Interchange Fees: Regulations and Implications

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Introductory Remarks

- Payment economics is complicated because of the interactions of a set of interdependent bilateral relationships
- The ongoing shift from cash and paper towards electronics potentially confers large economic benefits. But card payments in particular have remained expensive for merchants
- Innovation is key for dynamic efficiency. But there exists a fine line between cooperation and competition in payments
- Divergence of social and private incentives. But regulation may have unintended consequences.

Key Questions

- Is the payment market sufficiently transparent to generate the right price signals and incentives?

- How do you encourage innovation among the players in the payments industry?

- Will competition among payment providers, networks, or instruments improve consumer and merchant welfare?

- What guidelines should policymakers follow when regulating payment services?

Pricing and Usage Externalities

- Society will be best off when it relies on the most efficient payment system

- Interchange fees may be necessary to balance demands on both sides of the market. Both price differentiation and discrimination are observed in practice

- However, (wrong) incentives may have adverse effects (example: in Holland, ‘cheap’ debit cards were surcharged favoring ‘expensive’ cash use)

- Zhu shows unintended by-effects of (perhaps) well-intended price cap regulation

Incentives to Innovate

- Due to externalities payment prices cannot be purely cost-based (elasticities, feedback, benefit distribution)
- Payment innovation requires cooperation between competing players. Who captures the rent? Rents versus competition. Too much regulation may frustrate innovation and dynamic efficiency
- Cost-based approach may limit incentives to innovate. Networks and issuers may require years to recoup investments in new products. They may not introduce new products but upgrade existing rails
- Marianne discusses the incentives to innovate and the role of the interchange fee

Ability to Surcharge

- Merchant surcharges may alleviate “two-sided” tensions. Interchange fee may become neutral
- Card acceptance becomes virtually costless, yet one does not observe complete acceptance in countries that allow surcharges
- To what extent can card fees be passed on? Merchants also benefit from cards, and should absorb some of these costs. Competition may curb excessive pass-through. Complex issue of optimality
- Allan discusses the Australian experience where the RBA reduced interchange fees and banned no-surcharge rules, changing the total payment fee and its structure

Payment Competition

- Due to competition, merchants may be willing to pay higher fees than socially optimal (weak “merchant resistance”)
- Platform or network competition does not necessarily improve the price structure although the total price may decrease
- Payment competition may result in low or negative consumer fees if issuers compete too vigorously on the consumer side, tilting pricing against merchants
- Regulating 4-party schemes may also affect pricing strategies of 3-party schemes. Level playing field. Allan shows some evidence for Australia

Interchange and Credit

- Credit provides another source of extraction for payment providers.
- Who pays for credit? High finance charges may affect willingness-to-pay (fixed fees) thus influencing merchant fees allowing different interchange fees for debit and credit cards
- When debit and credit compete, banks may have incentives to increase credit card acceptance
- There may be a tradeoff between extending credit to less creditworthy consumers and the merchant fee
- Chun-Yu explains how interchange fees vary across Chinese industries with higher card penetration rates, higher margins, and higher credit risk

Conclusion

- Payment economics is complex. No consensus among economists and policymakers on what constitutes an efficient fee structure for card-based payments
- Regulation should be geared towards removing barriers of entry in payment markets and banning merchant (pricing) restrictions
- Path dependence and market specifics matter---no one size fits all. Theory alone is not enough. We also need to look at the facts
- Good mix of papers. Let us now turn our presenters!