

# Implications of the Changing Payments Landscape for Competition and Efficiency of Retail Payments Systems

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Moderator: Wiebe Ruttenberg

*Mr. Ruttenberg:* Implications of the changing payments landscape for competition and efficiency of retail payments systems is what we will discuss. It is all about competition, but also we have to remind ourselves that we will be talking about the payments industry, which is a network industry, and also cooperation is quite crucial in this context. So, it will be about competition, cooperation, and all that is in between.

*Mr. Bennett:* I will start with the standard caveat that everything I say is my own opinion and not necessarily that of the Office of Fair Trading (OFT). With that out of the way, rather than have a very general discussion about competition efficiency on retail payments systems, I thought I would talk a little bit about an area of recent interest: surcharging and whether surcharging could be a potential solution for many of the issues that we've been seeing and discussing over the recent years.

The argument here is essentially that surcharging creates a natural constraint on merchant fees. If merchant fees are above the level of benefit the merchants get from a credit/debit card relative to cash, then they'll simply pass on those additional costs to credit/debit card users. Higher fees should change consumers' consumption patterns, and will in turn constrain excess interchange fees above and beyond the level of the benefit from using credit versus cash. That's the theory.

A couple of comments here. First, in general, competition is really a good thing. However, we heard from Bob Chakravorti and Dennis Carlton yesterday that this is a slightly strange market because more competition may actually lead to higher fees to merchants as firms compete on cross-subsidizing card users. But surcharging, at least in theory, puts a limit on this. The more you try to extract from merchants, the more that merchants pass on these fees to consumers of credit cards, debit cards, etc. Hence, it reaffirms the beneficial role of competition.

Surcharging unravels any inefficiency in cross-subsidies. It ensures competition gets to play a more direct role than previously.

My second comment is it is not necessarily clear that all merchants are going to start surcharging. So, while in theory it seems like they have a clear incentive to do it, there is a potential coordination issue here. You don't want to be the first merchant to start surcharging, when all of your competitors are not surcharging. Why? Because we know some consumers will be sensitive to that and will potentially move away.

But there are ways around this. One way, potentially, is for merchants to offer discounts, rather than surcharges. Behavioral economics tells us consumers quite like discounts and, if you frame things in the phrase of discounts, then their response may be very different than if you frame them in the context of surcharges.

Second, there could also be a role for country institutions, such as the central banks or competition authorities, to try to encourage surcharging by merchants.

This brings me on to my third comment. Here, it is not clear that merchants will necessarily surcharge at the correct levels. One of the assumptions on surcharging is only the excess cost, the amount above the benefits merchants get from using credit cards and debit cards, will be surcharged to consumers. If you like, there are no excesses above and beyond the excess.

Looking around the UK, in many of the industries in which we do see surcharging, the surcharge levels appear to be unrelated to the actual merchant fees. The airline industry probably represents the most prevalent user of surcharging in the UK, although you also get surcharging in other sectors, especially by smaller merchants.

Why is this? Well, as we discussed very briefly yesterday, it may relate back to the behavioral economics literature. The literature discusses the fact that people like low upfront prices. People are more likely to consume when they see low upfront prices and don't think too much about the add-on prices that get included.

Airline pricing is pretty famous for having very low upfront prices. For example, in the UK, Ryanair advertises a zero price (or near zero) as the upfront price but with lots of different add-on prices afterward. The worry is that surcharges may just become another one of those add-ons, which are unrelated to merchant fees.

We at the OFT have been looking at these add-on-pricing techniques. We call the use of these types of surcharges "drip" pricing. The idea here is that your price is revealed to you only in drips and drabs. You get only the final price at the very end of the transaction.

An interesting thing here is, if there is going to be drip pricing in the payments industry, the possibility of cross-subsidy goes the opposite way of the cash-to-credit cross-subsidy we currently think about. In that instance, you might find credit card holders and debit card holders are actually subsidizing cash holders, if cash is a

viable method of payment and doesn't attract excessive surcharge fees. So, surcharges are interesting in the sense that the cross-subsidization we're worrying about at the moment, which is from cash to credit and debit, may actually be reversed, and go from credit to cash or debit to cash.

Do these issues mean surcharging is not desirable? Well, like many things in this industry, there is no simple answer. I do think surcharging is worth looking at closely, for two reasons. First of all, it creates transparency and does restore the direct competitive constraint on the level of fees. Now, there is this additional problem in that it may be used as a way of hiding fees for retailers later on down the line. But I believe drip pricing is actually a different and wider issue and as such should be tackled separately. So, to the extent that surcharging is a potential solution for the merchant fees issue, this really seems like something we should invest time to think about.

Second, surcharging may also encourage dynamic efficiency through innovation. As Harry Leinonen said yesterday, it is difficult for firms to compete when consumers don't see a price. What I can imagine here is the emergence of different types of payments systems with different types of surcharges. You might start seeing credit card companies who are offering very generous rewards, but you have to pay more to use them at the merchant. Likewise, you might see credit card companies offering no-frills models with no rewards, but then the surcharge is very low at the merchant. In that sense, one can imagine seeing more choice emerging for consumers.

Just to conclude, I think surcharging is a really interesting area. It may not be a complete panacea, but it is something that definitely deserves to be explored more. I don't think we have a huge amount of empirical evidence on that, but I would like to call for more empirical evidence to determine whether it is a possible solution to a lot of the issues we've been looking at for a long time now.

**Mr. Bézard:** I'd like to share one key thought with you as far as competition and efficiency are concerned. That thought is that, when looking at the debate about cost of payment and interchange in the United States and around the world, we tend to forget merchants have opportunities to compete in payments. One of the questions that was asked to us as part of the introduction was, is the retail payment market a perfectly competitive market? My answer to that is no. And to be honest, I do not know any market that is perfectly competitive. From the airline industry to the car manufacturing industry, I do not know any industry that is perfectly and purely competitive with no regulation and no government intervention. Ultimately, most markets are going to be skewed one way. The retail payment industry to a large extent is skewed in favor of the card issuers. The issuers have the relationship with the consumer and they have a huge say over consumers' payment behaviors. Now, from a merchant's standpoint, if merchants have concerns over the cost of payments and the deck being stacked against them, what are the alternatives for them? Over the past 10, 15, 20 years and more, the merchant community has

generally tried to address its concerns through litigation or through regulation. In the meantime, merchants have often overlooked opportunities to use competition to defend their interests. Merchants haven't been very supportive of payment alternatives to the offering from banks and card networks. Too often we are looking at the debate between the business interests of the banks and the business interests of the merchants as a debate about what is fair versus what is unfair. Regulators, lawmakers, and courts are increasingly pulled in to address and fix the conflict between the distinct business interests at stake. Few, however, ask the tough question of whether or not merchants are willing to compete. Over the years, there have been a number of ventures in the United States, such as Pay-By-Touch and Debitman (now Tempo), new start-ups or new payment ventures that were built upon the premise that merchants would be interested in sponsoring alternative payment networks that would reduce their merchant-acquiring fees. Those ventures didn't go anywhere. I don't think their failure is simply merchants' fault, but I would argue the merchant community did not try very hard to support those alternatives.

The point I would like to make to regulators is that merchants should be encouraged to be active in supporting alternatives to what is being offered by the banking industry. I will conclude with one example. There are a few examples in the world of payment schemes that are very merchant-centric, very merchant-friendly. One of them is ELV, in Germany. ELV is a very low-cost debit scheme, which is merchant-centric. It accounts for about half of debit card transactions in Germany. So there are some real examples, situations in some countries where merchants do promote some payment alternatives to what banks are offering. Another example is in the United States. Today you have some card networks, like MasterCard, that enable the decoupled debit card product, which is essentially a product merchants could leverage to offer their own debit card alternative to the traditional debit card being offered by banks. Few merchants have expressed serious interest in such a promising product yet. In a nutshell, before trying to fix business conflicts through regulation and litigation, I do think we should give a bigger chance to competition.

*Mr. Chu:* I am not a regulator. I am not an economist. I am not an academic. So, I am not really sure why I'm here, but I have been in the field, as it were, for quite a few years. Someone asked me at lunch yesterday, "What do you get out of coming to these things besides meeting some very smart people?"

I always use it as an opportunity to set the record straight about who PayPal is and what we are because I believe out in the field—out in the wild—there is still quite a bit of myth and some presumption.

Let me spend a minute giving you some fast facts, and this came out of our third-quarter earnings, so this is all blessed by our Public Relations folks. The rest of what I'll say is my opinion and not necessarily that of my company. Let me give you some quick facts about PayPal.

First of all, we were founded in 1998 as Confinity. The whole thesis of the Series A funding the founders were able to secure—and, boy, those were the salad days of venture capital—was beaming money back and forth between Palm Pilots. It was an interesting idea, though it didn't actually go anywhere. The great thing about start-ups in Silicon Valley is you can fail fast, recover, innovate, and continue to find unmet needs of customers, and we found that in e-commerce payments.

We are an 11-year-old company. We were acquired about five years ago by eBay and are a wholly owned subsidiary. We have 8,000 employees around the world (across 19 countries), and we operate three businesses. We are a payment mark, which is what most people understand us to be as another alternative payment type. We also have a fairly healthy merchant-acquiring business. When I joined PayPal 5½-6 years ago, it was precisely to do that—to form a merchant-services business. That is about 52 percent of our revenue now. We provide merchant processing to a lot of small businesses that would otherwise not get access.

Last year we bought a credit business called BillMeLater. We operate as both issuer and acquirer—and, Tony Hayes, yes, we are a network. In fact, we are a network of networks. We sit on top of the traditional networks, and we believe we add value by making it more efficient to operate between the networks and allow both buyers and sellers, our participants in our business, to be able to efficiently and cost-effectively conduct a payment transaction, which then gets to this notion of efficiency, which seems to be a big theme here as well as competition.

I'll make a couple of observations and leave some questions. If you define an efficient payments market as having, say, four characteristics: 1) low cost with a long downward trend toward lower costs; 2) real-time speed of authorization and hopefully at settlement; 3) easy and convenient access by all parties—consumers and merchants; and finally, 4) part of an efficient market would be that it is standards-based and fully transparent—if that happened and if those conditions were true, I would think in the retail payments market, the outcome would be you would have payments that would have the ubiquity of cards and the ease of use of cards and yet the speed of a wire transfer and the cost of a bank transfer and ACH. I don't think we quite have that, so to Gwenn's point, there isn't a perfectly efficient market in payments today, but there certainly are a number of conditions that would lend themselves to say there should be an efficient market. If the two primary levers of payments networks that drive costs and efficiency are technology and risk management, if you look at the trend—what Dan Hesse was talking about yesterday in his great example about 1G through 4G in telecom—Moore's Law is completely true. The cost of technology has dropped tremendously. That is probably the biggest cost driver. The risk in the network has also dropped tremendously. Loss rates within the acquiring business are pretty low anyway, notwithstanding the current situation on the issuing side of charge-offs. Nevertheless, I don't think that is a problem merchants ought to bear.

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If technology costs keep going down and risk is under control, why has the wholesale price, as expressed by interchange, been flat to increasing over the last few years? It seems like there is an interesting gap there. We don't quite have all the benefits of an efficient market.

I would say, though, that notwithstanding all of that, there is a tremendous amount of innovation in the retail payments market, as evidenced by our company. We've been lucky enough to survive and thrive, but there has been an enormous amount of innovation and there continues to be. That innovation employs a lot of people, it generates quite a bit of value in the market, and it continues to put pressure on some of the underlying conditions that may not lead to an efficient and low-cost market. As open competition and more innovation continue, we will incrementally move ourselves to a more efficient payments market.

**Mr. Levitin:** It's pretty clear right now the payments industry is very focused on the interchange debate. I want, at least in my opening statement here, to look beyond the horizon to speculate on the future. Currently, payments systems are dominated by interbank schemes. These interbank schemes feature bank cooperation, in addition to bank competition. But cooperation is a central element of interbank schemes.

This means, though, there is a delicate ecosystem. There is a balance that has to be maintained between banks that are natural competitors with each other. I want to suggest this balance in the payments ecosystem could shift pretty radically if we see product changes and profitability. There are several potential, maybe even probable, shocks to payments system profitability that are in the immediate future.

First, we have interchange and we have potential shocks to the system, coming both on the litigation side and on the legislation side. What's going to happen first and exactly what it will look like is hard to say. But there is a good chance something is going to give there.

Second, we already have shocks happening on the consumer fee side. So we have Regulation AA and the Credit CARD Act. Even beyond that, a (possible) Consumer Financial Protection Agency might start to change the profitability of credit and debit card issuance.

Third, we have consolidation affecting the industry, particularly in the United States. Right now, all is uncertain whether we are going to see institutions running to be larger or whether we are going to maybe see some institutions split up to be smaller. But we have a dynamic of size going on, especially on the bank side.

Fourth, we have the potential addition of new parties to the system. I am thinking in terms of mobile commerce. I see a move, especially in the United States, into mobile commerce, that will probably mean more mouths to feed. Unless the pie grows, there is going to be stress put on existing business models.

Finally, we are starting to see some movement from credit to debit. That may be exacerbated by what's going on in the U.S. economy right now. Debit is a less profitable product, if only because the consumer fees are much lower. All of this means we are very likely to see substantial shocks to the payments business model.

What does this all mean? If the current system is likely to be destabilized in some way, what is going to happen? I want to suggest we might see some large banks consider setting up independent networks. In the United States, we have at least three banks that have significant enough presence on issuing and acquiring sides that could be sizable stand-alone networks: Chase, Bank of America, and Citi. In Europe, I'm not as familiar with the situation and my sense is, if you look at the entire European payments area, we don't have banks that dominate the scene Europe-wide, rather than nationally, the way we do in the United States.

These large banks have some incentives to become stand-alone networks. First of all, why should they be subordinating their brands to MasterCard and Visa? We can see this when Chase rolled out its contactless card. It went with its own branding of that. Blink is a Chase brand. It's not a MasterCard brand; it's not a Visa brand.

Second, the networks involve a cross-subsidy from the large banks to the small banks. The nature of interchange fees is that—because it is one-size-fits-all—large banks are bearing some of the risk for small banks. There are rebates that offset some of that, but there is still a likelihood the large banks are subsidizing the small banks' participation.

Finally, if we have large banks pulling out of the networks, that may make it harder for small banks to continue to issue cards. That actually is very good for the large banks because if your small banks and credit unions get out of the card business, they may also lose some of their deposit funding because people want full-service banking. And where do you go? You go to the large bank.

There are some reasons why we might see some defection at least on the large-bank side from the multiparty networks. There are certainly some limitations on this, not the least of which are problems doing international transactions. There are ways that could be structured around, and there are also questions of whether the economics of this ultimately would work. Looking into the crystal ball, I'm not so sure in five years we are going to see a payments landscape that looks anything like where we are today.

**Mr. Ruttenberg:** We had a quite interesting first introduction of the issues. I'll quickly summarize the remarks of each. Matthew made a clear plea for surcharging and the need for further investigation. Maybe my personal view a little bit on this point is that I'm in favor of surcharging also. We have decided in Europe, there just has been a European law introduced, the payment services directive, which makes it explicitly possible to surcharge, unless it is explicitly forbidden by laws on a national level. There is a general movement, so to say, to allow surcharging.

In the European context at least, but maybe there is a problem in the United States, surcharging is not that big of an issue. By now only the most expensive card schemes are surcharged and the low-cost card schemes, that would be currently the national card schemes, are not surcharged at the moment. But there will be competition between the different card initiatives at the point of sale.

On Gwenn's point about more retail merchant involvement in these kinds of businesses, indeed that's always a good point to raise. Looking at the different initiatives in the past where retailers have been involved in the payments business, they were not quite successful. Is it really the business which they would like to be involved in? Of course, if you talk about the big retailers—Wal-Mart, IKEA, and some others that are around us here—they can do it. Maybe some of them have banking licenses. But we also have a vast majority of small retailers, and we should not forget those institutions too. In that way, competition by merchants setting up their own initiatives could be interesting, of course, but we have to be careful that we do not favor only the bigger ones.

Dickson, of course, a tremendous amount of innovation is around indeed. A fascinating question is—and maybe we should go on with the discussion here—how can it be that on one hand we have tremendous opportunities for innovation and on the other hand everybody agrees to some extent that at least the banking sector is not addressing this opportunity in an appropriate way? Apparently there is a role for competition, but why is it that those who are challenged, i.e., the banks, by newcomers and new innovative services, are not reacting in an appropriate way at least in certain geographical areas in Europe?

Adam, it is about the old interchange fee debate. Yes, we have to look beyond that thing, because we have been dominated by this debate several times. And the big U.S. banks setting up their own networks is an interesting point, setting a new scheme, new network, and new card. But will this solve the issue, because who can tell me that in the end they will not make the same mistakes? They will try to make money out of it too.

That makes my point in general. You have to be talking about payments, just doing payments. Let's not make things more complicated than they are. We would like to reduce the use of cash in society. There is a security and convenience issue. On top of that, in the current world, cash is not sufficient anymore because of online commerce. But while at the core we are just talking about how to initiate a payment—that is, how to initiate a credit transfer, direct debit, and card transaction—we are ending up making things too complicated. Yet it is all about how to initiate a payment in the real and virtual world, and I am not sure whether we talk about innovation and competition, whether that focus is still around.

Okay, these are just some general remarks on the first round of introductions. We'll give the floor back to the panel. Adam, with these payment markets: Is there a tendency to become natural monopolies in this case? You indicated to expect new



card schemes to be set up in the United States. We talked about network economies. Can you tell us a little bit of your views on enhanced competition and how it relates to consolidation vs. fragmentation issues?

**Mr. Levitin:** Sure. This is the core of the problem with payments systems. They are network economies, and network economies have both economies of scale and also they exhibit network effects. That means you're going to have a natural tendency toward monopoly.

Part of the problem we're facing right now is that we're not dealing with simply one network that has this, but we have multiple networks that are in some ways each acting as their own monopoly and as social policy. But how do we know which one of these we want to favor? I think Dickson set up a nice metric of how we might think about efficiency: cost, access, speed, and transparency. It is not clear to me there is inherently any one network we would want to favor over another.

This is part of the problem. We have multiple competing networks. We don't really know what the economics should look like. We know when we have just one network product competing with non-network products that we want to encourage economies of scale. That can lead to efficiencies. But, when we have multiple competing network products, I'm not sure it is at all apparent what we should be encouraging.

**Mr. Ruttenberg:** Dickson, it would also be interesting for you to answer this question about mega-monopolies because with your business, aren't you creating a kind of monopoly? You are fighting the current business so to say, but yet you prosper as an organization and you are the only provider. What is your view on this?

**Mr. Chu:** Well, first of all, we're not the only provider. Let's just put it in context. On a global basis, PayPal has roughly 15 percent market share of e-commerce. E-commerce, on a good day, represents only 5 percent of total retail, so we're hardly a threat to anybody.

Now, having said that, we represent the perception of threat to the installed base of networks because we've innovated something that is somewhat unique in that we're creating a meta-network—a network of networks. We are trying to drive either access, costs or usability efficiencies into the retail payments system by covering and basically offsetting some of the inherent inefficiencies of some of these other networks.

I wouldn't say that leads to any kind of natural monopoly. There are plenty of other people. If you go to your average venture capital firm these days, and I talk to a number of venture capitalists, on any given week they're going to hear a dozen proposals about how they have the new PayPal and they are going to kill PayPal. So, there is plenty of competition. And there are always going to be folks out there, so I don't think it's a natural outcome that we become a monopoly. It may be a natural outcome, as we're successful and we gain more share, we will be big and we'll grow. That's slightly different from the notion of a monopoly.

I don't know what the right market structures are. I am very much a competition, open-market kind of person, and the conditions need to be there to encourage and enable more networks to form and perform as long as the outcome is driving value to customers.

It's interesting to me we talk about this four-party system, when most of the time we seem to forget a couple of the parties: the merchant and the consumer. I'd love to see a network emerge that is very much merchant-aligned or consumer-aligned—that's all about driving down costs of payments and providing more transparent access for those parties.

**Mr. Ruttenberg:** Matthew, could you talk about natural monopolies, networks, and so on? You are director of economics, though not specialized in payments, but there are other industries—the airline industries, the communication network industries, and these kinds of things. What are your reflections on these other elements about natural monopolies, network economies, and these kinds of things in relation to payments? And also react to what has been said by Dickson.

**Mr. Bennett:** On natural monopolies, not necessarily. I don't think so. Sure, it's a network, but when you start having things like multi-homing both on the merchant side and on the consumer side, then there is no reason why these should necessarily be natural monopolies. If you have single-homing, then perhaps, but I don't think that is what we see here. We see consumers holding multiple cards. We see merchants having terminals which will serve multiple cards, so I am not sure it is necessarily a natural monopoly.

Does more competition make things better? That was something I discussed slightly earlier. It is an interesting question. You may get static distortions with more competition. However, thinking about dynamic efficiency and innovation, which Dickson was talking about, generally more competition is better for innovation. Sure, you need some sort of profit stream for the winner, for the person who innovates. But, in order to have an incentive to move and actually innovate, you also need competition for that innovation.

I was reflecting on the PIN versus signature debit card system in the United States. When I was thinking about that last night, it sounded very much like a cannibalization issue to me. It sounded like there is an existing system—signature debit—that is pretty profitable. Do you want to create a cheaper system that is going to cannibalize some of that? If there is only one of you, then, yes, maybe eventually you want to because there is going to be some advantage in providing a better product. However, you are not going to want to do it immediately because it can cannibalize some of your existing signature sales.

If there are two or three of you going for it, you either cannibalize yourself or someone else cannibalizes you, so you are forced to move first. In that sense, competition's main benefit is not necessarily the static element, it is more on the dynamic side. I see competition as being very beneficial in facilitating the entry of

new payments systems such as PayPal.

**Mr. Ruttenberg:** To make some reference to what is going on in Europe, we have two problems to solve. First, we have to unite 27 countries in how they do a credit transfer, direct debit and card transaction. Currently we have 27 countries that do retail payments in a different way, i.e., different technical standards and different business rules. For many years, we've had a single market for goods, services, and capital, but we have 27 different ways to do payments. Consequently, in Europe the retail payments market is still fragmented along national borders.

Second, the retail payments market and banks offering retail payments services have to innovate. There are pressures because newcomers come in and take the market. So we have a double challenge to cope with: integration and innovation. What we currently have in Europe is the challenge to let the banks work together to agree on rules, standards, and schemes, which will be the same across Europe. We now have the pan-European technical standards and business rules to use for credit transfers, direct debits and maybe later for cards too. On top of that, banks have to cope with the competitive challenge to innovate, to create new payments services, especially in relation to online and mobile. I am not sure whether this is currently happening in other parts of the world, but in the United States, of course, you have had a united market for many, many years and innovation is a challenge that has to be dealt with.

My question to the panel is related to the practice we currently have in Europe with 7,000 banks and future payments institutions, which is kind of a new animal introduced by the Directive on Payment Services, working together in the European Payments Council to agree upon European standards, rules, schemes, and so on. To what extent can this cooperation model be used in other parts of the world not only for basic payment services, but also for payment innovations in the field of Internet's online payments and other things? Or is this unthinkable in a very competitive, focused market as in the United States? Can we have such a cooperation model outside Europe?

**Mr. Bézard:** Is your question about what is the best model to drive innovation?

**Mr. Ruttenberg:** I am not sure whether there is a best model, but to what extent is cooperation, in your view—because we are always talking about competition—necessary, needed, or possible to bring the retail payments market forward?

**Mr. Bézard:** In many respects, cooperation has been instrumental in developing the payments industry and is still critical to its future. Ultimately, the payment infrastructure we have right now across the world and in the United States was driven by banks getting together and building associations. Without global associations, I don't think we would have pervasive electronic payments. We would not have this platform upon which issuers and acquirers and other entities are able to compete. Cooperation has been and is very important. What I would add, however, is that when it comes to achieving payments efficiency or supporting

innovation, I also think there are different ways of getting things done. I'm French. I come from a country that is very keen on using government to drive change. And I've been living in the United States for eight years, which is a country keen on using free enterprise to drive innovation and change. There are different roads to get things done. Competition is one of them. Political will is also one of them. Just look at China. The Chinese government is putting a lot of political will behind the building of China Union Pay, building a world-class payments infrastructure. In years to come, we will see a fairly large payments infrastructure there emerging by political will. So, I think the question is, What method works best for which country? As far as the United States is concerned, it is fairly safe to say letting the market play a very active role, letting competition play out, is usually the best way of doing things. In Europe, it may not be seen as the best way of getting things done. You look at the integration of payments systems in Europe. It's taking political will. Without political will we are far from having an integrated payments system in Europe, right? It is not there yet. My bottom line is that I don't think there is a unique answer across every country in terms of how to best drive efficiency and innovation. The right mix of cooperation and competition depends on the local context.

*Mr. Chu:* I am going to expand on that a bit. This whole notion of getting banks to cooperate, as Gwenn pointed out, think about the birth of Visa and MasterCard and so forth. In a number of these payments networks we are talking about, it was precisely because banks found some way to cooperate and interoperate that these networks were created.

We are getting to the point where another evolution needs to happen, where the discussion needs to be broader. It's not just about banks cooperating with each other, which by itself is a huge challenge. Why not expand the discussion in Europe, or elsewhere for that matter, where you bring other parties into the discussion in terms of cooperation? Why aren't outside providers like ourselves and merchants that have a vested interest in whether or not there is an efficient and cost-effective payments network in the conversation for cooperation and mutually setting these standards and rules of engagement?

That should be a natural evolution because the alternative is that a group of banks gets together and cooperates, but they may very well find themselves in a classic innovators' dilemma where they are so worried about protecting their own interests that they will miss out on the disruptive innovation that is going to come about. Someone else is going to provide the value they traditionally had provided. I think there is a need for broader discussion.

*Mr. Levitin:* I just want to amplify something Dickson said, which is when you are setting standards, it really matters who is in the room, who is doing the standards-setting. It is not just a matter of, Is it the banks versus banks plus other payments companies or banks plus other payments companies and merchants? But let's remember the consumers are also in that. Who is the proper voice for representing consumers in this context is an interesting question. Is it consumer advocacy groups? Is it the government?

It is important to recognize the payments system is in effect lots of different parties and all the parties affected should have a voice at the table when standards are being set.

**Mr. Ruttenberg:** I can agree with you, Dickson, and also with what was said by Adam that it is not only about banks in the payments system. It is also about the end users, the merchants, the consumers, and so on. What is interesting—and I am not sure about the U.S. situation—but currently we have in Europe, in the different national contexts, already payment counsels, which are composed of not only banks, but also end users, merchants, corporates, and so on. We are currently in the process of setting this up at the European level in order to have a platform where we can discuss exactly these issues. What are the strategic direction and the framework of the retail payments markets in Europe? What role should everybody be playing and what should be left open to competitive forces?

Presuming involvement in those things is always a little difficult because to what extent am I being involved as a consumer in the standards-setting of my mobile phone or television? I don't know. I think it is completely industry-driven.

**Mr. Bennett:** I thought it might be interesting to give the OFT point of view of one of the times when we've tried to move the industry forward. This was around the Fast Payments System. In the UK, the banks have now introduced a faster payments system to process payments within one day, rather than the standard three to five days of the normal payment systems.

This came out of the Cruickshank Report in 2002 or 2003. Essentially the OFT's position was to get all parties into a room, including the banks, the merchants, and the consumer bodies as well, in order to gain an understanding of different positions and thereby facilitate the implementation of the Faster Payments System.

Of course, there are a number of different ways you can implement these things. Some ways were more expensive. Some ways had more functionality than others. So, in some sense, there was a value in them all sitting together and discussing what the best way of doing it was.

The consumer organizations surveyed lots of consumers to find out what they would value most. The banks went and looked at how much the different ways of doing it would cost. Eventually they came to a decision that was going to provide the best tradeoff between the benefits and the costs. On our website, we have a cost-benefit analysis of this payments system, which was published in April of this year.

This is an example—a third way, if you like. Of course, there was the OFT standing in the background with the threat of an investigation or legislation, but that gave a good incentive to come to a solution. Actually, there was a solution to be implemented there, and that turned out to be something that was very valuable.

**Mr. Chu:** By the way, I think faster payments are fantastic, but I think you've only done half the job. You should probably continue to push open access, so all

parties can participate in it. Finally, why is it that faster payments is only for credits and not for debits?

*Mr. Bennett:* I think that is one to reflect on.

*Mr. Ruttenberg:* This gives us a nice bridge to the final question to the panel and then we will open the floor for the audience. Because the title of the conference is “The Changing Retail Payments Landscape: What Role for Central Banks?”—Maybe we should call it, “What Role for Public Authorities?” I would like to ask you four to share your views on what should be the role of public authorities, be it a central bank, be it a competition authority, be it a legislator, in the field of retail payments?

*Mr. Levitin:* On a very general level, I am going to be saying something where there is likely broad agreement, that central banks and public authorities should be ensuring we have fair and efficient markets. What does that mean?

When we are confronted with the realities of payment networks, we have to recognize there is the tendency for natural monopolies that are used maybe for having a somewhat different role than usual for public authorities. I want to bring up by way of analogy the debate that’s going on about health insurance in the United States. There is an argument we have a market failure in health insurance and the only way private actors are going to be kept honest is by having public competition.

We actually have something like that in the payments world, at least in the United States; in pretty much every area except card payments we have public competition. For checks, we have the Fed competing with private clearinghouses. We have that for ACH. Even for cash, historically if you went back far enough, we had Federal Reserve notes competing with national bank notes, competing with U.S. Treasury notes.

We have this strange situation where cards actually look like the exception to the rule, where we don’t have public competition. I don’t think we want to have solely a public option. We don’t want only a government payments network. There are reduced incentives to innovation, but this may be a situation where in order to drive private networks to socially optimal standards and to have a nimble process that has enough innovation in it, but also protects consumer and merchant interests, we may really want to have some sort of government competition. So maybe not the usual role for government, but this may be a case where we have an expanded role for government.

*Mr. Chu:* I think public authorities have a tremendous role. I’ll use by way of analogy, a phrase I heard years ago: “No one likes taxes, but taxes are the price you pay to live in a free society.”

The public authorities, through regulation, play a tremendous role and, through the right kind of fair, balanced and transparent regulations, create a framework by

which further value is delivered as well as competition. Part of that role—and this is where I disagree with Matthew around the issue of surcharging—is a tactic.

The role of the public authorities should be to specify outcomes that benefit all parties and hopefully drive some societal good and maybe provide some frameworks by way of standards and so forth, but I don't think they should ever play a role in trying to specify "the how." Let the markets figure out how to get to the specified outcomes, as opposed to specifying tactics to the market.

**Mr. Bézard:** I can't say I am an expert, but I would think the role of public authorities is to care about public matters. I don't agree with Adam about what he said regarding the failure of the card systems in the United States. From a public standpoint, I don't think you can argue there is a failure of the cards' infrastructure in the United States. By many yardsticks, the usage of cards—debit, credit, prepaid—is very successful. There is a high level of penetration, a high level of reliability, lots of different stakeholders in the marketplace to pick up the slack if one network goes down. I don't see where Adam is coming from, when he says there is a failure from the public standpoint. Is there a conflict between business interests, between the merchant side and the bank side? Yes, there is. As a taxpayer—I am not a citizen, but I am a taxpayer—do I want public authorities to arbitrate conflicts between different special interests in the business community? I don't think so. What public authorities have to deal with is the public good and public matters. Again, from a consumer standpoint, I don't think you can argue there is a failure of the card system. I'll take just one example. If you look at low-value payments, which are payments made at the point-of-sale, for instance under \$15 to \$20, the United States has done extremely well by enabling the card network infrastructure to accommodate low-value payments. I can buy a bottle of water at the airport by swiping my card and, thanks to modifications to Regulation E, I don't have to sign a receipt or get a receipt when I do that. Compare that with the situation in many other countries, especially Western Europe, where for many years—10, 15, 20 years—European countries have tried to accommodate low-value payments by building new infrastructures, so-called e-purse schemes, that went nowhere. In comparison, just using that simple example of low-value payments, the U.S. marketplace has done very well in driving the use of cards, the use of electronic payments, for low-value payments. This is just one example, but I don't see how you could argue there is a failure of the card systems. There is an acute conflict between distinct business interest surrounding cards, but no failure of the system as a whole.

Now, back to what the role should be for public authorities. Referring back to what I said earlier, ultimately the role of public authorities is going to vary slightly, depending on the context. In the United States, public authorities are probably well-advised to have a light hand, whereas in some other countries for many historic reasons and cultural reasons, public authorities are probably well-advised to use a heavier hand. The context matters a lot. In the near term, besides caring about the public and not the special interest of certain businesses, I think the role

of the public authorities in payments should be to encourage merchants to step up to the plate and play a more active role in competing in payments. If I were in the shoes of regulators, that is the language I would have with merchants: Step up. What are you doing to compete? What are you doing to have a voice? What can we do to help you to have a bigger voice? To the credit of merchants, we cannot on the one hand say, "Oh, merchants are being beat up by banks and that's unfair," and on the other hand deny Wal-Mart the ability to have a banking license to get into the merchant-acquiring business. Again, I think what regulators and public authorities could do is to encourage merchants to step up and try not to be conflicted about it. In the case of Wal-Mart, ultimately public authorities have been conflicted about giving the firm more freedom to compete.

**Mr. Ruttenberg:** We have a lot of surprises in the panel because the two U.S. citizens are asking for a public option or asking for a strong government for setting a framework and the French citizen, traditionally in favor of an approach of centralistic government, is asking more for *laissez-faire*.

So, Matthew, what can you bring to us?

**Mr. Bennett:** Well, personally, I am not a big fan of regulating final outcomes. Having worked in a regulator previously, I believe that regulation is something that is very costly, resource-intensive, and sometimes necessary but you resort to it when it really is the last resort. So, if there are frameworks you can put in place to ensure a competitive outcome is reached, then those are the better things to do. The extent to which surcharges may or may not create that framework is something that's worth exploring before we necessarily go to regulating final outcomes.

Is there a role for government intervention? I will try to broaden things out a little. One of the things we have done in the OFT, which I thought was quite interesting because the payments services industry had an impact on it, was our investigation into personal current accounts in the UK.

One of the things we found was that customers don't like switching. They really are not very good at switching between banks. In fact, we had encountered the depressing statistic in the UK that you are more likely to switch your long-time partner than you are your bank account, which either says something about relationships in the UK or it says something about the banking industry.

One of the reasons why people are so reluctant to switch is because when they do switch, they often found a lot of their payments went missing, and they spent several months afterwards trying to unwind all the direct debits and the standing orders that have gone awry. We found something like 30 percent of all switching went wrong in some way.

In the payments services industry, there is a role to play in ensuring payments are done efficiently and as quickly as possible. Indeed, this was one of the



driving forces behind the one-day payments services: to ensure there aren't timing problems such that when you switch accounts you suddenly find some of your payments have not gone through. It is interesting in that it shows the payments industry is not just about payments services, merchants, and retailers. Payments services have wider implications on the banking industry and the efficient working of the banking industry. So, there may be roles to think about for government intervention—or for government studies, for example—on the wider implications of the industry.

# General Discussion

## Session 4

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*Mr. Ruttenberg:* It is now time to open the floor to questions from the audience.

*Mr. Wenning:* I found the discussion to be very interesting this morning. I have a couple of observations: As one of our members said to us in an industry meeting, cooperation and collaboration may sound fine to you, but from where I sit it sounds a lot like collusion. When you talk about the role of the central bank, there is a fine line between societal interests and societal balances.

The point was made yesterday during one of the conversations that somewhere along the line, after 60 years, the Federal Reserve made the decision to have checks clear at par. Seven out of the eight countries have debit that clears at par. Gwenn made the observation of having a light hand versus a heavy hand when it comes to the role of central banks.

But at some point there should be some balance of societal interest by someone in an oversight role of a payments system in terms of monetary policy. From where some people sit, they don't see any hand in the United States as it relates to credit or debit payments systems.

I guess my question is, when I look at the title of the conference, Where do you see that in terms of U.S. policy going forward? It seems to me there has to be some role in balancing the good for societal needs.

*Mr. Levitin:* I am going to respond both to you and also to Gwenn, because they go to the same point.

Gwenn rightly points out there is a lot that works really well in the U.S. payments card markets. Let's be careful; we don't want to throw out the baby with the bathwater. But we do have a very particular market failure and you have alluded to it, which is the par clearance problem. The payments system can either clear at par

or clear at a discount. Alan Frankel's work has shown that between the two, we actually want par clearance as there can be dead-weight loss with discounted clearance.

Payment cards in the United States are a really weird hybrid. The system has discounting in parts and then mandates par in other parts. Mainly between banks, interchange is a form of discounting. But then—and this goes to Matthew's point on surcharging—the merchant is told, "*You* can't do the discounting."

What the banks can do, the merchant can't do. To me, that's where the real problem lies. We can either have an entirely discounted payments system. That's fine. It may not be the optimal thing, but we could do that. Or, we could have an entirely par payments system. But the way the current system is set up, for both credit and debit in the United States, is that we have par for some parties and discount for others. That is where the failure lies. We could deal with that simply by fiat legislation or something like that. Just zap it, saying, "no-surcharge rules are out the window."

We could do it in theory with some sort of taxation. One of the concerns is the payments industry is pretty nimble. If no-surcharge rules go out the window, there are going to be a bunch of well-paid lawyers and economists, whose job it is to devise a runaround to whatever the regulation is. Another option is to have a competing par clearing payments system and see if that shifts the burden.

Whether ultimately the right move is going with the public option, I'm kind of agnostic. Dickson may have some arguments with me. I was more throwing that out as something we should talk about. It is certainly something the Kansas City Fed has raised with the idea of having debit transactions cleared through the ACH system. Frankly, with the Credit CARD Act, it might be more feasible to clear cards now that the cards are no longer such an "at will" line of credit.

If we like the move that happened with checks and cash—where they originally didn't clear at par and now we've moved them to being par-clearing—and we have systems that work very well, we should want to see the same thing happen with credit and debit in the United States.

**Mr. Bézard:** Again, I'm not saying merchants don't have issues and there is no problem. I actually run a market research company, and when some of our clients pay us with a credit card I frankly hate to pay the merchant acquiring fee. So, I understand first-hand what merchants are going through. But the broad question to me is the risk of unintended consequences when regulators step in. Look at the Department of Justice's decision in 2004 to let Visa and MasterCard issuers issue American Express cards to introduce more competition in the issuing world. This decision drove up the competition for issuers' business between Visa, MasterCard and American Express, contributing to increasing interchange. I am generally very concerned with unintended consequences of regulations. My main argument is that merchants have more options than meets the eye. There is room for them to start competing with the banks.

**Mr. Levitin:** I'd like to say a word in response to that. Lots of things have unintended consequences and the argument against unintended consequences of regulation is an argument against government at all. It is not an argument about particular regulation. The nature of government is to intervene in markets. Once you have a government that only requires taxation, taxation warps markets in its own way. So, if the only basis is a generic concern about unintended consequences, yes, we always have to worry about that. But, unless you can start to point to particular negative consequences you think are likely to result, not just a specter of maybe something we haven't thought of will go wrong, I don't think that argument can carry that much weight.

**Mr. Wildfang:** This is an observation. The debate here suggests the alternatives are regulation or no regulation. I've just observed, in the United States at least, there is regulation. If you've ever looked at the rules of Visa, there are thousands of pages. The difference is we have regulation by a cartel of banks instead of the government.

I think the real debate should be, assuming we are going to have regulation, Can government do a better job of regulating than a group of banks that have self interest to motivate them? I'd like to hear the panel discuss that, as well.

**Mr. Ruttenberg:** Maybe I'll misuse my authority here and handle the question myself. It's more than regulation and no regulation. If I look at the role of the European Central Bank and the Eurosystem as a whole (i.e., the ECB and the euro area central banks) we play much more the card of moral suasion. I think it was Dickson who was asking for public authority setting the framework but letting the markets decide on the "how." That is exactly how we do it at the moment in Europe. Of course, we have our special challenges—the integration of the retail payment markets of 27 European countries. There are also the innovation challenges already talked about. Every year, we publish nice reports describing developments we see in the market. We describe the challenges which have to be overcome by the banking community in close cooperation with end-user merchants and so on. We also describe the consequences if they don't do it—the consequences we think will happen. Over the past years, we have seen that this has been a quite successful approach. Very often you can see in banks, especially in the payments business, a lot of people are very busy with the day-to-day business in running their systems and asking for additional budgets to keep on track with whatever, but they maybe spend too little time on more strategic things: What will the market look like in 10 years' time, and what will be the role of banks, nonbanks, and so on in this market?

Maybe a very specific example of this, as a consequence of European integration, is we face the risk of losing the quite low-cost, efficient national card schemes (e.g., the PIN scheme in the Netherlands, Bancontact/MrCash in Belgium, Girocard in Germany). Those pure national card schemes will just disappear because banks have a much more European focus, not only a national focus. The larger retailers are asking for one scheme for Europe and not the more than 20 we currently have.

The risk of the SEPA project is that although we are striving for open, more competitive markets and choice for consumers, retailers, and so on, we'll end up with only two debit card schemes in Europe—Visa Europe and MasterCard International.

There we've said to the banks, "Look, Guys! Is this what you want? Because it also gives a clear indication of what your future will be in this market."

It's all about who will have, in the end, direct contact to account holders, to the account holder in your bank. What will be your role in setting the standards and governance of these kinds of schemes if they are not European-based? It triggered a debate within the banking community. And not only in the banking community, but also an initiative popped up backed by retailers, "Hey, maybe we should set up a new card scheme."

We are not there yet; whether we will get there is still uncertain.

There are now currently three initiatives working to set up a new additional pan-European card scheme, and it is purely based on public intervention by moral suasion by the ECB and the Eurosystem as such. When we pointed at the unintended risks of SEPA for the European cards market and called for an additional pan-European card scheme two years ago, people were laughing at us. They saw us as central bankers sitting in their high ivory tower in Frankfurt, not connected to the real world, but after a few months they said, "Hmm. Maybe you're right."

Maybe the market will not deliver the additional pan-European card scheme and, finally, we have to conclude that our call has not been successful. But, in the end, we can at least say that we have raised the issue and it was left up to the markets to decide how to do it, whether they would like to do it, or take the consequences if not. Concluding, moral suasion—at least in my personal experience—is a very effective, efficient role the public authorities could play before entering into the domain of setting rules by regulation.

**Mr. Bolt:** I'd like to raise Matthew's point again about consumer switching. The very essence of competition policy is that consumers must be allowed to switch to an alternative. Actually, you are saying they don't switch in the end. But I think there is a difference between *ex post*, not allowing it, or *ex ante*, allowing it and not observing it, because the threat of, let's say, being able to switch can already discipline the market participants.

There is a nice example in the Netherlands that, pressured by competition authorities, Dutch banks had to come up with a solution to make moving to another bank easier and they came up with that solution. Everything is automatically redirected—all your direct debits. And you can even take your account number to another bank, so you have portability.

But then, in the end, nobody moved to another bank. But still, it is there and people *can* move. If you don't observe it, it doesn't mean that it is of no use. It is still a disciplining factor. That is my first comment, and I have another comment on surcharging.

A very difficult question, and you also pointed this out, is What is the right surcharge? Is there a coordination problem among other retailers? Actually, in theory I'm not so sure about the welfare effects of allowing surcharges. I don't know if it is better when the retailers or the merchants swallow the 1 percent discount when consumers use cards. Or when consumers are faced with this 1 percent fee and do not use cards and then more cash payments will be made.

I don't know from a welfare point of view which is better when the assumption is that cash payments are more expensive than card payments if, in the end, surcharges drive people back to cash and cash is heavily subsidized. In the Netherlands, even foreign ATM use is free. I'm not so sure whether the surcharge is the best alternative to having better outcomes for society, if it drives people back to using cash.

**Mr. Bennett:** The switching comment is something we heard a lot from all the banks, unsurprisingly. The fact that there's a lack of switching actually doesn't necessarily mean there is a lack of competition. The possibility of switching is enough to discipline the market.

While I buy that story to some degree, the fact that when we asked people why they didn't switch, nearly 50 percent said they perceived there being problems and out of the people who did switch, 30 percent said, "We had problems." kind of implies there were fundamental problems, rather than it was all okay and people were just choosing not to switch. If, at the point that everything is fixed and people are still not switching, then I would buy the argument. But, at this point, we still have a long way to go.

On the second point, I think it is an interesting question whether you are going to have welfare increases or welfare decreases. It's probably not the time to get into it right now, but I am happy to engage you in that discussion later on, because I think actually it is welfare increasing, but maybe I can have a chat with you about that later.

**Mr. Moore:** My question is about the relationship between innovation in the payments system and the regulators' ability to keep up with the changes, especially as it relates to consumer protection regulation, for instance.

There are two examples I'm thinking of. One is you look where innovation has happened in the past few years. PayPal is a great example. You have this new network of networks, as Dickson described. One implication of this is you try to use your PayPal account to pay someone else and by default everything is set up to go through bank transfers, because the costs are lower. One side effect of having PayPal facilitate bank transfers is you don't have the same consumer protection regulations in the event of unauthorized transactions. Regulation E doesn't apply to bank transfers the same way as it does to credit cards.

You also see this in the UK with movement to chip and PIN. This was arguably innovation and improved the security of the payments system there, but one of the ways which banks have responded, since chip and PIN's introduction, is to deny

reimbursement to claims of fraudulent transactions to consumers whenever the PIN has been shown to be used. I am wondering, as we start to see movement toward new payments methods, whether there is going to be always an associated move in an attempt to circumvent or sidestep existing regulatory efforts.

*Mr. Levitin:* I can answer very briefly—Yes! To the extent consumer protection is costly for payments systems, there is a cost with that. To the extent that is a cost that can be reduced by having less consumer protection, then it makes perfect business sense to do so. This is a case where you may see the market driving against consumer protection rather than for it.

There is a case to be made that sometimes the market will drive for consumer protection, but in these cases consumers don't even know the difference between Regulation E and Regulation Z protections. If you can push them to Regulation E, rather than Regulation Z, you want to do that.

*Mr. Gove:* I'd just like to make one brief comment on surcharging, because a lot of the discussion has been about the impact of surcharging. A lot of the value in the Australian environment over surcharging has not been that people have actually been introduced to it. It's been as a negotiating tool and what can be achieved as a result of surcharging. So we're seeing a lot of the merchants and merchant associations use the threat of surcharging as the ability to negotiate better deals and lower prices in other areas.

In terms of the actual impact on cash, we're not seeing any move to cash in Australia as a result of surcharging. First, because there is not a lot of surcharging. Again, it is really being used as a negotiating tool. Second, when surcharging has been introduced, it is often only introduced on the more expensive cards. So really retailers surcharge on American Express and Diner's, but not on the scheme cards and the association cards, because they are now a lot cheaper.

And, of course, the EFTPOS domestic debit is also a lot cheaper again. Where there is movement, it is actually from one card type to another card type, rather than from card to cash. I can't really overemphasize the importance of surcharging as part of a suite of tools increasing competition in negotiations. To one of the points that Gwenn has made earlier, it is part of that role of merchants becoming more involved. And surcharging on its own is probably not likely to achieve a lot of these results in Australia. It has been that suite of changes, the ability for non-deposit-taking institutions to become members of Visa and MasterCard, to become self-acquirers, for new acquirers to enter the market, for merchants to do a whole range of fees that has been part of the improvement in the overall scene.