How Card Regulation is Killing Competition

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If you think there isn't enough competition in the payments industry, just wait a few years - there will be a lot less in the U.S. and European Union. Before I explain why let's take a survey of the state of competition. No, the payments card industry is not a perfectly competitive industry that would warm the cockles of your micro-econ college professor's heart. But then, what is?

In the U.S. we have Visa, MasterCard, American Express, and Discover, not to mention PayPal, several PIN debit networks, and a lot of startups, all slugging it out. In the EU the state of competition varies by country, but Visa, MasterCard, American Express and often some domestic systems are competing. Visa (either International or its European doppelganger) is the big dog in a lot of places. But Visa has a lot more competition than the leading player does in a lot of industries. And considering that payment card schemes have enormous network effects and scale economies, if anything, there's a surprising amount of competition.

There's been a lot of talk about even more competition, and challenges to the established players, in the U.S. and EU.

The Europeans have never been very happy that Visa and MasterCard - both perceived as U.S. companies (yes, this is odd given that Visa Europe is owned by European banks, but there you have it) - are the leading pan-European players. Then they got very worried when the efforts to create the Single European Payment Area (SEPA) picked up some steam. The Brussels-based Eurocrats and politicians fretted that Visa and MasterCard would wipe out the many domestic schemes. As a result there was a big push to create a homegrown pan-European system. The Monnet project, for example, consisted of a group of European banks that were considering giving Visa and MasterCard a run for their money.

In the U.S., the PIN debit networks consolidated and there was talk that they would compete with MasterCard and Visa. The telecoms started Isis, which was originally going in with a low-fee model. There have also been a slew of startups, from the long-gone Revolution Money to the on-a-hot-streak LevelUp, which have gone after the establishment with interchange-fee-buster models.

Sounds great: pretty competitive, and getting even more so! But leave it to the government to mess up an industry. Consider what's happening in Europe. The European groups that were considering challenging MasterCard and Visa have all bit the dust. They needed revenue to enter. But with the European Commission insisting that it was going to stomp down interchange fees - possibly even to zero - they have abandoned those efforts. Meanwhile, the domestic schemes are facing a world of hurt because they are likely to lose the ability to compete with MasterCard and Visa by offering higher interchange fees. In perhaps the weirdest development of all, the European Commission has proposed legislation that will prohibit merchant surcharges for MasterCard and Visa but allow them - 'encourage' is probably a better word - for the three-party systems such as American Express and Diners Club. Yup - stigmatize the underdogs.

Jetting back over the Atlantic, consider what's happening in the U.S. For many years there was a nice competition going on between the unaffiliated PIN networks and MasterCard and Visa. The PIN guys offered low interchange fees and MasterCard and Visa, well, didn't. The Fed, in one bold stroke of the pen, eliminated the fee differential between the PIN and signature networks. Advantage, Visa and MasterCard! Meanwhile, the Justice Department is trying to make it easier for merchants to surcharge American Express cards. While the experience in other countries suggests that few merchants will do that (although some of those who do may try to trick consumers into paying higher fees—that's been the experience in Australia and the UK) it seems nutty to be going after the distant number three network.

It gets much worse of course in the U.S. as a result of Judge Leon's decision last week. If it sticks - it is uncertain as I write whether the Justice Department will appeal, and, if it does, whether a higher court will reverse the decision - then the Fed will have to lower interchange fees to 12 cents per transaction and perhaps much lower.

Judge Leon may have thrown a lifeline to the unaffiliated PIN debit networks by insisting that merchants get multiple signature and PIN alternatives on each debit card. But the old logic for the PIN networks is they offered much lower prices to merchants. The original Durbin rules eliminated this differential. If the Judge's decision sticks, merchants will get to beat debit card switch fees down since they will get to play off multiple alternatives. I wouldn't rule them out but the unaffiliated PIN networks face a lot of challenges if they want to be more than commodity switches.

With debit card transactions costing merchants close to nothing, many startups have just seen their business models blown up. They will have a bear of a time getting merchants to bother to accept them. I know for some "profits" is a dirty word but the reality is that without a significant profit pool to attract innovators and their funders, there isn't going to be much innovation.

The U.S. and EU regulations will therefore squeeze competition out of the market for payment cards. Visa and MasterCard will be left standing and there won't be much nipping at their heels. So shouldn't these two schemes be high-fiving over regulators enabling them to live the quiet life?

Unfortunately, I don't think there's a happy end to the story, really, for anyone. Merchants will continue to see Visa and MasterCard as having too much control over them and regulators will dislike one or two private companies operating the payment systems everywhere. It won't take many years for these payment card schemes to be tied up in knots with regulations.

In fact, the problem with price caps is that they are like the little Dutch boy with his fingers in the dike. There are so many ways around price caps that regulators need to keep adding more regulation to prevent companies from figuring ways around them. Just wait until the Fed's wise-up that digital wallet providers could start paying fees to banks for steering transactions to their cards.

The irony is that the stampede towards regulation is happening during a period of creative destruction in which innovation could dislodge the long-time incumbents.