LEXECON

House of Cards: The Economics of Interchange Fees

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Why The Concern?

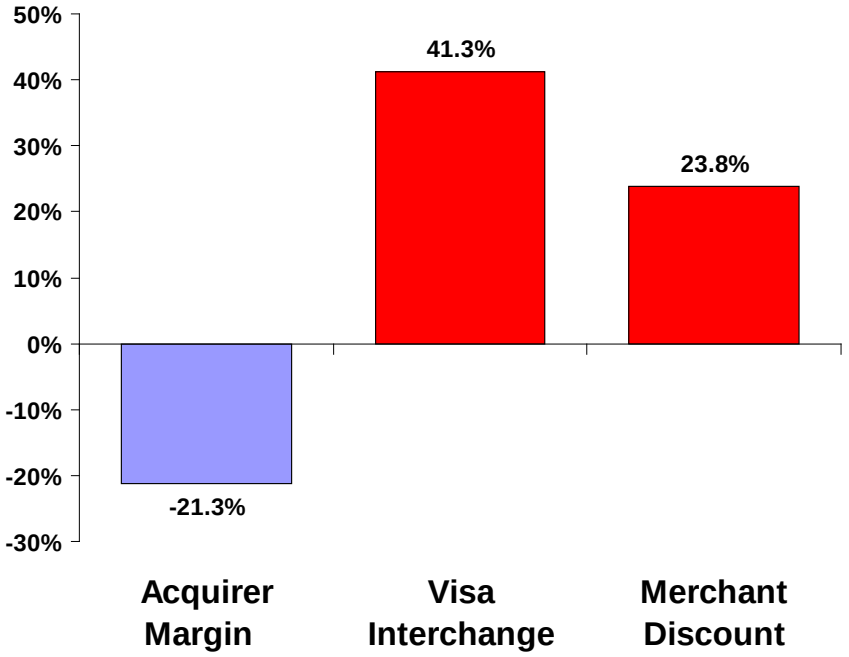
- Visa's Bill Sheedy:
  - "Merchants paint a misleading picture."
  - Average Visa credit card interchange rate grew only an average of 2.2% per year from 1990 to 2004.
- But this is a percentage growth rate of a tax *rate*.
- 14 years of 2.2% growth = **+35.6% higher *rate***:
  - 35% income tax rate ➔ 47.5%
  - 8.375% New York City sales tax ➔ 11.4%

Why The Concern?

- Bill Sheedy:
  - *"Over the past 6 years, merchants' Visa discount rate has been relatively flat."*

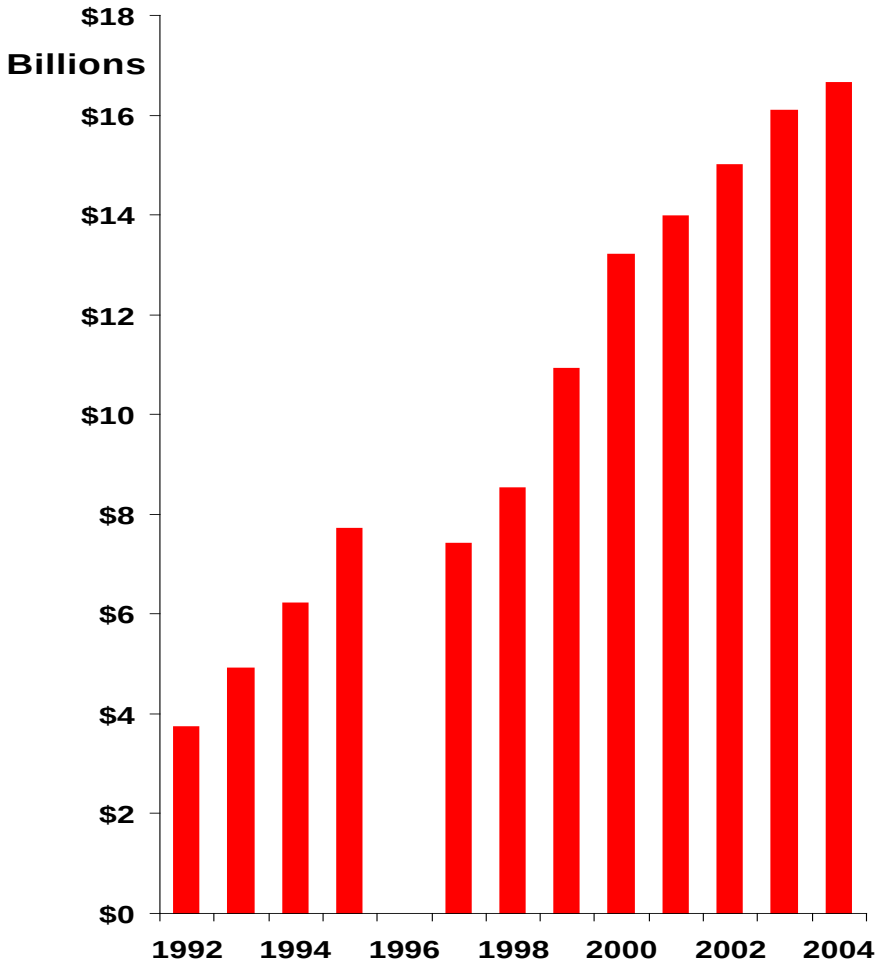
➢ But Sheedy's data show:

- **Acquirer margins: -21.3%**
- **Visa interchange +41.3%**
- "Blended" discount (including signature debit) +23.8% from 1995 to 2004.
- 83% of discount was interchange by 2004.



Why The Concern?

- **Interchange fees paid for credit cards alone:**
  - **+124%** since 1997 (CAGR = 12.3%)
  - **+349%** since 1992



Source: Credit Card Management.

Deregulating Self-Regulated Credit Card Networks*

- **Interchange fees are already regulated…**

  by the banks receiving the proceeds.

  - Rochet & Tirole (2004): The "platform" is a "licensing authority" and "competition authority."

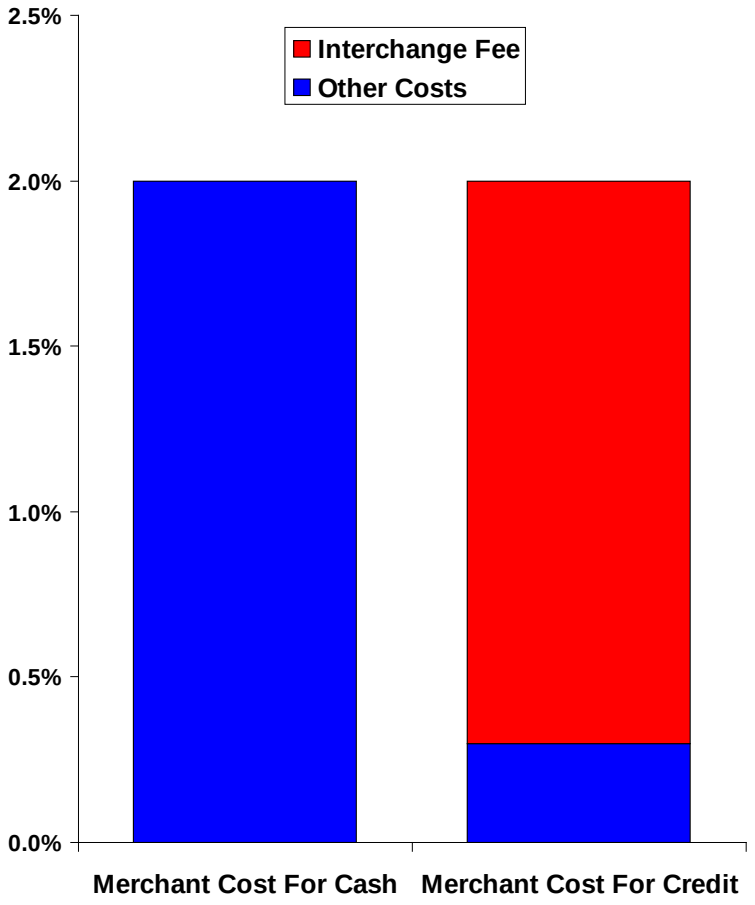
* An allusion to Steve Salop, *Deregulating Self-Regulated Shared ATM Networks*, 1 Economics of Innovation and New Technology 85 (1990).

Why is This Self-Regulator Regulating Interchange Fees?

- **Baxter's usage externality?**
- **Network externalities?**

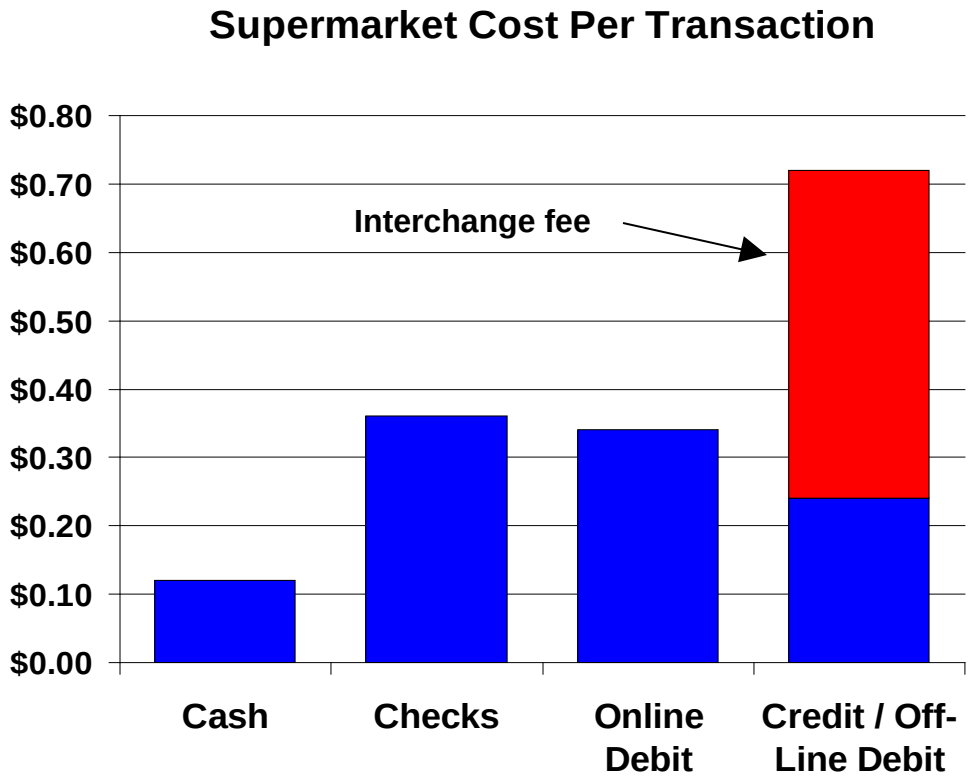
Usage Externality: Theory

- Consumer price signals do not reflect relative costs to merchant.
- "Optimal" interchange fee aligns consumer incentives with costs to merchant.



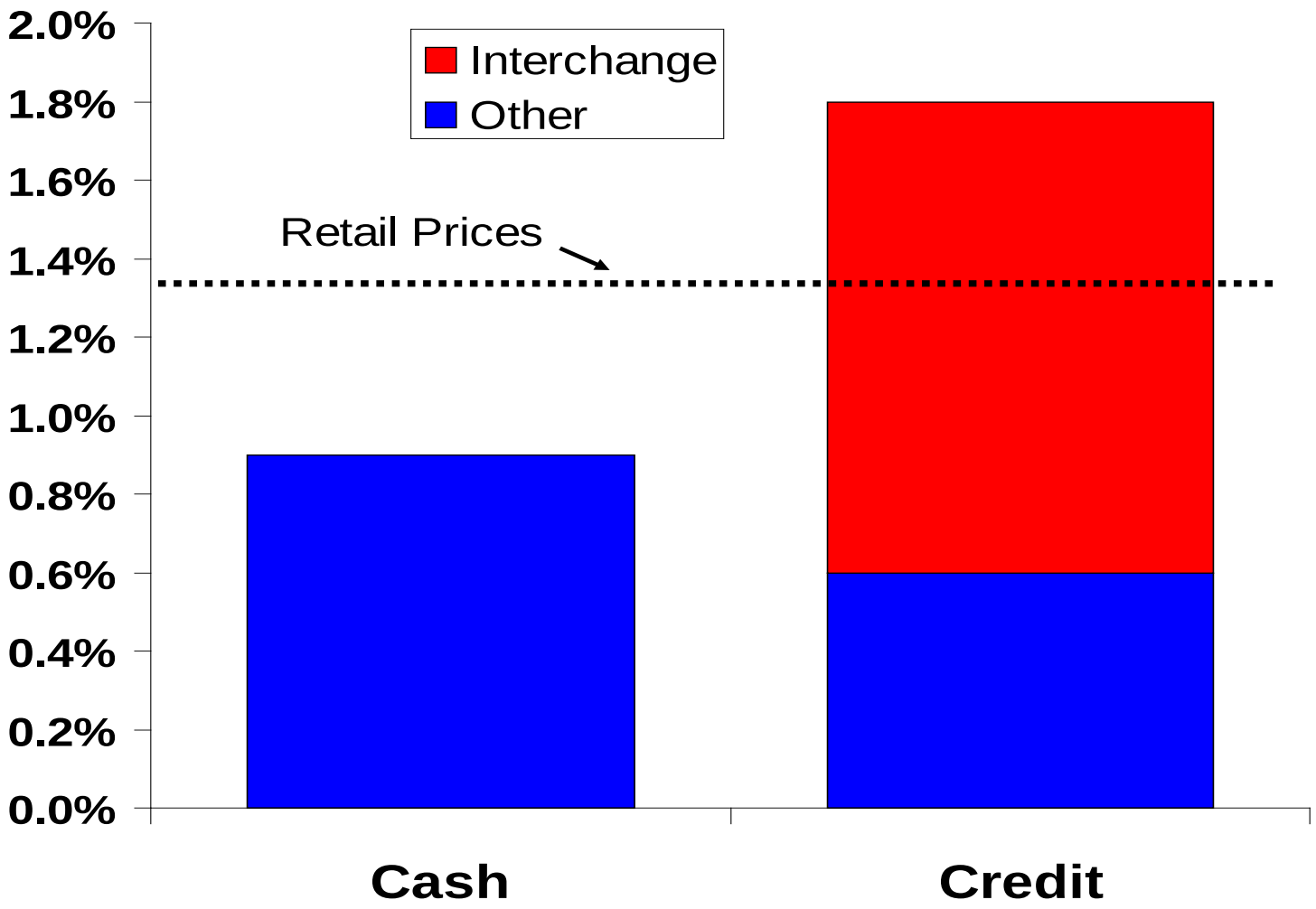
Usage Externality: Reality

- Interchange Fees: primary ***cause*** of usage externality.
- Credit cards cost more than other payments.
- We all bear resulting higher prices…
- but have no incentive to avoid costly cards.



Source: PriceWaterhouse Coopers (2001); www.cardweb.com.

Interchange Fees Increase Retail Prices



Network Externality: Theory

- "Chicken-egg" problem – entry is difficult.
- Problems with theory:
  - Don't usually permit price fixing to extract "value."
  - No effective competitive constraints on level of fees.
  - Merchants are in a "prisoner's dilemma."
    - Credit Cards cost merchants more.
    - Aggregate consumption does not increase.
    - A merchant's refusal to accept cards causes loss of customers to other merchants.

Network Externality: Reality

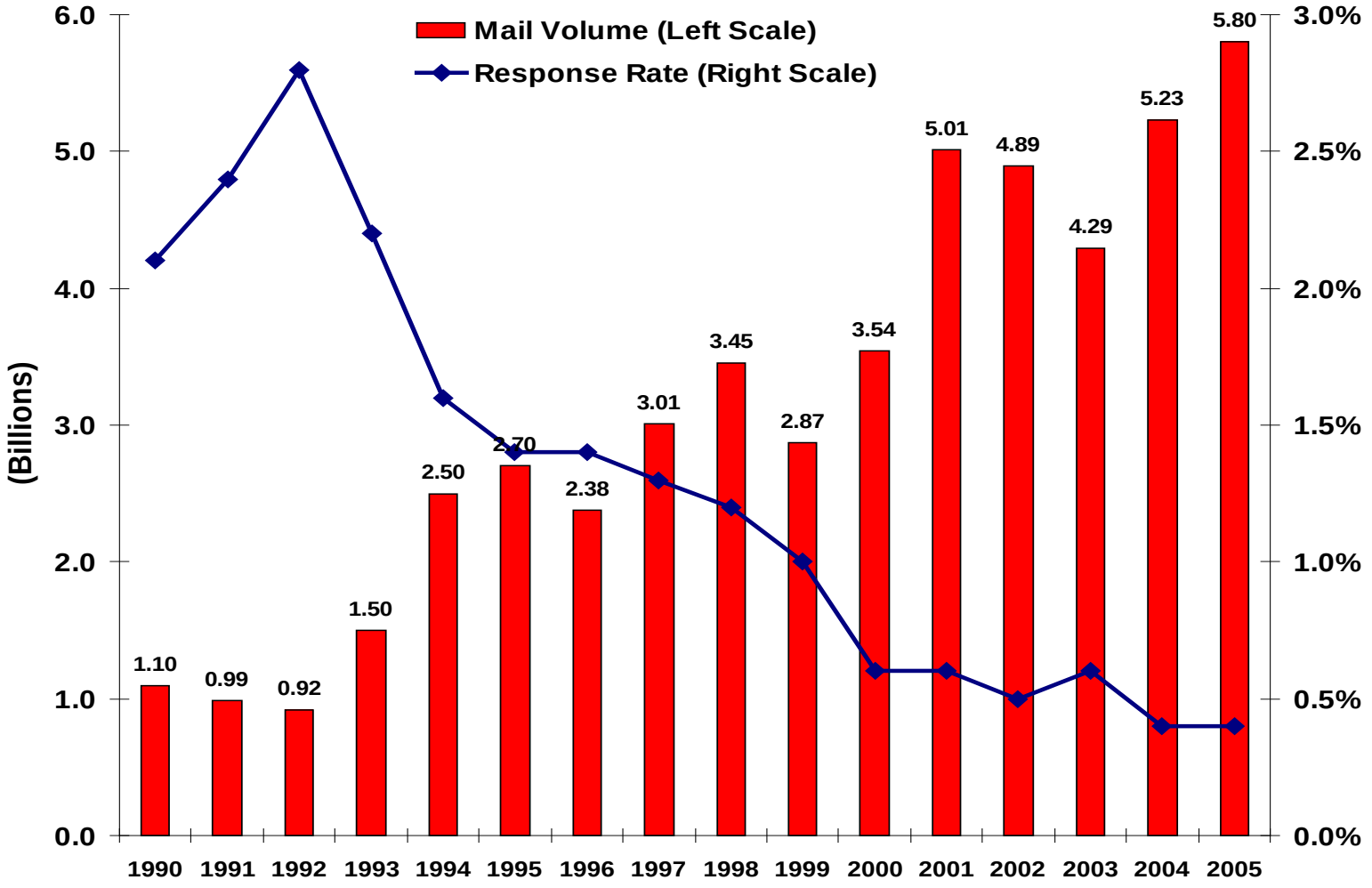
- Mature service.
  - Consumer acceptance not in doubt.
  - Most creditworthy households have cards.
  - Most merchants accept cards.
  - Entry costs incurred long ago.
  - Subsidy for mature service not sensible.

Collective Vertical Restrictions:

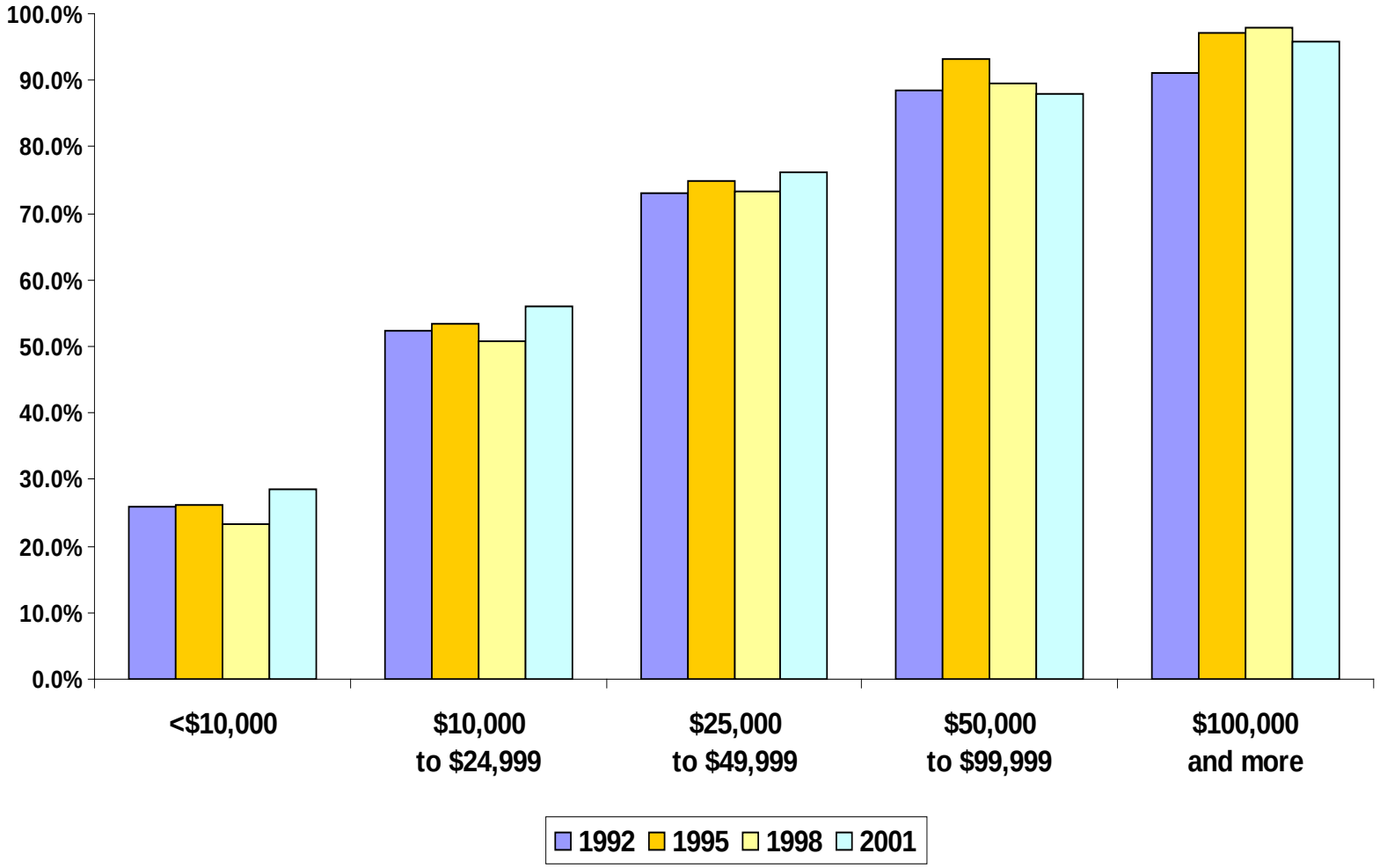
- "Honor all cards" rules
- "No surcharge" / "no discrimination" rules
- No bypass competition or "on-us" processing.
- No competing "bugs" on cards.
- Competitive features set (and priced) centrally.

➔ **Maintain & enhance market power**

Who Pays for Junk Mail & Rewards?



General Purpose Credit Card Penetration by Family Income



Par Collection

- Historical Examples:
  - The Fed got it right:
    - Interchange fees for checks resulted from monopoly.
    - Par has worked for decades in check settlement.
  - Until 1990s prevailed in PIN debit networks.
  - Par PIN debit most used payments in Canada.
- Par is not fixing a price; it is the absence of a mandatory payment between banks.

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