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Merchant Benefits and Public Policy towards Interchange: An Economic Assessment

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Margaret E. Guerin-Calvert, Competition Policy Associates

Janusz A. Ordover, NYU and Competition Policy Associates

Overview of Presentation

- Setting the stage for empirical and policy analysis
 - Public policy interest in credit and debit networks generally, and in interchange fees (including, processes, levels, fee structures), specifically
 - Network economics, efficiency, and the role of competition policy
 - Key policy questions – is there a need for intervention, and if so, what are the “best” policy tools
- Empirical analysis of benefits to merchants from card payment systems
- Evaluation of policy alternatives: why reliance on competition policy is superior to regulation

Public Policy Issues and Economic Fundamentals

- Regulators and private sector participants have raised concerns about interchange fees – including concerns about levels, structures, and the competitiveness of the related markets
- Economic analyses of debit and credit card networks, and policy prescriptions for network issues should account for:
 - Two-sided nature of the “market” and complexities of the interactions and feedback between and among participants
 - High fixed costs and the complexities of efficient pricing
 - Whether the issues/concerns rise to level of market failure that warrants heavy-handed regulation
 - Whether market conditions are conducive to regulation (which they rarely are)

Public Policy Issues and Economic Fundamentals

- Review of the literature on the role of the interchange fee, benefits of competition among networks and the “distribution” of benefits and costs, reveals that:
 - While there is relatively broad literature on consumer and societal benefits of card usage relative to other payments mechanisms, empirical analysis of the benefits to merchants from network services is sparse – this represents a critical gap in empirical evidence for informed policy making.
 - Policy formation requires “disentangling” concerns over the nature of inter-network competition and concerns as to whether competitively functioning networks provide benefits to merchants that are generally in line with the interchange fees that merchants have to recoup from their customers (and whether these benefits accrue solely or primarily to card-based transactions)
- To inform the discussion, we undertook:
 - Empirical analyses of merchant benefits
 - Assessment of policies to promote competition taking empirical analyses and market conditions into account

Empirical Analysis of Merchant Benefits

- Empirical analysis of merchant benefits focuses on networks services grouped into three broad categories:
 - Authorization services, including fraud protection and payment guarantee; billing and collection; finance/credit
- Investigate:
 - How these services are provided via networks to merchants
 - Nature, sources, and magnitude of merchant benefits
 - The alternatives that are available readily to merchants -- or could readily be developed -- were such services to be “unbundled” or not provided if costs not covered by interchange fees in long run
 - The likely costs of the alternatives

Empirical Analysis of Merchant Benefits

- Services provided as part of “authorization” services by network or network participants
 - Customer and transaction specific services (e.g., request/receipt of information, dispute resolution)
 - Fraud protection – customer specific, broader screening
 - Payment guarantee, immediacy of payment
- Overview of systems and services related to fraud protection and payment guarantee provided by networks
 - Infrastructure, investments
 - Processes: authorization/validation, address verification, card number verification, in some instances, password authorization
 - Scope of coverage – merchants, type of sales

Empirical Analysis of Merchant Benefits

- Sources and measures of benefits – consideration of direct measures and measures relative to alternative sources of provision
- Common principle: services are subject to network properties (economies of scale and scope and ability to defray costs over large number of participants)
- Direct cost reductions and other cost savings associated with network savings
 - Measures of savings
 - Internet sales
- Other benefits

Empirical Analysis of Merchant Benefits

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Evaluation of Alternatives:

- Provision by merchants (individually or in groups)
 - Moral hazard
 - Costs of provision by individual merchant likely exceed reduced fraud savings; impracticality of individual provision
 - Risks are across merchants and industries, not merchant or industry specific
- Third party alternatives
 - Check guarantee services as representative example
 - Private insurance – may not be available
 - If available, is likely to be costly
 - If available, likely to have limited scope of coverage – exclusions for smaller businesses, certain industries, and Internet sales
 - Implications of exclusions
 - If available, will not likely replace all network services - third parties will likely need to “ride on” network or pay for access to network services

Conclusion: Evaluation of Policy Alternatives

- Public policy should take into account merchant benefits in any evaluation of interchange fee “intervention”
- When choosing among policy tools, regulators should recognize that:
 - Credit and debit card networks do not meet conditions for price cap or other regulation
 - There are substantial costs associated with misplaced regulation
- The best policy “toolkit” is to rely on competition policy