WHITHER INTERCHANGE?

Interchange….It's the engine that drives the payment card system – and it's in trouble.

Around the world, regulators are clamping down on what they see as "predatory" issuer practices. Chief among them? Interchange.

Driven by noisy protests from well-organised and lavishly-funded retail groups (there's a surprise) and from show-boating politicians (there's another), the Government bodies responsible for overseeing payments systems are relishing the task of driving down these fees.

Are they wrong? In truth, it's not always easy to justify the level of interchange, or the ever-more complicated superstructure of discounts and incentives which sits on top of it[1].

Consider the picture in Europe: in a recent report[2], the ECB took two and a half closely printed pages just to summarise the principal tariffs across the region. Certainly, it's a complex business and for sure, financial dynamics and operational overheads vary from market to market. But we shouldn't be surprised that the authorities, under pressure to cut voters' cost of living and smite the banks (choose which order of preference you like best), find that taking an axe to interchange is a popular cause with merchants and customers alike.

The question is, what happens once the axe has swung, and interchange has been cut?

The pragmatists among us will be unsurprised to find that the ballyhooed benefits haven't always been delivered. One of the earliest regulators to tackle interchange, as far back as 2006, was the Reserve Bank of Australia. Philip Lowe, then Assistant Governor of the RBA, enjoyed describing what he saw as the various iniquities of the interchange environment, and set out in glowing terms the benefits that consumers and retailers would enjoy from a "more rational" regime. His comments are worth quoting in full: "The (RBA-led) decline in interchange fees has also reduced merchants' costs, and we have no doubt that this is flowing through into lower prices of goods and services than would otherwise have been the case. Lower interchange fees have also seen a re-orientation of competition in the credit card market. With less interchange revenue available, issuers are now competing for cardholders by lowering interest rates, rather than through reward points."

[1] In the US in 2009, Visa operated as many as 60 interchange rate categories, MasterCard an astonishing 243 (GAO-10-45 2009, p.15)

[2] Interchange Fees in Card Payments, European Central Bank, September 2011

He was right about two things: first, merchants' costs were cut – although the countervailing costs of cash handling rose. However, there is absolutely no evidence that customers were better off in the ways the RBA predicted. In fact, consumers were arguably worse off as Mr Rose was right about a second thing: rewards programmes (benefitting all card customers) were cancelled or made less rich. It was a lot less clear that APRs (benefitting only borrowers) fell in the way the RBA had forecast. What was very clear was that many issuers increased annual fees. Predictably enough, merchants quietly pocketed any savings.

THE US General Accounting Office on the Australian experience

"RBA…officials acknowledged that it would be very difficult to provide conclusive evidence of the extent to which these savings have resulted in lower retail prices because so many factors affect such prices at any one time.

In Australia, issuers reduced rewards and raised annual fees following that country's interchange fee cap."

http://www.gao.gov/new.items/d1045.pdf Nov 2009

Mr Rose and the RBA were noticeably less vocal about the "benefits" of their actions after their bold experiment than before.

The Dodd-Frank law in the US demonstrates the same powerful principle in action.

Launched to a great fanfare, it promised to help hard-pressed consumers and merchants alike by slashing debit card interchange from an average 44 cents per transaction to around 21 cents. At which point, the Law of Unintended Consequences swung into vigorous play.

The result? Small merchants report that debit card fees have risen from around 3.5% of sales before the legislation to 4.5% afterwards. Vending machine operators are hit still harder: their costs have risen from around six or seven cents a transaction to the 21 cents mandated by the law[3].

Rather like the RBA, Senator Durbin, who was so closely associated with the Act that it is widely known as "The Durbin Amendment", has declined to comment on its results. The big-box retailers have also fallen strangely silent. Do we see a pattern here?

But, given a choice, quite a lot of politicians prefer to bluster rather learn from others' experience. It's rational therefore, in those markets where interchange is under review, to assume that it will be cut. How best to respond?

The worst way, surely, would be to try to maintain revenues by introducing fees: politicians may be reluctant to learn from experience, but surely bankers will look around them for guidance. In particular, you'd hope that they would want to avoid the PR storm that blew up

[3] Wall Street Journal, 8 December 2011

around the catastrophic attempts by Bank of America and others to charge for previously free services.

A much better way to start the debate would be to do what banks haven't done nearly well enough: explain just how truly impressive the payments system is. A structure which allows me to walk into a store in Brazil, and pay for my purchase with a piece of plastic issued by a bank which the till operator has never heard of, and for that transaction to pass flawlessly to my account in the UK is truly astonishing. And that's cards at their most basic: add ATM access, contactless, Internet utility and the other capabilities that in the industry we are perhaps too familiar with, and we get a better measure of what customers benefit from – often at no charge.

A campaign along these lines would at least ensure that decision-makers understood the value of the system.

Next, banks should ….But that will have to wait till next month. Until then, please enjoy a Happy Christmas and a splendid 2012.

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