Pricing, Competition, and Regulation of Retail Payments

The Evolving Landscape of Payment Systems
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The views expressed are those of the presenter and do not necessarily represent the views of De Nederlandsche Bank or the ESCB.

Introductory Remarks

- Payments are absolutely essential. But 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. What is going on?

- Divergence of social and private incentives. But regulation may have unintended consequences. Payment competition need not increase efficiency and is hard to measure

- Innovation is key for dynamic efficiency. But there exists a fine line between cooperation and competition in payments

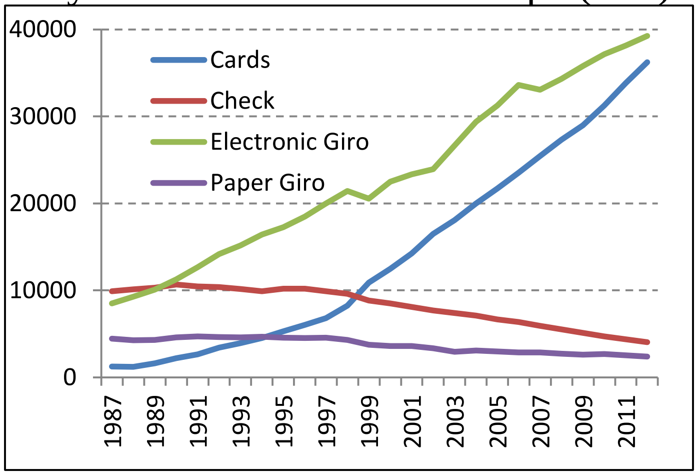
Key Questions

- Is the payment market sufficiently transparent to generate the right price signals and incentives?
- Will competition among payment providers, networks, or instruments improve consumer and merchant welfare?
- How do you encourage innovation among the players in the payments industry?
- What guidelines should policymakers follow when regulating payment services?

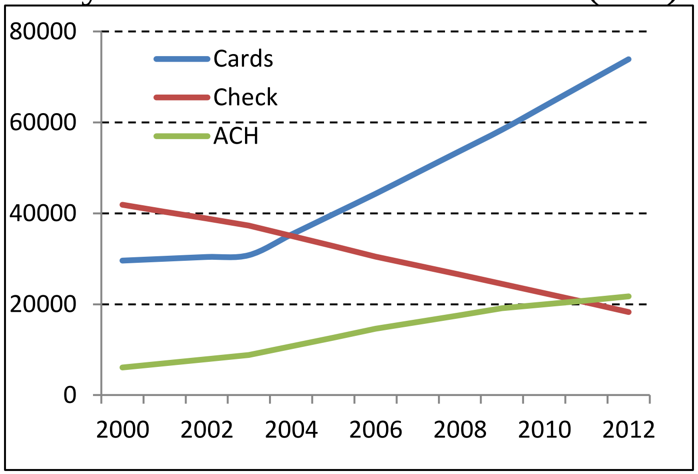
Changing Payment Composition

- The way we pay for goods and services is changing fast
- Mobile apps, digital wallets, “Bitcoin” are gaining ground

Payment transactions in Europe (mln)



Payment transactions in the US (mln)



Pricing and Usage Externalities

- Interchange fees (IFs) may be necessary to balance demands on both sides of the market. Uniform pricing, price differentiation and price discrimination are all observed in practice

- Are IFs still needed? Changing preferences and habits, convenience and safety, widespread acceptance and scale economies may shift overall picture

- Consumers usually face no transaction fees—are they responsive to pricing? Yes! Per-transaction pricing in Norway induced rapid shift to lower cost electronic payments (Bolt, Humphrey, Uittenbogaard, 2008)

Payment Steering: Surcharge or Discount?

- Merchant surcharges may alleviate “two-sided” tensions. Interchange fee neutrality
- 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. Merchants “overshoot” and abusive surcharging may lead to underusage (Bourguignon, Gomes and Tirole, 2014)
- Briglevics and Shy (2014) argue that cost savings from discounts may be too little to offset transaction cost of administering price menu’s. Reason for low incidence in U.S.

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
- Credit provides another source of extraction for payment providers. Banks may have incentives to increase credit card acceptance versus debit. Market segmentation yields a preferred “payment mix” but with an efficiency loss

Measurement Issues of Competition

- To ensure an efficient retail payment system, it is important to assess competitiveness among payment providers but relevant data is quite limited

- Main measures of competition, such as HHI, Lerner Index and H-Stat, seem uncorrelated across banks and over time

- Implementation of a frontier-based method to determine relative competition in bank-provided payment services

- In the US, small banks are among the most and least competitive, the very largest banks are in the middle. This suggests location affects competition: high income and high population density (Bolt and Humphrey, 2014)

Payment Regulation

- Due to externalities payment prices cannot be purely cost-based (elasticities, feedback, benefit distribution)
- Wrong incentives may have adverse effects.In Holland, ‘cheap’ debit cards were surcharged favoring ‘expensive’ cash use. Public campaign to stop surcharging was successful—strong growth in small card payments
- Perverse effects of “Tourist Test”: Doubling of scale (in the Netherlands between 2002-2010) leads to higher IFs (5 times higher!). Hard to swallow for merchants
- Unintended by-effects of well-intended IF price cap regulation in the US−small merchants may be worse off (Wang, 2012)

Incentives to Innovate

- 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

- IFs may be necessary to provide right incentives to innovate, but this also depends on adoption externalities (Bourreau &Verdier, 2012)

- Which business model is most apt to promote innovation among competing players—"old" credit card model for digital payments?

Conclusion

- Payment economics is complex. Can the market deliver efficient and fair outcomes? Non-banks want a piece of the “payment pie”, Internet increases privacy and safety issues
- Payment competition might not do the trick. Inefficient price structure due to “heavy tilting”
- 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 need data to understand the effects of payment competition and identify possible unintended consequences of regulation

Muchas Gracias!

Payment structure

Main players in a (card) payment network