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Let Markets Set Rates, Policies for *Interchange*

By Eric Grover

Interchange is a critical pricing system balancing the economics between the firms that issue credit and debit cards and those that service the merchants accepting them.

Government regulation of interchange discriminates against open, consensual, business models in favor of proprietary systems, which price as they see fit. A government-mandated *interchange* ceiling will discourage issuer experimentation in the creation of products and value propositions.

If regulation has a positive role, it is in encouraging open and proprietary systems to compete more vigorously in existing markets and on new fronts. As interchange enables innovation in issuing, government price ceilings are, in practice, anti-innovation and consequently anticonsumer. Interchange rates are set by committees of bankers overseeing MasterCard and Visa in the context of a market, albeit one in which the bank card associations enjoy significant strength. Given Visa's and MasterCard's formidable global contractual web of 21,000 banks, 29 million merchants, and more than a billion cardholders, many worry that the associations wield, and are abusing, undue market power. Consequently, governments have had a rationale for intervening.

More often than not, however, government actions have not made these markets more competitive. Vigorous competition is a far superior means of regulating the prices of network payment service. Regulators contend that the associations, by their very nature, conspire to fix prices and that, with their market power and bylaws, they can freeze out or severely handicap competitors.

Payment association rules and pricing have attracted regulators' ministrations around the globe. In 1997 the European Commission Competition Directorate preemptively challenged Visa's consideration of a bylaw banning EU member banks from issuing products from competitors such as American Express Co. In a similar spirit, U.S. District Judge Barbara Jones ruled in October 2001 that Visa and MasterCard could not prohibit members from also accepting Amex and Discover.

Prima facie, this created a more competitive environment. As a practical matter, however, the effect was modest. Amex has struck issuing relationships with a paltry 74 banks over the past five years. If there were an opportunity, it would involve second-tier banks enhancing their profitability by issuing Amex products with higher discounts, and effective interchange rates, to high-volume convenience users.

This year the EC Competition Directorate took it upon itself to review interchange**.** Visa uses a cost-based model developed by Arthur Andersen. Regulators immersed themselves in analyzing the underlying cost rationale. The associations agreed to lower the cross-border rate to 0.7%, and the regulators gave their imprimatur to interchange and the rates. It was a disturbing precedent of the state, rather than mutually consenting private commercial actors, determining the appropriateness of pricing.

Also this year the Reserve Bank of Australia forced the associations to reduce interchange by 40%. The underlying notion, again, was that the government should determine the reasonability of interchange pricing.

In the United States, the Wal-Mart case illustrates how government intervention inhibits competition in the payments and retail banking markets.

Several years ago Wal-Mart sought approval from the Office of Thrift Supervision to acquire an Oklahoma thrift, a request the OTS denied. Subsequently, the agency rejected the merchant's proposal to offer retail banking through its cashiers. In October, California stymied Wal-Mart's most recent attempt to acquire a banking platform.

These actions did not make the financial services market more competitive or innovative. Rather, they protected incumbent providers from competition and restricted consumer choice.

In 1996 Wal-Mart initiated a suit claiming that Visa and MasterCard were violating the Sherman Antitrust Act by enforcing their "honor all cards" rules, which tie together what are, arguably, discrete products. Though it objects to the payment associations' offline debit pricing, Wal-Mart continues to accept their bundled propositions and seeks a resolution of a commercial pricing dispute in the courts.

This suit assumes that plaintiffs' attorneys and the government should concern themselves with the intrinsic fairness of private-sector pricing and that the state, rather than the market, can and should determine what suppliers can legitimately bundle into a product.

Wal-Mart's attorneys argue that Visa and MasterCard's delayed debit fees are unfair, because they are higher than those for PIN-based products provided by First Data Corp.'s NYCE, Concord EFS, and a host of regional programs. These products are not the same, but that is almost beside the point. When people talk about "fair" prices, wages, or trade, "fair" is generally a euphemism for producing a result different from what mutually consenting parties would reach in a free market.

Visa's and MasterCard's "high" debit pricing encourages banks to issue and promote debit products under association payment brands. The "honor all cards" rules leverage the associations' point of sale credit card dominance and prevent retailers from cherry picking products, separating point of sale payment based on back-end treatment between the issuer and cardholder, and conceivably frustrating and confusing cardholders.

Government intervention, putatively, rectifies market failures. Structural changes that deregulate markets where competition has been restricted -- generally by the government -- produce superior results for consumers.

All too often, however, the government intervenes at the behest of suppliers seeking protection or privileged status. These interventions are very specific, mandate particular pricing, meddle in product definition, and favor particular suppliers or shareholders. When this happens, consumers lose.

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