General Discussion
Session 3

Mr. Weiner: Thank you, Bob, and thank you, Dennis. I think you have both done a masterful job of summarizing what is a very complex and technical literature. Obviously, a lot of important issues have been raised, a lot of controversial issues, and, all kidding aside, we want to hear all views. Some central banks are actively looking at these markets and have put in place special policies. Others are analyzing them. It is not just central banks, of course. It is also competition authorities and so on. So, this is a very, very important area to be thinking about. And, again, you have done a wonderful job.

First, Bob, is there anything you want to react to?

Mr. Chakravorti: Thanks, Dennis, for those comments. They were great. Let's open it up.

Mr. Levitin: In the United States, at least, the reason we have four-party networks is really a historical matter. We had interstate branch banking restrictions at the time the networks were created, and that's why four-party networks were needed if we were going to have depository institutions involved in them.

Looking ahead, do either of you see an economic case for having four-party networks instead of three-party networks? Do you see benefits to one arrangement or the other? Or, is it like a lot of the questions, just indeterminate in the abstract?

Mr. Chakravorti: If you look at the evolution of the credit card market in the United States, for example, it was Bank of America that started issuing general-purpose credit cards. They realized in order to expand, partly due to branching restrictions, they had to partner with other financial institutions. But, in a global economy, I don't see four-party networks losing their place. That is not to say there shouldn't be three-party networks that co-exist and compete with them. I see a role for four-party networks going forward.

Mr. Carlton: My answer is similar and it has to do with the fact we are not starting from scratch. It would be a different question if you say, "I am going to allow three-party networks and four-party networks. Who is going to win in light of everybody starting at a market share of zero?"

In many countries, there already is very large penetration, say, of Visa and MasterCard and that means—even if you have three-party systems—they have a tough fight on their hands because Visa and MasterCard have an established advantage. So that's why, if you look in, for example, Australia, there has hardly been any significant movement in market shares, even though Visa and MasterCard could claim that the recent regulation of interchange harms them relative to three-party systems, which do not have interchange fees. That disadvantage has not materialized in significant drops in market share. My view is—and the evidence so far is consistent with it—is that Visa and MasterCard will remain important payment systems.

Mr. Bennett: My question is on surcharging. Both Bob and Dennis seem to be pointing toward surcharging being a possible solution to many different issues here.

One of the interesting things we looked at in the OFT was, when we see surcharging, and we are increasingly seeing surcharging in the market, we are very seldom seeing it as being proportional to the actual fees that are charged. Often we are seeing it as significantly higher.

My question is, do the panelists think that is because of a transparency issue and these retail companies are finding another way of extracting greater profits or is there some other type of logical explanation which could account for the fact their surcharging doesn't seem to be proportioned to their costs?

Mr. Chakravorti: There are clear examples of higher surcharges than the retailer's cost to accept payment cards. I agree with Dennis. If you want to rule that out, you could regulate it, but that gets tricky. The U.S. gas station that I mentioned before has been surcharging for years, and they earned revenue from this practice. Are the people who are paying the surcharge harmed? If you compare it with them going to a cash machine and paying the potential surcharge on the cash withdrawal, perhaps not. One has to compare apples to apples. In our Spanish study, we looked at rival ATM density, because those are the ones that could have surcharges on them. So you have to consider all sorts of factors when determining how big or small a payment card surcharge is.

There is also price competition to some extent. The gas station that I mentioned offers among the lowest gas prices in the area. There is a relatively low gas price coupled with debit card surcharges. How do you separate those two effects? It is not clear to me.

If you have really intense competition, you wouldn't expect the surcharge to be higher than the cost to accept payment cards. It depends on the structure of competition to some extent.

Mr. Carlton: To my thinking, I separate things into two parts. The first is the opportunity to charge two different prices, the opportunity to surcharge. Just having that opportunity provides constraints, and my preference is to rely on the market to figure out what it wants to do in terms of whether to levy the surcharge or not.

Whether I then want to go further and either regulate the surcharge or regulate interchange fees raises all these questions about the difficulty of regulating. You can get it right or you can get it wrong. I would rather not have to regulate anything. If you think there's some market failure, for some reason, that is imposing very large costs, then maybe you want to intervene. But my own preference is always to see if the market would solve the problem first.

I don't have a good answer to your question of why there is surcharging in excess of costs other than to say, if you look at a distribution of who is surcharging and who is not surcharging, my suspicion is some people aren't surcharging because it is just not worth their while. And then the people who are surcharging are people who not only don't want to pay the differential costs, but for some other reason have another justification for wanting to charge a higher price, but I have not studied that.

Mr. Kimmet: Dennis, I don't know if you've followed what happened in New Zealand, but it is my understanding there—concurrent with allowing merchants to surcharge on the issuing-bank side—the issuing banks can now negotiate against the four-party systems, say, the Visas and MasterCards of the world, and have that rate set by them be the cap. As I understand, how that has played out in that market is the smaller merchants have started to surcharge, the issuing banks then have started to negotiate with merchants, and the prices are collapsing pretty rapidly. Do you have any insight into that?

Mr. Carlton: Are you talking about this recent New Zealand case that just settled?

Mr. Kimmet: Yes.

Mr. Carlton: I don't think it has gone into effect yet. It is going into effect in January, so I don't know whether there have been any effects yet.

Mr. Kimmit: You are starting to see some conversations happen very quickly.

Mr. Carlton: My understanding of that settlement is that surcharging is going to be allowed absent other contractual arrangements, that a four-party system will not be allowed to pass a rule that prevents surcharging, but individual negotiations with banks are possible such that the interchange fee relevant to that bank's payment cards can be set at or below the cap with the possibility that the bank and merchant could agree to not allow surcharging. I think that is right.

Mr. Kimmit: That is my understanding as well. I would encourage everybody to understand that system.

Mr. Wildfang: Of interest to the group, I am lead counsel for the merchant plaintiffs in the pending litigation.

I have just a couple of observations. One, with respect to real-world evidence: I know the economists here complained that it is hard to get data and evidence. After looking through some 60 million pages of documents in the litigation, I can tell a lot of the assumptions built into a lot of these economic models are inconsistent with the record. One of these days, hopefully, that record will be available, so people can look at it.

Another observation: The rationale for two-sided markets and the need to balance by charging one higher than the other, if that were valid, that would permit issuing banks to also fix the price of interest rates to cardholders or annual fees to cardholders. The economic justification seems identical and yet it seems to be unlikely the Department of Justice would not crack down on an agreement by all the issuing banks to charge the same interest rates or charge annual fees.

Mr. Carlton: I want to make a comment on that. There is an article—I think it's by Liebowitz and Margolis in the 1990s—which talks about the economic literature on network externalities. It makes the point that it is easy to go off the deep end in reading this literature and suggest every single market needs intervention and therefore should get an exemption from some collective-action problem. It makes a very similar point to the one you are making.

Mr. Ruttenberg: In this debate on cards, surcharging, interchange, and all these kinds of things, nobody has explicitly made the point that in the end we are talking about doing payments. If we make a comparison between cash usage versus cards, in the end you would like to replace cash in favor of using cards.

All the debate on interchange—whether or not it is allowed and how high it should be and so on—the point in the end we have all this debate in Europe over the future of the cards business in Europe and yet it is all about the need to have a plastic alternative for cash. If we take this approach, ask yourself the question, why should a merchant pay for my interest-free periods? Why should a merchant pay for the insurance? Why should the merchant pay for the miles I get? In the end, it is just about getting a payment done.

I am in this debate just a little bit. The core function of using a card is doing payments. This approach is just a down-to-earth approach. Is it not also missing in the United States when we discuss cards? It's about doing the payments and not about free miles and all these kinds of things. I would like your reaction for this.

Mr. Chakravorti: For some of those benefits, such as free float, there are merchants in the United States that give you similar terms on their own credit cards they issue, so it is not just bank-issued credit cards that offer some of these benefits.

We can quibble over whether you should get miles, toasters, and other things. In the United States, banks used to give away toasters because they couldn't give interest on checking accounts. We cannot say whether receiving miles for making a purchase at Starbucks with your payment card improves social welfare or not. And there are probably differences in the room about the benefits of rewards, but some essential functions of credit cards are going to be very difficult to mimic with cash.

The second thing I would add is that it's not abundantly clear cards always dominate cash. You could have situations where individuals value their privacy and prefer to use cash. We certainly have heard of southern European examples of tax evasion. Also, like the gentleman on the plane that I mentioned earlier, wanted to use cash because that was his best way to control spending.

Mr. Cook: Bob, you mentioned earlier about the gas station owner in California who surcharged for debit transactions. If I am not mistaken, that is only PIN debit they accept, not signature debit. The two entities that control signature debit don't allow surcharging on those networks. In fact, the network that's owned by one of large schemes only allowed them to surcharge on their network because they were grandfathered in at the time. Is that not correct?

Mr. Chakravorti: There are examples of where the gas station owner actually accepts a credit card that belongs to that chain. So, there are examples where you are right. Although they have to pay a higher fee for credit card transactions, they are not allowed to surcharge for them.

Mr. Cook: But, in the debit card example that you gave, where we're mentioning to the European folks that surcharging does exist in the United States, it is really only in that one example, only in PIN debit, and it's only because of a grandfathered situation.

Mr. Chakravorti: It is true that these are PIN debit transactions because there are network rules that don't allow you to surcharge other types of payment cards.

Mr. Cook: The gentleman from the UK mentioned surcharging may not be a direct correlation to the cost. Would you all like to talk about whether or not you believe interchange is a direct correlation of the financial institutions' cost?

Mr. Chakravorti: The one thing that's clear, I think, is you can't just separate costs and benefits. There is a lot of debate on the cost-based approach to setting fees. Some people argue fees should be purely cost-based. Then the problem arises of trying to figure out what does cost-based mean. So, if a merchant gives out an interest-free loan and then chooses not to give that loan but chooses to accept a four-party credit card, why shouldn't he share in the cost of providing an interest fee loan to move merchandise? There are several arguments that can be made against that—maybe the customer has money in his account. But separating these different types of customers is difficult and trying to figure out the cost is also very difficult in these cases.

Mr. Carlton: In a two-sided market, I think there is agreement an interchange fee by itself isn't necessarily cost-based and it doesn't have to be to create incentives to get the other side on board. That is why regulation of interchange fees is hard if you intend to have a cost-based regulatory system. You have to decide what costs, whose costs.

Mr. Hayes: Dennis, you expressed some skepticism around, would lowering interchange fees curtail efforts to issue new cards into the marketplace? Then, later on in one of your responses, you talk about we're not starting with a clean slate. There are existing competitors here today. As I look at the U.S. market, there are a number of efforts to create new payment mechanisms that do have a much lower interchange rate structure—like Debitman then became Tempo, like Revolution Money, like PayByTouch—all of these were based around being a low interchange cost structure and all of them basically fell by the wayside because they couldn't get cards into the marketplace. They couldn't get the issuing piece figured out.

There does seem to be empirical evidence that a lower revenue proposition of card issuing is insufficient to get consumers to adopt that payment mechanism. I would be curious to get your thoughts—at least in the United States where the pricing mechanism is the way it is today—if there is room for reducing interchange and still growing the card business.

Mr. Carlton: I think you would have to look at when they failed. In other words, if it was at a time (and it must have been) when there still were no-surcharge rules, that's different than if we didn't have no-surcharge rules. So, that's one relevant question.

In the presence of the ability to surcharge, the question is does that so undermine the ability to collect interchange fees, as sometimes Visa and MasterCard allege that it would impair the diffusion of card payment systems. All I'm saying is, based on some of the evidence I gave you, I can see some positive support for the proposition that interchange fees help dissemination of cards. On the other hand, there is a lot of negative support for that proposition. Perhaps one of the simplest implications, as I said in my talk, of the position that interchange fees are critical is that the decision related to the Federal Reserve System to have a par clearing system for checks must have been a mistake. Maybe it was and maybe it wasn't. I won't take a position here. I am just pointing out that it is an *implication* of the position that interchange is critical. That sounds a little strong to me. That's all.

It also sounds a little strong that interchange is critical for promotion when you look at some of the European countries that have zero interchange fees but have very high per capita debit card usage. Now, I'm willing to entertain the possibility that interchange could matter because I believe there are examples of even small systems trying to use interchange. All I am saying is it seems like sometimes people overstate the importance of interchange for card dissemination.

Ms. Masi: My question is to Bob. You mentioned earlier the impact of a two-sided market on innovation. I would like to know more because from the network externality theory and also from reality we know for sure there is some influence of the market power in making an obstacle to innovation. So, it is not so clear but this is traditional theory, a conventional competition theory. My point is just to know your opinion on what the impact is for a two-sided market innovation.

The second one is really a question. Which kind of regulator? Regulation is a word, but regulators are different. As Stu mentioned before, we have a competition authority and we have a standardization authority, which is something we didn't mention before, you know that is implied in this market more than in other sectors. Then there are central bankers. So, tell us more.

Mr. Chakravorti: Let me first say maybe it wasn't clear in the talk. The two-sided market literature doesn't say much on innovation. It's not there. I've had discussants of mine tell me that it is an important issue.

An example of where cost-based pricing was used is the market for electricity in California. As a result of this pricing policy, there wasn't sufficient capacity built up resulting in a crisis in that market. So the notion here is, if you don't have incentives such as the ability to earn profits to innovate, you might not.

One payments example that comes to mind is if you look at checks in the United States, they took a long time to be truncated, partly because of the way they are cleared. An act of Congress was needed to facilitate the mass migration to check truncation. But, in credit cards, you didn't quite see that.

In terms of the other question as to who regulates, that really depends on the country, what's involved and whether the central bank has the authority to regulate retail payment services. Purely for a selfish reason, being an economist, I like the Australian way because comments from all participants are online, whereas in court cases, I have no way of accessing those comments. They are sealed from me for many years.

It seems there may be differences, but in the United States traditionally we've gone through the courts on these challenges, whereas in Australia they went through the central bank. In Spain, they went through the antitrust authority.

The U.S. Department of Justice has had an effect on various types of regulation in terms of the ability to issue non-Visa and MasterCard cards by financial institutions that are members of those networks.

Mr. Hunt: I just have two observations. One is this analogy to par value clearance of checks. I think the analogy to the credit card market is really the honor-all-cards rule, rather than an inference about interchange. We can talk more about that later, if you are interested.

Second, this discussion about surcharging is very interesting. But, in the U.S.

context, it is interesting we do allow a cash discount and yet the implicit assumption here is for some reason that freedom of pricing doesn't seem to work. It is very important to understand the friction, whether it's behavioral or legal or whatever, that prevents the cash discount from behaving in the same way allowing a surcharge would behave.

Mr. Carlton: I think you're right. It is somewhat puzzling there aren't more cash discounts. However, there is a difference between a surcharge and a discount. The surcharge can differentiate among the various credit cards that have different merchant service fees, while a discount for cash cannot.

I also think the salience point people have mentioned earlier would matter. The fact of the matter is, for whatever reason, whoever designed those rules that allow discounting but not surcharging, didn't say, "I allow surcharging too."

So, they must have thought it mattered. My suspicion is it does matter.