

General Discussion

Session 2

Mr. Bierbaum: Thank you. Now we are going to start with the Q&A portion of the session.

I might start with a question of my own—maybe for Alan, but for the entire panel. We talked about consumer value proposition, merchant value proposition, and a little about the steering. My question would be, Is there an argument there should be public policy that would limit the associations, Visa and MasterCard rules, that they cannot impose this steering requirement on merchants to give merchants more say in the cards and solutions they adopt, therefore, giving them a little bit more flexibility in the marketplace to use some of these emerging solutions?

Mr. Frankel: There already have been public policy efforts along those lines. Legislatively, part of the Durbin Amendment addressed, as I recall, the ability to give discounts by payment type. The DOJ achieved a settlement with Visa and MasterCard that liberalized some of their steering policies. Not all of them: merchants still cannot surcharge any particular cards. American Express has not settled. Although now you can give a discount for debit cards, Amex would not let you give a discount for a cheaper credit card, for example; whereas Visa and MasterCard have agreed to let that happen. Until Amex also relents, it is unlikely that is going to be occurring. I think there is a role for public policy to allow price signals to work at the point of sale.

Mr. Bierbaum: Any others like to comment on that?

Mr. Evans: I would like to make a comment on a couple of things on the networks. I just want to go back to the comment Bob made and maybe tie back to Nick. One of the things we need to be cognizant of here is that a lot of the innovation we are talking about in this business that is actually happening now in the marketplace is actually riding on the existing payment structure. It is using Visa,

MasterCard, Amex, and all the stuff that is out there. Before we beat up on Visa or MasterCard too much, we really do need to recognize that they are enablers of an awful lot of innovation that is happening in this business, including Square and LevelUp and, for that matter, PayPal, which is obviously using Visa or MasterCards in its wallets.

In terms of Alan's comment, the other thing we need to recognize about the networks, which is really true about any platform business, is any platform business is serving two masters. If you take payments, it is serving merchants, but it is also serving consumers. The platform has to be in a position where it can balance the needs of consumers and merchants. So, yes, merchants would like more stuff. They would like to have pure restrictions from the networks, but on the other hand once you do that you tip the balance against the consumer.

I would be surprised first of all, Alan, whether any of the things you talked about are actually going to have any material impact on the markets. So I suspect they are not really all that important. But to the extent they have any impact, they also have an impact on consumers. We need to be very careful when we talk about public policy here that we are taking into account both the needs of the merchant but also the needs of the consumer. And the networks are in a particularly good position, unlike regulators and courts, to design that balance in the right way.

Mr. Economides: If I can comment on that issue as well. It is very important for the merchants to be able to charge according to costs. Consider the position that Visa and MasterCard traditionally have taken, compared with a position that maybe two other producers of substitutes might have taken, think of Coca-Cola and Pepsi. Coke says, "You cannot sell Coke at a different price than Pepsi." And Pepsi says, "Oh, you cannot sell Pepsi at a different price than Coke."

What would you think if the merchants were forced into that situation on physical products? You would think something is wrong. But they have been forced in that position on these payment services products. That is the problem. The merchants need to be able to have the flexibility, if the costs are different, to be able to charge differently. That is obvious, I think. It is kind of side-stepped in this debate.

I also wanted to comment on something David Evans said about market failure. He said essentially that the government should not intervene, because it is not obvious there is a market failure from non-adoption of innovation. If innovation has not been adopted, how would we know that in fact if we have non-adoption because of market failure or for another reason? That is impossible to prove and therefore impossible for the government to do the right thing. I am not saying the government always does the right thing or anything like that. I am just saying, in the absence of something being adopted, it is practically impossible to say, "This is because of market failure" or "this is because of dominance of the market by the network operators."

Mr. Salmon: I have a question about interchange. David, I am interested that

you think the interest of merchants and consumers are sort of against each other. It seems to me that some of the most interesting innovation right now is especially in the P2P space, where the distinction between merchants and consumers basically disappears. I think that where merchants and consumers are very much aligned, is that they both want lower interchange. I think that Esther George's point this morning about checks clearing at par is incredibly important. The reason why checks and the reason why cash have been so incredibly ubiquitous and powerful are precisely because they clear at par. I worry that all of this talk, basically this whole panel and what Bob was saying about his interests being aligned with Visa and MasterCard, maybe I am just being stupid here, but I do not see it. It seems to me Visa, MasterCard, and Amex are sort of rentiers and everyone else is aligned against them. The rest of us do have a strong interest in things clearing at par. That is not happening and it does not seem close to happening. If there is a public policy response we need, it would be to try to make that happen. That would drive a huge amount of innovation, not just in the merchant-to-consumer space, but also in the consumer-to-consumer, P2P space.

Mr. Evans: There is an awful lot to unpack there. I will try not to talk for more than a minute or so because I am sure a lot of other people would like to talk.

The interests of the consumer and the merchant, in a lot of instances, are aligned, but there are some instances in which they are not. Any platform, whether it is Visa or whether it is Google or whether it is Facebook, is making trade-offs between the different participants in the platform. That is just a simple point.

In terms of on par somehow being the optimal interchange fee and the nirvana, a couple of points: The reason we have a massive, massive private-sector payments industry is for a simple reason. And the simple reason is the government failed. The check system and the monetary system did not provide enough value to consumers and merchants. As a result of that, in 1950 we started a general-purpose payment industry and a lot of things have happened as a result of that. The card industry and a lot of the other payments solutions we have nowadays are a response to the need on the part of both merchants and consumers for things the public-sector payments system was not providing—a public payments system that operated with this at-par mechanism you think is so important. Maybe I should just stop at that point and let the other people contribute.

Mr. Frankel: I cannot fully respond to David unless you give me another four hours. But I would make a couple of simple points. One is the main incentive here for payment providers—the gold mine, the treasure trove at the end of the rainbow—is the ability to tax retail sales. If you have the bottleneck monopoly or one of the bottleneck monopolies, you can impose a private sales tax and be just like the state of Illinois or California or Missouri and skim something between the buyer and the seller. That is what this is all about.

In general—sure they are going to be exceptions, and there are some theoretical

exceptions—but, by and large, consumers and merchants have an interest to keep the spread between what the buyer pays and what the seller gets as small as possible. I disagree with David and we have debated this at great length at other times.

There is separation really. All of the innovation you are talking about here—Square and the others—they take the level of interchange fees, whether it is par or 200 basis points, as a given. All of their value-added rides on top of that. I think that if interchange fees were lower, they would continue to innovate.

Mr. Economides: I was going to say one thing adding to what Alan Frankel said. In my opinion, the crucial thing is not if we are at par or at this particular price or at that particular price. The crucial thing for public policy is to create the right conditions so normal competitive forces that work in other industries also work in this industry.

So the problem is relatively simple. We are not going to have a magical number—zero or 5 percent or 2 percent or 0.5 percent—the thing is to create the right conditions so merchants will be able to pay different fees to different credit card networks and pass these savings along appropriately to the customers. If we manage to get there, then that is a giant step forward. At least that is my point of view.

Mr. Evans: I just remembered my final point I wanted to make over here. We have gotten ubiquity with positive interchange fees for credit and debit cards. So, it cannot be you need “on par” to get ubiquity.

Mr. Summers: I am an independent thinker and consultant on these matters. I would like to ask the panel, maybe starting with David Evans, to explore a little bit more broadly and deeply this proposition or assertion that the government has failed the payments system. By the government, I presume you mean the Federal Reserve System. But the Federal Reserve Banks are bankers’ banks. You and I do not hold accounts or get services from the Federal Reserve. So is that an intended and complete statement that the government has failed or is it something different—maybe the banking system has failed?

Mr. Evans: No, and I was obviously too flippant on this point in my remarks. I do not mean to suggest the Federal Reserve System has failed. Obviously, the Federal Reserve System is a great institution and has done wonderful things both for currency and for checks. I do not want to suggest anything differently.

My real point, though, is really two things. One, the reason why you have these alternative forms of payments, the reason why you have credit cards, debit cards, and this private-sector system of payments is because consumers and merchants have reached the collective judgment over the last 50 years that there are forms of payments they would like to use that the government does not provide. So it is a market response to that. It is not that the government has failed; it is that the private sector was really the source of a lot of innovation when it comes to payments. That was really the only point I wanted to make.

Two, the related point—and this really would be a long discussion that you would see Alan and me debating for the next eight hours—is whether we needed the Federal Reserve System to go on par for checking and whether there was actually a market failure there. I actually think there is virtually no evidence of that, just based on a couple of anecdotes from the early 20th century on the circuitous routing of checks. There is very little evidence the Federal Reserve was needed to solve that particular problem.

Mr. Greene: One thing emerging this morning is whether we are going to see a shift in power among the different players in the ecosystem that Michael Katz showed us. We heard about consumer-centric payment models. We heard from Square about technology-centric models. I am curious on the back of Alan's comments about the power or powerlessness of merchants, whether merchants might not emerge. We saw a recent announcement from Wal-Mart and Target that two dozen merchants are pooling on a merchant-centric payment system. Perhaps some of those participants here this morning could comment on their work in that area.

Mr. Frankel: Well, I have worked with merchants and I probably should have given a disclaimer at the beginning. I have done a lot of work for competition authorities and merchant associations in litigation matters.

My thinking about a merchant-run payment system is that it is an interesting possibility. The problem has always been the market has evolved with the interchange system, as a commercial bribery system. Consumers are bribed to use the higher cost payment methods. The merchant would have to undo that. One of the intriguing ways they can undo that is with point-of-sale incentives, as opposed to backend end-of-the-month, end-of-the-year incentives, miles that you see later. But point-of-sale incentives might be effective.

When Visa was set up, they had to corral hundreds of bankers and it was a hard problem. With merchants, it is a much bigger problem. It is a very decentralized marketplace. Merchants have to think really big and, if they are going to be successful, my advice to them would be to not try to own it in a small clique of a few merchants, but to create a new open-payments system that any merchant could participate in.

Ms. Haskin: I think the reason that customers are so willing to accept a lot of this new technology and readily use it is because they feel a sense of security in our payments system that has resulted from banking. The consumer bears very little loss in our system currently and that is due to regulation in the banking system.

So my question is, What happens if one of these new startups fails and both merchants and consumers lose money?

Mr. Economides: Fannie Mae failed; what happened? Do you feel it? I am not so sure. I would not worry so much about that. We have had failures in recent memory and we didn't feel them that much, because of the various corrective actions of the same regulators.

Mr. Frankel: For small-value payments, if you could imagine a stored-value function on an iPhone, where you have Square Cash, an idea I just invented. But we will see. If Square were to die—God forbid—people are going to be out relatively modest amounts of money. We are not talking about someone’s bank account being depleted. So, as a practical matter, it might not be of enough concern to deter consumers from embracing it and taking some risk that, if this company dies suddenly, they are left with some unusable value on their phone.

There also may be things that a provider can do to provide a guarantee that, that even if it were to die, you would still be able to go to an ATM and withdraw the remaining cash value.

Mr. Henry: A question for the panel: What is your opinion of the success or failure of the Durbin Amendment and the downstream ramifications of this well-intended public policy legislation?

Mr. Frankel: I do not know. David may have filed something on the Durbin Amendment. I worked on this for an amicus in the TCF litigation. There were many predictions of catastrophic effects of the Durbin Amendment. We have seen these stories before—death-spiral arguments. TCF said it could not possibly provide the services and the status quo was the only way they could possibly offer free transaction accounts. I looked up TCF. It had been offering free checking accounts to its customers eight or 10 years before they offered their first debit card. So why do banks give you free payment services? It is because they want to attract your deposits so they can lend them out and make money. That is why there are free checking accounts.

Debit cards reduce costs relative to checks. It would be insane if a bank gave you a free checkbook, but charged you for debit cards. A lot of the predictions, I thought, did not have much credibility and I still think they do not have much credibility.

Mr. Evans: I think Alan and I agree probably on the TCF case, which is a little bit of a stretch. I made a number of filings to the Federal Reserve in the course of the Durbin proceedings and the basic thrust of those was that the effect of sharply reducing debit card interchange fees would result in basically a loss to consumers as banks increased fees or reduced services. And that is more or less what we have seen in the marketplace.

By and large, free checking has substantially declined and fees have increased for consumers. That is what you would expect. It remains to be seen how much money consumers will get back at the merchant end. That is a harder thing to analyze. My analysis for the Fed indicated the view we have documented pretty extensively that the amount of additional money consumers would pay as a result of increased fees to the banks would vastly exceed the amount they would get back from merchants. I suspect that is what happened.

Ms. Wells: My question is for Bob, although I would be interested in hearing from others as well.

After you spoke, I went to download Square on my iPhone, because it sounded really cool. And I do not mean to put you on the spot or to be sarcastic, but the reviews all said, “No merchants accept this.”

They gave it one star and a few of them said it is great, but most of them said that you cannot use this at very many merchants. It raises an interesting point—your point about letting regulations stay away. The merchant acceptance piece is difficult. You would basically need a massive sales force, right, or something to sign up merchants to Square and the same could be said for any other cool innovation. If the market were to sort that out, you might not get the adoption, right? Is there some need for something to help along these cool innovations?

Mr. Lee: That is a great point. She is talking about Pay with Square, that is the payer-side product. While we have a million merchants that can accept Square payments today, last time I checked we have 75,000 merchants you can pay with Square. Definitely in some areas it is a little harder to find people to pay, but it is actually growing extremely fast and, to me, Square Card Reader is the product of today and then Pay with Square is the product of tomorrow. It does not have to hit critical mass today. I do think it is going to grow very quickly. In a couple years, you will see a lot more density.

Mr. Evans: So, in Boston, I could pay with my iPhone, using LevelUp or Pay with Square (I call it Card Case) at probably somewhere between 500 and 750 merchants in Boston now and it is growing very quickly.

Mr. Lee: I just want to add one more point to that, too. One of the key things that is going to make it successful in the long term is it does add a lot of value. It makes the payment experience a lot easier. We also couple it with loyalty programs, so the merchant can automatically recognize when you have come back so he can give you a 10 percent discount. So there will be lots of motivation for people to keep using it.

Mr. Segendorf: My question concerns surcharging. I agree it would be very nice, but there is also an incentive problem with surcharging. For most, it is easier to charge customers through a hidden margin on their prices than on an explicit surcharge. When I talked with a merchant, they usually said, “Well, we tried this and we got so much bad will that we would never, ever do it again.”

How do we change the norms? It is not sufficient to allow surcharging. We must also change norms so that people accept them. How do we do that?

Mr. Frankel: There have been some different experiences with that. In the United States, we had ATM surcharging. When it first started, there was a lot of outrage. The people were paying an additional fee at the point of using an ATM, but over time they became accustomed to it. Now they have adapted their behavior.

In Australia, they ran an ATM experiment and found the same thing. People adapted and changed their behavior and ended up spending less overall for ATM withdrawals.

For credit card surcharges, the kind of messaging matters. The word “surcharge” is horrible. It was designed to be horrible. No one likes to pay a surcharge. If you think of it as differential pricing depending on what kind of service you select, that is really the concept.

In Australia again, which is our favorite experiment lab, the Governor of the Reserve Bank went out of his way to say, “We like surcharging. We think it is good. We think payments should reflect differential cost at the point of sale.”

Messaging that this was an OK and desired practice was helpful. Still it has taken 10 years and surcharging is still gradually ramping up there. Not all merchants do it, but it is taking a lot of time.

Mr. Evans: So we have a whole bunch of countries that allow surcharging and have for a number of years. In those cases, merchants do not avail themselves, as you point out, of the ability to surcharge. This is probably one of the biggest red herrings in the payments industry. I do not think it was an important rule for the card networks to have. And I do not think it has turned out to be terribly important for merchants. It has generated an enormous amount of income for economists and lawyers. So it is good in that sense.

Mr. Economides: Well, first of all, at least in gas stations in the New York area, many of them have two different prices—a cash price and a credit price. It has been used there.

But I would say, practically speaking, it is just a matter of terminology and what the actual level of prices is. Any surcharge rule you would purpose is equivalent to a discount rule, in which the price is set at some higher price and then consumers get discounts. If people have psychological impediments to the word “surcharge,” I am sure they do not have psychological impediments to the word “discount.” So there is a way to implement this in a pretty straightforward way.

Ms. Benson: I have a question. It is about Square, but it is for the economists. So I live in a small town and several small merchants—my hairdresser and some people like that I talk to through the years about payments—have been paying 5 percent or 6 percent for card acceptance to their acquirers. Several of them are now delightedly starting to accept Square at a very much lower cost. Why did it take Square to bring those prices to those merchants? Was this a failure of our market before that? What was going on that made that happen?

Mr. Frankel: Five percent to 6 percent sounds like they just did not shop. They probably could have gotten a better deal. But what do you think, David?

Mr. Evans: For a small merchant? Yes, 5 percent to 6 percent is probably pretty common.

Mr. Frankel: It cycles me right back to the main point, which is it is insane that 400 basis points to 600 basis points, even from a small merchant transaction, would be going into the payment. That tells you something is not happening that should be happening.

Mr. Evans: You can listen to the economists. My guess is Bob is probably in a better position to answer this than we are. These guys have identified a massive transaction problem in the payments industry and they innovated.

Mr. Lee: I talked a little bit about this, but the key to Square is our sophisticated backend. Typically, a small merchant had to go through multiple layers before they actually got to the credit card company. They also had the ISOs, which take their cut. Whereas with Square, there is nobody in between. We are going directly to our back-end processor. That took a lot of work to do that level of integration. As we scale, our rates will continue to go down and will be able to continue to pass that along to merchants.

Mr. Tomasofsky: This is not a backhanded or another way to get around this question. I have no hidden agenda here. We should not call it Durbin anymore, of course, because once it became a law then the amendment did not matter and now that we have Regulation II it does not matter, so that is a personal peeve.

Under Regulation II, the price that has been set for financial institutions over \$10 billion for debit interchange—again, this question is not to debate that process—but from the title is that type of thing that is going on, a regulated price, is that something that impedes or encourages innovation (the title of this topic)?

Mr. Frankel: If debit cards were still clearing and settling at par like they once did and they still do in Canada, innovation would be just as attractive for the sort of applications that we are mostly talking about here—the innovative front-end interfaces. The kind of marketing innovations, the reward programs, and incentives to get you to use a more expensive card, those sorts of innovations will decrease with lower interchange rates.

I just disagree with David about how that all nets out for the public. If you are really getting at the difference between the \$10 billion, the difference between credit unions, I really have not thought about if that causes innovation problems.

But, in general, setting lower interchange rates, I think par debit cards would work just fine and innovation would proceed apace. Going from a high interchange rate to a lower interchange rate would also be OK. What you are not going to see, though, are the innovations designed to compete to get the interchange fees.

Mr. Evans: The answer is it probably alters the nature of innovation. As you change the rates, you are going to have different kinds of innovation in the marketplace. There is an argument that price fixing for debit cards has reduced innovation but, for the purposes of the conference today, maybe it alters things a little bit.

Mr. Drechny: So when I look at it, the problem we see in the marketplace today is a matter of transparency. The problem is the consumers do not see the pricing signals that are related to the expense being incurred by the merchant. Merchants and consumers are generally aligned. They want the cheapest transaction that happens for them to be able to complete it. But, when you are giving 100,000 miles free to a consumer and that consumer does not see any cost associated with that, then the consumer sees no fault or no harm in using that product. Without creating those pricing signals, we will always have this problem that exists in the marketplace today, which is that consumers do not see the price that is associated with the products they are using. So that would be similar to your Coke and Pepsi example at Wal-Mart that we did not tell you what the price was and we just charged your card and you never saw it.

It is similar to what the argument is around gas tax, right? It is very similar to a hidden tax. People do not know what gas tax is. They have no idea, because it is charged into the price of the product, the gallon that is used, and that is to me where the market breakdown is. And we don't solve that. It used to be it did not matter as much, because there was fairness in the marketplace.

When debit cards first came out, I argued the opposite. As merchants, we were actually getting paid for those debit cards. People were giving us money to take them, because it was creating such efficiency in the marketplace for the other players. What happened over time is market volume, market share, and power grew and the courts had determined Visa and MasterCard had market power in the check card case. They then use that to extract more and more money and because that fee is transparent, it never changes what is happening in the marketplace. It is at the point now where you can have somebody increase their fees by 30 percent and not lose a single customer. Where else in the marketplace can that happen besides in the card industry?

Mr. Evans: So how many people use OpenTable? I can spend just a minute digressing from the card industry to OpenTable. OpenTable is this incredible business to solve this massive problem in making reservations. Remember the old days when you had to make reservations? You called up the restaurant and hoped you would get someone on the phone, then you make a reservation, it took five or so minutes of your time, and the restaurant had all this difficulty.

So OpenTable comes in and they develop this reservation system for consumers and for restaurants. How does it work? The restaurants have to pay for software. When you make a reservation on OpenTable, how much do you pay? You do not pay anything. How much do you think the restaurant pays? Well, the restaurant

actually pays something. When you make a reservation on OpenTable, the restaurant pays \$1 per reservation being made. At first, when OpenTable introduced the service and lots of restaurants signed on, restaurants just absolutely loved it. It saved them cost. Consumers were happy. It was just great.

Now that OpenTable has solved this problem, you have all these restaurants on board, and all these consumers using OpenTable, what do restaurants start saying? Well, gee, when consumers make a reservation, I have to pay a fee. This is horrible. That consumer would probably come to me anyway. Why do I have to pay a fee?

It is perfectly analogous to the card industry. OpenTable comes in. They solve a problem. It is free to the consumer. There is a charge to the restaurant. The charge eventually is passed on to the consumer. The consumer does not know this. It is perfectly analogous. It is a simple situation where merchants are getting a very, very valuable service, and they are business people and they like to pay less.

Mr. Drechny: What about the savings the bank experiences from not having to process checks anymore? That is different than that OpenTable system that you mentioned.

Mr. Lee: I would also add, at least with OpenTable, the merchant knows up-front how much they are paying; whereas with cards, most merchants have no clue and the processors go out of their way to hide that.

Mr. Evans: There is a lack of transparency issue on the pricing.

Mr. Economides: There is a problem with credit cards. It is not comparable with the OpenTable in my opinion.

I have in my wallet five credit cards. One of them pays me 2 percent back in cash. That is the one I use. It is the most expensive to the merchants, but why do I care?

So this is a real market failure, if I can use David's words. Somehow I have incentive to use the product that is best to me and worst to the merchants. If we had a different system and the merchants could charge me according to their costs on credit cards, then I would use a different credit card. No doubt about it!

Mr. Williams: Alan made a point about merchants not typically being organized. So I was trying to rack my brain to think of a good example where they have been organized. I thought of one, which was Germany, where the merchants got together and created a system called the LV by which they, instead of taking debit card transactions, initiate direct debits. That would obviously save them quite a large amount of money. I was wondering what we could learn from Germany. Obviously the creation of that system does not appear to be a market obstacle. What is it about Germany that would not work anywhere else?

Mr. Evans: I think if you want the at-par world, you should move to Germany.

Mr. Frankel: It is a good question. The American retail marketplace is incredibly fragmented. I do not know what concentration is like or what organization is like. I think merchants probably wish they had done this 20 or 30 years ago, gotten in at the ground floor, and created a system. It is very hard to enter now and compete when, as people have been pointing out, I get bribed to use my most expensive card. I can get benefits that people who are using cheaper cards and cash payments are funding.