

## **Nonbanks in the Payments System: Innovation, Competition, and Risk**

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General Discussion

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Moderator: Kenneth Posner, Managing Director, Morgan Stanley

### **Mr. Posner:**

There are a number of interesting issues. I could launch you some questions, but I am more interested to hear from the audience at this point. Let's start with Eric Grover.

### **Mr. Eric Grover, Principal, Intrepid Ventures:**

Ken, you mentioned that Visa and MasterCard require their customers to have a bank charter. Isn't that a legacy of their bank ownership? Won't the management of independent banks in serving their shareholders have every interest to loosen or eliminate that requirement?

### **Mr. Posner:**

What a great question for me to duck and pass on to our panelists. By the way, just factually, I would believe that to be a legacy. As an independent company, I don't see why Visa or MasterCard couldn't change the requirements for membership.

Let me ask Mike: You said you had talked to Visa or MasterCard—what was their response to the idea of Wal-Mart joining as a member of Visa or MasterCard?

Then, Pam, I will ask you—you are a member of Visa or MasterCard—what would you tell them about that kind of idea, to the extent you have a view on it?

**Mr. Michael Cook, Vice President and Assistant Treasurer, Wal-Mart Stores, Inc.:**

In our case—I am not even going to get close to how they actually said it—there was a lot of hand wringing and “Yes, we’d like to do that, but we can’t.” Our operating rules don’t allow it. It wouldn’t be possible for us to do that under our current structure.

A very valid point, Eric. It may change, but I doubt it will in the next 10 years because it is a situation, in my view, where again collectively they wouldn’t be able to act to ....

**Mr. Posner:**

Pam, how about you?

**Ms. Pamela Joseph, Vice Chair, U.S. Bancorp:**

I would never venture to answer a question that has to do with Visa and MasterCard and their rules and regulations. But I would say this: There are financial requirements in terms of fraud and coverage of

receivables, as well as—even as a merchant acquirer—we have to constantly have a certain reserve that is required. So, there are a lot of rules around the financial well-being of the participants within the network. There are banks, frankly, that cannot be members or have been kicked out because they don't meet the financial requirements and don't have the required balances to run the business they are running.

In the case where somebody is an AAA-credit-rated industrial leader such as Wal-Mart, I am not sure that ...

**Mr. Posner:**

Hang on. You guys are AA+? So, are you really drawing the line at AAA?

**Ms. Joseph:**

No. That would be the easy way to draw the line, but I am not a member of either group. Again, it may come down to making sure they can meet the rest of the financial requirements.

**Mr. Posner:**

I'll throw in an additional observation. At least in 2006, the top four banks accounted for 33 percent of MasterCard's revenues. That is an interesting situation. It could unfold in two ways. Either

MasterCard might be terrified of anything that its top four banks might not like, or they might be interested in coming up with members that could provide large volumes and start to reduce their customer concentration.

**Mr. Gerard Hartsink, Chairman, European Payments Council:**

The professor gave a very interesting story. On page 26 of your **handout**, you talk about discount pricing, while the focus is on payments networks, but it is similarly true for trading, clearing, settlement platforms, or the SWIFT platform globally. The larger players always plea for the highest discounts they can get, but that is perceived as unfair by the smaller players. The smaller players also have a problem with the discounts because they perceive they pay too much. What is your view as to what the proper balance is from an economic, from a legal, and from a competition point of view? How should we resolve that in all the market infrastructures we have globally?

**Mr. Economides:**

I will try to give an answer. I actually believe that the ability of players to price-discriminate is generally a good thing. Under some circumstances, when they have a tremendous amount of market power and they are dominant, price discrimination could have bad effects.

The US Department of Justice and the European Union can go after them.

Excluding those cases in which there is a tremendous amount of market power by the network or the firm that offers these discounts, generally speaking, offering discounts is a good thing. Particularly in that slide on page 26, it is clear why because you can attract—through a large discount—clients who have a lot of business and can sell a lot of cards for you, if you want to put it that way, and therefore get other benefits as a credit card network. You can to some extent internalize this so-called externality by offering this discount.

Generally speaking, these discounts are a normal part of business, and they should be available. Of course, if you are small, you are going to have to pay more, but I don't think that should be considered something obviously bad. There are efficiency reasons to provide these discounts. Unless we are talking about some level of discounts that are extreme and some dominance that is also extreme, otherwise discounts are a good thing.

**Mr. Posner:**

Now, there are no policymakers on the panel. If there is anybody else in the audience who has a view on this question of price discrimination, I will solicit your comment.

In the meantime, Mike, we believe, based on industry sources, that American Express has a deal with Costco, where Costco has a discount rate that is under 1 percent, compared with American Express' 250-basis-point average discount rate. I don't know if you want to comment at all on whether you feel you are able to successfully negotiate the kind of discount that a retailer of your size should be able to get from the payments associations, or whether you are frustrated with attempts to negotiate with them.

**Mr. Cook:**

I would have to say we are not satisfied with—for example, again I go back to and I am not meaning to repeat this—but can you imagine if we were able to, with Home Depot, Target, the five largest retail institutions, collectively set a rate of what we are willing to accept at. If on one hand you can collectively establish a rate of what you will charge and then on the other hand you cannot collectively establish a rate of what you are going to accept at, then you do not have a level playing field. If we were able to do that, our rate would be significantly different than what it is today.

Our estimate in the Costco situation is that it is approximately 1 percent, slightly under that, and the way the deal may be structured is that one institution cannot expand acceptance to another wholesale club, if you will, without having opened up where that wholesale club,

Costco, would then be able to open acceptance to other marks as well. So, you have the chicken and the egg: Does Costco act first and start acceptance of MasterCard and Visa? Or does American Express push for acceptance at Sam's?

**Mr. Ross Anderson, Professor, Cambridge University:**

I don't know how this is in the States, but in the UK, the problem appears to have been ameliorated recently in that retailers are now allowed to add on charges corresponding to what the card brands charge them.

When I bought my ticket to come here, it will be X plus 1 percent, if I paid MasterCard debit; X plus 2 percent if I paid Visa credit; and so on. I believe, although I am not an expert on this, this was simply seen as a competition policy issue in the UK. If the brands told the merchants, "You may not charge anything extra for accepting our plastic," that was anticompetitive. If you could do something like this worldwide, would that not fix the problem?

**Mr. Posner:**

Do you have any data on what the effect of that changed? You are saying that change was recent?

**Mr. Anderson:**

I think about two years ago. I speak only as a consumer and as a user of bank cards, not as anyone with any inside knowledge on this. It has been noticeable, and it seems to have had a good effect.

**Mr. Posner:**

Well, surcharging does exist in other parts of the world—for example, Australia. Let's first start with the professor. What would be your prediction of the effect of surcharging on the market power—if there is market power—of a payments system?

**Mr. Economides:**

Surcharging or discounts—they can go both ways, right?—will increase the firm-specific elasticity of demand. For those of you who are not economists, what does this mean? It means there will be more sensitivity by the consumers to using one card versus the other. That is likely to increase competition among the various card networks. Generally speaking, it would be a good thing, or at least that is the expectation.

**Mr. Posner:**

Mike, do you surcharge? Are you allowed to? I think the answer is no in the United States, right?



**Mr. Cook:**

That would be correct. You know, the interesting thing about that—and we would like the right to do exactly what you are suggesting—we may or may not implement it. You could imagine the negotiation would come closer to being a level playing field if we had that right to say, “I am going to surcharge this brand, but not this brand, or pass this cost along to the consumer.”

Why shouldn't a consumer who reaps the benefit of frequent flier miles be the consumer who pays for those frequent flier miles, instead of those going on the back of the consumer who could least afford it and paying for it in higher goods because they are living paycheck to paycheck?

One thing you may find interesting is how government entities are allowed to surcharge. The IRS can surcharge. Universities can surcharge. But retailers can't.

**Ms. Joseph:**

Nobody says you cannot discount cash. Your prices could be lower for people who pay with cash. That is perfectly acceptable.

**Mr. Cook:**

You are absolutely right, but that is one veil to hide behind in our view because, if you can imagine with the 140,000 SKUs in our stores,

we would have to dual-price everything. Can you imagine the difficulty getting the price right the first time without having to double-price everything in your store? It is not feasible to double-price every item in your store.

**Ms. Joseph:**

Again, I would think you would do a flat discount. As we all know, they don't control cash.

**Mr. Cook:**

Under the operating rules, you have to dual-price everything.

**Mr. Economides:**

But the issue is not really cash; the issue is between different credit cards to be able to discount across credit cards.

**Ms. Joseph:**

Let's face it, in the petroleum industry years ago if you paid cash, it was 4 cents a gallon cheaper, or whatever it used to be.

**Mr. Cook:**

How many SKUs do they have?

**Mr. Economides:**

But again, the competition policy issue is not with cash. If you want to increase competition among the credit cards, then the issue is, Would you allow surcharges or discounts for different credit card brands?

**Mr. Posner:**

Let me pause just for a second. It is just a fact that this question of surcharging rules and how it is done is part of the punitive litigation that is going on in the United States, so it is therefore, by definition, a controversial issue.

Was there a following point? Yes, sir.

**Mr. Philip Klopper, Executive Director, De Nederlandsche Bank:**

In the Netherlands, surcharging has been possible for a long time, but credit cards have not been widely used. Recently, there has been an increase of the use of credit cards by consumers. Shopkeepers are complaining loudly. The funny thing is we tell them, "You can surcharge."

But they don't. When you ask them why they don't, you don't get a clear answer. As the central bank, we agree it would add greatly to the efficiency of the payments system if the consumer would pay the appropriate price for the payment instrument he chooses.

I understand in the United States, government agencies can surcharge. Do they surcharge? Well, good for them!

**Mr. Posner:**

Go ahead, Pam. The next speaker will be the gentleman from Australia. Is that right? Because I think we will have some more data. Pam, go ahead first with your comment.

**Ms. Joseph:**

I have just one clarification because there are convenience fees. What that means is, again, if you are taking payments through the Internet or through a source where every single payment has a surcharge on it, so if you take a check or if you take debit or credit, they are all charged equally, then you can have what you call a convenience fee or what you may call a surcharge. It is primarily used, to my knowledge, across the board, across all payment types they accept, and again, because it is primarily for transactions that are not done in a face-to-face environment—i.e., over the Internet or over telephone or through the mail. If you think about Ticketmaster, from day one, they have always had a surcharge on their tickets, but they charge it whether you pay with check or even cash. Then that is acceptable.

**Mr. Posner:**

So, I'll throw in one observation on it, and then we will go to the gentleman from Australia.

I believe it was Michael Brown—an economist from Berkeley or somewhere in California—at this conference two years ago who said the interesting thing about surcharges is they can be a little bit like speeding tickets. You may not see a lot of them, but they may give merchants a little bit more edge or effectiveness in negotiating. That is one possible theoretical explanation for your observation.

Yes, sir.

**Mr. Philip Lowe, Assistant Governor, Reserve Bank of Australia:**

We forced the schemes to remove their no-surcharge rules in 2003, and we also forced them to get rid of their honor-all-cards rule so that, if you accept the scheme credit card, you don't have to accept the scheme debit card.

One thing we have seen recently is when the schemes have been setting there ready to change fees on the scheme debit, getting rid of these rules has been quite important because some of the large retailers have said to the schemes, "If you don't set a low interchange fee, we won't accept your debit card and/or we will impose a surcharge." In response, the schemes have set lower interchange fees for scheme debit.

The other observation I will make is that when we first got rid of this rule, there was hardly any surcharging. We had 30 years where it was illegal and neither consumers nor merchants were used to surcharges. We do a survey each quarter and, since we have gotten rid of this rule, every quarter the percentage of merchants surcharging has risen, and it continues to rise. Now around 15 percent of merchants, by number, levy surcharges for credit cards. More than 50 percent of merchants say they are considering doing it. The culture can change. It takes a while. It can change, and it is changing in Australia.

**Ms. Margaret Weichert, Senior Vice President and Strategy, Innovation and Payments Executive, Bank of America:**

I had just one other observation on surcharging in the United States. Some PIN debit networks, in fact, do allow surcharging. Taco Bell is a client of ours that, if you go to the Charlotte airport, they surcharge at Taco Bell. When we talked to Taco Bell about what behavior it is driving, guess what behavior it is driving? Cash. I throw that out there as an observation.

**Mr. Cook:**

I would like to jump in on the two points on that. I apologize; if someone knows the exact facts, I would appreciate them. In the example that I gave with the government entities, I believe the IRS did

not charge the same amount for all types. If you allowed it to be debited out of your DDA account, there was no charge. If you use Discover the first year they started allowing this, there was no charge. It was only whenever MasterCard, American Express, and Visa were implemented that you had a surcharge being surcharged on those products only.

Regarding the comment the lady from the Bank of America made regarding surcharging: I am not aware of which PIN debit network allows surcharging. However, Pulse allows surcharging at this point in time. So, if we started surcharging for Pulse, what we believe would happen, if you go back to this chart that I showed earlier, is you would have an even faster migration away from Pulse and the lower priced PIN debit networks to Visa, which does not allow surcharging on their PIN debit network.

So, it does us no good to implement surcharging on a product that is already cheaper than the other ones in the market.

**Mr. Posner:**

Let's put a pause on surcharging for a second because we have about nine minutes left. We can spend the rest of the nine minutes on surcharging, or are there other topics people want to ask about?

**Mr. Peter Burns, Vice President, Federal Reserve Bank of Philadelphia:**

I wanted to get back to this structural discussion of vertical integration. I noticed when Pam was talking about some of the things you are doing in the medical area—and I forget exactly what the term was, but I think was like an authentication of medical records and so forth—these are nonfinancial transactions, right, in the sense that all you are doing is verifying the person is properly insured or has funds in his or her HSA?

It is my understanding, and I say this as Michael was doing with caveats that I do not pretend to understand all of this, but in a bank-owned card scheme, the interest of the banks is to settle financial transactions. I think that would be the primary interest from the payments side, and perhaps there is some financing associated with it. So, there is probably not a lot of interest in a bank-owned network to facilitate those kinds of nonfinancial authentication transactions. Having said that, MasterCard, Visa, or whoever have wonderful networks and would certainly have the technical capability to provide all kinds of similar-type nonfinancial authentication transaction processing sorts of things.

Ken says we are not going to see any change in the Visa and MasterCard business model as a result of the privatization. Eric thinks a little bit differently. I am in between, but I am wondering whether there wouldn't be, in a private type of an environment, more of an incentive for these networks to move into other ways to leverage their



technology platforms in similar situations like yours. I presume you are doing this all internally, right?

**Ms. Joseph:**

At this time. But I agree with you. When you have an infrastructure like Visa and MasterCard that is a railroad that touches worldwide almost every endpoint and as many consumers as they do, you have a huge railroad. You look at it from the outside looking in and think, “Wow, there are a lot of things you could do with that!”

I do not believe—they are clearly in this space—they are moving forward in this space. Because we are relatively small and regional, we can do things like this and get them a little bit quicker and get them out into the marketplace. I assume they will be there. We have seen American Express go into this space with a vengeance. Again, we will see more and more of this as time goes on.

**Mr. Posner:**

Yes, sir.

**Mr. Jamie McAndrews, Vice President, Federal Reserve Bank of New York:**

This is a question for Trey and Pamela. The history of your companies is very interesting because Synovus spun off TSYS, whereas U.S. Bank is still within the bank. You explained some of the

advantages and disadvantages of that, but I would like to explore that a little bit more.

It seems the difference is that U.S. Bank has the merchant relationships that TSYS does not and that it is a card issuer itself. What other advantages and disadvantages do you see in the different approaches your companies have taken? Pamela, you said your company was like a nonbank within a bank.

**Ms. Joseph:**

Specifically, for our bank, we are 25 percent of the revenue at the bank. We grow in double digits year after year, so it is a very important segment for the bank and a very high-growth area. They have done a lot of investing. We have done a lot of acquisitions. A lot of our space in the payments space is directed towards our corporate customers of the bank. We do quite a bit in procurement. We have a supplier-buyer ASP model that we run on behalf of our large corporate customers.

Now that we have gone global, for a regional bank that is in 24 states to be in 18 countries—just in the payments space—is rather unique and unusual. Again, the bank sees the true value. I will say this and then I will hand it over to Trey: I have been in the payments space since 1981. You continue to see cycles where banks get in, they get out, then they think they should get back in, and I am just waiting

five years because I think the banks will get back out again. I know Trey is waiting as well because it is a never-ending cycle we see.

One thing I will say about U.S. Bank, they have been in for a long time. I do not see them getting out.

**Mr. Trey Jinks, Senior Director, Corporate Strategy and Planning, TSYS:**

From the TSYS perspective, and these comments are purely mine, not TSYS or Synovus', because from my perspective at least there is a lot of structural change going on now—Visa, MasterCard, KKR/FDC, things going on in Europe, Asia, Metavante. So, the nearest comparable that TSYS really had in the structural relationship with Synovus was Metavante. Now that is going public. Probably the difference between Synovus/TSYS and the U.S. Bank example is we are a subsidiary of Synovus. We are a third of the net income of Synovus at the 81 percent level, so it is not integrated at all, in as far as Synovus and the banking franchise goes. Synovus is primarily a commercial lending bank. They have never been a real issuer or real acquirer. It was another add-on to the banking relationship. So, it is just a different philosophy that has emerged over time from the Synovus perspective. I am in total agreement. We will know a lot more about how this shakes out in less than 10 years, as far as the industry structures go. It is just a philosophical and oversight difference from my perspective.

**Ms. Joseph:**

Ken, from your perspective, you might want to touch on the whole PE evaluation. We are a payments company that has 12 PE because we are sitting inside of a bank. On any given day, if they were to spin us off—when you look at where a payments company trades from a PE perspective—there would be quite a bit of value to the shareholders. At this point, they are still far more valuable to the bank as a whole.

**Mr. Posner:**

I suppose I would have to explain why MasterCard is at 30 or something today? I don't know. Here is our last question.

**Mr. Scott Schuh, Senior Economist and Policy Advisor, Federal Reserve Bank of Boston:**

I have a question for Nicholas. I know this is a hard question, but could you give us your assessment of the existing structure of networks in the United States in terms of prices, market structure, and efficiency—the size, the number, the structure of the networks? Are we about close to what is efficient and optimal? Payment networks, including ACH.

**Mr. Economides:**

I would not be able to give you a full answer on this. That would require some additional study. Let me put it that way. I cannot really answer this on the spot. Sorry.

**Mr. Posner:**

Please thank our panelists for an excellent time.