

# General Discussion

## Session 6

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*Mr. Oliver:* Thank you for being provocative, Joshua. I would start by saying perhaps you give us far more credit than we deserve. The statement that the Federal Reserve might set a market price or something like that has certainly not proven to be the case in the past years.

I was particularly struck by the questions about innovation. By the way, I am a big free-market advocate; I absolutely believe in the power of innovation in the private sector through market means. The discussion about, if in fact the Federal Reserve and the check world should have innovated sooner to move into electronics or cards or e-checks or something like that, that's a rather interesting discussion, because the fact of the matter is we tried to do that, starting 20 years ago.

I assumed responsibility for the product office 11 years ago and, at the time, we had already been providing electronic check collection services for 10 years. But we weren't seeing those practices mimicked in the private sector. These are interesting questions, and I would say if the only business the private sector was running in that case was the check business, it would have happened.

But, instead, what we've seen recently—whether it's been in innovations we've tried to bring to the marketplace like same-day ACH or getting at your issues—is we don't have an ACH system that particularly serves the temporal needs of improved payments practices, reducing risks in debits by limiting the number of days of exposure and whatever. It is absolutely an accurate comment from my point of view.

We have announced we are going to offer such a service in the second quarter of next year. We've had difficulty in convincing the industry we should offer such a service when it would seem to be a natural evolution of not only efficiency, but effectiveness, risk reduction, and what have you. Why? Because the silos that exist within payments across banking institutions cause them to try to defend their own

turf. Putting in a same-day ACH network might seem like a great efficiency and a great public policy move for the country, but it may not be a move that is particularly good for the wire transfer business, the electronic check business, or the debit card business, which may see a portion of their marketplace threatened.

This always seemed to me to be puzzling. Why would an institution do this? My own personal opinion is because we don't have in place in this country individuals managing the overall payments operations of financial institutions whose singular goal is to look out for the bottom line profitability of the organization. Instead, we manage it within silos, and we find out the kinds of things you ought to expect to see aren't happening.

I don't think what you've suggested is a necessary consequence, and I don't think the Federal Reserve's engagement has hindered. Rather, I think we've done a great deal of innovation and have very much expedited the adoption of electronic checks through our presence and persistence in trying to get our customers connected through the network.

**Mr. Weiner:** First of all, thanks, Josh, for your comments. They were very insightful, as usual. To be as succinct as possible, I believe the Fed's presence in check collection and ACH has served the nation well historically. Going forward, I don't have strong views about the Fed's role in checks. As regards ACH, I believe our continued presence there is entirely warranted, if for no other reason than to help ensure a competitive environment. Were the Fed to exit, leaving only EPN, new entrants could appear but certainly can't be assured. As far as innovation goes, it strikes me that the Fed has been innovative in ACH. But, arguably, we could be more innovative. Rich, of course, is much closer to that than I am.

Finally, this session, of course, examines the Fed as operator. But, I also think it is important to examine the Fed as overseer. In my view, the Federal Reserve could be doing, and potentially should be doing, much more in overseeing not just traditional systemic payments systems, but what the Bank of England has called systemwide systems. The Dutch central bank, for example, provides a very good example of my preferred way of going about it. I am anxious to hear what Ron Berndsen has to say in the next session.

**Mr. de Armas:** I have to say, Josh, I really found your statements about free and cheap to be very enlightening. I don't disagree, actually. I think services should not be free, but that belief is inconsistent with your practice, because you force merchants to process payments for free at the same cost as cash. So we're providing a service to consumers for free. Why shouldn't we have the opportunity to charge for that service?

You also talk a lot about customer choice. You believe consumers have the right to choose, but how can consumers make the choice if they are not aware of the cost? If a bus, a cab, and a limo cost me the same thing, I am going to take the limo every time. Without understanding the cost piece, how can you make a choice?

*Mr. Peirez:* I'll just answer the question I think you're asking.

First, let me say that just because I believe a consumer doesn't need to know exactly what interchange rates apply on a particular transaction or what a merchant claims the overall cost of that particular payment form is to them doesn't mean I think a consumer understands what those products cost them. It is no different—and we've had this debate a million times with all of you so I'm not going to belabor it—it is no different than all the other costs a merchant incurs in providing a service.

You provide an integrated service, just like you provide an integrated refrigerator. With consumers, they don't get to decide they would have been fine with a cheaper icemaker than the one they ended up getting in the refrigerator they bought. When they use their cards, they know the fees that apply to them; just like when merchants choose which cards to accept, you know the fees that apply to you.

There have been great strides in the last few years in making those fees more transparent to you. Maybe there is more that could be done. We've talked about some of those things. I have no problem, as I've testified before Congress, in terms of printing your costs to a consumer on their receipt or telling them those costs at the point of sale. Go ahead. I have no problem with that. So, if it's a question of knowledge, do it. Our rules don't restrict it. I can't speak for the other guys, but they are over there. You can ask them. So I agree in that regard that consumers should be able to make those choices.

In terms of surcharging, which is the heart of the other part of your question, if I am correct, again it's something we've spoken about quite extensively. As I said in Chicago, although I will try to repeat that answer here as best I can, we have a number of markets where surcharging has started in the last few years. We're monitoring it very closely to see the results and to see how it plays out. You've heard some interesting things on both sides here today, which is what we're witnessing as well, in terms of surcharging—which is that in some cases it bears no correlation to cost—and thus begs the question.

I disagree on the answer that was given to the question today about the difference between discounting and surcharging. Merchants do have the ability to discount for cash. I just don't think cash is really cheap, even though merchants like to say it is. You just don't have a line item that says "my cash discount fee." If you did, it would be a much higher percentage in my mind for many, many merchants—not all—than what they see for cards. There are just some fact points there we disagree on, Mario—more so than the principles.

*Mr. Levitin:* Josh, this is also a question for you. You are right that cost efficiency is the main metric we should be looking at. In my mind, that raises the question of whether the new value that card networks have provided tracks the increase in the cost of payments. Since 2000, we've seen something around a 50

percent increase in interchange costs. Has there been a 50 percent increase in new value provided, or where is the new value? Can you spell it out?

*Mr. Peirez:* I am not going to take your assumption on the numbers as fact, because that is not accurate.

*Mr. Levitin:* If you want to show some other numbers, I'd love to see them.

*Mr. Peirez:* We have and we can show others. I also appreciate the question, because I've seen your work extensively and we've never had a chance to meet, so thanks for the question.

Let me say two things on this question. First, there was a lot of discussion about the investment required to bring a network live and put out the infrastructure, etc. So, yes, to some extent as you build in those networks, you do have the ability to bring new things to life quicker, to use the network you've built to bring new innovations to bear. I don't agree that costs overall in the system have gone up. You have to look across the board at costs; you can't look at one particular cost. You have to look at interchange add-ons by the acquirers in terms of discount fees and cardholder costs. And, yes, times have changed in terms of write-offs and things like that, so you're bearing that. But I still believe there is a great correlation between the value we bring and the costs that are involved. Sometimes you bear certain costs in one year as a loss leader for value you get in the later year. Sometimes you extract it at the same time. I'm not held to a formula like the Fed is of saying, "Here are my costs and now I'll extrapolate a mark-up based on what I see in the market."

I look at it based on my investment dollars, and it's no different than anything else. You have a period of time where you have an innovation that's different from what others have where you can extract a different rent. Then others come in with a similar product and your rent goes away. Then you have to spend a lot of money to bring it back up. What we've done is exactly explicable in basic economic and pricing theory that any business would engage in. It's no different.

*Mr. Taylor:* This is a quick question on PIN-debit markets for Richard. The Kansas City Federal Reserve issues the status of PIN-debit report every three years. I think there is one due this year. In looking through the data, from 1996 to 2005, which was the last data point, PIN-debit costs have risen about 15 percent compounded annually. Can you comment on the value in the new innovations that have occurred within the PIN-debit market that would justify that kind of price increase?

*Mr. Oliver:* The answer is no. I actually don't have a lot of engagement in the card world at all. There are two other people here who could better answer that question, but I assume the answer is nested someplace in the technology that has to be adopted first of all to accelerate PIN-debit. I might add, by the way, we're just starting into the fourth cycle of the Fed's payments system market research study. We are growing that study also, asking banks for the ratio of PIN-to-signature debit and so forth as another means of trying to corroborate the data. I'd ask my other two panelists to comment.

*Mr. Weiner:* You're probably referring to the Kansas City Fed studies we've done in the past—about six years ago and then three years ago—on ATM and debit card markets. We have a lot of information on what's been developing in those markets, including pricing. Yes, there has been a movement up in PIN fees, and they have narrowed the gap with signature. The last time we wrote about that, there certainly was the thought among myself and my coauthors that it has something to do with competition in that market, and we heard yesterday, of course, that competition in these two-sided markets can sometimes be counterintuitive. In that case, it can sometimes, because of the competition for issuers, lead to an increase in interchange fees. But I really don't want to go any further on that topic. Maybe we can talk offline. It's rather tangential to this discussion of the central banks' role.

*Mr. Leinonen:* I want to comment on consumer choice because I am really in favor of consumer choice, but you have two different levels here. You have the customer service provider level where you should have consumer choice and there should be competition, but then you have the service provider at the trunk network level, between the service providers, and there it is good to have only one way, an overly efficient one, and see the governors keep that efficient. So, if you compare with SMSs, you have just one SMS-type of service—the trunk level for that. Would it be better for customers if you have two non-interoperable text message systems? The same applies if you look at e-mails. If you would have two different e-mail systems, you would have to transfer e-mails somehow between them. That would be a problem.

When you go to payments, it is very interesting here when you talk a lot about checks, but you still have the situation that all checks are accepted in shops and in banks—the one without having check type 1 or check type 2 and different networks for different checks. But, in cards, you suppose it would be more efficient in having three or four different trunk networks, instead of having a situation where all cards are accepted and all card transactions transferred in one network, and then the competition would be among acquirers and among issuers towards their customers, but not in the trunk networks, and the problems you have now where I see extra costs at least and not full efficiency, which you could reach.

In many countries, we have that kind of situation. I'm coming back in a little bit to Finland, and I can say we have not had any ACH in Finland and we have open acquiring of cards. So all cards are accepted and all in one network, and this network operates directly between all participants. That, you could say, is the Internet way of doing it. There's no e-mail ACH and no SMS ACH. You could also work without payment at ACH if you really want to make it efficient.

*Mr. Peirez:* Harry, I couldn't agree more with your analogy. I just disagree with the underlying facts you present, which is the behind-the-scenes service providers in those industries are more than one. You heard Dan Hesse yesterday. It is not the industry creating a single new pipe. They may create interoperable

standards and that is essential. And I do think any work central banks can do in helping create standards more quickly and bringing parties together for standard creation more quickly would be great. As an industry, we coordinate on that across systems. Yes, you want that interoperability of standards, but you also want people competing on that pipe in terms of what else they are going to bring to market, what they are going to give to those front end providers in terms of enabling them to compete on the back-end.

So I fundamentally disagree that you can have one underlying technology pipe that everyone in the front end then accesses, and that somehow creates consumer choice. There is only so much you can do off that one pipe. That's like saying, "Here you would have had the check-clearing pipe and everyone could have innovated off that to have cards."

That's true and, until four years ago, you would have everyone still clearing with paper. I just disagree on where the analogy follows.

**Mr. Leinonen:** I just ask you if there is enough consumer choice in the telco industry and mobile telephones?

**Mr. Peirez:** It varies substantially by market, actually. In some markets, no, and in some markets, there is great choice on handsets, but not on network operators and plans. In some markets, there is great choice on network operators, but not on available handsets. Then, in some markets, you have both. So, in some cases, yes, and there are markets where I would argue maybe not.

**Mr. Duncan:** This morning, Gwenn Bézard asked a provocative question, which was, Why don't merchants compete to create new payments products? I was pleased to hear Josh answer that when he said, "How do you compete with someone who gets to create the rules and can change them when you try to innovate?"

As the two regulators potentially on the panel, what should be the role of government in removing rules that prohibit parties from discouraging or encouraging the adoption of innovative products?

**Mr. Weiner:** Well, my reaction is that one of the roles of central banks is overseer, and the overseer role is itself a spectrum. Josh mentioned we should perhaps consider our regulator role as well. In my view, regulator is a part of the overseer role. Another part of the overseer role is thinking through the rules and regulations and ensuring there is a level playing field in whatever market the central bank has a mandate in ensuring efficiency and safety.

Without commenting on this specific example, I think there is certainly room for central banks around the world to periodically rethink and reexamine their retail payments systems and ask themselves, Are there things we could be doing to make these systems more efficient and safe? And much of what we've talked about the last couple days, in fact, falls under that umbrella.

I was struck this morning by the discussion about security. Security standards seem to be lacking in many cases. There was a suggestion that, Why don't central banks, or the Fed in particular, step up to the plate and, say, be a little more vocal in encouraging certain security standards? Personally, I think that is a suggestion that ought to be taken seriously. So this is an indirect answer to your question, Mallory, but I certainly think it is in the purview of a central bank to be thinking about what's efficient and, specifically, the kind of rules and regulations that are in place, as long as it doesn't overstep its bounds.

*Mr. Oliver:* You raised an excellent point about the issue of your competitor being your regulator. The issue is, how have we dealt with that dilemma, because it is a serious point, and we've dealt with it with a very strong and wide Chinese wall. Anytime I try to develop a service, I have to get it approved by people who ask the question, Will this service be detrimental to private-sector competition?

By the same token, coming the other way, as an overseer I fully agree overseers should try to find ways to adopt rules that enhance competition. It doesn't always happen. Instead, they find rules that enhance political outcomes sometimes or something like that. But, in that context, with the passing of the Expedited Funds Availability Act in 1988, the Board forced the adoption of certain rules that eliminated the concept of presentment fees; that is, one bank could charge another bank for the privilege of collecting the checks at their door.

The Reserve Banks from a competitive standpoint should have been totally opposed to that because it meant these checks could now bypass us for free on the presentment side. Instead, we supported it and adopted competitive services as a means to try to address that issue. So it can be done, but it has to be done carefully.

