A regulatory ‘Brezhnev Doctrine’ looms over payments regulation

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A regulatory Brezhnev Doctrine prevails in payments, under which price controls, once established, are never repealed, writes Eric Grover, of Intrepid Ventures.

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The worldwide regulatory assault on payments industry fees continues. Governments, by law and regulatory fiat, are imposing price controls on payment networks, treating them as public utilities. The payments industry has bent the knee.

When the former Soviet Union controlled most of Eastern Europe, the "Brezhnev Doctrine" dictated that countries could not leave the Eastern Bloc once they entered it. A regulatory Brezhnev Doctrine prevails in payments, under which price controls, once established, are never repealed. They become the starting point for the next tightening of the regulators' vise.

There's always a constituency for price controls: those who want the government to gift them lower prices than they can get in the market. Politicians and regulators sell themselves and the public on a visible reduced cost, assuming suppliers and buyers won't change their behavior, or conveniently ignoring that they will. A fifth grader, if not every congressman, understands that lower prices reduce supply.

Prices set in the market dynamically allocate resources to where they're most highly valued. The cleverest central planners can't match the vast and dynamic distributed intelligence of decisions by billions of consumers, tens of millions of merchants, tens of thousands of financial institutions and processors and hundreds of payment systems.

Two-sided retail-payment networks use asymmetric pricing to balance participation on both sides of the network and thereby maximize holistic value. Interchange and network fees are higher for the acceptance side of the network. That's because buyers' payment preferences trump sellers'. Interchange fees fund issuer innovation, cardholder rewards and benefits, fee-free payments and banking and challenger banks, which benefit consumers across the socio-economic spectrum. It's a favorite regulatory target.

Partisans of interchange price controls hail lower payment-acceptance costs, but ignore foreseeable second-order effects of reduced issuer innovation and value for cardholders.

Canadian regulators jawboned Mastercard, Visa and Canadian banks into reducing credit-card interchange for small businesses effective in the fall of 2024, while disingenuously declaring that rewards Canadian cardholders love would be unaffected. Reward programs are funded by interchange. For Canadian banks to maintain these programs, much less enrich them, either cardholders will pay higher fees or shareholders will suffer thinner profits.

On October 25 the Federal Reserve proposed reducing caps on debit interchange fees earned by banks with over $10 billion in assets by 28% for a $50 transaction. Debit-issuing behemoths BofA, Chase and Wells Fargo each stand to lose over a billion dollars a year in interchange revenue. The Fed, however, is not the culprit. Congress is. The Fed is merely implementing Congress' policy as expressed by law (the Durbin Amendment), and from the payment industry's standpoint has done so charitably.

In 2015 the European Union, by law, capped credit and debit interchange at 30 and 20 basis points, respectively. Regulators generally have been reluctant to impose price controls on cross-border payments where only one side of the transaction is in their jurisdiction. The Fed made no attempt to impose the Durbin Amendment's price caps on foreign debit cards used in the U.S. or U.S. debit cards used abroad. Nevertheless, in 2019, the supranational European Commission bullied Mastercard and Visa into reducing interchange for cards issued outside the E.U. but used in the E.U. Rates on in-person transactions fell to 30 and 20 basis points and online transactions to 150 and 115 basis points, for credit and debit, respectively. The commission did not, however, demand E.U. issuers forego market interchange when their cards are used in New York or Los Angeles.

On December 13 the U.K.'s Payment System Regulator announced it plans to slash cross-border interchange fees between the U.K. and EU, capping them at 30 and 20 basis points for credit and debit, respectively. Instead, to unleash issuer innovation and value creation for cardholders, the PSR should call for repealing post-Brexit legacy domestic EU interchange price controls.

In April 2023, Brazil's central bank, by diktat, adjusted its interchange price ceilings on debit and prepaid interchange to .5% and .7%, respectively.

The payment industry's response has been to quietly try to persuade regulators to moderate each contemplated tightening of their vise, to try to appease regulators. This approach will doom it to the role of a public utility. Nobel-

Prize-winning economist James Buchanan's Public Choice Theory explains that regulators act to maximize their own utility, their power and prestige. They can't be appeased.

The payments industry should change tack and seek to change how the public views price controls and to repeal them.

More pro-market politicians and regulators would help, but aren't sufficient. Economist Milton Friedman counseled that the key to durable reform "is to establish a political climate of opinion which will make it politically profitable for (even) the wrong people to do the right thing." He further warned that "Unless it is politically profitable for the wrong people to do the right thing, the right people will not do the right thing either, or if they try, they will shortly be out of office."

Captains of the payments industry want to run their businesses and not engage in the political arena even when their businesses' interests are at stake. Paraphrasing Leon Trotsky, the payments industry may not be interested in politics, but politicians and regulators are interested in the payments industry. It needs to make an affirmative case in the public arena for the enormous value it provides, and for the freedom to compete, innovate and set prices in the market, and to educate and alarm consumers about the huge harm price controls and other prescriptive regulation cause.

The payments industry should work vigorously to change the political climate, so it becomes unprofitable for politicians and regulators to impose more restrictive value-destroying regulation and profitable to start rolling back extant price controls.

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