

## The demutualisation dilemma

- **Cards International 213**
- **19th February 1999**
- **Word count: 1,961**

**In the ‘hearts and minds’ battle between Visa and MasterCard, demutualisation is a key issue. Eric Grover\* gives a strictly personal — but provocative — view of the way forward**

THE BANKCARD payments associations have been accused of engaging in anticompetitive practices and inhibiting innovation. While Visa International is a for-profit, non-stock corporation owned by its members, and MasterCard International is a not-for-profit association, both behave like the trade associations or clubs that they are. Both could pre-empt concerns about a lack of competition and innovation, and concomitantly better serve their existing customers/owners and end consumer and business users by demutualising: converting to investor-owned, publicly traded, for-profit corporations.

Global electronic consumer payments systems have enabled the provision of convenient, safe payments, credit and marketing products to more than one billion consumers and 15 million businesses, facilitating commerce and making people’s lives far easier. Three systems — Visa, MasterCard and American Express — predominate, offering their cardholders and merchants worldwide utility.

Is this good for the banks that own them and are their principal customers and, further, does it well serve the diverse interests of end consumers? Is the market sufficiently competitive?

The most enduring and costly anticompetitive behaviour occurs when government sanction protects firms from competition. Witness the old AT&T and the European PTT monopolies, the US Post Office, and the public school system. Neither bankcard association enjoys government protection. In many markets, however, they have virtually exclusive access to banks that have historically enjoyed the mixed blessing of government regulation, support and protection. The Department of Justice (DOJ) contends that Visa and MasterCard have harmed credit cards competition and further that they have inhibited innovation potentially beneficial to consumers.

Compared with the intense competition one sees among Cisco, Informix, Sybase, Microsoft and IBM, or First USA, Capital One and a host of aggressive, fast-moving cards issuers, intersystem competition would appear nonexistent.

It is important to distinguish between the cards issuing and merchant acquiring markets and the payments delivery system market. In the US, issuance and acquiring are ferociously competitive. Neither MasterCard nor Visa is directly in the credit cards business, however. Each provides enabling services to businesses that in turn compete in a variety of cards markets. Each manages payment brands: Visa, MasterCard, Maestro, Plus, Interlink, Cirrus, and Electron. Each provides a rule and arbitration infrastructure that has enabled thousands of independent firms to co-ordinate their offerings to cardholders and merchants worldwide, and thereby facilitated sustained massive growth. Lastly, they supply network and computer processing services to members and nonmembers. In markets where third-party processors or individual banks control significant portions of issuing and acquiring, significant authorisation and settlement processing is 'on-us' and does not pass through association systems. Many national markets have their own interbank authorisation switching and settlement systems.

The DOJ alleges that duality is anticompetitive. No-one suggests that it has enhanced competition. When the Worthen Bank challenged Visa's duality ban back in its early days, Dee Hock and Visa strongly opposed duality as anticompetitive. The DOJ's unwillingness to affirmatively bless the by-law banning duality caused them to cave in. These are clubs with by-and-large the same membership. Forcibly ending duality would create two clubs with distinct memberships. Members would therefore be more likely to countenance intersystem competition. Given current market shares, it would also weaken MasterCard, which presumably runs counter to the DOJ's aim of increasing competition.

The DOJ contends that association bylaws restricting members from issuing competing products from AmEx and Discover are anticompetitive. In 1997, the Competition Directorate of the European Commission preemptively looked at and challenged Visa's consideration of a bylaw that would have banned member banks in Europe from issuing competing products such as AmEx. Discover and AmEx want access to banks as a channel. They have, of course, access to other channels: direct — whether electronic, telephone or mail; indirect — through insurance companies, brokerage houses, retailers, telecom providers, online service providers, airlines, and other less conventional channels.

Would the market be more competitive if AmEx and Discover had unfettered access to banks as distribution partners? Absolutely. Similarly, the market would be more competitive if Visa and MasterCard were incentivised to distribute their products through non-bank channels.

Innovation requires the freedom to experiment and the freedom to fail. The association structure stifles competition because developing political consensus is the paramount consideration. The glacial pace of innovation within consumer payments systems is due to a structure in which innovations championed by management are watered down, if not smothered, working their way through nested layers of advisory and board committees composed of member bankers and management. The immense cost has been not only the delayed introduction of new products but countless innovations never born.

Visa and MasterCard's paradigm, like the old AT&T and European PTT paradigms, is 'stasist'. Plans developed and controlled by a central bureaucracy, designed to neither ensure mediocrity nor produce a pace and quality of progress one would expect from the Department of Motor Vehicles, the Post Office or the old telephone monopoly.

The phone companies invested in, protected and refined the centrally managed PSTN with little significant innovation for decades. Its certainty, its reliability and its safeness were touted as proof-positive of the appropriateness of the approach.

Visa's new chief, Malcolm Williamson, likens Visa's payments delivery system to a railroad. The old-economy metaphor is not appropriate. The core of a payments transaction is digital: encrypted bits hurtling down a wired or wireless pipe. It should not much matter who owns or manages the 'tracks'. Witness the old telephone monopoly: one set of tracks, one provider. The result: minimal innovation for decades and this in spite of the fact that AT&T's labs produced leading-edge R&D whose value was often realised elsewhere or remained to be realised after the breakup. Telecommunications deregulation brought a proliferation of new providers, plummeting prices and a cornucopia of new services.

In Silicon Valley, there is a critical mass of entrepreneurs, technologists and venture capitalists, and a culture that celebrates innovation, verve and growth. Visa sits not far from Silicon Valley and MasterCard not far from Silicon Alley.

Both, however, are culturally light years distant from the magical recipe in Silicon Valley. Many of Visa's and MasterCard's employees are not different in capacity and potential from those to be found in enterprising hi-tech Silicon Valley firms. What's different? Cisco, Oracle, Intel and, to throw in a non-Valley business, Federal Express are fast-moving and competitive. It is not that the payments titans lack for talent but that the talent's incentive system is flawed.

What then is the key to change? The entire association should be demutualised. Existing member banks would be issued shares based on their pro-rata contributions and there might be an IPO raising capital to develop the next generation of services, and, importantly, to broaden ownership. Banks that wanted to redeploy capital could do so. It is easiest to envision processing functions consuming most of the associations' resources being privatised. This would also be the most palatable to member banks.

If an investor-owned, for-profit company would offer better service at a lower cost, why should a privatised firm managing the brands, rules and interchange not produce superior performance as well? So long as there were competing systems, a dynamic rate and interchange structure, this would best serve institutions buying enabling payments system services. Some large members such as Citibank have competing brands. Would not consumers be best served if Visa and MasterCard had to compete for John Reed's brand business and processing.

It is overly optimistic to believe that the associations would initiate demutualisation themselves. There is tremendous decision-making inertia within both. While some bolder management would undoubtedly welcome the opportunity to compete, to make a meaningful impact, many, particularly among existing bank owners, will resist changing the established order. A government nudge toward making both associations overtly competitive, commercialising their management reward systems, rather than government lawyers and economists trying to recalibrate the rules, would help.

The current bankcard structure's biggest cost is innovation never tried, new functionality never realised and new services never launched.

What if the payments system associations were transformed into commercial enterprises? Drawing upon what has happened in virtually every industry that has been privatised, where the creative intelligence and energy of individuals has been unshackled, prices would fall, the pace of innovation would increase and clients would benefit from a profusion of new services.

Unfettered competition spurs relentless product improvement. Microsoft's browser Explorer became stronger because of Netscape. Both are now free. AOL improved because of MSN, Prodigy, and Compuserve. Unleashing the associations to compete would produce a trove of innovation, failures and successes.

The DOJ suggested that the mediocre progress of smart cards to date may be attributable to the associations. Maybe in some form they make economic sense, maybe they don't. Certainly the e-purse pilots in Atlanta and NYC seemed uninspired set against the multiapplication smart cards systems described by the evangelists. With exponential increases in chip power why can't Joe Sixpack have a menu of payments instruments, loyalty programmes, security information, a phone book, etc, in his wallet, or perhaps watch? Because it must be trusted and ubiquitous, both associations remain well positioned to influence, if not, drive development and commercialisation.

Both associations possessed a global payments infrastructure tying in virtually every bank, merchant and adult in the developed world and should therefore have been well positioned to build electronic payment and bill presentment systems. The electronic home payments ventures, Masterbanking and Visa Interactive, both failed. Would CheckFree and TransPoint have had opportunities to build businesses if the associations had a corporate ethos more like Cisco's?

With demutualisation, the payments systems would have a ready currency — their stock — to acquire businesses which management believed would enhance their services.

There will, of course, be objections. Threats to upset the status quo cause resistance because the advantaged inevitably fear losing. This is not a zero-sum game, however. Credit delivered via cards has expanded enormously. It would expand at an accelerating pace continuing to displace other more cumbersome vehicles for delivering consumer and commercial credit. Cash and cheques still account for more than 80 percent of payments

in the US. Large owner/customer banks are likely to worry about diminished influence, about a diminished ability to control the associations. To the extent that the payments delivery system firms provided superior tools at better prices to large banks hungry to compete, they would be well served.

Smaller owner/customer banks may worry that a commercial enterprise selling authorisation, settlement, risk management and exception processing services might pay less attention to them. Small banks would in fact benefit immensely from more and better enabling tools with which to compete.

AmEx might well rue the day that its lobbying and suits triggered freeing competitors rich in talent and well-positioned to compete — to introduce new products, to explore new markets, to collaborate with existing customers and heretofore unthinkable partners.

Other national or niche market payments systems such as Diners Club and JCB in T&E, Discover in the US, Cetelem in France, and a plethora of proprietary debit and P/L programmes would have to retool and enhance their offerings to compete with newly invigorated, motivated, opportunity-focused behemoths.

In an open, competitive market, the consumer is king. He votes with every purchase. If the associations were transformed into profit-seeking, publicly traded firms, they would behave very differently, relentlessly seeking better ways of serving their consumers. Each existing leg (brand, rules and processing) would be continually marked to market. The payments system enterprises would be incentivised to innovate, to grow and to compete, and Janet Reno et al could devote themselves to other worries. ♦

*\* Eric Grover has worked for GE Capital's credit cards business and for Visa International. He also developed a course on 'Developing Electronic Commerce' at the ellinger Business School. (EricAGrover@Netscap*