Central Bank Session Comments

Thomas M. Hoenig

I want to start my remarks by emphasizing a couple things that are particularly prudent for me to say here today. First, please understand that I am speaking for myself and not for the Federal Reserve System. Second, and more generally, I want to make sure, as I go through my remarks, that I am clear that this conference has been designed for us to get these issues out on the table and to become better informed. Although there have been moments of tension, heated moments perhaps, I believe it has served that purpose. I certainly have found the presentations and the discussions to be very informative and insightful and expect you will find that to be the case also for the speakers after me.

In listening over the course of the conference, I was struck by the variety of interchange arrangements that exist across countries. It is difficult to make broad generalizations, because country-specific factors are crucial in understanding interchange and related issues as they have evolved.

Let me just say once again, the Federal Reserve Bank of Kansas City, and, I believe, the Federal Reserve more generally, have an interest in understanding the functioning of the payments system. It is important to businesses and consumers that we have a safe, accessible, and efficient payments system. Because credit and debit markets are becoming highly important to the payments system, it is necessary—perhaps imperative—for the Federal Reserve to monitor payments trends and inform itself, and for central banks generally to inform themselves, about these markets.

We need to better understand these markets, and the conference, I believe, has helped identify key questions more clearly—questions that policymakers are in fact focusing on, as discussed in the Regulatory Panel.

We have heard about and discussed some economic theories that are important to explaining behaviors within these markets. A growing body of economic theory may help policymakers evaluate the behavior of the payments markets and judge whether they are performing efficiently. Many economists argue that an analysis of payments markets based on standard economic theories is not necessarily applicable to these payments markets. New theories of two-sided markets are being offered to provide further insight. However, such theories are complex and are underdeveloped at this stage. One of the more interesting aspects of this theoretical work is that we may not be able to say that the interchange fee that comes out of a four-party payments system is more, less, or the same as a socially optimal fee. Some, of course, would not agree with that conclusion.

My own observation is that until the theory is further developed, definitive answers about what systems provide the best outcomes will be difficult to assert. So, there is significant work yet to be done. Nevertheless, the point was made—and I would agree—that we cannot wait for the theory to be fully developed, as we must confront these very important issues now.

In addition to theory, market behavior is an important consideration. Policymakers can examine (and in some countries, have examined) actual market activity to evaluate whether markets are performing—in their judgment—appropriately. Many attendees at the conference are direct participants in payments markets, and their comments have provided useful insights and information on how payments markets work in today's environment. Antitrust authorities often emphasize market behavior, including pricing, output, and market structure.

Regarding pricing, one contested question is whether having interchange fees set by card associations represents collusive behavior in setting prices. Case law in the United States has allowed this type of cooperation, as we've heard, although some now argue that ruling is perhaps out of date.

Regarding market structure, card issuers point to the significant volume of card transactions, cardholders, and merchants that accept cards as evidence of its effectiveness. Yes, this is useful evidence of a well-functioning market. On the other hand, courts have ruled that, in some cases, card issuers have exercised market power, and litigation has successfully challenged certain card association rules. Some observers also see sluggish innovation as evidence of insufficient competition.

If economic theory is accurate in predicting that pricing is not necessarily an informative element regarding the social welfare performance of a card payment industry, then policymakers may need to rely more heavily on nonprice indicators. But from what I have heard at the conference, some nonprice indicators of market behavior also are open to question. Thus it may be wise not to ignore completely levels and trends in interchange fees. Perhaps most importantly, the disagreements and uncertainties shown to exist at the conference confirm the need for more and better evidence, and therefore more research.

As we look at the payments market, there have been many issues raised that deserve more attention. Do we have accurate and complete information on price-setting practices by card associations to help determine the degree to which there is absence of competition? We observe rising interchange fees in the United States and declining fees elsewhere in the world. Is that a sign of a lack of competition, or is there a higher value proposition in the United States, as some would argue?

In terms of output, while the success of card payments suggests a well-functioning market, a more difficult question is whether things could be better. Of the merchants I have heard in the audience here, some have said, "Yes," while the card associations say, "No." And so the dialogue continues.

Some evidence suggests that rising concentration among card issuers is giving them more market power. Yet there seems to be vigorous competition among card issuers to obtain customers. On the other hand, we have heard that allowing more debit and credit card issuers into the market is not necessarily procompetitive. So, while market behavior is important, right now it indicates opposing conclusions that appear to depend on one's perspective.

We also discussed potential remedies. First, I would like to say, in terms of remedies—and I am not the general counsel of the Federal Reserve—I am not convinced that the Federal Reserve could simply decide to regulate prices under the current economic environment and legal structure of the United States. Certainly, in some other countries, analysis based on theory and market behavior has led to the conclusions that there is failure in card payments markets and, therefore, a need for regulatory intervention.

There is not a consensus for such intervention in the United States. It is my experience in the United States, and you have heard this view expressed in the Regulatory Panel, that we are very reluctant to intervene in terms of regulating prices, unless there is an overwhelming case to be made for doing so. We prefer to rely on the market in the United States because it has served us well.

People hear different things when others speak, but the one thing I have heard from all sides is that greater transparency would serve all interests well—card company and merchant both. Perhaps that is an opportunity for common ground from which we could start. That also would lead us, from my perspective, to the next steps in our research agenda.

We have heard that a proper evaluation of the performance of the card payment industry would require statistical studies of all participants. We need information on the benefits cardholders and merchants receive from card payments. The Federal Reserve has done some research on consumer preferences toward payments, but more of this research would be useful. Depending on how much you want to rely on it, of course, more research on the social cost of various forms of payments may be useful. But to conduct more research, we need more complete data on the costs that issuers, acquirers, and networks incur when they process payments.

One of the intriguing questions posed by theory, perhaps, is how competition among the different payments systems affects the performance of individual payments systems. For a more complete understanding of this topic, we would need similar statistics on all participants and on all forms of retail payments—cash, checks, Automated Clearing House, and so forth. International data also would be useful, because, as we've seen at this conference, a promising avenue of research is international comparisons of the performance of the card payment industry.

Perhaps, then, the best way to conclude this conference is to agree that if we have a common interest, it is to search for a better understanding of how the market works in this instance, and that requires a greater sharing of data and information across the industry.