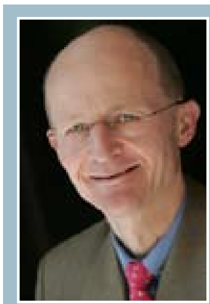
Regulation of interchange is not the solution

European regulators have got it wrong. Innovation and a reduction in cash usage will only come from freeing banks to set their own interchange level. The US offers a good source of inspiration, argues payments guru Eric Grover in this highly charged opinion piece exclusive to the Insider

As we have learnt from the sector inquiry EU policymakers are highly critical of the card payments sector's performance. Regulators are increasingly willing to intervene, bringing antitrust charges and reducing interchange, with a view to fostering competition and creating a more open and integrated pan-European payments market. They also want to reduce cash. However, treating banks' card payment networks as public utilities in pursuit of these goals is misguided.

What ails Europe's payment's industry is not insufficiently vigorous regulation, but rather insufficient card payment network competition. This is the result of bank control, a lack of profit seeking, and a regulatory climate (particularly vis-à-vis interchange) decidedly hostile to growth and new entrants.

One can glean some insight into the problems and potential remedies by considering the increasingly stark contrast with the US.



Eric Grover

Bank Control

European and American payment network markets were both originally a patchwork of regional and national bank-owned, not-for-for-profit organisations. In the US networks consolidated. A handful became robust national and international systems. Spurred by litigation, MasterCard went public, with Visa to follow suit in the first quarter of 2008.

After Visa's IPO all significant US card payment networks will be commercial and independent of banks.

Discover is being spun off from Morgan Stanley. It has struck merchant acquiring partnerships with First Data, TSYS, Global Payments, RBS Lynk, Nova and TransFirst, which will enable it to achieve close to acceptance parity with MasterCard and Visa in the US.

Meanwhile, American Express CEO Ken Chenault has said his company would consider offering debit to its bank issuer customers.

So, the US will have four for-profit, public, general-purpose card networks, It also boasts a number of commercial PIN debit networks, such as those owned by First Data, Metavante and Fiserv.

As a result competition is intensifying, interchange rising, and cash use declining.

In Europe on the other hand, all major payment networks remain bank controlled.

Regulators are pushing to dismantle national payment barriers, heralding the demise of most domestic debit networks.

There are only two pan-European full-suite card payment networks: MasterCard and Visa. Both are controlled by banks. Visa is not-for-profit. MasterCard's prices in Europe are set by its bank 'customers', which also decide who can be a customer.

Bank control inhibits payment networks' motivation and ability to compete and innovate, and limits what type of customers they serve.

French central bank governor Christian Noyer complains European Commission (EC) moves to liberalise European payment markets would permit non-banks to compete and that this was "dangerous." Au contraire, mobile phone operators and retailers have much to offer consumers. A Vodafone could issue handset and mobile phone-number-linked payment products. And, unconstrained by bank cartel rules, merchants would become even more formidable retail finance competitors.

Profit Seeking

The pursuit of profit guides talent, capital and entrepreneurial zeal to where it is most highly valued. In most card payment markets issuers' reap the lion's share of profits. Cleaved from banks, payment networks would grow by cultivating new customers and enriching their offers. They would also realise their inherent operating leverage, generating robust returns.

But regulatory mandarins view profits as dirty. EC antitrust tzarina Neelie Kroes derided card provider profits as "abnormal," "excessive," and "outrageous."

Profits stimulate innovation and competition. In their absence, it should therefore be no surprise that the payment network market underperforms. It is by design.

Regulation

In the US since the Department of Justice's suit ended MasterCard's and Visa's prohibitions on member banks issuing American Express and Discover, regulators have been hands off. Notwithstanding grand-standing during interchange hearings in the Senate and the House, this is unlikely to change.

On the other side of the pond however, regulators have created an environment hostile to payment network growth, innovation and new entrants.

From a national regulator and bank cartel perspective it makes a certain sense. Why would the French central bank or the retail bankcard group Cartes Bancaires want to eliminate national payment barriers, open up the market or give up network control? Competition is messy. Given free rein it relentlessly undermines the established order.

At the EU level however it's harder to fathom.

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Interchange

The EC, European Central Bank and national regulators have interchange in their cross hairs. Kroes described it as an "obstacle" to creating a single payments market. Quite the opposite.

In contrast with destroying national payments barriers, regulating (ie, reducing) interchange undercuts efforts to encourage competition and create a more liberal, predominantly electronic payments market. Higher interchange would drive pan-European payment product issuance and use.

Regulators accuse MasterCard of hindering interbank payments competition through interchange. They deride it as a tax. They are wrong. Only governments, with armed policemen, tax.

The ECB worries payment networks are not sufficiently competitive, which is true, and further that the international schemes' displacement of national networks will result in higher interchange and consequently higher merchant fees.

Interchange determined by a highly competitive market would indeed be greater, and, would serve policymakers' goals of creating a pan-European payments market and reducing cash.

Higher interchange encourages payment card issuance, fuels innovation and cardholder benefits, incentivising use. It means lower prices and greater value for consumers.

Moreover, in high-tax Europe richer interchange will reduce the grey economy. An unintended consequence of lowering interchange is more cash spend, and therefore, increased tax avoidance.

The EC Competition Directorate has outstanding interchange antitrust complaints against MasterCard and it intends to revisit the five year antitrust exemption it granted Visa, which means it will seek further interchange reduction.

Meanwhile this January, the Polish Office for Consumer and Competition Protection went the final mile, eliminating the existing interchange arrangements in Poland. This puts a damper on card transaction growth there.

Elsewhere regulators have indulged in what Frederick Hayek called the fatal conceit, believing they can orchestrate more optimal results than the market. The Reserve Bank of Australia entertained eliminating interchange, but opted instead to lower it 9 percent in 2006, after a 40 percent reduction in 2006. The intention was to improve payment efficiency.

Polish competition authorities, more legitimately, worried about how it was set. The head of the Polish competition authority Cezary Banasinski's said "We do not question the level of the fees but the fact that they are the result of an agreement among banks and the market is not free here."

Visa Europe is and will remain a not-for-profit bank association and in the opinion of the Polish and most regulators therefore deservedly subject to interchange regulation.

MasterCard is another story. It's a for-profit public company. Interchange is set by MasterCard International management. But, all other material aspects of MasterCard's business in Europe are controlled by a European banker board. The Polish Competition Authority does not buy the notion MasterCard's interchange rates are not, de facto, controlled by banks.

What can be done?

A Fix

Regulators root for the creation of a third European network, touting the Euro Alliance.

It is unlikely to be successful. But even if it was, another not-for-profit bank payment utility is far from a sliver bullet.

Euroland needs at least two genuinely independent, vigorously competitive, commercial pan-European networks, free to price as they see fit, and to serve whomever. A couple more would be better still.

The best candidates are American. First Data has a broad, European card-issuer-and-merchant-processing footprint. If it, Discover or even American Express, acquired national debit networks, it could cobble together a viable competitor, notwithstanding the angst this would cause Euro-essentialists who believe a network owned and managed by Frenchmen and Germans is intrinsically preferable.

Establishing payment network critical mass and relevance is enormously difficult. In the last quarter century Discover, PayPal, and perhaps China UnionPay, are the only genuinely new payment networks of size to have been established.

Public choice theory explains regulators act to maximise their own welfare.

However, EU policymakers can best serve consumers and the single-market cause by taking the path less traveled: letting the free market rein. They should let the interplay of a handful of commercial payment networks and processors, thousands of financial institutions, millions of merchants, and hundreds of millions of consumers, in tens of billions of purchasing decisions, determine what pricing, terms and products are optimal. It is beyond the comprehension of even the cleverest regulator.

Nonetheless, narrowly tailored, one-time, regulatory actions targeted to make systematic fixes can work. There several areas where the EC should act.

Foremost, Kroes and McGreevey should jawbone European banks to relinquish control of MasterCard Europe and to have Visa Europe participate in Visa's IPO.

They should broadcast that the EU would welcome a foreign, ie, American, payment network or processor acquiring bank-cooperative networks to build a third (or fourth) payment network.

Lastly, regulators should promise that any genuinely commercial payment network will be free to establish interchange to increase transactions and maximise its value.

In summary, Europe's consumer and policymakers' goals would be well served by invigorating the card payment network sector. Complete demutualisation of MasterCard and Visa, unfettering interchange, and encouraging new commercial entrants would jump start the process.

Eric Grover is a principal and founder at Intrepid Ventures, providing corporate development and strategy consulting to private and public financial services, processing, technology and payment network businesses, principally in North America and Europe. Grover's prior experience includes Visa International, GE Consumer Finance, Bank of America, NationsBank and Transamerica. Eric.Grover@IntrepidVentures.com