance charges on credit cards. Penalties currently make up a large portion of the consumer revenue stream from payment products as a result of competitive developments in the payments space. Forty years ago, when checks were the primary noncash payment instrument, consumers *paid* for them, explained Richard Oliver, Federal Reserve Bank of Atlanta. This model gave way to differential pricing based on minimum balances, which rewarded consumers who kept more money in their accounts. Once that model became ubiquitous, financial institutions introduced today's indirect pricing model, which removed upfront fees (e.g., free checking and no annual fees on credit cards), to retain customers, according to Oliver. But this model is difficult to sustain, since it effectively shields many consumers from the consequences of their payment choices while adversely affecting others.

The debate over pricing issues

The two-sided[4] nature of payment products makes it difficult to determine whether the costs of such products are being properly distributed to promote social welfare. Duncan Douglass, of Alston and Bird LLP, described several components of this market, such as consumer protection and fraud prevention, whose costs are particularly hard to define and thus correctly allocate. Eric Grover, Intrepid Ventures, pointed out that asymmetric pricing often is needed in two-sided markets to get both sides on board. While this may be ultimately the case, this imbalance fuels the perception that certain participants are bearing a disproportionate share of the cost.

Merchants complained about the lack of transparency in the fee-setting methods for certain payment products, as well as the sheer complexity of the fee schedules; many questioned whether the costs justify the benefits they receive for accepting these products. Dwaine Kimmet, The Home Depot, pointed out that interchange fees are his company's third largest operating cost, even larger than its costs for health care. Josh Peirez, MasterCard Worldwide, argued that the pricing of payment products is just like the pricing of any other product; prices are set to maximize the throughput over the network. Peirez argued that the benefits merchants receive by accepting credit cards, such as guaranteed credit, far exceed the interchange fees. Mallory Duncan, National Retail Federation,[5] disagreed, suggesting that the high fees and complex rules of card payments add friction to doing business rather than facilitating it. For example, Duncan said single entity rules require merchants to make payment acceptance decisions uniform across all their locations, forbidding any local flexibility. Moreover, the general consensus among merchants is that they have little or no recourse when it comes to challenging the interchange fees and rules set by the card networks. Instead of competing for merchant participation, these networks bid for consumers using *merchants' money*, argued Michael A. Cook, Wal-Mart Stores Inc.

Some merchants contended that the tension between merchants and card networks over fees and rules hampers their own ability to design pricing strategies that properly reflect these costs. Wendy Sutton, The TJX Companies, noted that when the price of a particular payment product goes up, passing the cost on to the consumer through higher merchandise prices is not always an option. In addition, the general complexity of payments pricing makes merchants reluctant to adopt explicit pricing for different payment mechanisms. As a result of uniform pricing for all payment types from the consumer standpoint, Adam Levitin, Georgetown University Law Center, and Jean Ann Fox, Consumer Federation of America, argued that consumers who use lower-cost payment types, such as cash or entry-level credit cards without rewards, subsidize others by bearing a disproportionate share of payment costs. Cook stated that, as consumers move toward more expensive electronic payments and away from cash and checks, they do not see the impact of this switch. Because generally the pricing of payment products is not explicit, this makes it difficult to engage consumers in the pricing debate. Stewart countered that recent McKinsey research reveals that merchants' preferences were quite effective in influencing consumers' choices.

While much of the discussion revolved around the expense of electronic payment instruments, particularly credit cards, it also revealed that the costs of some traditional paper-based payment products, such as cash and check, may actually be harder to quantify. Several conference participants argued that cash is cheaper for various constituents, but others suggested that this is only because cash is subsidized.[6] Tom Brown, of O'Melveny and Myers LLP, pointed out that even the U.S. Treasury Department claims there are cost savings for the U.S. as we move from paper-based payments (e.g., checks) to electronic payments. This example complicates the case made by merchants for charging their customers different prices based on their payment choice.

Responses to pricing issues: Regulation

Conference participants debated the role of public authorities in regulating the pricing of payment products. Jean Allix, European Commission (EC), remarked that ideally it should not be up to one entity to decide which payment forms are most effective; rather, society as a whole must determine the benefits of different types of payments through a democratic process. While this is an admirable goal, it is difficult to achieve in practice. Consequently, several foreign authorities have intervened directly in the market for payment card services.

Within the past five years, the EC, Reserve Bank of Australia (RBA), and Banco de México have opted for regulation to promote market efficiency. John Simon, Reserve Bank of Australia, described how the RBA prohibited "no surcharge" rules and narrowed interchange fee differentials between card payments systems. In the European Economic Area (EEA),[7] MasterCard lowered its multilateral interchange fees for cross-border transactions, temporarily, in response to inquiries from the EC.[8] Furthermore, Allix recounted, the EC now requires banks to inform retailers of the different costs associated with different cards and allows explicit pricing in order to increase competition in the EEA. According to Simon, as a result of the Australian reforms, price signals are now better at providing the necessary incentives to increase social welfare, and the narrower range of interchange fees better reflects the similarities of the card products.[9] However, since direct regulation is costly, the RBA is considering negotiating voluntary targets for interchange fees with the private sector or pushing the industry to find a solution under the threat of greater regulation if it fails to find one.

Because the card market is less developed in Mexico, Banco de México encouraged pricing that would increase overall card usage, according to Jose Negrin, Banco de México. Banco de México allowed merchants to choose whether to accept debit, credit, or both types of cards, and pressured card networks to reduce interchange fees and adopt a fee schedule that encourages card acceptance by small merchants. The bank announced targets for interchange fees for the private sector, indicating regulation would follow if targets were not met. As a result, Negrin explained, the fees decreased and card usage and acceptance increased.

U.S. public authorities have not regulated interchange fees. Wilko Bolt, De Nederlandsche Bank, cautioned that because it is so difficult to determine the true costs and benefits of payments, regulatory initiatives may produce unintended consequences. Many U.S.-based conference participants advocated a more hands- off approach by public authorities. Some, like Grover, said that direct intervention, such as price controls, will stifle value creation. Many of those who saw a role for the government envisioned it more along the lines of removing the barriers that exist in the current payments market—e.g., allowing differential pricing at the merchant level and leveling the bargaining power of the major participants.

Responses to pricing issues: Innovation

Whether or not government regulation is necessary to increase social welfare, merchant complaints that interchange fees are too high and too complicated, as well as consumers' fears of unpredictable interest rates on credit cards and overdrafts, provide opportunities for innovation. In fact, consumers are more willing than ever to adopt new payment devices that bring them increased value, according to Scott Grimes, Cardlytics. He cited the growth in online consumerism, 80 million underbanked consumers,[10] and the mainstream transition from cash to debit for everyday purchases as opportunities for payment innovations. Since banking relationships are becoming more multilateral and financial institutions are no longer depending on physical locations, the industry appears ripe for such innovations, Grimes said. Moreover, Steve Mott, BetterBuyDesign, presented data indicating that, although Generation Y has not adopted online banking to the extent that baby boomers have, the younger cohort is more receptive to alternative payments such as mobile payments and potential payment instruments in virtual social networks like Facebook.

In addition to seeking out such opportunities, payment providers are targeting underserved markets, particularly underbanked consumers, with products that offer more value to these segments than the status quo. Steve Streit, Green Dot Corp., said that prepaid cards provide transparency and financial control because they automatically prevent consumers from overspending. In the past, debit cards were like prepaid cards in that they limited spending to the available balance, but now debit card consumers are allowed to exceed their balance (with an overdraft fee of up to $35). Streit said that because Green Dot limits spending to the card balance and is forthright in its pricing, its products attract consumers concerned about overspending and expensive debt.

Retailers have also innovated their payments processes and offerings in order to reduce costs. Cook detailed how Wal-Mart improved the technology for cash handling and used point-of-purchase (POP) conversion of checks into electronic payments to reduce its costs. Kimmet and Sutton discussed how their stores' private label credit cards help them reduce their payments acceptance expenses while generating loyalty from their customers.

The conference also addressed how innovation can build on existing systems. Gloria Colgan, Discover Network, described how finding a new profitable balance between consumers and merchants can lead to a more sustainable approach. For example, Discover partnered with over 100 merchants to offer enhanced cash-back bonuses redeemable with participating merchants. According to Colgan, both sides need to find value, or the market risks ending up with intrusive regulation. Instead of competing directly with legacy systems as Discover does, Dickson Chu, PayPal, explained how PayPal extends the utility of these systems. According to Chu, PayPal appeals to consumers because it allows them to make fast, easy, and secure payments using their preferred payment method, such as a debit or credit card. PayPal also provides smaller merchants that cannot get merchant accounts at banks access to electronic payments systems.

Innovations may also be needed to offset forthcoming declines in the usage of some legacy products. Both Mott and Richard Crone, of Crone Consulting LLC, described the opportunities that new technologies are providing to increase the value of traditional products. According to Mott, many financial institutions have failed to embrace new technologies, such as mobile phones and social networks; this has allowed alternative payment providers, such as Obopay and PayPal, openings to the market. Crone touted the opportunity for financial institutions to get on board with mobile payments to reduce transaction costs and promote loyalty through mobile self-service, payments, and banking. One drawback of mobile payments for financial institutions, he warned, is that mobile carrier networks will naturally expect to receive part of the revenues.

Conclusion

At some level, we all bear the costs of payments, Sujit Chakravorti, Federal Reserve Bank of Chicago, stated, but how these costs are passed on to consumers and merchants may affect the adoption and usage of mature and emerging payment instruments. Participants at the conference recognized that because the real benefits and real costs of payments are often hard to discern, efficient pricing structures are naturally difficult to define. Still, given the weakened economy and changing consumer preferences, many players are searching for ways to lower the cost of payments while remaining competitive. Overall, participants agreed that an increase in transparency in pricing would help the payments system to function more efficiently. This may be achieved through innovation—both directly, by introducing more-transparent products, and indirectly, through the competition generated by these new products. However, if too many participants in the U.S. continue to think that they are being shortchanged by the card networks, they are likely to turn to the regulators and the courts to redress what they regard as an unacceptable imbalance in the market.

1 Social welfare is defined as the sum of the economic surplus realized by each participant. Economic surplus is defined as the difference between the willingness to pay and the price paid for the good or service.

2 Interchange fees are per debit or credit transaction fees paid by the merchant's bank to the card network's bank; these fees are typically passed on to the merchant via merchant discount fees. The value of interchange payments has become quite large partly because of the success of card payment products. This expense is a major source of contention between merchants and the credit card networks.

3 Overdraft fees are paid by the consumer either as a flat fee for overdrawing a checking account or as interest paid on the overdraft amount.

4 Two-sided markets are economic networks having two distinct user groups that provide each other with network benefits (e.g., credit cards with cardholders and merchants). For more discussion on two-sided markets and payment networks, see Wilko Bolt and Sujit Chakravorti, 2008, "Economics of payment cards: A status report," *Economic Perspectives,* Federal Reserve Bank of Chicago, Vol. 32, No. 4, Fourth Quarter, pp. 15–27.

5 The National Retail Federation represents 1.6 million retail establishments in the U.S., and its members are primarily smaller merchants.

6 Cash is subsidized in part by the resources the Federal Reserve uses in supplying genuine currency to financial institutions and ultimately the general public.

7 For details on the EEA, see www.efta.int/ content/legal-texts/eea/EEAtext/ EEAagreement.

8 See a recent MasterCard Worldwide press release at www.mastercard.com/us/company/en/newsroom/european_ commission_announcement.html, as well as the EC's earlier press release at http://europa.eu/rapid/ pressReleasesAction.do?reference=IP/ 07/1959.

9 For more details on the RBA's review of its actions, see www.rba.gov.au/PaymentsSystem/Reforms/RevCardPaySys/Pdf/conclusions_ 2007_2008_review.pdf.

10 Underbanked consumers are those who supplement some or many mainstream financial services with services from alternative providers, such as check cashers.