Trouble Ahead for the Dynamic Duo

Eric Grover

Visa and MasterCard have emerged from the Great Recession in fine shape. What have they got to worry about? As it turns out, plenty. But they and their investors could still have plenty to smile about—if the networks play their cards right.

Unshackled from bank ownership and association governance, MasterCard Inc. and Visa Inc. have demonstrated the enormous power of the network and their to-die-for business models.

They enjoy substantially fixed platform costs and variable licensing and processing revenue tied to payments growth. Tellingly, they have weathered, indeed prospered in, the Great Recession, enjoying continued, albeit slower, transaction growth, modestly trimming costs and boosting licensee fees.

What, if anything, should incoming MasterCard chief executive Ajay Banga, Visa chief executive Joe Saunders, and investors in the two companies lose sleep over?

The paramount threat is government. Having suzerainty over the largest payments markets, Brussels and Washington pose the most worrisome challenges.

European Union regulators view retail card payment networks as public utilities. In December 2007 the European Commission Competition Directorate ruled MasterCard's interchange system illegal. MasterCard's appeal to the EU Court of First Instance isn't likely to be decided until 2011.

In 2009, the EC bullied MasterCard into rescinding an acquirer-fee increase—the first time a regulator interested itself in network licensee fees as opposed to interchange. It also has an outstanding interchange complaint against Visa Europe. In April, Visa caved on debit interchange, agreeing to a 60% cut.

Here in the U.S., legislation to cap card-acceptance fees was introduced in Congress in 2008 and 2009. In February, Sen. Arlen Specter's spokeswoman said he was mulling introducing an interchange bill. In April, the House Judiciary Committee held hearings on the "Credit Card Fair Fee Act," with witnesses stacked in favor of regulation.

Interchange foes' best chance in 2010 is Sen. Dick Durbin's amendment 3989 capping debit interchange. By a vote of 64-33, it was attached last month to Senate banking chairman Chris Dodd's misnamed "Restoring American Financial Stability Act." It would permit retailers to discount different payment systems and refuse payment cards for purchases below and above certain thresholds. It would also mandate a Fed-determined debit interchange based on processing cost—the public utility model, meaning a fixed fee, probably 90% lower than current rates. Issuers with under $10 billion in assets, however, would be exempt.

A Bigger Pie

House Financial Services chairman Barney Frank, however, opined that Congress is unlikely to pass interchange legislation this year. Having just hiked PIN-debit interchange by 24% to boost usage, Visa is betting Frank is right. We'll see.

Even if the networks run out the clock in 2010, partisans of regulating retail payment networks as public utilities have made headway and will persist in their political campaign. Paraphrasing Leon Trotsky, while MasterCard and Visa may not be interested in politics, politics is interested in them.

They would do well to make a more forceful affirmative case in the political arena, hammering home to voters that network freedom to compete and to craft products and price is pro-consumer, and that card-acceptance price controls mean fewer cards, higher cardholder fees, and reduced benefits.

The networks spend several billion dollars annually promoting their brands. Investing a couple hundred million fending off government regulation would be money well spent.

Network power increases enormously with the number of connections and increased dispersion of

issuer-and-acquirer payments share. Thirty million merchants, several billion cardholders, and tens of thousands of financial institutions are a lot of connections.

But Goliath issuers such as Bank of America Corp., JPMorgan Chase & Co., and Citigroup Inc. concentrate share. Issuer consolidation hurts network economics. Small community banks, however, are keen to piggyback on network brands and processing.

In contrast, Chase, pointedly, is not including network brands in promoting MasterCard and Visa credit and debit cards, underscoring giant issuers' desire to reduce network brand prominence to the minimum necessary.

Neither MasterCard nor Visa has done anything material to boost smaller and non-traditional issuers' share. They should encourage, and vigorously enable, the payments ambitions of small banks, retailers, insurance carriers, and mobile-phone operators. The networks would benefit from increasing not only the total electronic-payments pie, but the shares of other players at the expense of issuing behemoths.

No Duopoly

The recession hurt the entire payments industry. But networks were better insulated from its ravages than banks. Recent pricing moves testify to network value and power. In April 2009 MasterCard hiked net acquirer transaction fees 1.35 cents. In July 2009, Visa increased net acquirer transaction processing fees 1.45 cents and introduced new exception-processing and address-verification fees.

In October 2009, Visa implemented a 45-basis-point cross-border acquirer support fee, and MasterCard boosted cross-border acquirer fees 20 basis points. In April, MasterCard hiked acquirer fees by 1.5 basis points and acquirer ATM support fees by 12 cents per transaction. And, in July, Visa plans to increase acquirer fees by 1.75 basis points.

Much as they would like it to be otherwise, MasterCard and Visa are not a payments duopoly. While each worldwide network focuses on the other, there are a host of longstanding and new competing payment systems representing another threat to the networks.

Cash remains the world's primary retail payment method. Gray and black economies encourage cash. In many European markets, its use has increased because of high taxes, large gray markets, and payment-card-network price controls that cause high cardholder fees and anemic benefits. That said, e-commerce growth and a handful of restaurants and airlines refusing to accept cash are a harbinger.

Protected Chinese network monopoly China UnionPay, the Euro Alliance of Payment Schemes, Cartes Bancaires (Europe's third-largest network), Canada's Interac, a slowly surging Discover, American Express Co., and JCB all compete in specific markets. But none yet matches up well against MasterCard and Visa worldwide.

There are efforts of varying seriousness by governments and banks to curb MasterCard and Visa in Brazil, Russia, India, China, and Europe. Bradesco and Banco do Brasil are launching a payment network called Elo, initially aimed at low-income consumers.

The Russian government is discussing developing a national payment system to be owned by banks including Sberbank, Bank of Moscow, and Promsyazbank. Indian banks have flirted with launching IndiaNet to process interbank transactions.

MasterCard and Visa should try to smother such efforts in the crib.

In the world's most populous market, notwithstanding China's commitment to the World Trade Organization to have completely opened up its domestic card-payment market by December 2006, MasterCard and Visa are still not permitted to compete.

Pull out the Stops

There are a slew of alternative-payment systems. E-commerce phenom PayPal has 84 million active users. Satisfying e-auction payment needs inadequately served by MasterCard and Visa enabled PayPal to build network critical mass and momentum in general-purpose e-payments. Now it has partnered with First Data Corp. to take Star PIN-debit online, and inevitably will jump to the physical point of sale.

The Biggest Challenges for Visa And MasterCard ...

- The developing threat of utility-like regulation by government, extending into pricing and network rules;
- Dominance by gigantic banking corporations, which downplays network brands and stifles innovation and growth;
- Multiple threats on multiple fronts worldwide from both established and emerging payments systems.

... And What They Should Do About Them

- Stop pussyfooting around Washington. Make a stronger, positive case against government regulation, directly to voters;
- Encourage, even enable, payments products for small banks and non-bank players like insurance companies, retailers, and mobile-network operators;
- Be more aggressive about developing services for emerging payments markets, especially P2P payments;
- Leverage strong cash positions to buy network-enhancing assets; Orbiscom (MasterCard) and CyberSource (Visa) are a good start.

China's top e-payment firm Alipay has a whopping 300 million registered users, does 1.8 billion payments annually, and is extending acceptance abroad. MercadoPago focuses on e-auctions in Latin America. Amazon is leveraging its Internet-retailing mastery and customer base to provide payments to other e-retailers.

While much ballyhooed, Revolution Card never demonstrated a viable business model, much less a business. But its new owner, AmEx, may reinforce and recalibrate the effort or simply harness the technology to accelerate its mobile payments, person-to-person, prepaid, and debit development.

Mobile offers multiple enticing payments hooks, starting with 4.6 billion handsets—a device eminently suitable to deliver and receive payment-account keys—and billing relationships.

Danal partnered with Verizon Wireless, enabling shoppers to bill e-commerce to phone bills. Bling Nation uses mobile phones with a contactless sticker rather than a plastic mag-stripe card to carry payment account keys, enabling consumers to use handsets to pay at the point of sale.

Bling Nation is an open, two-sided, general-purpose retail payment system serving consumers and merchants through bank licensees, like Visa, MasterCard, Discover, and First Data's Star do. Bling's attempting to build pockets of critical mass with community banks in small towns. That's a tough row to hoe.

But mobile-payment systems such SmartMoney, Global GCash, and M-Pesa challenge the card networks in the Philippines and Kenya, respectively, where cell phones have much greater penetration than payment cards.

Notwithstanding a battery of threats, the electronic-payments world remains MasterCard's and Visa's oyster, if they aren't complacent.

There is no bigger opportunity than person-to-person payments. Analysts often compare it with the traditional $420 billion cash-to-cash branch-based remittance market. But this is like having tried to size the electronic-copier opportunity by looking at the market for carbon paper.

Seven billion people make payments to each other. Providing P2P payments from and to any MasterCard- or Visa-branded product worldwide would transform what is possible in local, national, and cross-border markets. It's a natural network business, leveraging networks' brands, processing, and global licensee web.

Startup Square's idea of enabling anyone with a mobile phone to accept payment cards speaks to the opportunity. Traditional card-payment boundaries between small merchants and individuals are eroding. MasterCard and Visa should pull out all the stops to make their P2P offers synonymous with the brands, and ubiquitous. Where necessary, the networks ought to provide, indeed mandate, use of their processing.

Getting Acquisitive

MasterCard and Visa developed as bank associations. But today, as independent commercial enterprises, they have every reason to extend their global web of licensees beyond banks.

Mobile-phone operators have enormous reach and would enable the networks to get to merchants and consumers in emerging markets such as Africa, where cell-phone penetration significantly outstrips the banked population, and to diminish dependence on gargantuan retail banks. In Europe, regulators have provided a formal legal vehicle, the PI, for non-bank participation in payments.

Both global networks generate gushers of cash and have strong public currencies with which to acquire assets extending or enriching the network.

With its $100 million acquisition of Orbiscom last year, MasterCard picked up capability enabling issuers to give cardholders more control and, in theory one day, port it across issuers.

Visa's $2 billion CyberSource acquisition is bolder and riskier. Joe Saunders said Visa "didn't see any [e-commerce processing] business we were interested in acquiring other than CyberSource." If acquiring a gateway makes strategic sense, CyberSource, with its market position, fraud-management tools, and geographic proximity may well have been Visa's most compelling acquisition. But the asset Saunders should be keenest to pick up is Visa Europe.

The valuation multiple for CyberSource, at 11.3 times 2009 revenue and 6.7 times annualized fourth-quarter revenue, is rich. Visa will have to divest CyberSource's acquiring business, which has 6,600 clients and contributes 33% of its revenue. CyberSource's European business will create a turf squabble with Visa Europe.

Still, CyberSource's gateway business serves 300,000 merchants. It represents a shift in Visa's business model of serving financial institutions, which in turn deliver payment products to merchants and consumers. Visa's new e-wallet, Rightcliq, also reaches beyond licensee banks to cardholders.

Touching e-commerce on the spend and acceptance side of the transaction offers Visa the intriguing and potentially game-changing possibility of enhanced fraud prophylactics and real-time interactive marketing.

MasterCard's and Visa's first-quarter year-over-year transaction growth of 7.9% and 13.2%, respectively, attest to returning secular tailwinds. But both are capable of more.

If MasterCard and Visa fend off value-destroying government regulation, make P2P ubiquitous, cultivate new distribution, and push into emerging markets, they will create and capture more electronic payments and delight their shareholders. DT

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