Regulatory straitjacket will put a damper on payments innovation and competition

About the author:

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Eric moderates the session on interchange fee cap and regulation at the Merchant Payments Ecosystem (17-19th February, Berlin).

Retail-card networks were the greatest payments innovation in the 20th century. Over the last several decades, falling like dominos, there have been regulatory, legal and political assaults worldwide on payment networks' interchange: a pricing system used to balance participation and value on the spend and acceptance sides of their two-sided markets, and thereby to maximize total value and transactions.

In payments it's an increasingly rare regulator who doesn't believe he can improve on the market - economist and philosopher Friedrich Hayek's "fatal conceit." The European Commission suffers Hayek's fatal conceit, somewhat more so than American regulators, and is on the brink of completing a long-sought-after regime regulating payment networks as public utilities.

Interchange concerns originally stemmed from four-party payment-card schemes' collective bank ownership. However adhering to a view enlightened central planners could produce better results than parties engaging in voluntary market transactions, anti-interchange partisans shifted focus to reducing narrowly-defined acceptance cost, decidedly not system-wide value and cost.

The first high-profile attack on networks' asymmetric pricing was the US Nabanco antitrust interchange suit against Visa. In 1984 Visa prevailed. Judge Hoeveler ruled interchange was necessary for the bank joint venture to work, Visa did not have market power – "had little power"- in the relevant market defined as retail payments including general-purpose and private-label cards, cash, travelers checks, and personal checks, and that interchange was pro-competitive.

Since however, the industry has beat a slow but seemingly inexorable retreat in a multi-front global war.

Australian regulators with much fanfare imposed price controls on four-party payment systems' interchange and prohibited surcharge bans; Mexican and Spanish regulators jawboned banks and networks into reducing interchange; New Zealand competition authorities sued MasterCard and Visa; the EC implemented cross-border and intra-EEA-fallback interchange caps; and the US Congress limited debit-interchange for large banks.

In 2013 the EC proposed curbing cross-border and domestic interchange. Internal Market and Services Commissioner Michel Barnier blasted MasterCard's lobbying against interchange price controls as "unacceptable" but deemed Visa EU's response as "more responsible" – i.e. deferential to Brussels. While a cowed payments industry lobbied to moderate the Commission's proposal, there was no serious political effort to defeat it outright.

Brussels mandarins sought policy gravitas by justifying limiting interchange with the "Merchant Indifference Test" – a theory the "optimal" card-acceptance fee is one where cash and card acceptance costs are identical and merchants therefore indifferent between cash and card. The test however ignores consumer preferences, which matter. Brussels' vaunted indifference test makes not even a pretense of addressing holistic value including convenience, security, robust chargeback protections, record keeping, credit, and rewards consumers enjoy with electronic payments but not cash. Consumers spend more on cards. Credit-card issuers take credit risk generating retail sales. Moreover, merchants in a penny-wise and pound-foolish policy ignoring customer preferences for cards will lose business to competitors keener to satisfy them. Consequently merchants accept cards even when they cost more.

In "Tourist test or tourist trap? Unintended consequences of debit card interchange fee regulation" Dutch Central Bank economists Wilko Bolt, Nicole Jonker and Mirjam Plooij observe over time with reduced volume cash costs tend to rise and with more transactions card-payments' costs to fall. A dynamic merchant-indifference benchmark would cause the interchange ceilings to rise. This isn't EC overlords' intent, giving away: policy wasn't made to conform to the Indifference Test but rather the test was

embraced at a point in time to buttress desired policy.

Moreover, from a public policy perspective cash facilitates Europe's robust gray economy – commerce otherwise legal conducted in cash to avoid taxes. In "Shadow Economies All Over the World" World Bank economists Friedrich Schneider, Andreas Buehn and Claudio Montegnegro estimate Belgium's gray economy is 22% of the total, Italy's 27%, Spain's 23%, Sweden's 19% and Poland's 27%. Making payment cards less attractive for consumers boosts the shadow economy.

Nevertheless, it appears all but certain early in 2015 the European Parliament will rubber stamp: (1) caps of 30 and 20 basis points for personal credit and debit interchange respectively for four-party payment schemes including traditional closed-loop systems such as Amex when they license third parties to deliver payment products in 6 months if they enjoy greater than 3% market share, after 3 years otherwise, (2) separation of scheme and network processing, (3) banning honor-all-products rules, (4) regulation of networks' issuer and acquirer fees to prevent synthetic interchange, and (5) cement pan-European acquiring. While the Parliament may tweak them, it's not going to eliminate credit-interchange controls or increase the debit ceiling to 80 basis points.

Barnier and Competition Commissioner Joaquin Aluminia crowed interchange caps mean €6 billion in annual savings. Viewed in isolation arguably so. But we have ample hard data from the RBA's slashing interchange that issuers offset lost revenue by increasing cardholder fees and cutting rewards. And in the US in response to Congress putting a hatchet to debit interchange, the number of major banks offering free checking accounts fell from 76% in 2009 to 38% in 2013 and they hiked monthly service fees, ATM surcharges, NSF fees and minimum balances to avoid fees, and pruned rewards.

The EC asserted price controls help build a common market, but only proposes a uniform cap, leaving national regulators free to mandate lower fees. To promote a common market it could instead have banned national price controls and required payment schemes have the same interchange for like transactions across the EU.

Forcing interchange down by regulatory diktat, importuning issuers and networks to cut it, legislation and antitrust law suits, haven't killed the golden goose, but have put a damper on innovation and consumer value.
In markets with no network competition however, regulation, while problematic, may be warranted.

In China UnionPay still enjoys a government-protected monopoly and consequently there's a case for interchange regulation, because of a problem Beijing created and maintains. Until recently French banks' Cartes Bancaires too enjoyed a domestic monopoly meriting a modicum of oversight.

The US network competitive landscape is at the other end of the continuum. It's fiercely competitive and becoming more so. American Express, Discover, MasterCard, PayPal and Visa, half a dozen national pin-debit networks and, with smaller footprints, UnionPay and JCB compete.

The most significant US regulatory payments intervention was unambiguously pro-competition. In 1998 the US DOJ challenged MasterCard's and Visa's bans on members participating in Amex and Discover, and dual governance. It was discrete and aimed at a narrow fix to foster competition, rather than putting regulators at the helm. In 2005 Fed Chairman Alan Greenspan declined to intervene in interchange. In 2006 Fed Vice Chairman Don Kohn said interchange disputes were best resolved by private parties in the market.

In contrast, only the Commission's support for pan-EU acquiring is unambiguously pro-competition. It's done nothing to encourage network competition and fruitlessly cheered would-be continental champions Monnet and EAPS, and to a lesser extent Eufiserv and fledgling PayFair. Meanwhile, national networks including Switch, Laser, PIN and Paknkkikortti have fallen by the wayside. While requiring separation of scheme and processing businesses will weaken all networks, it is likely particularly to weaken legacy national networks relative to MasterCard and Visa.

Banning honor-all-products rules will hurt commercial cards.

Policing network fees underscores the Commission views networks as utilities, deterring new entrants and investing in existing players.

Brussels should say to the payments industry "Europe is open for business." Additional competition from Amex, PayPal, Discover, AliPay, UnionPay and perhaps a rollup of surviving legacy national networks, would enhance value for European banks, retailers, consumers, mobile network operators and nontraditional stakeholders.

Central planning won't outperform the enormous dynamicism and intelligence in billions of decisions by consumers, merchants, financial institutions, networks, and processors.

Light regulation fostering competition, with issuers, networks, acquirers and processors free to design and price products as they see fit, is the best recipe for greater payments value for consumers and merchants, and a common market.

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