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Enter the Pricing Mandarins

In the name of competition, Congress is proposing to control the way card acceptance fees are set. The damage to a market that's already the most competitive on the planet would be severe, says Eric Grover.

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Congress has the card-payments industry in its crosshairs and is on the brink of converting it wholesale into a regulated public utility. House Judiciary Committee Chairman John Conyers, D-Mich., proposes the Orwellian-sounding "Credit Card Fair Fee Act of 2008." Meanwhile, Sen. Richard Durbin, D-Ill., is sponsoring a companion bill in the Senate.

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Three "electronic payment systems judges" would be appointed. These pricing czars would divine what MasterCard and Visa merchant card-acceptance fees would be in a "hypothetical perfectly competitive market." In 2010 their determination would become a uniform price cap for all merchants regardless of size or risk. Retailers could continue to negotiate singly or collectively for better terms, which would be filed with the regulators.

Americans of all stripes seek government favor, and merchants are no exception. Merchants want to pay less for card acceptance. In particular, they're exercised over interchange, fees that are set by the card networks and are generally the largest component of card-acceptance costs. A number of merchants and merchant organizations have already sued the card associations and some banks over interchange. Now they're lobbying Congress for relief, and believe the climate in Washington to be propitious.

Asymmetric Pricing

Price-control advocates cite regulation overseas to support their case.

Australia's central bank reduced interchange fees and permitted surcharging. The result? Banks hiked what had been low cardholder fees and slashed rewards, while merchants tacked on charges often exceeding their card-acceptance costs. Not surprisingly, credit card transaction growth slowed.

Nonetheless, Australia's central bankers are eminently pleased with themselves, contending their intervention improved price signaling and payments efficiency. They do allow, however, that they prefer a market solution, hinting they might rescind interchange price controls if a third bank-owned national debit network morphed into a more credible competitor to MasterCard and Visa.

Regulators in the European Union, too, pine for a third network to compete with MasterCard and Visa. Ideally—can you catch a whiff of protectionist and paternalist sentiment here?—this network would be European.

Is there a problem in the U.S.?

Each stage in the American card-payments value chain is as competitive or more so than any other on the planet.

Consumers and merchants have enormous choice. The card-issuance and merchant-acquiring sectors delivering American Express, Discover, MasterCard, and Visa products to consumers and merchants have long been fiercely competitive, though networks in the middle less so.

A quarter century ago all the principal card-payment networks at the heart of the system save AmEx were owned by banks and not for profit. However, there's been a sea change.

In 2004, a Justice Department suit ended MasterCard's and Visa's prohibitions on member banks participating in AmEx and Discover. In 2006, banks spun off MasterCard. Morgan Stanley spun out Discover in 2007. And in March the largest network, Visa Inc., went public.

Today the U.S. card-payment-network market is the most competitive in the world, bar none, and becoming more so. EU regulators worry about having only two pan-European credit and debit card payment networks, one of which, Visa EU, remains a bank association. In the U.S., there are four full-suite networks: AmEx, Discover, MasterCard, and Visa; national debit networks Star and NYCE; and e-commerce gorilla PayPal; all of which are commercial enterprises independent of banks.

At the other end of the spectrum, notwithstanding China's World Trade Organization commitments to open up its domestic card market, China UnionPay continues to have a protected domestic card payment network monopoly. In Brazil, RedeCard and VisaNet enjoy monopolies acquiring MasterCard and Visa transactions, respectively, and pricing excluding interchange is almost eightfold greater than in the U.S.

Building critical mass in payment networks is immensely difficult. Nevertheless, the U.S. payments space continues to attract capital and entrepreneurs who believe they can develop better mouse traps. There are a host of payment challengers including Revolution Money, Tempo, Danal, Bill Me Later, and National Payments, several of which, notably Revolution Money and Tempo, trumpet lower merchant fees. But that implies higher costs and lower benefits for cardholders and is therefore not necessarily better.

Most two-sided networks charge merchants and subsidize the spend side to maximize transactions and value. For the same reason ATM interchange flows in the opposite direction: to merchants.

Networks' asymmetric pricing, while not immediately intuitive, is hardly unique. It's employed in a variety of two-sided markets. Content providers charge advertisers more than subscribers. Client-side software is often free while developers pay. Bars sometimes give women, but not men, free drinks.

Who Will Reign?

Rep. Conyers contends merchants are "forced" to accept payment cards. Patent nonsense. Cash is the only payment product merchants are compelled to accept. Some 7.2 million merchants, and 10% more each year, choose to accept cards because they provide value and consumers want to use them, not because of network coercion. Only government, ultimately backed by armed policemen, forces Americans to do anything.

Conyers argues MasterCard and Visa are associations "owned and controlled" by banks, implying a lack of competition, collective price setting, and an anti-trust issue. He is entitled to his abiding belief in the efficacy and goodness of a greater state role managing the economy, but not to his own facts. The networks sell to but are not controlled by banks.

What if Conyers's bill passes?

Card issuers, networks, acquirers, merchants, and consumers would all be hurt.

Because issuers through interchange capture the lion's share of card-acceptance fees, they would take the biggest revenue hit in absolute terms, though they would offset it by introducing new cardholder fees and cutting reward programs.

If Conyers's bill passes, card issuers, networks, acquirers, merchants, and consumers would all be hurt.

Merchant-acquirer operating margins would be squeezed. Moreover, whereas acquirers and independent sales organizations have been pushing back the card-acceptance frontier, they would no longer be able to profitably serve many smaller, riskier, and non-traditional merchants.

MasterCard and Visa would be affected by greater fee visibility with issuer customers relative to diminished interchange, weaker pricing power with acquirers, and reduced transaction growth.

Card-payment products would be less competitive and displacement of cash and checks would slow. Capital pouring into payments would dry up. And cardholders, with no voice at the table, would be hit with a battery of new fees and reduced benefits.

The issue isn't what prices are. It is how they're set. In a free payments market, ultimately the consumer is king. In Conyers's world, Washington regulatory mandarins would reign. DT