Pricing, Competition, and Regulation of Retail Payments

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Introductory Remarks

- Payments are absolutely essential. But payment economics is complicated because of the interactions of a set of interdependent bilateral relationships

- Payments are different: a two-sided market! Appropriate pricing needs to get merchants and consumers “on board”. But which side pays..?

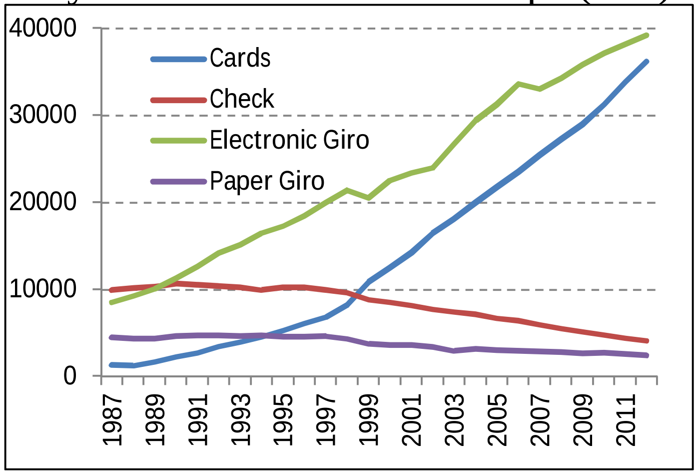
- The ongoing shift from cash and paper towards electronics potentially confers large economic benefits. But they remain expensive for merchants. Can innovative digital payments (and virtual currencies) bring any relief?

- Payment competition need not increase efficiency but regulation may have unintended consequences

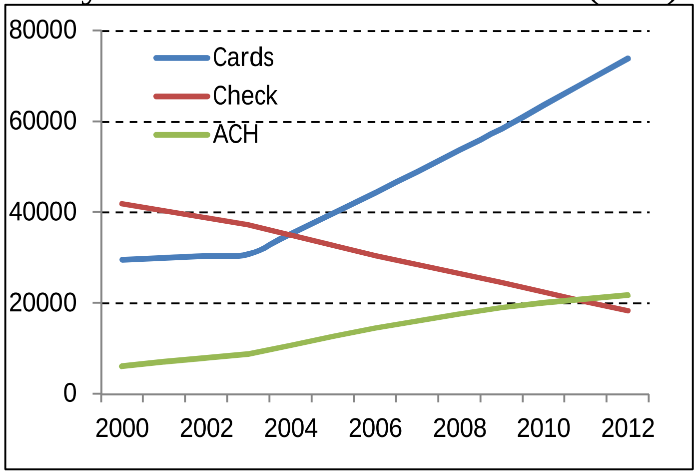
Changing Payment Composition

- 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

- Acceptance becomes virtually costless, yet one does not observe complete acceptance in countries that allow surcharges

- To what extent can payment fees be passed on? Merchants also benefit from new payment solutions, and should absorb some of these costs. Merchants “overshoot” and abusive surcharges 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")
- 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. Market segmentation yields a preferred "payment mix" but with an efficiency loss due to market power
- Non-banks enter the payment space. This calls for "level regulatory playing ground"

Incentives to Innovate

- Innovation is key for dynamic efficiency.

- Payment innovation requires cooperation between competing players. Who captures the rent? Rents versus competition. Too much regulation may frustrate innovation and dynamic efficiency

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

- 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

Payment Regulation

- Due to externalities payment prices cannot be purely cost-based (elasticities, feedback, benefit distribution)
- Regarding antitrust, due to two-sidedness, you cannot simply isolate the retailer side from the consumer side. The “relevant market” is more complicated
- 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. Contactless takes off!
- 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

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

Merci!

Payment structure

Main players in a (card) payment network