Published in the *American Banker*, March 14, 2008

Let Market, Not D.C., Set Interchange Rates

By Eric Grover

The specter of price controls looms over the U.S. card industry.

Retailers have been calling for interchange regulation to get better terms than they can in the market. House Judiciary Committee Chairman John Conyers has introduced the Orwellian-named Credit Card Fair Fee Act of 2008, which would cap MasterCard and Visa acceptance fees and, de facto, their largest component: interchange.

But the case for regulating card acceptance fees has never been weaker.

No one has seriously suggested that the merchant acquiring and processing market, as distinct from the networks, is not competitive. The United States is not Brazil, which, for now, has monopoly MasterCard and Visa acquirers: Redecard and VisaNet. With Paymentech, Nova, B of A, Global Payments, et al, the United States has one of the most fiercely competitive acquiring markets in the world, if not the most competitive one.

However, the card networks at the center of the payment system are another matter. All major general-purpose card payment networks except for Amex were once bank-owned and not-for-profit. Moreover, there are fewer networks than acquirers, and entry barriers are enormous.

Nonetheless, once Visa Inc. completes its IPO, there will be four commercial full-suite card payment networks — Amex, Discover, MasterCard, and Visa — along with national debit networks owned by First Data, Metavante, and Fiserv. Challengers such as Revolution Money and Tempo aim to woo retailers with lower prices, and PayPal could compete at the physical point of service.

The payment market has never been more competitive, and network competition, differentiation, and innovation are increasing.

Interchange was set collectively by banks through the bank card associations, providing the rationale for many central banks and competition authorities abroad to intervene. But banks no longer control U.S. networks.

Two-sided payment networks' asymmetric pricing is not intuitive and has proved a red flag to regulators. In most networks, interchange flows from merchants to issuers and cardholders. Networks use interchange to balance issuance and acceptance and maximize transaction volume and their enterprise value. Higher interchange, which incents issuance and fuels issuer innovation and cardholder benefits, is often evidence of more vigorous network competition. Higher acceptance prices mean lower fees and better value on the consumer side of the network.

And two-sided asymmetric pricing is hardly unique to payments. In the Internet browser and Adobe markets, client-side software is free, and developers pay. Content providers often charge advertisers but not readers. There is nothing intrinsically unfair or anticompetitive in asymmetric pricing.

The paramount question is how prices are set and who determines if fees are "excessive" — the market, bank cartels, or the state in the form of Rep. Conyers' "electronic payment system judges," who would determine acceptance fees that would exist in "a hypothetical perfectly competitive marketplace."

Prices allocate resources. If three government lawyers establish payment system prices, rather than markets, resources will be misallocated, innovation and competition will be dampened throughout the payment value chain, and U.S. consumers, 164 million of whom hold general-purpose credit cards, will be harmed.

Regulators cannot replicate, much less surpass, the dynamic intelligence embodied in tens of billions of payment decisions involving consumers, merchants, networks, processors, and financial institutions.

Retailers cite lower interchange in Europe as evidence they are being gouged.

But European payment networks are more regulated, still to a large extent controlled by banks, and less competitive and innovative. Consequently, European consumers enjoy less choice, pay higher fees, and receive minimal benefits. Additionally, along with higher taxes and different attitudes, less robust network competition and suppressed interchange contribute to larger gray economies in Europe.

Consumers vote every time they choose to use one of thousands of competing credit, debit, and prepaid cards, a check, Internet bill payment, or cash. Each offers different convenience, security, familiarity, acceptance, anonymity, records, credit, and reward features.

And consumers take feature-rich cards for granted. Why organize to defend the status quo?

In contrast, merchants are politically galvanized, have made their argument vividly, and have policymakers' ears.

However, commercial payment networks have not made an aggressive affirmative case in the public and political arenas for managing interchange as they see fit. They have been defensive and accepted the cost-recovery framework for interchange, which segues naturally to regulators' determining what fees are reasonable.

Rep. Conyers' payment-system czars would set reduced card acceptance prices for all unless payment systems agreed to lower fees. With suppressed acceptance prices, cardholder fees would be increased, benefits would be cut, and interchange-fueled issuer innovation would be stifled.

Price controls would inhibit emerging competition.

The debit card market has never been competitive. Banks, not consumers, chose debit products. But network independence, and the prospect of interchange revenue, are bringing choice and a whiff of competition to debit. For example, MasterCard has launched a game-changing decoupled reward debit card with Capital One.

Rep. Conyers' bill testifies to an abiding belief in the regulatory state and would convert America's vibrant card industry into a public utility. Consumers would have less choice and pay more for weaker payment products, and card networks would be less competitive with other payment systems.