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The Way We Should Pay: Comments on "The Way We Pay: Transforming the Canadian Payments System"

By

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THE WAY WE SHOULD PAY

COMMENTS ON "THE WAY WE PAY:TRANSFORMING THE CANADIAN PAYMENTS SYSTEM"

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EXECUTIVE SUMMARY

As outlined in the Task Force for the Payment System Review report, Canada's payments system is falling behind. For instance, the thirty-year-old Interac system has facilitated widespread adoption of debit cards in Canada, but it is proving increasingly antiquated to the needs of a modern global economy. This paper explores the current state of the payment system in Canada within a global context and discusses the strong economic principles that should guide the work of the Task Force. Building on a robust framework of innovation and competition, it aims to positively orient the Task Force's future decisions, while continually reaffirming the negative impact that can result from misaligned institutional incentives.

SUMMARY OF RECOMMENDATIONS

Our paper includes a number of specific suggestions and guidelines for the Task Force's final recommendations. Most important among these we recommend that:

1. The Task Force focus on removing existing regulatory and governance structures that may be impeding innovation and competition before considering adopting new ones.
2. The Task Force recognize first and foremost these impediments in the debit card market, and more specifically limitations on co-badge cards, uneven rules and standards, and operating constraints related to the Consent Order that effectively precludes meaningful competition on a level playing field.
3. The Task Force carefully define and limit what it means by "fairness" lest it be used to undermine, rather than bolster, the evolution of dynamic, competitive, innovative and efficient payment networks in Canada.
4. Any regulations or governance changes follow only from the identification of a significant market failure as well as a demonstration that the proposed regulation or governance mechanism can address that market failure without imposing greater costs in its stead.
5. The Task Force stress that any interventions should be minimal, clearly defined and limited, and ensure that all its recommendations not impose specific market structures, allocations of cost, decision-making processes or other organizational constraints on complex and evolving payment networks, but rather allow network operators and the markets in which they operate to determine these.

INTRODUCTION

The Task Force for the Payments System Review (the "Task Force") report, *The Way We Pay*: Transforming the Canadian Payments System, says that "Canada is falling behind" in the adoption and innovation of electronic payment systems and that its payment system "has proven resistant to change." In many important respects we agree with this claim. This brief submission is intended to highlight, however, our strong sense that, even if it has properly identified the symptoms, *The Way We Pay* may have misdiagnosed the disease, and may be headed on a dangerously wrong path toward a cure.

While Canada's thirty-year-old Interac system has facilitated widespread adoption of debit cards in Canada, it is proving increasingly antiquated, ill-suited to the needs of a modern global economy, and inefficient in meeting the changing needs of consumers, businesses, and the wider economy. Under the operating framework imposed on it, Interac was able to meet the low-tech needs of the past, but that framework is ill-suited to provide the foundation for transactions in an economy increasingly based on borderless e-commerce and flexible payments. Moreover, Canada's governance framework has proven ineffective in supporting the kind of innovation required for Canadians to enjoy the full range of available electronic payments options.

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It is imperative that the designers of any new governance framework for Canadian payments recognize and facilitate the powerful forces of competition and innovation in the market. Likewise, they should seek to limit the negative impact on dynamism and innovation that can result from excessive "political rent-seeking" (the costly process by which interested parties manipulate the political and regulatory apparatus to transfer wealth to themselves at the expense of broader social welfare) and the necessarily limited knowledge of governmental regulators that makes top-down design a perilous task.

It is well established that, in general, markets and related voluntary interactions organize economic affairs more efficiently, and foster greater innovation, than does politics. While economic markets can and do fail, political markets can and do fail with regularity as well (and political failures are often more difficult to correct), and the likelihood and costs of governmental failure are especially high in markets as complex and dynamic as payment markets today.

From this flows a bedrock principle of sound regulation: a regulation is justified only if (a) there is a substantial market failure and (b) the market failure it is intended to address is worse than any government failure that is likely to result from the regulation.

The extraordinary successes of modern global payments systems have been hard-won. The evolution to efficient electronic payments has proceeded by fits and starts through trial and error in a process that began, in truth, more than 2000 years ago. At no point along that path was it clear what development was next nor whether (or how) any intervention could enhance the process, making any particular intervention dangerous. The same remains true today, and it is our opinion that the primary focus of the Task Force should be to set the basic ground rules under which market forces can flourish and to clear away the regulatory obstacles that may have impeded the basic process of market evolution through competition and choice, on a level playing field, in the Canadian payments system.

Rather than adding new regulatory burdens… the Task Force should focus first on eliminating barriers to competition and innovation.

This Comment addresses four key issues for the Task Force to consider in achieving these goals: efficiency, fairness, innovation, and governance. To date there have been no significant market failures that would support corresponding regulatory interference in the payments cards market. Rather than adding new regulatory burdens that would further hamper competition and innovation in the Canadian payments sphere and promote wasteful politicking, the Task Force should focus first on eliminating barriers to competition and innovation.

THE STATE OF THE CANADIAN PAYMENTS SYSTEMS

Although *The Way We Pay* is ostensibly concerned with all types of payment systems, there are particular concerns associated with debit cards and electronic invoicing and payment.

With respect to debit, although Interac has had some successes—Canadians are among the heaviest users of debit cards in the world—the model under which it operates is showing its age and has proven ineffective in keeping up with market developments. In effect, the model is frozen in time. As noted in *The Way We Pay*, for example, “online” bill payments are still processed like paper cheques, in batches and with clearing times of more than 24 hours.[1] Since 1996 and as a consequence of a Consent Order related to competition authorities’ worries about the association’s

1 *The Way We Pay* at 10.

dominant position, Interac must now operate under an ineffective governance structure, must set its price on a cost-recovery basis, and must allow merchants to surcharge on Interac debit transactions.

Interac's governance structure was erected fifteen years ago when the world was a very different place as an ad hoc settlement to complaints about alleged anti-competitive acts at that time, rather than as part of a coherent regulatory framework with well-specified goals. Moreover, Interac's governance structure has proven exceedingly difficult to update as the world has changed. As such, it has become a shining example of unintended consequences from intervention in competitive markets. Interac's governance structure slows and complicates the decision making process. As a result, investments in new technologies, for example, do not occur or are delayed. Its non-profit status, coupled with the fact that it must set its prices based on costs, makes it difficult for Interac to raise the capital that would enable it to invest in new technologies, even if such investment decisions were made.

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Perhaps most important, as a direct result of the Consent Order, and also of the recently adopted Code of Conduct, there is no real competition among debit payment networks in Canada. The Code of Conduct erects a massive barrier to new entrants by imposing limits on the number of networks that can exist on a given payment card. Yet it is competition that really drives innovation and efficiency in any market—and has certainly been a driving force in the development of other payment networks. What is needed instead is true competition: a level-playing field among different networks without constraints on the types of arrangements these networks can make with other players in the payments sphere.

Canadian debit cards also lack many of the most important features taken for granted in other parts of the world. For example, because of the dominant position of Interac and the absence of Visa and MasterCard in the debit market, until 2004 Canadian consumers could use their national debit network only to pay in Canada.[2] Starting in 2004, they could also do so in the United States, but only at merchants that accept the NYCE debit card system. Today Canadians cannot use Interac's network at all outside of Canada and the United States.[3]

2 David S. Evans, Howard H. Chang, and Margaret Weichert, *Economic Analysis of Claims in Support of the "Durbin Amendment" to Regulate Debit Card Interchange Fees*, working paper (May 12, 2011) at 23.

3 Evans, et al., Economic Analysis at 23.

Using Interac debit cards for e-commerce and online transactions in Canada is cumbersome and inconvenient. Notes one analysis,

> Today, it is possible for Canadians to pay with their cards at [only] 600 Internet merchants—but not by simply entering their debit card number as people do in the United States. Internet consumers selecting the Interac online payment option are redirected to their financial institution's website where they log in to their online bank account and select the amount to debit. Consumers are then redirected back to the merchant's website where they receive the confirmation details of the transaction.[4]

Further, Canadians still make a large number of payments by cheque, an archaic payment system: relatively risky, slow to clear, expensive, slow to use as a purchasing medium, and unsuitable for online transactions. The Canadian payments infrastructure – and by extension the Canadian Payments Association (CPA) that oversees many of its parts – has failed to facilitate the move away from cheques by supporting necessary innovation and investments.

While every payment type has its costs and benefits, and each is probably better suited than the others for some situations, some of the time, there can be no doubt that the future (if not the present) of payments is decidedly electronic. Electronic payments are speedy, versatile, safe, inexpensive and dynamic. A governance regime (and Canada's is hardly alone in this—cheque usage is even more rampant in the U.S.) that impedes a widespread shift from paper to electronic payments is bound to be a costly one.

There are bright spots in the Canadian payments firmament—for example the vibrancy of its credit card system, which is world class in quality, innovative, and fully integrated into the global economy. We urge the Task Force not to help saddle the Canadian payments system with an overly cumbersome legislative and governance framework, similar in concept to the failed intervention of competition authorities with the Interac model, but rather to follow the light-touch legislative approach that has supported the most vibrant parts of that system.

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4 Evans, et al., Economic Analysis, at 24 (citing "Products and Services," Interac, http://www.interac.ca/consumers/productsandservices_ol_main.php). Many of the largest Internet retailers do not accept debit payments. *Id*.

"MODERNIZING" THE CANADIAN DEBIT CARD SYSTEM IS ABOUT REMOVING REGULATIONS RATHER THAN CREATING NEW ONES

For the Task Force to participate constructively in a project as ambitious (and as ambiguous) as the "modernization" of payments systems, great care and appropriate humility should be exercised.

A more modest, achievable and singularly helpful goal for the Task Force should be the removal of impediments within its purview that impede competition and risk-taking investment in the Canadian market. While payment networks such as Visa and MasterCard provide the backbone of the most significant global electronic payments networks around the world, their absence in the Canadian debit sphere, combined with the dominance and inefficiency of Interac, has cut off Canadian consumers from important developments in the rest of the global economy.

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Interac's defenders argue that although the network may be expensive and highly cumbersome for consumers, it is inexpensive to other players in the payments system. This argument is overstated, however. As we will discuss, in complex systems, even "low" fees improperly allocated by fiat can degrade the system for all participants—and Interac is no exception.

In *The Way We Pay*, the Task Force asks, "Does the patchwork of regulation and oversight present a challenge to governments in protecting consumers and ensuring competition?" Indeed it does! The contrast between Canada's debit and credit card systems provides a useful case study: whereas Interac's debit card network has been subject to a cumbersome governance structure, credit cards have been subject to few regulations. The results of these alternative approaches are stark. While Canada's debit card system is stultified, its credit card system is innovative, of world class quality, and fully integrated into the global economy. This should be the pole star for any recommendations emanating from the Task Force.

IDENTIFYING THE PROPER TASK FOR THE TASK FORCE

In order to accomplish the goals that the Task Force has set out, it is imperative that the Task Force and any regulatory bodies established to monitor and/or regulate Canadian payments have the proper principles in mind before starting work.

The Task Force identifies four "Fundamental Challenges" to be addressed for Canada to become a "payments leader"

1. Increasing fairness
2. Updating regulatory and governance structures
3. Improving security and privacy
4. Transitioning to a digital economy[5]

It is our view that this reflects a crabbed conception of payments systems and the Task Force's mandate—to provide "recommendations to the Minister of Finance to help guide the evolution of the payments system in Canada."[6] Regulatory action should follow the identification of overall aims and the conclusion that a market failure exists and the conclusion that proposed regulation will improve results along the identified dimensions. The creation of a political governance framework is not an end in itself but instead just a vehicle for identifying and correcting market failures, where they exist.

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Instead, we believe that the basic characteristics that a regulatory or governance overlay should seek to embrace are

1. Increasing efficiency
2. Minimizing political interference and the ability to use governance mechanisms to transfer economic rents ("Ensuring fairness," but not in the way the Task Force seems to mean it)
3. Facilitating dynamic competition
4. Facilitating innovation

In comparison, some of the Task Force's identified fundamental challenges are in our opinion mis-specified or outside the sphere of appropriate policy actions:

- The question of updating regulatory structures, for example, is mis-specified: the structure of regulatory governance should follow from substantive premises; it is not an equivalent activity or an end in itself.
- While online security and privacy are surely important issues, there is neither any strong indication that they are fundamentally threatened or singularly more important than a host of other important payment system attributes, nor does there appear to be any market failure in this realm (such as private actors within the

5 The Way We Pay at 13.
6 The Way We Pay at 5.

system being unable or even under-incentivized to deal with the problems).[7]

- Moreover, both governance and security should properly be understood as a sub-set of both the efficiency and innovation of the system. Prioritizing these particular aspects of a successful payments system over others puts the cart before the horse and presupposes particular mechanisms for achieving overall aims rather than letting the means evolve once the aims are clear.
- Importantly, "fairness" as the Task Force seems to use the term is problematic. While there is nothing wrong with a regulatory framework that purports to promote fairness, the term must be defined very clearly and objectively. Otherwise, it can be used arbitrarily and there is a grave risk that it will be used to justify fundamentally unfair outcomes or provide cover for special-interest rent-seeking. Partial, incomplete or un-economic understandings of the term fairness can produce regulatory interventions aimed at ensuring fairness but which instead do precisely the opposite. Because notions of fairness are typically arbitrary, subjective, and prone to abuse and unintended consequences, regulators generally tend to avoid basing large-scale policy on subjective feelings of "fairness" as opposed to rigorous, objective economic analysis.[8]

While there is nothing wrong with a regulatory framework that purports to promote fairness, the term must be defined very clearly and objectively.

In what follows, we briefly examine the four areas identified above that the Task Force (and the Department of Finance) should carefully consider before recommending or taking future action, or constructing new regulations or governance institutions. This short document is really a marker—an opportunity to lay out our most basic points at a high level of abstraction commensurate with the sort of skillful summarizing of complex and wide-ranging issues that *The Way We Pay* itself presents. We intend to flesh out these points in more rigorous detail in a longer follow-up paper to be released shortly. We hope and expect that this will be an ongoing conversation, and that as the Task Force's recommendations are finalized and as the Finance Minister (and other participants) begin to digest and possibly act on those recommendations, that our more detailed analysis will be duly considered.

7 The existence of a plethora of private companies offering verification and other privacy and security related services suggests that this is an area in which private parties are innovating solutions. There is a high likelihood that any government intervention would stymie this innovation.

8 For example, is it "fair" that someone who is impatient to read a book must pay substantially more to buy the book than someone who is more patient and can wait until it comes out in paperback? Is that question subject to an objective answer?

EVALUATING *THE WAY WE PAY* AND APPLYING THE PROPOSED FRAMEWORK

Efficiency Arguments and the Regulation of Payments

The benefits to the Canadian economy of an integrated electronic payments system hardly need belaboring. Near ubiquitous ownership of payment cards by consumers and acceptance by merchants generate important benefits. For many merchants (especially online retailers), payment cards provide benefits other payment methods can't match, including, for example, instantaneous access to funds without the processing time, delay in clearance, physical limitations and non-payment risk associated with cheques. One recent survey found that 40% of American merchants, including many national retailers, no longer accept cheques for payment from consumers.[9] Payment cards meanwhile also eliminate the costs of handling, storing, securing and transporting cash.[10] While many transactions in the economy can be and are efficiently conducted with paper payments, it can hardly be doubted that payment cards offer unique and significant benefits, and that there is no justification for impeding their advance.

An efficient, secure payment card network is also important for e-commerce and on-line shopping, and robust e-commerce can be especially valuable for small start-up businesses to get a leg up, providing the engine for economic dynamism.

Payment cards also facilitate economic efficiency by relaxing liquidity constraints on consumers by enabling them to make purchases even when they lack immediate cash in their wallets (for example, to make purchases of goods when they are unexpectedly on sale), flexibility that benefits both consumers and merchants. An efficient, secure payment card network is also important for e-commerce and on-line shopping, and robust e-commerce can be especially valuable for small start-up businesses to get a leg up, providing the engine for economic dynamism.

The benefits to consumers of electronic payments are also manifest. Electronic payments relieve consumers of the risk and inconvenience of obtaining and securing cash, and widespread use of electronic payments also makes it easier for consumers to manage their finances by providing an itemized record of their purchases and to return defective or unsatisfactory products by creating an accessible record.

While every benefit comes with a corresponding cost—and the benefits of electronic payments are no exception—the global, widespread use and

9 *See* Ed Roberts, *Average Account Overdraft Is $40, but Total Cost is $58, Study Finds*, Credit Card Management (Aug. 22, 2011).

10 *See* Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and Their Regulation* (June, 2, 2010) *available at* http://laweconcenter.org/images/articles/zywicki_interchange.pdf

acceptance of payment cards, and especially debit cards, suggests that their benefits outweigh their costs, and the continuing substitution away from paper payments and into various electronic payments suggests that their net benefits outweigh those of their paper alternatives, as well. But as a result of its sometimes balkanized and, in important respects, underdeveloped debit card system, however, Canadians do not enjoy some of the benefits taken for granted elsewhere in the world.

Two culprits can help explain this state of affairs: the Consent Order and the governance framework. As argued earlier, the Consent Order has stifled innovation in the debit card market and may have hampered competition from other payment networks. And the governance framework has failed to provide the necessary incentives for market participants to invest in technologies needed to facilitate electronic invoicing and payments (in particular to overcome current information limitations associated with Canada's Large Value Transfer System (LVTS)).

The purpose of payment systems is to coordinate the interactions of two groups of market participants, buyers and sellers, like a language that enables the two parties to communicate.

Efficiency and the Complexity of Two-Sided Markets: The Difficulties of Intervention

Understanding the efficiency analysis of payment systems as well as the challenges of regulating to increase efficiency begins by recognizing that the purpose of payment systems is to coordinate the interactions of two groups of market participants, buyers and sellers, like a language that enables the two parties to communicate. Such systems are sometimes referred to as "two-sided markets"[11] and are ubiquitous in the economy.

Shopping malls, for example, are two-sided markets in that they provide a platform to facilitate the interaction of consumers and retailers. Newspapers offer another example, with the paper itself (and/or its website) acting as a platform for the interaction between advertisers and consumers. In the case of payment cards, the larger the number of merchants who accept a particular card, the more attractive that payment form will be to consumers and the more likely they are to hold such a card, which in turn makes the card more attractive to merchants.

Pricing in two-sided markets tends to be complex because of the need to balance the aim of expanding the number of participants with the need to provide value to individual participants.

11 Jean-Charles Rochet and Jean Tirole (2003). *Platform Competition in Two-Sided Markets*. Journal of the European Economic Association, 1(4): 990-1029

In two-sided markets cross-subsidies both between the groups on the two sides of the market, as well as within various sub-groups on either side of the market, are common—if not essential to their functioning. Thus, for example, advertisers pay a large proportion of the cost of producing newspapers; they "subsidize" the readers in order to increase the number readers (to them, potential customers) they reach. Everybody wins.

Similarly, cross-subsidies among consumers are also common. For example, in the United States convenience stores often charge low price markups on milk to draw consumers into their stores, and then charge high markups on discretionary products such as candy bars. This pricing strategy essentially has those consumers who buy candy bars "subsidize" those who only buy milk. Yet this differential pricing is recognized as an inherent part of the process of maximizing the overall value of the "convenience store system." Moreover, this differential pricing and cross-subsidization is completely voluntary—no one is forced to buy candy bars—but everyone who buys them presumably benefits from so doing.

A review of the theoretical economic literature reveals no consensus on whether current fees are too high, too low, or just right, once all social costs and benefits are taken into account, nor is there a consensus that there is even a market failure to be addressed.

Efficient pricing in a two-sided market, therefore, requires a delicate balancing of the various prices charged to different actors in the market: price the milk too low relative to the candy bars and all you sell is milk—at an unsustainably low price because it is not subsidized by candy bar profits. Moreover, the efficient price is likely to vary over time according to developments within the market and in related markets.

Unfortunately, even leaving aside problems of political rent-seeking and special-interest influence, it is highly unlikely that even the most earnestly-motivated economic central planner will be able to know the "right" combination of price and product attributes for payment cards in the economy.

With respect to payment cards and any other payment device, this balancing is typically done through the interchange fee, which mediates the relationship between consumers (or their banks) and merchants (or their banks) across the payment card network. It is very difficult to establish as a matter of economic theory the optimal interchange fee at any given time. A review of the theoretical economic literature reveals no consensus on whether current fees are too high, too low, or just right, once all social costs and benefits are taken into account, nor is there a consensus that there is even a market failure to be addressed.[12]

12 As several U.S. Federal Reserve economists observe, "The conclusions of the theoretical literature [on interchange fees] vary substantially depending on the assumptions underlying the models. Assumptions about the degree of market power for acquiring banks, issuing banks, merchants, or

More generally, there simply is no consensus that permitting interchange rates and other terms and attributes of payment cards to be set by market forces will produce a market failure. Indeed, establishing efficient prices in a highly dynamic and evolving market is generally thought to be exactly the type of situation most conducive to market competition, as experimentation and free choice will enable market actors to discover the best set of prices through the market process and to adjust as circumstances change.

What does seem clear and important for the Canadian experience is that any attempt to interfere with the setting of interchange fees can have unintended, deleterious consequences. Further, it also seems obvious that Canada's economy would benefit from increased market experimentation that might allow alternative pricing and price-value combinations to arise in the market.

The proper criterion for evaluation is not the relationship between marginal cost and price but whether the actors within the system are receiving greater benefits than the price that they pay.

Fairness, Properly Understood, in the Regulation of Payments

If the case for intrusive regulation of payment card networks on efficiency grounds is weak, the case for regulation on the grounds of purported "fairness" is weaker still. The criteria of fairness invoked in *The Way We Pay* is not specified, but it appears that it might be a mixture of two concerns: first, that pricing that does not reflect underlying marginal cost is somehow unfair to merchants; and second, that there is an unfair cross-subsidization among various identifiable classes of consumers.

Neither argument is, in our opinion, well-grounded. Nor, even if fairness could be rigorously defined in theory, is there any reason to believe that political intervention would effectively rectify those concerns in practice.

Fairness as Marginal Cost Pricing

The marginal cost pricing criteria of fairness is misguided for several reasons.

First, as noted above, payment cards are two-sided markets. In two-sided markets there is no reason to believe that the prices charged should necessarily reflect the marginal cost imposed by various actors in the system.[13]

networks, and the elasticities of demand for card services and final goods all influence the results." Prager et al., at 21.

13 *See The Economics of Payment at 18*

For example, there is no reason to intervene politically to rectify "unfair" newspaper pricing simply because advertisers subsidize newspaper readers and pay more than the marginal cost of printing ads. It is equally nonsensical to condemn Adobe because those who pay to purchase Adobe Writer (at a price considerably above the marginal cost of approximately $0 to produce a copy of the software) to create pdf documents subsidize those who use the free Adobe Reader to read those documents. In each of these cases, the prices charged to individual actors in the system are not related in any natural way to their underlying marginal costs because the function of price in these examples is far more complex than mere cost recoupment.

Second, as these examples illustrate, what truly matters is the overall benefits created by the platform for all of the actors that access it. In that sense, the proper criterion for evaluation is not the relationship between marginal cost and price but whether the actors within the system are receiving greater benefits than the price that they pay. Thus, for example, there is nothing incongruous in the idea that newspaper readership might rise, thereby reducing the marginal cost of newspaper production, but that the price of advertising might actually rise as the marginal cost of production falls if the benefit increases.

Third, in a two-sided market, declaring one allocation of cost to be intrinsically "unfair" implicitly suggests that some other allocation of cost can be known to be "fair." But where costs are reciprocal—i.e., arise only from the interaction of both parties agreeing to use a certain type of payment—there is no valid basis a priori for believing that one allocation of costs is more or less "fair" than any other; both parties are voluntarily engaging in exchange that is presumed to be mutually beneficial, whatever the precise allocation of fees. With payments in particular, both merchants and consumers know before transacting what their costs will be (at least at a general level), and it is not clear that there is any reason to substitute a third party's judgment for their own.

Finally, and importantly, marginal cost pricing begs the question of which party should bear the fixed costs of constructing and maintaining the network from which they all benefit—a question left unaddressed, for example, by the U.S. Federal Reserve Board's implementation of the Durbin Amendment.[14]

14 *See* David W. Kemper, *Testimony before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services United States House of Representatives,* (Feb 17, 2011), *available at* http://www.aba.com/aba/documents/press/KemperInterchangeTestimony021711.

Fairness as "Just" Distribution Among Consumers

Thus, the idea that there exists some valid criteria for measuring the "fairness" of various allocations of costs of payments between consumers and merchants is fundamentally misguided. But perhaps even more important, the idea that we have a firm grasp on the actual incidence of costs and benefits in such a complex system sufficient to quantify the allocation (let alone the fairness) of costs is problematic.

As we have noted, it is important to understand the dynamics and underlying economics of a market before intervening. It is often the case that even well intentioned regulations end up having unanticipated consequences, precisely because regulators insufficiently consider the full complexity of the market being regulated (or else because the market being regulated is so complicated that even careful consideration necessarily yields insufficient understanding).

Central to an appreciation of the complex dynamics of payment markets is an understanding of the various moving parts and their interactions. It is well understood that the four-party system incorporates a web of connections among consumers, merchants, acquiring banks, issuing banks and networks. But, unfortunately, the full implication of this interconnectedness is often overlooked. As a result, claims about both the fairness of the system and the ability of any particular intervention to improve it are tenuous, at best.

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Pass-Through

We begin by stressing the obvious: that parties in the whole range of relationships inherent in the payment network can (and do) adjust both prices and services in response to exogenous (i.e., arriving from outside the relationship) changes (like a cap on interchange fees, for example).[15] Changes in interchange can't be viewed in isolation, and it is essential to have a sense of how the loss (or gain) of revenue from a reduction (or

15 *See* Evans & Mateus*, How Changes in Payment Card Interchange Fees Affect Consumers Fees and Merchant Prices: An Economic Analysis with Applications to the European Union* (June 27, 2011), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1878735*

increase) in interchange by issuing banks, for example, may be passed on through other means to consumers. Thus:

- Some cardholders and some merchants (to say nothing of others outside the four-party system) are borrowers from both acquiring and issuing banks and the terms of these relationships may be affected in unexpected and/or undesirable ways by banks' cost of capital going up from a reduction in interchange.
- Some of these borrowers borrow in the form of revolving credit, and the terms of these arrangements, including the willingness of banks to issue credit to risky (read: poorer) applicants, may be affected by banks' other sources of revenue and risk exposure changing.
- Some of these same participants are shareholders in those banks, and some consumers and banks are shareholders in merchants' companies, and these relationships and each party's respective wealth will be affected by banks' and merchants' revenues or costs—and thus profits—going down (or up).
- Moreover, cardholders very often interact with each other, and merchants with consumers, through cash and cheque transactions, and the relative cost of these transactions will be affected by changes in other payment network relationships.

The most important determinant of the extent of the effect on these relationships from a change in the interchange fee (or any cost) is the extent of "pass-through"—the extent to which changes in costs to merchants and banks are absorbed by them or shared with their customers.[16] The degree of pass-through will be a function of the relative degree of competition in the various markets as well as other factors. Less-competitive industries and smaller cost savings are less likely to be passed through to customers (whether merchants (from banks) or consumers (from merchants and banks)) than the opposite.[17]

On average, according to a recent paper by David Evans and Abel Mateus, the rate of pass-through is about 50%, meaning competition induces retailers (whether banks or merchants) to pass on only about half of their cost savings (or increases) and to pocket the rest as windfall profits (or losses). At the same time, studies demonstrate that even this pass-through

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16 Evans & Mateus at 12 ff.

17 *See* David S. Evans, Robert E. Litan, and Richard Schmalensee, *Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses* (Working Paper, Feb. 22, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1769887.

is not immediate, and prices tend not to change at all for a year or more following a cost change.[18] In addition, the overall effect on consumers (and the overall cost saving for merchants) will depend on the relative mix of debit, credit and cash payments for every merchant in the economy, as costs savings would arise only from transactions that would have incurred an interchange fee—by no means all transactions.[19]

Measuring pass-through in general, and specifically for each industry, is an exceedingly complex—but essential—task for understanding the consequences of payment system regulation. Knowing, in other words, whether a reduction in a merchant's interchange fee by 50% will result in 0%, 20% or 100% of that reduction being passed on to consumers in the form of lower prices (and when this might happen) is essential to understanding the resulting distribution of costs. Unsupported, blanket claims uninformed by a rigorous pass-through analysis should be disregarded.

But whatever the specifics, pass-through cannot be expected or assumed in most conditions, and analyses that explicitly or implicitly assume otherwise (often because the assumption makes the calculation much easier) are problematic.

Cross-Subsidies

It should not be surprising that cross subsidies (say, from cash-paying consumers to rewards card holders) persist and are perfectly consistent with—even necessary for—a well-functioning payments system. As we have discussed, cross-subsidies among consumers are ubiquitous in a wide range of well-functioning markets. To seize upon one purported subsidy out of the countless cross-subsidies among various consumers in dynamic economic markets and derive implications from it defies any coherent regulatory logic. To some extent this is a sub-species of a problem we have repeatedly flagged—the problem of excessive focus on specific costs of a payment system to the exclusion of consideration of the overall value of the system.

The problem of assessing the full effect of interchange fee price controls—and the risks inherent in pursuing an amorphous fairness

18 Evans & Mateus at 15-16 and Appendices A & B.

19 For example, as a fraction of annual gross revenue, debit cards accounted for 26 percent of transactions in Canada in 2006. Arango & Taylor, Merchant Acceptance, Costs and Perceptions of Retail Payments, Bank of Canada Discussion Paper (2008), available at http://www.bankofcanada.ca/wp-content/uploads/2010/01/dp08-12.pdf.

standard—is illustrated by the Federal Reserve Bank of Boston study featured prominently in *The Way We Pay*.[20] The study is cited for the proposition that lowering interchange fees would increase social welfare and fairness by transferring wealth from card-paying households to cash-paying households and from high-income households to low-income households. In essence, the study claims that (a) because merchants charge all consumers the same price; and (b) because merchants pass-through to consumers the full cost of interchange fees (100% pass-through) in their retail prices; then (c) cash consumers (who are, on average, likely to be poorer than credit card consumers) subsidize credit card consumers (the relatively wealthy) because credit-card consumers don't bear the full cost of their transactions and cash customers pay more than the direct cost of theirs. Moreover, (d) the interchange fees thus charged by merchants to their consumers and ultimately passed along to issuing banks pay for the expensive rewards programs that issuers use to attract high-value consumers. And since these cardholders also tend to be wealthier than cash- and non-rewards-card-paying consumers, the regressive transfer is exacerbated.

Neither form of "fairness" argument provides a persuasive foundation for political intervention.

Unfortunately, the study bases its conclusions on a set of unrealistic and counter-intuitive assumptions that render its conclusions suspect:

1. First of all, the paper assumes that interchange pays directly for card rewards, even though the direct relationship between the two is simply made up by the authors; there is no actual business (that we know of) or economic connection between the two.
2. Moreover, and as we have noted, pass-through is never 100%.
3. As we have also cautioned, the paper fails to assess the value of the system (and thus share of that value enjoyed by poorer- and cash-paying consumers) and thus presents an incomplete accounting. Recall that everyone involved is a voluntary participant in transactions mediated by payment card networks with myriad alternate payment choices (including refraining from transacting at all) available. Each must be realizing value for himself—and is unmoved by the "unfairness" of other participants also receiving value, possibly even greater than theirs.
4. Finally, by prescribing the reduction or elimination of interchange as a solution to the problem, the paper fails to account for the

20 *The Way We Pay* at 14. The Study is Schuh, Shy & Stavins, *Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations* (August, 2010). The authors have since updated their study, but because the version endorsed by The Way We Pay is the older version, we stick to analyzing only that paper here. The results in the new version are subject to most of the same criticisms offered here of the original version.

other ways costs may be imposed (e.g., through higher interest rates, lower risk-taking, annual fees, etc.) in response.

The point, illustrated by the Study's discussion but made throughout our discussion in this paper, is that cross-subsidies, properly accounted for and in voluntary markets, are simply not a source of concern.

Thus neither form of "fairness" argument provides a persuasive foundation for political intervention. Unless there is still some other unexpressed but nonetheless cogent fairness argument that the Task Force has in mind, we urge the Task Force to eliminate the use of "fairness" as a criteria for formulating payments systems policy. At the very least, we urge that any such criteria be made express, well defined, narrowly-tailored, and objective in nature, in order to reduce the mischief of self-interested interest groups and other parties in seizing upon it as a basis for policy.

The task force's recomendations should stress the need for regulations not to impose unnecessary delay in bringing new payment products and services to market.

Ensuring that Regulation Does Not Impede Entry and that it Fosters Competition

Innovation is important for the continued development of payment systems. As highlighted in the Task Force's report and as documented herein, however, Canada is falling behind in adopting new technologies.

Why is Canada failing behind? As argued above, the best way to ensure that Canadians can enjoy the payment methods that best serve their needs is to ensure that we have a competitive marketplace supported by a legislative, regulatory and governance framework that doesn't interfere with the marketplace but rather sets the basic ground rules for market participants.

As things stand, however, there are important hurdles and regulatory difficulties that impede competition in the Canadian payments market. First, there is no level playing field among market participants. Regulations are not applied evenly among different payment networks, with some networks facing greater regulatory hurdles in bringing new technologies to market, for example. Interac transactions clear and settle through the Automated Clearing Settlement System and are therefore subject to the CPA's rules and standards, while other networks are not. For Interac, the development of new payment methods and technologies such as mobile payments may require the development of new CPA rules and standards, which are subject to an extensive internal and external consultation process.[21]

These regulations slow down the introduction of new payment methods. As a general objective, all payment networks should be subject to broadly similar rules and standards while taking into account the particular circumstances under which they operate. At a minimum, the task force's recommendations should stress the need for regulations not to impose unnecessary delay in bringing new payment products and services to market.

As noted, Interac currently suffers from a lack of investment in new technologies.[22] If it is to be able to compete more effectively with other payment platforms, it requires better access to capital. That is only likely to happen if it is allowed to compete on a for-profit basis, freed from the shackles imposed by the Consent Order. While it is ultimately the purview of competition authorities to make changes to the Consent Order, we believe that the Task Force should emphasize the need for market players to be able to compete on an equal footing to ensure effective competition among them.

Ultimately market forces and innovation should shape the future of the Canadian payment system, not the government, and the Task Force should therefore avoid leaning towards a more directive approach.

Further, the government should refrain from imposing unnecessary restraints on the type of arrangements these networks can make with other players in the payments sphere. More specifically, limitations with respect to so-called co-badge cards imposed by the code of conduct represent an unnecessary and harmful limitation on the efficient functioning of the payments market.[23] In effect, the ban makes the entry of new networks very difficult because new networks will have to convince financial institutions to issue more than one debit card to their customers (a move that may be resisted for fear of confusing their clients) or to change networks altogether. Competition and innovation invariably suffer, and so do all Canadians.

A better route would be to have a payments system where all payment networks are able to compete freely, full stop. The government may wish to set some ground rules, as it has done in the code of conduct regarding transparency and disclosure. But ultimately market forces and innovation should shape the future of the Canadian payment system, not the government, and the Task Force should therefore avoid leaning

21 *The Way We Pay* at 9.

22 *See* Philippe Bergevin, *Change is in the Cards: Competition in the Canadian Debit Card Market*, C.D. Howe Institute Backgrounder No. 125 (Feb. 2010).

23 The code of conduct demands that "Competing domestic applications from different networks shall not be offered on the same debit card".

towards a more directive approach.

Governance for Innovation and Growth

Addressing the current patchwork of legislation, regulations and bylaws is in our opinion an appropriate goal for the Task Force. We repeat our earlier injunction that a regulation is justified only if (a) there is a substantial market failure and (b) the market failure it is intended to address is worse than any government failure that is likely to result from the regulation. The evidence for such market failures in Canada's payments system is weak.

Meanwhile, interventions in Canada's payment system have clearly resulted in unintended and undesirable consequences. The first priority of the Task Force should be to identify ways in which regulatory intervention can be reduced, so as to ensure that the payments system is more effectively regulated and that each player is subject to regulations that are based on clear, abstract principles applied equally, rather than on arbitrary rules applied differentially.

Market structure is an extremely poor indicator of market efficiency... without evidence of actual competitive effects, it is improper to infer anything about the quality of a market from its degree of concentration.

An effective governance regime must take into account the incentives for innovation. The best way to achieve this is by facilitating entry and competition on equal footing. Competition drives efficiency and incentivizes innovation, as each competitor seeks to provide services of a higher quality and at lower cost, and ensuring that markets are "contestable"—that is, that entry is possible and incumbent players operate under the threat of losing customers to more attractive rivals—is essential.

It is thus disheartening to see the Task Force identifying first among the characteristics of a "Basic Payments Infrastructure" that it "[r] educe concentration of ownership and control of payments networks."[24] It is putting the cart before the horse to instill this as a bedrock principle of a basic infrastructure. It may be that the market structure that emerges from a competitive system is highly fragmented and diverse. Or it may be—as is often the case in network industries like payments—that the resulting structure is fairly concentrated. Economists have long understood that market structure is an extremely poor indicator of market efficiency, and that, without evidence of actual competitive effects, it is improper to infer anything about the quality of a market from its degree of concentration. The aim should be efficient competition, not particular market structures.

24 *The Way We Pay* at 28.

Perhaps more important, however, the governance scheme must preserve the ability of the payment network's builders, owners, operators—those with "skin in the game"—to allocate costs (fees) not only on the basis of direct cost incidence, but instead on the basis of price sensitivity (elasticity), risk bearing, and a concern for systemic efficiency, not simply the effect on isolated participants. Such allocations cannot readily be observed, understood and regulated by third parties.

We are thus particularly concerned that the Task Force appears to favour shifting decision-making on these and other crucial issues towards a broad group of participants, especially given their divergent incentives and the long-run consequences they might have on the development of the system. Further, the report claims, that "[i]t is also apparent that payments stakeholders, including merchants and consumer groups, do not have an effective forum in which to work together with payment service providers to resolve issues."[25] A significant and consistent flow of global evidence suggests that this is effectively a euphemism for merchants and consumer groups substituting their private interests for those of the network's operators and, in the case of the former, lobbying for lower merchant fees.

We are thus particularly concerned that the Task Force appears to favour shifting decision-making on these and other crucial issues towards a broad group of participants, especially given their divergent incentives and the long-run consequences they might have on the development of the system.

This amounts to an inversion of the structure that has naturally emerged in payment systems (and tends naturally to emerge in all two-sided markets): Fees are generally incurred by those who get paid, not by those who pay, in the system. And wherever attempts have been made to impose such an inverted structure, the overall efficiency of the system has been reduced, both burdening consumers directly with additional costs and reducing the net surplus generated by the system.

While it may be important for the effective operation of any complex system that its governance enables input from a range of participants, the manner by which this is organized can and should be left to the designers and/or operators of each network.

Most important, the implicit claim that "stakeholders" other than the builders and operators of a network have an equal stake and an equal ability to ensure its optimal operation is inherently flawed. These participants can and should (and no doubt network operators know this better than anyone) provide information necessary to the efficient operation of the system, but this should not be mistaken for the ability or incentive of these participants to actually efficiently operate the system.

25 *The Way We Pay* at 15.

We are further concerned that *The Way We Pay* seems to presuppose new regulation and more layers of regulation (creating not only a self-governing organization (SGO), but also a "Payments Oversight Body" (POB)—on top of existing regulatory components including, among others, Parliament, the Department of Finance and the Financial Consumer Agency of Canada), but without first demonstrating the requisite market failures that might justify such interventions, nor sufficient sensitivity to the costs such new structures would entail. Among other things, the availability of multiple rule-making and enforcement bodies, each open to complaints and even direct governance by non-risk-bearing, non-investing participants seems a recipe for politicized and inefficient decision-making.

While the establishment of an industry SGO might seem like an appropriate avenue to address some of the policy issues associated with the payments system, the dangers in adding another layer of regulatory governance to the existing structure or to the new proposed POB are potentially significant, and the devil is in the proverbial details. As such, mandates need to be clear and conducive to innovation and an efficient payments market. Terms need to be defined and rules need to be put into place that prevents rent seeking and myopically inefficient fee shifting and rule setting.

Moreover, the required participation of all market participants in the SGO to manage the integration of new technologies poses risks to the competitive nature of the market. While industry-wide collaboration is certainly warranted and beneficial in some instances, market participants should be able to freely pursue all avenues in terms of technological standards and alternative arrangements with other participants, the very foundations of an efficient and competitive payments market. Moreover and as noted, the prescribed structures seem likely, without great care, to facilitate the inversion described above at great potential cost to the system and Canadian consumers.

Here the case of Interac offers valuable lessons. The Consent Order expanded the list of eligible Interac members and implemented a new governance structure that, among other things, imposed measures to transfer some decision-making power from charter members to other Interac members and introduced specific governance rules. This kind of tinkering with existing structures has proven very detrimental to Interac's ability to make timely decisions and to invest and adopt new technologies.

The lesson here is that unintended consequences cannot be dismissed—but also that incentives are important. In any governance structure, the ability of decision makers to be able to make timely decisions, and to be able to profit from them when things go right (and to suffer losses when they don't), is an essential characteristic of any functioning organization.

In addition, political intervention in payment card markets can spawn wasteful and inefficient political rent-seeking and an endless regulatory cycle as initial interventions produce unintended consequences and political winners and losers. In the United States, for example, it is estimated that both merchant and bank lobbying groups spent millions of dollars lobbying for political regulation of the payment card market that finally culminated in the Durbin Amendment to the Dodd-Frank Act.[26] In addition, any intervention in a market as complicated as payments invariably will produce unintended consequences that will lead to calls for further rounds of interventions and all of the special interest politicking that accompanies it, as illustrated by the Australian experience in which the initial round of interventions produced unintended consequences that have spawned a cycle of repeated calls for intervention.[27]

CONCLUSION

Going forward, it will be important for the Task Force and the Department of Finance to keep their eyes on high level policy objectives and not get side-tracked by immediate market concerns. As it continues to flesh out proposals for a new legislative and governance framework for the Canadian payments system, it will be crucial for the Task Force to recognize the powerful forces of competition and innovation in the payment market. It is also crucial to ensure that political rent-seeking and the relatively limited knowledge of governmental regulators do not thwart dynamism and innovation. Any future legislative and governance framework must not ignore the realities and limits of trying to organize complex and dynamic markets through political means.

26 Brian Burnsed, *Credit-Card Fee Reform Stays on the Back Burner*, Business Week, Oct. 16, 2009, *available at* http://www.businessweek.com/smallbiz/content/oct2009/sb20091016_047806.htm; Anna Palmer, K Street Files, Roll Call, Nov. 18, 2009, http://www.rollcall.com/issues/55_58/kfiles/40705-1.html.

27 *See* Zywicki, Interchange Fees at 53-54.