Interchange fees and the quality of service obtained by consumers and merchants

Marianne Verdier, Economix
University Paris Ouest Nanterre
Introduction

• General idea of this presentation: challenge the common view that the main impact of IF on consumers and merchants is a price impact

• IF are interbank transfers which impact:
  ◦ 1) The quality of service perceived by consumers and merchants
  ◦ 2) The costs of accepting payment instruments.
Common view: Interchange fees impact prices

Payment system

Issuing bank

Interchange

Acquiring bank

Lower price?

Consumers

Higher price?

Merchants

Retail price?
Broader view: potential IF impact on consumers

<table>
<thead>
<tr>
<th>Price and fees</th>
<th>Quality of service</th>
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</thead>
<tbody>
<tr>
<td>• Price of current accounts</td>
<td>• Security and protection against fraud</td>
</tr>
<tr>
<td>• Price of payment transactions</td>
<td>• Convenience (speed, acceptance, recordkeeping)</td>
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<tr>
<td>• Other fees?</td>
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<table>
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<tr>
<th>Other costs of using payment instruments</th>
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<td>• Costs of fraud losses</td>
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Broader view: potential IF impact on merchants

**Price**
- Merchant service fee including IF
- Other fees for acceptance and equipment
- Chargebacks

**Quality of service**
- Security
- Speed of processing/ network reliance
- Payment guarantee
- Customer satisfaction

**Costs of accepting payment instruments**
- Costs of fraud losses
- Costs of investments
- Cost of accepting cash
- Cost of access to funds (float)
A challenge of the common view: Interchange fees impact prices

Two main questions:

1) How are Interchange Fees passed through to consumers and merchants?

2) How do changes in IF revenues impact banks’ investment incentives?
IF and investment incentives

- Investment incentives
- Quality of service
- Price pass through

Coordination between issuing banks and acquirers on investments

Competition on banking retail markets
### IF and Quality of Service (Verdier (2010)):

<table>
<thead>
<tr>
<th></th>
<th>If the issuers invest more… + high merchant benefit of quality</th>
<th>If the acquirers invest more… + high consumer benefit of quality</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit maximising IF compared to IF without investment</strong></td>
<td>Higher</td>
<td>Lower</td>
</tr>
<tr>
<td><strong>Examples</strong></td>
<td><strong>Payment guarantee</strong></td>
<td><strong>EMV standard UK</strong></td>
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</table>

- If the issuers invest more, there is a high merchant benefit of quality.
- If the acquirers invest more, there is a high consumer benefit of quality.

Examples of profit maximising include:
- Payment guarantee
- EMV standard UK
IF and the Costs of Accepting/Using Payment Instruments

Interchange fees

Tranaction volume

Liability regimes

Allocation of fraud losses

Merchant investment

Platform investment

Bank investment

Fraud losses
IF and the Costs of Accepting Payment Instruments

- The concern that IF impact the costs of fraud is present in the document issued by the Federal Reserve Board in the US.

- Creti and Verdier (2011) show that banks may react by increasing the level of liability borne by merchants if the regulator chooses a low level of IF.
  - Higher share of fraud losses for merchants
  - Lower investment incentives for the platform?
Conclusion

• IF may impact the quality of service obtained by consumers and merchants
• The quality of service obtained by consumers and merchants depend on banks’ investments

• Investments are particularly important
  ◦ To fight fraud in payment card payment systems
  ◦ To develop innovations (cf other presentations)
References

• Verdier (2010), *International Journal of Industrial Organization*:
  ◦ ‘Interchange Fees and Incentives to Invest in Quality of a Payment Card System’

• Creti and Verdier (2011), Working Paper:
  ◦ ‘Fraud, Liability Regimes and Investments in Payment Platforms’

• Verdier (2011), *Journal of Economic Surveys*:
  ◦ ‘Interchange Fees in Payment Card Systems: a Survey of the Literature’