Setting Interchange Fees Best Left Up to the Market

■ BY ERIC GROVER

Interchange fees are a component of every MasterCard and Visa transaction and play a critical role in enabling and encouraging thousands of businesses to collaborate on providing and innovating payment products.

While interchange remains obscure to the average cardholder, regulators and plaintiffs' attorneys have taken a keen interest in it. Government intervention, however, is not the way to maximize consumer value.

The bank card systems — in particular, their interchange practices — have been subject to a battery of legal and regulatory assaults in jurisdictions across the globe. The associations have been paralyzed in the attendant debate, like a deer caught in the headlights.

The settlements in the Wal-Mart suit are the latest example of their woes. The associations agreed to no longer bundle debit and credit point of sale acceptance, to lower offline debit interchange by a third, and to pay $3 billion to merchants, $558 million of which will go to their attorneys.

In the world's second-largest electronic payments jurisdiction, the European Community Competition Directorate challenged interchange's cost rationale. Visa agreed to lower cross-border rates by 20% over five years, to 0.7%. The agreement, which the Europeans approved in July 2002, was a disturbing precedent of a government, rather than mutually consenting commercial entities, determining pricing appropriateness.

The Reserve Bank of Australia also has taken a cost-based approach. It approved issuers' recouping costs that it deems "eligible" via interchange. These include grace-period, fraud management, and transaction processing costs.

It engaged in classic static regulatory analysis: If the rate is x, and we reduce it to 0.6x, then merchants, and by extension consumers, will reap 0.4x. That is not, however, how markets work. There are always second-order effects.

In February the United Kingdom's Fair Trading Office said MasterCard's interchange infringed on the Competition Act. The British Retail Consortium wants regulation to reduce interchange and accuses MasterCard of using it to recoup grace-period costs. The accusation presupposes the retailers' right to influence MasterCard pricing and features with the "visible hand" of government intervention.

Retailers have said more generally that they are upset that the associations decide what costs can be covered by interchange. What retailer would not howl in protest if the government regulated its pricing this way?

There is a delicate dynamic balancing the interests of retailers, banks, processors, and consumers. Mastering this interplay is beyond the scope of even the most competent regulator.

Public choice theory, for which the economist James Buchanan won a Nobel Prize, explains that regulators act in their own best interests, seeking to expand the scope (and importance) of activities they regulate. Bank card interchange — which generates over $50 billion a year, more than the gross domestic product of over 160 countries — makes an almost irresistible target.

Interchange provides an immense revenue stream for issuers. It enables grace periods, frequent-flier and buyer programs, cash rebates, and noncredit-product enhancements. It fuels a trove of gift, payroll, and consumer-directed health-care products.

While the issuing and acquiring businesses are ferociously competitive, neither MasterCard nor Visa, with their sclerotic association cultures, is a paragon of competitive vigor. The most immediate step to make network payment services and interchange pricing more competitive would be for the two biggest suppliers, Visa and MasterCard, to be demutualized and to broaden their ownership on the public market. MasterCard took the first step toward this and is today appreciably more nimble and flexible than its larger cousin.

While the associations dominate the network payment services market, they have competitors.

First Data Corp. has long processed Visa and MasterCard transactions end to end. Under its First Data Net brand, it now competes overtly with them in processing card transactions. True to its dominant-share mind-set, Visa attempted to use its bylaws to restrict First Data. Consequently, Visa and First Data are suing each other.

In 1990 there was a patchwork quilt of 200 regional automatic teller machine and electronic funds transfer associations and cooperatives. First Data's deal to buy Concord EFS Inc. would culminate years of consolidation. It would create a giant with a national debit network, 182 million cardholders, 1,500 bank and 2.6 million merchant clients, and its own payment brands. That would give it the wherewithal and reach to go toe-to-toe with MasterCard and Visa. First Data's data center management culture may be its greatest impediment.

PayPal is an upstart with very different roots and culture. It could purposefully venture beyond Internet auctions to compete with Visa, MasterCard, and American Express. Notwithstanding its e-auction focus, PayPal could be used at the physical point of sale. An e-mail address is a wonderfully flexible payments key. Point of sale systems could receive payments initiated from personal digital assistants, mobile phones, contactless or contact chip cards, and keypads.

Ultimately, PayPal's most serious constraint is its ownership by eBay Inc. PayPal has credit and fraud risk, and it is difficult to imagine eBay being enthusiastic about increasing that risk outside of e-auctions.

Payment networks compete for firms to issue their products by providing richer features, higher interchange, and up-front payments. The interchange analog for proprietary programs is internal. In secondary markets, Amex offered its richly priced acquiring business to issuers, enabling them to enjoy its interchange equivalent. Interchange price controls favor proprietary systems that are unrestricted in features supported by interchange.

Wal-Mart's lead attorney, Lloyd Constantine, forecast that the U.S. government would again start playing an active role in the payments industry. He is right. However, in every industry in which the government assumes a role beyond that of the night watchman, performance deteriorates, and consumers pay the price.

Increasing legal and regulatory interference in interchange pricing and practice is a powerful prophylactic to issuer innovation. Fiercer competition is the path to better value for consumers and merchants.

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How to Revitalize Your Branch

■ BY PATRICK BRAZEL and MARK GREENE

It wasn't long ago that the future of the branch was in question.

A combination of increased competition, tough economic conditions, and industry consolidation meant that achieving rapid cost savings was right at the top of the management agenda. Rapid changes to demographic and commuting patterns left increasingly time-poor customers looking for alternatives to their local branch. With advances in self-service banking — particularly via telephone, ATMs, and the Internet — it looked like branches were becoming unnecessary, and closing them seemed to be the way to go.

However, as more and more customers access products and services through multiple channels, banks have realized that the distinctions between channels are increasingly blurred and that the branch is an important engine for growth.

Customers know what they want. They like the convenience of Internet banking, but they also like the personal nature of branch banking.

Deloitte & Touche's research report "Bring Back the Branch," done in the United Kingdom and published in September 2002, shows that the branch is used by more than 80% of all bank customers and is the preferred channel for the majority. A similar study, Forrester Techstrategy's "Comparing Channel Usage at the Top U.S. Banks," published in June, indicates that 47% of U.S. households that are online say they have used an electronic channel to manage their financial accounts in the past, but they plan to use human channels in the future.

Underpinning the trend towards multichannel banking and the growth of full-product sales and service centers is the realization that providing real-time customer knowledge is the key to ensuring consistent delivery of products and services. Doing so across all channels is the key to retaining profitable customers — especially now that they are increasingly mobile and fickle. Electronic transactions such as balance inquiries and account transfers are exponentially cheaper than those conducted through a branch or a call center. Yet personal contact with a bank representative is still the most effective way of building revenue from high-value sales and services. Optimizing the channel mix for servicing and selling to customers is the new reality, and at the heart of this reality remains the branch.

Highly adaptive to local market niches and conditions, transformed branches are lightly staffed collaborative-networked service centers. They sell multiple product streams and are differentiated by open standards, connectivity to internal or external service networks through integration hubs, and the ability to easily add customer-focused services to meet changing demands.

Reductions in development costs, time to market, implementation costs, maintenance costs, and total cost of ownership can be achieved by reusing and deploying applications built from proven banking services across multiple channels and disparate systems. Such services must operate independently of the channel that uses them, resulting in a consistent outcome for the customer and the bank at every point of contact.

Operational risk may be reduced by leveraging existing systems, maintaining a rigorous and disciplined software development and delivery environment, deploying proven applications that are flexible and scalable enough to meet the most challenging demands, and using proven, open platforms.

Sales can be increased by boosting cross-selling and up-selling opportunities. To best achieve this, banks need to excel at two things: meeting specific customer needs by quickly rolling out new and enhanced banking services, and leveraging customer knowledge at the point of contact.

Branch transformation is rapidly becoming one of the key drivers of competitive advantage allowing banks to maximize revenue opportunities by delivering highly focused services to customers while at the same time managing costs and improving productivity.

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