Unshackle the Card Associations

BY ERIC GROVER

In 1996 the U.S. Department of Justice accused Visa and MasterCard of illegally restricting payment network competition by permitting members to participate in the governance of both associations, and by prohibiting them from issuing American Express and Discover products. This, the DoJ contended, deprived banks of the ability to provide a full range of payment services, ultimately hurting consumers.

There has long been ample reason to worry about the lack of innovation and competition in payment network services. While the payment-product market to end consumers is ferociously competitive, with many issuers offering a rich range of debit and credit cards, the payment network services market is highly concentrated and less competitive.

Last October, U.S. District Judge Barbara Jones's split decision upheld duality, leaving association governance as is, and ruled that banning U.S. member banks from issuing AmEx and Discover cards was illegal. Her ruling will not, however, meaningfully improve network competition and innovation.

Banks' immense reach has long made them tantalizingly attractive as a channel to AmEx and Discover. Jones's ruling opens the door. The compelling value proposition, however, is not clear. For Visa and MasterCard issuers, cardholders who pay interest drive profitability. In contrast, AmEx's profitability derives from its higher discount rates, merchandise sales, and membership fees. Among thousands of potential AmEx issuers, the putative opportunity lies in larger banks issuing AmEx products to heavy transactors.

But governance is at the root of why the associations behave as they do. Visa and MasterCard are owned by thousands of member banks, and managed by bureaucracies. Perhaps inevitably, they are motivated by risk avoidance, consensus seeking, and internal competition.

In recent years major issuers have increasingly aligned themselves with one system or the other. While duality's influence is waning, Visa and MasterCard remain associations. Demutualizing them, separating ownership and the members' consumption of their services by taking them public, and explicitly motivating management to maximize shareholder value, whether that shareholder was a bank, pension fund, or mutual-fund group, would be the silver bullet. It would spur innovation by unshackling two formidable competitors with a wealth of talent, and a global web of 21,000 banks, 21 million merchants, and more than a billion cardholders.

Wrong Focus

The DoJ argued that more association-led innovation should have occurred in several areas, including smart cards. The case is stronger that Visa and MasterCard, which are in the payments business, should have led person-to-person payment innovation. Instead, PayPal Inc., with 10.6 million accounts and backed by venture capital, pioneered this market. Visa considered introducing a P2P payment product a decade ago, but banks worried it would compete with their money-transfer products.

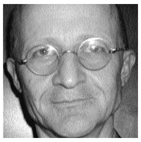
Similarly, Visa and MasterCard could harness existing infrastructure and reduce their pricing to displace small cash transactions and enable Internet micropayments. With computer processing and telecommunications power constantly increasing, incremental payment transaction costs should be plummeting.

The associations are processing businesses with powerful settlement, authorization and risk-management systems. If there were genuine intersystem competition, they ought to compete fiercely for each other's processing business as well as that of AmEx, Discover, and private-label cards. Instead, while Visa U.S.A.'s president famously said Visa's mission was "to kill MasterCard," too much of the competitive focus is internal. For example, Visa U.S.A. and Visa European Union are investing in separate application development organizations for banks in each region, the cost of which may be hundreds of millions of dollars.

In Silicon Valley, many leading technology companies recognize that it is difficult for large corporations to develop genuine breakthrough technology, opting instead to outsource research and development. Visa and MasterCard, with demutualization and a public stock listing, would have a currency to acquire assets management believes would enhance their business.

The bank card system's biggest costs are innovations not tried and services not launched. In virtually every industry that has been privatized, where the creative intelligence and energy of individuals have been unshackled, prices have fallen and customers have benefited from a profusion of new services. MasterCard is in the process of demutualizing, issuing private shares to member banks based on their pro rata membership interests. This is a first step, but does not broaden its ownership, nor separate ownership from the use of services, nor provide an acquisition currency, nor raise capital.

Transforming the two largest, best-endowed payment networks into public, profit-seeking firms would hugely increase intersystem competition and innovation. A Visa and MasterCard brimming with testosterone and competitive verve would relentlessly seek ways of better serving their customers, explore new markets, and cultivate nonbank channels. Consumers worldwide would be the ultimate beneficiaries. ■



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