

Editor's Introduction

This *Review* contains the proceedings of a symposium on antitrust issues in the operation of payment system networks, sponsored by the Federal Reserve Bank of St. Louis in March 1995. This article introduces the topic and provides an overview of the articles in this issue.

Antitrust enforcement in the banking industry, which dates from the early 1960s, has focused primarily on banking consolidation, not on the operation of payment systems. For several decades preceding the 1960s, the overriding objective of federal banking regulation had been the safety and soundness of banks. Restrictions on banking competition were part of a policy to limit the chances of bank failure.¹ Federal legislation and rulings of the U.S. Supreme Court in the early 1960s, however, changed this policy by making the banking industry subject to the antitrust laws.

The new legislation and court rulings sparked research on the effects of consolidation on competition among banks.² Research on the determinants of banking competition has focused primarily on the concentration of deposits or assets among banks with offices in local markets. In this framework, researchers assume that all banks in a market compete with each other for consumers, who are limited to services from banks in their market. Banks in markets with higher concentration are assumed to compete less aggressively for local customers.³

This framework is not adequate for dealing with some issues concerning banking competition. An efficient payment system requires that banks cooperate to process the payment orders of their depositors. The challenge of applying the principles of antitrust to the payments activities of banks involves permitting enough cooperation among banks to facili-

tate an efficient payment system, while preserving incentives for competitive behavior.

The development of clearinghouses in the United States illustrates how banks can improve the efficiency of the payment system through cooperation. Myers (1931, pp. 94-97) describes the problems that banks in New York City had in operating the payment system prior to the formation of the clearinghouse in that city in 1853. To settle for banknotes and checks drawn on other banks, each bank would send messengers with banknotes or checks to other banks to receive gold coin in exchange. Banks had to hold large inventories of gold to meet these demands and had to face the risks inherent in having their couriers moving about the city with large amounts of gold.⁴ Bankers learned that they could settle their accounts more efficiently by exchanging bank notes and checks at a local clearinghouse, which also would hold the gold inventories of the clearinghouse members. Settlement among banks in the clearinghouse involved the movement of gold within the vaults of the clearinghouse.⁵ In addition, banks coordinated their activities through clearinghouses when facing widespread runs by depositors.⁶

The cooperation of banks through clearinghouses also became a means to limit competition. Clearinghouses attempted to coordinate restrictions on the interest rates that banks paid on deposits.⁷ At times, clearinghouses expelled member institutions that were considered to be competing for deposits or loans too aggressively or unfairly.⁸

Banks must cooperate to achieve efficiencies for themselves and their customers in operating networks of automated teller machines (ATMs). The first two articles in this issue examine the history of antitrust policy on mergers of ATM networks from

¹ White (1992), pp. 1-3.

² Kaufman, Mote and Rosenblum (1989).

³ For a survey of these studies, see Gilbert (1984).

⁴ Myers (1931), pp. 94-97.

⁵ Cannon (1910).

⁶ Dwyer and Gilbert (1989).

⁷ Cox (1966).

⁸ Tallman and Moen (1995).

the perspective of antitrust lawyers: Donald I. Baker, "Shared ATM Networks — The Antitrust Dimension" and David A. Balto, "Payment Systems and Antitrust: Can the Opportunities for Network Competition be Recognized?" Baker and Balto note that a series of ATM network mergers have resulted in virtual monopolies of ATM systems within large regions of the country. They interpret the actions of the antitrust authorities (including the Federal Reserve in its role of approving acquisitions by bank holding companies) as reflecting the view that regional ATM networks have characteristics of natural monopolies. Baker and Balto challenge the view that regional ATM networks are natural monopolies and argue for the benefits of preserving network competition. They cite cases of vigorous competition between ATM networks that ceased when networks merged. Baker ends his article with a warning that the policy of permitting the formation of ATM network monopolies over large regions will require involvement of government agents (including the Federal Reserve). Because banks can argue that participation in regional monopoly networks has become essential for remaining viable, the government will have to participate in settling disputes over the terms on which banks may join the networks.

The third article focuses on the privilege of payment systems to restrict their membership: Dennis W. Carlton and Alan S. Frankel, "Antitrust and Payment Technologies." Their article focuses largely on a court case involving Visa and Discover Card. Visa denied an application for membership by a depository institution owned by Discover Card, and Discover Card sued Visa. Their analysis of this case includes evidence that the entry of aggressive competitors into the Visa credit card network made the credit card industry more competitive.

One of the discussants, James J. McAndrews, examines the arguments of Carlton and Frankel concerning two aspects of the market for credit cards: interchange fees and duality. Interchange

fees involve the payments from banks that issued cards to the banks that received the deposits of the merchants that accepted the credit cards as means of payments. The issuing banks pay a fraction of the amounts purchased with the cards to the acquiring banks. The fraction of the purchase price withheld by the issuing bank is called the interchange fee. Carlton and Frankel examine the potential for members of credit card systems to extract monopoly profits from merchants through interchange fees. McAndrews challenges the argument that the existence of interchange fees necessarily reflects anti-competitive practices by members of a payment system.

Duality involves the freedom of banks to offer their customers access to more than one competing payment system. In the past Visa and MasterCard restricted duality. A bank that joined one card system was not permitted to join the other. The credit card systems removed this restriction and permitted duality in response to a legal challenge. Some antitrust analysts, including Baker and Balto, argue that duality reduces the degree of competition among payment systems. McAndrews argues that a policy of restricting duality may be ineffective as a means of promoting competition among credit card networks. To increase its market share, a network would have to induce banks to switch all of their credit card business from other networks, possibly disrupting relations with its merchant customers and card holders. The costs to banks of switching networks may be too high for effective competition among networks, operating under restrictions on duality.

Nicholas Economides, a second discussant, examines the competitive implications of payment system networks from the perspective of his research on other industries characterized as networks, such as the telephone industry. He suggests a solution to the natural monopoly issue that is being implemented in other network industries: connectivity. To illustrate, long-distance companies are authorized to route their customers' calls

over lines owned by other telephone companies, including their competitors. The equivalent arrangement in the operation of ATM and point-of-sale (POS) systems would be a network with no ATM or POS terminals in a given market area offering its payment services through the terminals of the existing regional monopoly network. This would be a new approach to dealing with the natural monopoly issue in the operation of payment systems.

The articles and discussant comments in this issue of the *Review* deal primarily with two components of the payment system—ATM networks and credit card systems. The articles and comments indicate that issues concerning competition among payments networks are far from settled. These issues are relevant for other components of the payment system, since all components of the payment system function as networks. In addition, development of new payment instruments, such as stored value cards, will have implications for the competitive pricing of payment services. These development will create new challenges for research.

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