Anti-Trust: USA vs. Visa and MasterCard

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Jessica Benson investigates the case of USA vs. Visa and MasterCard. The author examines the practices of Visa and MasterCard, and whether these practices damaged consumers and competition in the market. She concludes that these practices blunted innovation and reduced competition in the credit card market.

Introduction

This case deals with two issues, the governance rules of Visa and MasterCard and the exclusionary rules, which Visa and MasterCard operate. I will give a brief overview of the relevant markets involved. I will then summarise the issues involved and the court's findings of fact. In the main body of the essay, I intend to critically analyse and assess the economic issues involved and the impact these have on consumer welfare. I will conclude with the measures that I think should be taken to enhance consumer welfare.

The Market for Credit Cards

There are two relevant product markets in this case, the network services market and the issuing market. The market for network services that support the use of credit and charge cards is highly concentrated. There are four significant network service competitors, American Express, Discover, Visa and MasterCard. American Express and Discover are for-profit corporations, Visa and MasterCard are not-for-profit joint ventures owned by associations of thousands of banks. Merchants and issuers are consumers of network services. The second relevant product market is the issuing market. This is the market for credit/charge cards issued under these brand names. Here American Express and Discover compete with each other and with thousands of Visa and MasterCard member banks. This is not a concentrated market, no single issuer dominates the industry however banks constitute a very significant distribution channel.

Competition at the network services level plays a major role in: determining the overall quality of brands; investment in advertising; the creation of new products, features and cost-saving efficiencies; and the discount rate which is charged to merchants. Competition among issuers determines the price people pay and the variety of card features they can obtain.

Merchants' demand for general-purpose cards is derived from consumers demand to use these cards, merchants' attitudes reflect consumers. Consumers' perception of merchant acceptance is vital to a network i.e. if consumers perceive high merchant acceptance, they are more likely to demand that brand and increase their transaction volume on that brand, at the same time merchants are more likely to accept a brand if they see more consumers with those cards.

Visa and MasterCard control over 73 per cent of volume transactions on general-purpose cards in the U.S., they control 85 per cent of the market in terms of cards issued. There are high barriers to entry in the card network services market. There are high costs of establishing a network and developing a brand name. It is difficult to develop merchant acceptance without an initial network of cardholders as noted above. No company has entered the network services market since Discover in 1985. Citibank concluded that an entrant would need to capture 20-25 per cent of market share to be successful. The card network services business is driven by scale, increased scale lowers network costs and increases networks ability to offer services at lower competitive prices.

The issues and findings of fact

The two issues that this case deals with are the governance rules of Visa and MasterCard and the exclusionary rules that Visa and MasterCard operate.

Governance Duality

Governance duality permits banks to have *'formal decision-making authority in one system while issuing a significant percentage of their credit and charge cards on a rival system.'* The plaintiff suggests that these overlapping financial interests reduced the incentive to invest in or implement competitive initiatives that would affect their other card product. The plaintiff argues that Visa and MasterCard have failed to compete with each other by constraining innovation and investment in new and improved products. They claim that this failure to compete delayed and blunted innovation in:

- Chip-based smart cards.
- Encryption standards for Internet transactions.
- Advertising.

- Premium cards.

The government's proposed solution was that an issuer (bank) who served on the Board of Directors of either company agrees to issue credit, charge and debit cards almost exclusively on that associations network (known henceforth as dedication). This is in fact the direction the industry is taking with dual governance virtually at an end and dedication occurring. In any case, the court found that governance duality is not anticompetitive.

Exclusionary Rules

The penalty that banks face for issuing American Express or Discover cards is forfeiture of the association members' right to issue Visa or MasterCard. The plaintiff argues that this weakens competition and harms consumers by:

- Limiting the output of American Express and Discover in the U.S.

- Restricting the competitive strength of American Express and Discover by restraining their merchant acceptance levels and their ability to develop and distribute new features such as smart cards.

- Effectively foreclosing American Express and Discover from competing to issue off-line debit cards which will soon be linked to credit card functions on a single smart card. Off-line debit cards are the future focus of credit card relationships. They require access to Demand Deposit Accounts (DDA) which only banks have.

- Depriving consumers of the ability to obtain credit cards that combine the unique features of their preferred bank with any of the four network brands.

- Issuers (banks) restrict competition among themselves by ensuring that so long as all of them can not issue American Express or Discover none of them will gain competitive advantage.

Overall the plaintiff claims that while Visa and MasterCard have not conspired to increase price, exclusionary rules have significantly reduced product output and consumer choice (and in turn welfare) in the issuing market and have reduced price competition in the network services market.

The court found that exclusionary rules created an output restriction on the number, type and quality of goods produced that is particularly anti-competitive in its effects on consumer welfare (similar to the effect of a price restriction). The exclusionary rules were repealed with the court claiming it would result in increased output and consumer choice and the strengthening of American Express and Discover networks by increasing their scale and relevance.

There appears to be an inherent contradiction in the Justice Department seeking a remedy that would force banks that sit on the Visa or MasterCard board to issue new cards only under the brand of the association they govern while banks that do not sit on either board would have the freedom to issue any number of card brands they choose (American Banker, 22/08/00; FT, 30/08/00). At the same time small networks such as Discover would be further disadvantaged if large banks who sit on Visa or MasterCard boards were forced to dedicate themselves to either Visa or MasterCard (Wolffe, FT, 19/07/00).

Economic Issues

Essentially what we are interested in is the impact of dual governance and exclusionary rules on consumer welfare. I intend to examine each in turn focusing on the pro-competitive and anti-competitive arguments, which I find most plausible in each incidence.

Dual Governance

I see dual governance as a horizontal issue. Visa and MasterCard are potential substitutes for each other. Banks can sit on the board of Visa or MasterCard and continue to issue the competing brand. It appears that there is a strong incentive not to compete vigorously against each other. *'Antitrust is rightly suspicious of any horizontal restraint on trade'* (Schwartz & Eisenstadt, 1982: 4). Agreements between firms who produce substitute products tend to be at the expense of the final consumer, as agreements tend to dampen competition between competitors. It was claimed that while there were no explicit agreements, competition was dampened in the areas of advertising, encryption standards for the internet, premium cards and chip-based smart cards. I will look at the anti-competitive arguments, briefly at the advertising issue and then at the pro-competitive arguments that I see as most relevant in relation to dual governance.

Anti-Competitive Arguments

I see the failure to introduce smart cards as the strongest anti-competitive argument, however many justifications have been given for it. The plaintiff claimed that consumer welfare was affected because they had to rely on American Express to innovate through the Blue Card. This has been brushed off as nothing more than a *'marketing coup...as the rest of the economy is not yet smart enough to let it do much more than any other charge card does'* (Economist, 17/01/00). Visa and MasterCard have both shown that there was no business justification for introducing smart cards because of the high costs and the small gains involved. Even if Visa and MasterCard were true competitors they would have an incentive for the other to introduce the card because of scale issues involved. Finally, even the fact that the introduction of smart cards was favoured by banks in countries without dual governance as a means of gaining competitive advantage can be put down to a more advanced wireless infrastructure in those countries (Economist, 17/07/00). Despite these points I would contend that governance duality made Visa and MasterCard complacent in innovating in this area. Chip cards are dependent on application developers to write the software to support innovative new uses of the card. Software developers have no incentive to write applications for hardware that does not have wide distribution. The introduction of smart cards should create a snowball effect: as scale increases, functionality should increase. So initially costs will outweigh the gains, however I do not see this as a valid argument for not introducing a smart card. As Visa and MasterCard had exclusionary rules in place, they did not face the prospect of widespread distribution of smart cards by American Express or Discover. At the same time governance duality meant that they were safe in the knowledge that the other (the only competitor that did have access to wide distribution channels) would not innovate in this area. I would contend that consumer welfare may have increased had smart cards been introduced. A combination of governance duality and the exclusionary rules operated by Visa and MasterCard blunted innovation in this area.

Advertising

In the case of advertising it appears that Visa and MasterCard competed in all ways other than actually naming each other in their ads. There was no advertising information that consumers lacked as a result of MasterCard's and Visa's decision regarding advertising. Visa compared its services and products to MasterCard's in promotional materials and advertising directed at member banks and argued that Visa was superior. Both Visa and MasterCard offered cash incentives to member banks in return for dedication agreements and agreements over mail solicitation.

Pro-Competitive Arguments

In the case of implementing an internet security standard it appears that there are strong pro-competitive arguments for Visa and MasterCard working together.

Vertically, it helps to align upstream and downstream firms, which avoids the wasteful duplication of costs. Two different standards in the marketplace would be costly and inefficient. They would require dual issuing banks to implement two standards to accept transactions and merchants to operate two technologies at market place. This involves duplication of costs for all parties. It is alleged that duality may have lead to a delay in the introduction of internet security standards by around four months. However it seems clear that the introduction of two conflicting standards could have negatively impacted on consumer welfare to a greater degree than this delay.

This points us to another welfare increasing argument. Efforts by members to drive Visa and MasterCard co-operation on working bulletins, charge back rules and software changes are all operational in nature promoting efficiencies in network systems by reducing duplication and costs. Standardising backroom operations at issuing institutions are pro-competitive because of cost savings.

The government's proposed solution to the dual governance issue is dedication. It has already been noted that there appears to be an inherent contradiction in proposing this solution while trying to abolish exclusionary rules. This would mean that banks on an associations board could only issue that brand while all other banks could issue any brand they wish. Historically issuance duality gave MasterCard the opportunity to obtain business from members which otherwise might have only issued cards under the Visa brand name. This increases consumer choice, which improves consumer welfare. At the same time small networks such as Discover would be further disadvantaged if large banks were forced to dedicate themselves to either Visa or MasterCard. Especially as the credit card industry is driven by scale.

Conclusion on Dual Governance

On balance I think that governance duality as it stands is not anti-competitive. If full dedication was enforced it would deprive consumers of the ability to combine the unique features of their preferred bank with either of the brands. Reducing consumer choice in this way would reduce consumer welfare. At the same time Visa and MasterCard's boards appear willing to vote to allow vigorous competition and share shifting.

Exclusivity Agreement

Visa and MasterCard's exclusivity agreements constitute a vertical restraint. Vertical restraints involve firms in different complementary activities, they often increase efficiency in the buyer seller relationship. *'Vertical relationships thrive on one another's efficiency. Each desires increased output and lower prices of the other. It should therefore be clear that the interest of parties imposing vertical restraints are generally not antithetical to those of ultimate consumers'* (Schwartz & Eisenstadt, 1982: 4). However, vertical restraints may facilitate collusion among established competitors by significantly excluding existing competitors (foreclosure) and promoting price-discrimination. Specifically, what we are dealing with is exclusive dealing which *'denotes a vertical relationship in which one party can buy from or sell to only the other party'* (Schwartz & Eisenstadt, 1982: 88).

Welfare increasing functions

Vertical restraints can increase welfare by combating the conflict between the incentives of the manufacturer and those of an individual dealer, notably the tendency of an individual dealer to free-ride on a products' reputation. *'Where exclusive dealing is used to overcome free-rider problems, it is generally welfare enhancing since it leads to increased investment in valuable assets'* (Schwartz & Eisenstadt, 1982: 89). Visa and MasterCard claim that American Express or Discover would free-ride on the training that they have provided to banks. As American Express and Discover have not incurred the costs of this training, they could offer their services at a cheaper rate, thus free-riding on Visa's and MasterCard's investment. Here it is argued that exclusive dealing is protecting Visa and MasterCard's property rights. However the most important property rights in this case appear to be at the bank issuing level the rights over customer relationships. Exclusive dealing plays no part in protecting these.

Visa and MasterCard claim that exclusive dealing prevents American Express or Discover from cherry-picking the most attractive banks to issue through. Presumably the argument behind this is that Visa and MasterCard issue through all banks, the most attractive and smaller less attractive banks. This wide distribution is positive from consumer's point of view as it increases choice. If American Express or Discover were allowed to issue through banks they would choose only the most attractive banks, this would reduce Visa's and MasterCard's profits in this area so reducing their ability to service less attractive smaller banks. MasterCard has been cherry-picking Visa's best banks using price breaks and other incentives, this has pro-competitive effects (American Banker 1/08/00).

Another pro-competitive argument for exclusive dealing is that it can prevent excessive entry. There may be inefficiencies associated with American Express and Discover being allowed to issue through banks as they may invest large sunk costs in trying to take profits from Visa and MasterCard. Rather then actually increasing the market (which is pro-competitive) they may wastefully duplicate investments in trying to reshuffle profits.

Finally an argument in favour of foreclosure is that while vertical restraints may delay entry, they merely prevent an entrant (American Express or Discover) from gaining unfair advantage. The entrants costs may be raised by the incumbents (Visa and MasterCard) vertical practices, but even with these practices the entrants cost may be no higher than that originally incurred by the incumbent. According to this argument *'vertical restraints should be permitted even if they discourage entry because, like patents, they ultimately increase welfare by protecting incentives for innovation and pioneering entry in new markets'* (Schwartz & Eisenstadt, 1982: 23). However allowing entry may still be desirable. Clearly, all patents have an expiry date, how long should such benefits last?

Welfare decreasing functions

Exclusive dealing can be designed to foreclose competitors by denying them distribution outlets. Schwartz & Eisenstadt (1982) argue that for exclusive dealing to actually raise the distribution costs to rivals, it is necessary that the manufacturers (Visa and MasterCard) possess a high share of the product market, control a large share of distribution outlets and that entry into distribution be costly. I would contend that these three conditions hold in this case. Visa and MasterCard control 75 per cent of the market in terms of transaction volume while banks issue over 85 per cent of general-purpose cards and, given the scale economies in the industry, entry into distribution is costly (Visa 1998 found that branch solicitations cost $29 per account acquired while direct mail solicitations cost over $60 per account acquired). Vertical restraints may also reduce welfare by enabling a firm to exploit its existing market power through increased price discrimination (I wish to look at price-discrimination specifically in relation to merchants).

It has been alleged that in the 1920's automobile manufacturers signed exclusive dealing contracts with distributors partly in order to raise the cost of distribution to prospective manufacturers and discourage their entry (Schwartz & Eisenstadt, 1982:17). This appears to be analogous to this case.

Visa and MasterCard sell to particular banks on condition that those banks do not buy off American Express or Discover. If banks are good distributors, it is possible that Visa and MasterCard are trying to tie up the best distribution outlets (member banks are a unique distribution source because of their experience, expertise and control and access to the "primary financial relationship in America" the checking account). If this were the case, in a normal competitive environment, banks would bid for lower prices from Visa, MasterCard, American Express and Discover. This is pro-competitive and good for consumer welfare. Banks already play Visa and MasterCard off against each other for lower prices. Adding American Express and Discover to this would increase the number of service providers from two to four enhancing price competition and benefiting consumers. However banks cannot play networks against each other because of the exclusionary rules in place and the fact that they face major barriers to exiting their relationship with Visa and MasterCard. Entering an agreement with American Express or Discover would require a bank to convert all Visa or MasterCard accounts to American Express or Discover, causing major customer disruption and potentially damaging customer relationships. Banks would have to liquidate or sell existing Visa and MasterCard accounts, terminating the bank's Plus and Cirrus ATM network membership, which are tied to Visa and MasterCard. In Europe where no exclusive rules exist, '*evidence suggests that tie-ups, such as National Westminster's short-lived UK venture with American Express are rare*' (Wolffe, FT, 19/07/00). Whether they are rare or not though is somewhat irrelevant, it is the fact that they have the potential to take place that is relevant.

Visa and MasterCard exclusionary rules foreclose the market. They limit the output of American Express and Discover in the U.S. by limiting their access to distribution channels. Due to the fact that the credit card industry is driven by scale, they restrict the competitive strength of American Express and Discover by limiting their ability to distribute their cards. This increases costs and may lower their merchant acceptance levels (this will be addressed below). As has been noted under governance duality, smart cards (specifically American Express's Blue Card) would benefit from a broad distribution network, this has been limited because of exclusionary rules (American Banker 04/08/00).

Exclusionary rules deprive consumers of the ability to obtain credit cards that combine the unique features of their preferred bank with any of the four network brands. Finally in discussing the future of the industry it was noted that off-line debit cards are highly significant. Banks have access to DDA, which are required for such cards. The exclusionary rules prevent American Express or Discover from accessing these consumer relationships and the unique expertise of banks.

Merchants are consumers of network services. At the same time merchants' attitudes reflect consumers' attitudes, merchants demand for general-purpose cards are derived from consumers' demand to use them. If American Express and Discover are limited in terms of distribution it will affect merchant acceptance. It is very difficult to analyse the effect on consumer welfare of an increase or decrease in interchange rates. However Visa and MasterCard interchange rates rose by 13 per cent in 1999, consumers did not switch brands because they did not know they were paying more for the goods. Merchants did not switch because they cannot afford to stop accepting Visa and MasterCard (American Banker, 01/08/00). Competition from American Express and Discover at the issuing level is likely to cause Visa and MasterCard to be more responsive to the interests of merchants. The welfare effects of price discrimination are ambiguous. Visa and MasterCard successfully price discriminate *'Since price-discrimination increases total profit extractable for a given degree of market power, the resources devoted to obtaining this market power will increase. Posner views such dissipation of resources for monopoly (rent seeking) as the major inefficiency of price discrimination'* (Schwartz & Eisenstadt, 1982:29). Schwartz and Eisenstadt (1982) argue, *'if market power is acquired through lobbying and litigation, Posner is correct; if acquired through R&D and patenting the effect is less clear.'* I think that it is clear that the former situation is true in this instance.

Finally a number of banks demonstrated that the issuance of American Express was a desired option for them. American Express and Discover, due to their closed-loop systems, can offer certain data collection skills that MasterCard and Visa can not.

Conclusion on Exclusivity Agreement

Removing exclusionary rules increases competition at the issuing level. Competition at the issuing level determines the price consumers pay, and the variety of card features they can obtain. This has a positive impact on consumer welfare. At the same time, increasing competition at the issuing level will strengthen American Express and Discover. This will increase competition at the network services level where the creation of new products, features and cost saving efficiencies occur. As the card network services industry is driven by scale it will lower network costs ultimately having a positive impact on consumer welfare.

Overall Conclusion

Governance duality did not have significant adverse effects on competition or consumer welfare. In fact if full dedication was enforced, it would reduce consumer choice and so would have a negative impact on consumer welfare. Exclusionary rules have suppressed competition in the issuing market that in turn has had a negative effect on competition in the network services market. In my opinion, this has resulted in a blunting of innovation in terms of smart cards for customers, a restriction in output, higher prices for merchants that are then passed on to consumers and higher costs for American Express and Discover. I see the exclusionary rules as being anti-competitive, they have had adverse effects on consumer welfare and so should be abolished.

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[1] All facts used in this analysis are taken from this case unless otherwise stated in the text.