

Death Before Ad Valorem

A RESPONSE TO “REGULATING DEBIT CARDS: THE CASE OF AD VALOREM FEES”

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As long as I can remember, the argument of whether Interchange, and particularly Debit Interchange, should be charged Ad Valorem¹ has been hotly debated. When Interlink grabbed the PIN Debit reins and introduced Ad Valorem Interchange pricing in the late 1990's, it sent shockwaves through the industry.

The NYCE Network, at the time the number three U.S. PIN Debit Network, was the first EFT Network to respond – though it took a lot of internal and external wrangling to follow suit. I was lucky enough to help NYCE through that time – and got to experience firsthand what a difficult decision it was to make – not only strategically, but, due to the systems complexities, operationally.

GENERAL SENTIMENT

Now, 10 years later, the debate rages on. Talk to any banker, merchant, or payment systems professional and you will get an earful. Just this past year, the Canadian Senate Committee on Banking, Trade, and Commerce ruled that an Ad Valorem structure was not supportive of a healthy payment system:

“We also feel that debit card transactions are inherently less risky and costly than credit card transactions; consequently, *they do not warrant a percentage-based fee structure*, whether at the level of interchange fees or switch fees. Finally, we recognize the need for these fees to finance reasonable innovation costs as well as a reasonable return on investment. Given these considerations, we think that switch and interchange *fees in the debit card market should be set on a flat fee per transaction basis...*”

¹ Latin for “According to Value,” it is the method of determining the amount of Interchange based on

Ask Visa and MasterCard what they think about this ruling, and they will likely tell you that this hurts innovation and consumers.

WHAT DO WE KNOW ABOUT AD VALOREM VS. FLAT FEE?

I have a few beliefs about the two different models. While I will agree that more could be articulated, these are the ones that I think are general truths – hard to dispute unless you are significantly biased.

Ad Valorem

1. The Ad Valorem model provides a mechanism to dynamically change Interchange (or fees) in order to adjust for different economic realities of specific merchants and/or segments.
2. If you believe that Interchange is a value-based fee, an Ad Valorem structure can accurately transfer that value.
3. Small-ticket merchants love it; large-ticket merchants hate it.
4. For a merchant, it does not decrease transparency, it only increases the level of merchant sophistication necessary to make payments decisions

Flat Fee

1. It is simple – both logically and operationally.
2. It is more easily understood across the entire system.
3. It may disadvantage some merchant segments at the same time it advantages other, creating a disproportionate burden on the payment system.
4. If you believe that Interchange is a cost-based fee, a Flat Fee structure best supports the cost transfer.
5. Small-ticket merchants hate it; large ticket merchants love it.

the transaction amount. Typically, this is done as a percentage of the transaction amount.

- If a merchant wants to pass the cost on to the consumer, it is easier to pass along a flat fee.

So What?

There is a reason that payments industry leaders, like Visa and MasterCard, use Ad Valorem. It supports their strategic interests. These organizations are very good at figuring out what they can extract out of a particular market segment, and Ad Valorem typically allows them to maximize this. It allows them to pass that along to their card issuers so that these issuers can offer consumer incentives, like reward points or miles.

There are some sneaky aspects of Ad Valorem that most don't think about. For example, prices are, for the most part, increasing. We haven't had a serious run of deflation for quite a while. Ad Valorem takes advantage of increasing prices. If fees were flat, that amount would stay the same, but the buying power of that amount would decrease. Sure, the flat fee could be routinely adjusted, but that would only give merchants more reason to be upset.

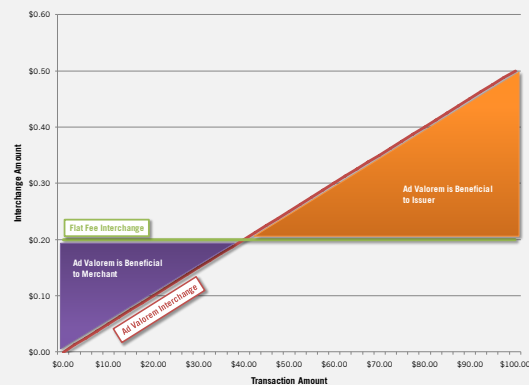
I guess the biggest problem I have with those that hate Ad Valorem is that it is not the structure that is the problem, but instead the level. If the Interchange rate for PIN Debit was 20 Basis Points instead of 65 basis points, would anyone complain? No. People in and out of the payment system would see the benefits of the structure. Detractors say that this structure enables higher levels because it lacks transparency. I think this is wrong. Ad Valorem is equally transparent. Yes, it may take a quick calculation to know what the fee will be, but assuming the fees are public (which is required in either case to support transparency), transparency for a merchant is equal.

Additionally, it is strategically more relevant. Assuming merchant adoption is guaranteed, Ad Valorem is the only way to effectively compete against other Ad Valorem competitors (assuming they have some market power). Ad Valorem's dynamic nature supports an environment that is substantially diverse – one full of a varied mix of merchants.

For example, let's look at competing against Visa, who we will assume has a 50 Basis Point Interchange. Competing only using Flat Fee, I

need to set my price based on the average ticket of \$40. So, let's say I set interchange to 20¢ to be equal. In fact, it will only be equal for those right at the average. For smaller-ticket merchants, I am over-priced. For large ticket merchants, I am attractive. Therefore, small-ticket merchants will select away from me and large ticket merchants will use me more. This makes my average ticket higher than Visa, and therefore my Interchange proportionally lower. My Issuers will know that I can only effectively compete for certain segments, and that I am giving up Interchange for those larger merchants. For my Issuers, they know that I will not get any transactions in the low range, and they will lose interchange for large-ticket merchants. It is a no win strategy.

Interchange Strategy: Flat Fee vs. Ad Valorem



KANSAS CITY FED TO THE RESCUE?

If I were a betting man, I would have guessed that any paper from the Federal Reserve Bank of Kansas City on Ad Valorem Interchange would beat it up. But the latest article written by Zhu Wang entitled “Regulating Debit Cards: The Case of Ad Valorem Fees”² does the exact opposite.

Through an economist’s eye, it looks at who gains and who loses in various scenarios using Ad Valorem fees. And the conclusion is interesting. Some things we know, such as:

“The analysis shows that, when card networks and merchants both have market power, card networks earn higher profits by charging *ad valorem* fees than fixed per-transaction fees... but merchants experience a reduced profit.”²

However, what is more interesting is the conclusion about consumers and the overall social gain:

“Meanwhile, consumers are relatively better off under Ad Valorem fees... If policymakers regulate debit cards by requiring fixed per-transaction fees, but allow networks to freely set the fee levels, merchants would gain from the regulation but card networks and consumers would lose. Altogether, overall social welfare is likely to be reduced.”²

I think the thing that is missing here is the concept of a zero sum game. I think it is bit wrong to assume that the merchant bears the brunt of this pricing. What I have seen in practice shows me that the burden is placed on the consumer in the form of higher prices. This ultimately reduces the lost profitability for the merchant, and may even present opportunities for greater profitability (if strategically planned correctly). For the consumer,

² Wang, Z. (2010). Regulating Debit Cards: A Case of Ad Valorem Fees. Kansas City: The Federal

the impact is based on the value placed on the convenience of card usage. If a high value is placed on card usage, the consumer still comes out ahead. If low value is placed on card usage – or worse yet, the consumer we look at is paying cash and not using a card – the consumer comes out behind. I believe that economic theory would say that equilibrium will be achieved – that the price increase will match consumer value, system wide.

CONCLUSION

This debate will continue. And for each market for which I analyze this, my opinions are revised.

What will always be true is that parties on one side will disagree with the parties on the other. Ultimately this argument is about level and power – not about structure.

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Reserve Bank of Kansas City. The entire report may be download at: www.kansascityfed.org.