

Not aggressively making an affirmative case in the public arena for interchange, and not trying to roll back extant regulation, are strategic blunders that imperil the value of the card-payment network franchises

Visa And MasterCard Need to Ditch Their 'Rope-a-Dope' Interchange Strategy

The card networks have let merchants and regulators frame the terms of debate on interchange. That's a big mistake, says Eric Grover, that can only lead to the radical reduction or outright elimination of interchange and the eventual undermining of the networks' valuations.

Are MasterCard and Visa losing the interchange wars? If so, is it because they aren't fighting back in the court of public opinion? And what would a card business without interchange really look like? I contend the answers are yes, yes, and not good.

Let's take a look at what's going on.

Arrayed against the global card payment networks are central banks, competition authorities, retailers, and, in the U.S., plaintiffs' attorneys. It is an epic struggle whose outcome will have enormous consequences for the electronic-payments industry and for the value of open, two-sided payment-network businesses.

Visa won the opening battle—the Nabanco suit, in 1984. Since then, however, the global card-payment networks have beaten a slow but steady retreat. There were skirmishes throughout the '90s. More recently, the tenor of regulators' investigations and interventions has become decidedly more menacing.

The Reserve Bank of Australia entertained the elimination of interchange in that country, but in 2006 opted instead to lower it by 9% for three years, after having initially reduced it 40% in 2003. In 2009, it is likely to seek further reduction, perhaps to zero.

In June 2006, the European Commission (EC) Competition Directorate fired a second salvo, charging MasterCard's fee system with being anti-competitive. In January industry insiders breathed a sigh of relief when the EC's final report on retail banking and European Union (EU) payment systems, while highly critical, did not call for eliminating interchange, as many had speculated it would.

In February, competition czarina Neelie Kroes said the EC will revisit Visa's interchange antitrust exemption, which expires later this year. It will inevitably demand another cut on top of what it obtained in 2002. To address the Single European Payments Area and appease regulators, MasterCard pre-emptively announced it will lower Maestro interchange by roughly 60%. There is little reason to believe the regulators won't ask for more.

In November, 2006 New Zealand's Commerce Commission charged MasterCard, Visa, and 11 financial institutions with anti-competitive price fixing.

In January 2007, rejecting the incrementalist approach taken by kindred regulators, the Polish Office for Consumer and Competition Protection eliminated interchange in Poland.



Eric Grover is a principal at Intrepid Ventures, Menlo Park, Calif. Reach him at eric.grover@intrepidventures.com.

Regulators worldwide will take a cue from this.

Strategic Blunders

Part of the problem, from the card networks' perspective, is that they have allowed regulators, merchants, and trial attorneys to frame the terms of the interchange debate. The UK's Office of Fair Trading deriding interchange as "a tax on consumers" is illustrative. Never mind that the power of taxation rests only with governments backed by policemen.

U.S. retailers are running ads attacking interchange to influence Congress to legislate interchange regulation and reduction. They're having an effect. The new chairman of the Senate Banking Committee, Chris Dodd, said interchange fees were "opaque" and "growing exponentially."

In March, Senator Arlen Specter said, "We may need to modify our antitrust laws to stop credit card companies from engaging in collusive or conspiratorial activities to gouge or jack up [via interchange] prices."

In contrast, in the public arena the global payment networks seem to have adopted Muhammad Ali's "rope-a-dope" strategy, hoping retailers and regulators will punch themselves out. That's not going to happen. Quite the contrary: Not aggressively making an affirmative case in the public arena for interchange, and not trying to roll back extant regulation, are strategic blunders that imperil the value of the card-payment network franchises.

That bank consortiums MasterCard and Visa set interchange underpins U.S. litigation and most regulatory authorities' interventions. However, MasterCard's public offering transformed it into an independent business, at least outside Europe. Regulators nonetheless continue to treat it as a public utility.

Higher interchange spurs card use, and beyond some point hurts accep-

tance. Conversely, lower interchange—potentially even negative interchange, with fees flowing through acquirers to merchants—stimulates acceptance, but ultimately inhibits spend.

Interchange rates and practice can be set by bank consortiums, regulatory fiat, or the interplay of competing commercial payment networks, thousands of issuers and acquirers, millions of merchants, and billions of consumers. Perversely, just as the largest networks



are morphing into commercial enterprises, the prospect of regulators setting rates seems greatest.

Costly Cash

Trends suggest interchange will continue to be reduced or even eliminated in many markets, notwithstanding significant hikes this year in the U.S. for reward and super-premium cards. Payment systems can exist without interchange. But what would a payments world without it be like?

Eliminating interchange would put a damper on MasterCard's and Visa's transaction growth, which drives their revenue. Issuer business models would be hurt and, in some

cases, destroyed.

Interchange is a, and sometimes the, major revenue source for card businesses. It nourishes issuer innovation. In its absence, issuer innovation would be radically diminished. Fees charged consumers by issuers would increase to offset the revenue loss. Cardholder benefits and rewards, such as cash-back and frequent-flyer programs, enhance payment products. They would be gutted or outright eliminated.

Open four-party card electronic payment networks would be less competitive with cash, checks, and proprietary integrated payment systems such as American Express, Discover, PayPal, and private-label systems.

Governments run a very expensive payment system called cash. The European Payments Council estimated the EU's 360 billion cash transactions per year cost at least \$65 billion per year. Factoring in large-scale tax avoidance facilitated by cash, the real cost of cash is considerably higher.

If electronic payment products became less compelling because interchange was eliminated, the gray economy—otherwise legal commerce transacted in cash to avoid taxes—would increase. A restaurant or hardware store where 90% of customers prefer using reward cards for which they pay no or modest fees has more difficulty steering business to cash than those in an environment in which cardholders are less motivated to pay with cards.

Indeed, without interchange, open payment networks' power relative to their acquirer and particularly issuer customers and value delivered would be diminished.

The card payment networks are likely to continue to cede ground in the global interchange wars. But without interchange, cash would be more resilient and MasterCard and Visa would deliver less value and consequently be worth less. **DT**