

Kemppainen, Kari

**Working Paper**

## Assessing effects of price regulation in retail payment systems

Bank of Finland Research Discussion Papers, No. 19/2005

**Provided in Cooperation with:**

Bank of Finland, Helsinki

*Suggested Citation:* Kemppainen, Kari (2005) : Assessing effects of price regulation in retail payment systems, Bank of Finland Research Discussion Papers, No. 19/2005, ISBN 952-462-231-9, Bank of Finland, Helsinki,  
<https://nbn-resolving.de/urn:nbn:fi:bof-20140807129>

This Version is available at:

<https://hdl.handle.net/10419/212017>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

Kari Kemppainen

# **Assessing effects of price regulation in retail payment systems**

Bank of Finland Research  
Discussion Papers  
19 • 2005

**Suomen Pankki  
Bank of Finland  
P.O.Box 160  
FI-00101 HELSINKI  
Finland  
☎ + 358 10 8311**

**<http://www.bof.fi>**

Bank of Finland Research  
Discussion Papers  
19 • 2005



Kari Kemppainen

# **Assessing effects of price regulation in retail payment systems**

The views expressed are those of the author and do not necessarily reflect the views of the Bank of Finland.

<http://www.bof.fi>

ISBN 952-462-231-9

ISSN 0785-3572

(print)

ISBN 952-462-232-7

ISSN 1456-6184

(online)

Multiprint Oy  
Helsinki 2005

# Assessing effects of price regulation in retail payment systems

Bank of Finland Research  
Discussion Papers 19/2005

Kari Kemppainen  
Monetary Policy and Research Department

## Abstract

This paper considers effects of price regulation in retail payment systems by applying the model of telecommunications competition by Laffont-Rey-Tirole (1998). In our two-country model world there is one retail payment network located in each country and markets are segmented à la Hotelling. We show that the optimal price under price regulation is the weighted average of pre-regulation domestic and cross-border prices where the degree of home-bias in making payments serves as the weight. Furthermore, we find that the general welfare effects of price regulation are ambiguous: gross social welfare is higher under price discrimination than under price regulation in the special case where costs of access to banking services (transportation costs) are high. However, there also exist cases where prohibitively high transaction costs make price discrimination to reduce total welfare. Finally, if transportation costs are reduced sufficiently, segmentation of payment markets is eliminated. Markets then become fully-served as in the original Laffont-Rey-Tirole model, suggesting that price discrimination would be beneficial for welfare.

Key words: payment systems, price regulation, retail payments

JEL classification numbers: D49, G28, L59

# Hintasääntelyn vaikutuksista vähittäismaksujärjestelmissä

Suomen Pankin tutkimus  
Keskustelualoitteita 19/2005

Kari Kemppainen  
Rahapolitiikka- ja tutkimusosasto

## Tiivistelmä

Tässä tutkimuksessa analysoidaan hintasääntelyn vaikutuksia vähittäismaksujärjestelmissä soveltamalla Laffont – Rey – Tirolen (1998) telekommunikaatioalan kilpailumallia maksujärjestelmiin. Tarkastelussa käytetään kahden maan mallia, jossa kummassakin maassa toimii yksi vähittäismaksujärjestelmä ja markkinat ovat jakautuneet Hotellingin mallin mukaan. Tutkimuksessa osoitetaan, että hintasääntelyn tilanteessa optimaalinen hinta on sääntelyä edeltävistä koti- ja ulkomaan maksujen hinnoista laskettu painotettu keskiarvo, jossa painona käytetään ns. kotimarkkinaharhaa. Hintasääntelyn hyvinvointivaikutukset ovat mallissa epäselvät: hyvinvointi on suurempi hintadiskriminaation tilanteessa verrattuna sääntelytilanteeseen, kun pankkipalveluihin pääsyn kustannukset ovat suuret. Jos nämä kustannukset otetaan eksplisiittisesti huomioon, kokonaisyhyvinvointi on pienempi hintadiskriminaation vallitessa. Kuitenkin, jos pankkipalveluihin pääsyn kustannuksia alennetaan huomattavasti, maksupalvelumarkkinoiden segmentaatio katoaa ja markkinat tulevat täysin katetuiksi kuten alkuperäisessä Laffont – Rey – Tirolen mallissa. Tällöin hintadiskriminaation salliminen parantaisi hyvinvointia.

Avainsanat: maksujärjestelmät, hintasääntely, pienet maksut

JEL-luokittelu: D49, G28, L59

# Contents

Abstract.....	3
Tiivistelmä (abstract in Finnish).....	4
<b>1 Introduction.....</b>	<b>7</b>
<b>2 The model.....</b>	<b>9</b>
2.1 Cost and price structure.....	11
2.2 Demand structure.....	12
<b>3 Effects of price regulation.....</b>	<b>13</b>
3.1 Discriminatory pricing case.....	13
3.2 Uniform pricing case.....	17
3.3 Welfare effects of price regulation.....	19
<b>4 Discussion and policy implications.....</b>	<b>22</b>
References.....	27
Appendix 1 Proportionality rule.....	29
Appendix 2 Welfare analysis.....	31





# 1 Introduction

Payment system issues have received an increasing attention as an integral part of the integration process in the European financial markets. The final goal in the payments area is to achieve a *Single Euro Payments Area (SEPA)*, where there should be no difference between domestic and cross-border euro payments. Concerning large-value value payments, much progress has been achieved, and today the central bank owned TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system) and the privately owned Euro Banking Association's Euro 1 – payment systems are the main large-value payment systems offering their services in the EU-wide scale. In contrast, the development in the cross-border retail payment system area has been slower, and the fact that the prices of cross-border retail payments have remained higher than comparable domestic retail payments has provoked much discussion in recent years. In the advent of introduction of euro notes and coins, the authorities decided to resort to a strong regulatory measure to correct the situation as well as to foster the development in the cross-border retail payments area. As a concrete measure, the European Parliament and the EU Council adopted Regulation (EC) No. 2560/2001 on Cross-border Payments in Euro in December 2001. The Regulation obliges banks to charge equal prices for domestic and cross-border retail payments, and it has applied to card payments and ATM (Automated Teller Machine) withdrawals as from 1 July 2002 and to cross-border credit transfers as from 1 July 2003.

Concerning the regulated payments, the wording in the Article 3 of the Regulation is the following:

1. *With effect from 1 July 2002 at the latest, charges levied by an institution in respect of cross-border electronic payment transactions in euro up to EUR 12 500 shall be the same as charges levied by the same institution in respect of corresponding payments in euro transacted within Member State in which the establishment of that institution executing the cross-border electronic payment transaction is located.*
2. *With effect from 1 July 2003 at the latest, charges levied by an institution in respect of cross-border credit transfers in euro up to EUR 12 500 shall be the same as charges levied by the same institution in respect of corresponding credit transfers in euro transacted within Member State in which the establishment of that institution executing the cross-border transfer is located.*

In a nutshell, the implementation of the Regulation has meant that the price discrimination between comparable domestic and cross-border euro retail

payments has been banned and the payment service providers have been forced to change their previous pricing policies.

On the one hand, the Regulation can be seen as a strong regulatory measure to foster the integration process in financial markets by ‘forcing’ the Single Market - concept also in the retail payment systems area. On the other hand, the Regulation and its effects also offer an interesting research question that can be approached theoretically by applying models of competition used in other network industries. This is justifiable on the grounds that payment industry has many characteristics in common with network industries, like telecommunications. Accordingly, the general framework of our study is related to the literature on competition in telecommunications: eg Armstrong (1998), Laffont-Rey-Tirole (1998a, 1998b), Schiff (2001a, 2001b) and Dessein (2003).

The central research question of our study is simple: what are the effects of price regulation in retail payments in the light of an applied theoretical model. The question is interesting because the Regulation on Cross-border Payments in euro was heavily debated when it was launched. The adoption of the Regulation was strongly criticised by the payment service provider sector (mainly the banking sector) who argued for a market-driven solution.<sup>1</sup> The authorities, in turn, saw the Regulation as an ultimate measure to facilitate the lagging development efforts in the sector. These real-life controversies provide a fruitful background for our theoretical study. For policy analysis purposes, our study also aims at contributing to this debate by providing some aspects and theoretical considerations that can be taken into account.

A further motivation for our study is the scarcity of existing literature analysing the retail payment system industry as network industry.<sup>2</sup> To our knowledge, there exist very few theoretical studies analysing the pricing of payment services based on price competition between the service providers. In fact, the study by Weinberg (2002) comes closest to our study. He analysed the differences between cooperative and independent setting of interbank prices (prices for customer payments between banks in this context) in alternative market environments: segmented versus fully-served markets. He concluded that cooperation in setting interbank prices typically leads to lower prices and greater consumer welfare and profits when markets are segmented. When markets become integrated (fully-served), cooperation in setting interbank prices can result in higher interbank prices and reduced consumer welfare.

---

<sup>1</sup> However, after the adoption of the Regulation, the banking sector activated and reacted by establishing a common decision-making body, the European Payments Council (EPC) to foster the development. The EPC has published a White Paper: European Payments Council (2002): *Euroland: Our Single Payment Area!* where measures and steps towards the Single Euro Payments Area (SEPA) are presented. Thereafter, the work of the EPC has been intensified and more concrete plans have been published, see [www.europeanpaymentscouncil.org](http://www.europeanpaymentscouncil.org).

<sup>2</sup> A brief review of literature on network effects in retail payment systems is provided eg in Chapter 3.4 in Kempainen (2003).

In our study, we focus on effects induced by price regulation on retail payment systems and base our analysis on the telecommunications competition framework of the Laffont-Rey-Tirole (1998a, 1998b). As stressed above, this is justified because many similarities exist between the payment and telecommunication industries. Moreover, there are several reasons to utilise the Laffont-Rey-Tirole modelling framework. First, the Laffont-Rey-Tirole model has become a ‘standard model’ to analyse competition in telecommunications. Secondly, in contrast with many other network industry models, the Laffont-Rey-Tirole model provides an elegant way to introduce network externalities. Thirdly, if we give transportation costs a ‘payment technology interpretation’ in the model, we can analyse the effects of deepening financial integration by lowering the transportation cost leading to integrated and fully-served payment markets where national borders do not pose obstacles for payment system competition.

The outline of the paper is as follows. Chapter 2 presents the main building blocks of the Laffont-Rey-Tirole -based model that is used to analyse the effects of price regulation in retail payments. Chapter 3 studies first the pre-regulation pricing case (discriminatory pricing) and then the post-regulation case (uniform pricing) that prevails when the Regulation is in force. Thereafter the welfare changes between the two cases are examined. Chapter 4 concludes and provides a discussion on the main policy issues.

## 2 The model

The Laffont-Rey-Tirole (1998b) (hereafter LRT) model of telecommunications competition and interconnection is applied to analyse effects of price regulation in retail payment systems. In the original LRT-model, there are two horizontally differentiated networks that supply telecommunication services. The networks discriminate in their tariffs according to the destination network: a network offers two prices to its subscribers, one for calls made to other subscribers of the same network and one for calls to the rival network.

In our model, the two networks are interpreted to be retail payment networks located in two countries offering price-discriminated domestic and cross-border payment services to their customers. As in LRT, we also assume that the retail payment networks are differentiated à la Hotelling and consumers are uniformly located on the segment  $[0,1]$ . The payment networks are located at the two extremities of the segments. In contrast to LRT where the markets are assumed to be fully covered, we assume that the transportation costs (costs associated with access to banking services) are so high that the markets are segmented; ie only

partially covered.<sup>3</sup> This is the first change we make to the original LRT-framework. Secondly, we modify LRT's balanced calling pattern assumption to correspond better the payment service world (discussed below) and, we also drop out the fixed cost term,  $f$ , of serving a customer to reduce complexity in calculations. It turns out that these simple modifications change some results LRT obtained in their analysis on telecommunication markets.

There are two key assumptions made in LRT, (i) reciprocal access charges and (ii) balanced calling pattern (balanced payment pattern in our model), that deserve some attention in the payment systems context. The reciprocal access charge assumption means that a network pays as much for the termination of a payment on the foreign network (cross-border payment) as it receives for completing a payment originated on the foreign network and resembles thus multilateral interchange fees.

The balanced payment pattern assumption, in turn, is more problematic and would imply that statistically a consumer had an equal chance of making a payment to a given consumer belonging to her network and another given consumer belonging to the foreign network. Accordingly, the percentage of payments originated on a network and completed on the same network (domestic payments) would be equal to that network's market size. In our framework, this would imply that the division of domestic and cross-border payments depended directly on the sizes (denoted by  $\alpha_i$  and  $\alpha_j$ ) of payment networks in the two countries: ie fraction  $\alpha_i$  of the payments originated in network  $i$  were domestic payments and fraction  $\alpha_j$  cross-border payments.

However, this balanced payment pattern assumption is in conflict with the real-life situation because domestic retail payments are much more frequently made than cross-border payments. In fact, currently cross-border retail payments represent roughly 1–2% of all retail payments in the EU. Therefore, in order to better reflect the real-life situation, we introduce a sort of 'home bias' (denoted by a scale factor,  $S$ ) in making payments. Home bias in making payments simply means that the cross-border payments are scaled down by a scale factor  $S$  ( $0 \leq S \leq 1$ ). The home bias is assumed to be the same in both countries. The aggregate payment pattern is then ( $\alpha_1$  and  $\alpha_2$  representing the sizes of payment networks in the two countries).

---

<sup>3</sup> The use of segmented market Hotelling model to describe the competitive situation in retail payment markets is grounded because, in the international context, the retail payment systems located in different countries are not directly competing with each other and are more or less acting as local monopolies. Furthermore, when assuming first segmented markets, we can also study the effects of technological progress lowering transportation costs: once transportation costs are so low that the payments markets are fully-served, we move back to the original LRT-framework.

	Aggregate payment pattern	
	country 1	country 2
domestic payments	$\alpha_1\alpha_1$	$\alpha_2\alpha_2$
cross-border payments	$S\alpha_1\alpha_2$	$S\alpha_2\alpha_1$

The ‘home-biased’ payment pattern in our model means that a consumer belonging to the payment network  $i$  has a probability  $\alpha_i$  to make a domestic payment and a probability  $S\alpha_j$  to make a cross-border payment. If  $S=1$  (no home bias), then the situation is the same as in balanced payment pattern where the probabilities for domestic and cross-border payments are  $\alpha_1$  and  $\alpha_2$ , respectively. If  $S=0$ , then only domestic payments are made.

## 2.1 Cost and price structure

As in LRT, the two retail payment networks have the same cost structure. A network incurs a marginal cost  $c_0$  per payment at the originating and terminating ends of the payment and marginal cost  $c_1$  in between. The total marginal cost of a payment is thus

$$c = 2c_0 + c_1$$

The total marginal cost of *a domestic payment* (a payment that is originated and terminated in one network) is then  $c$ .

The cost of *a cross-border payment* differs from  $c$  because payment networks pay each other a reciprocal two-way access charge for terminating each other’s cross-border payments. The unit access charge to each other’s network is denoted by  $a$  and is assumed to be same for both networks. Accordingly, the total marginal cost of a cross-border payment is  $c + a - c_0$ .

Under price discrimination,  $p_i$  and  $\hat{p}_i$  denote domestic and cross-border prices charged by retail payment network  $i$ , and  $\alpha_i$  denote network  $i$ ’s market size defined in terms of network subscribers. In our model, markets are segmented so that  $\alpha_1 + \alpha_2 < 1$  (in LRT-model markets are fully covered:  $\alpha_1 + \alpha_2 = 1$ ).

The cost and price structure can be summarised as follows:

	Network 1	Network 2
Domestic payment	price $p_1$ , cost $c$	price $p_2$ , cost $c$
Cross-border payment	price $\hat{p}_1$ , cost $c + a - c_0$	price $\hat{p}_2$ , cost $c + a - c_0$

## 2.2 Demand structure

Following the LRT-model, we assume that the retail payment networks are differentiated à la Hotelling. Consumers are uniformly located on the segment  $[0,1]$  and the networks are located at the two extremities of the segments,  $x_1 = 0$  and  $x_2 = 1$ . Given income  $y$  and payment consumption  $q$ , a consumer located at  $x$  and joining network  $i$  has a utility

$$y + v_0 - t|x - x_i| + u(q)$$

where  $v_0$  represents a fixed surplus from being connected to a payment network,  $t|x - x_i|$  denotes the cost associated with access to banking services ( $t$  being the ‘transportation cost’). The variable gross surplus  $u(q)$  is given by

$$u(q) = \frac{q^{1-(1/\eta)}}{1 - \frac{1}{\eta}}$$

which yields constant elasticity demand function

$$u'(q) = p \Leftrightarrow q = p^{-\eta}$$

It is assumed that the elasticity of demand,  $\eta$ , exceeds one and is same for both domestic and cross-border payments. It is also assumed that  $v_0$  is ‘large enough’ so that both networks have positive market sizes even though the transportation cost  $t$  is also assumed to be so high that the payment networks in the two countries are local monopolies (segmented market assumption).

Under linear pricing and the possibility of price discrimination, and for market sizes  $(\alpha_1, \alpha_2)$ , network  $i$  offers its customers a *variable net surplus*

$$w(p_i, \hat{p}_i) = \alpha_i v(p_i) + S\alpha_j v(\hat{p}_i) \quad (2.1)$$

where  $v(p_i) = \max_{q(p_i)} \{u(q(p_i)) - p_i q(p_i)\} = \frac{p_i^{-(\eta-1)}}{\eta-1}$  (net surplus from domestic payments)

$v(\hat{p}_i) = \max_{q(\hat{p}_i)} \{u(q(\hat{p}_i)) - \hat{p}_i q(\hat{p}_i)\} = \frac{\hat{p}_i^{-(\eta-1)}}{\eta-1}$  (net surplus from cross-border payments).

According to Equation (2.1), consumer's variable surplus depends on the prices of both domestic and cross-border payments, on the market sizes of the networks as well as on the magnitude of home bias,  $S$ , in making payments. From equation (2.1), it can also be seen that price discrimination creates positive, tariff-mediated network externalities. Customers of network  $i$  are better off the bigger (smaller) the network is if  $p_i < \hat{p}_i$  ( $p_i > \hat{p}_i$ ). The existence of these network externalities can lead to the same kind of coordination problem for consumers, and possibility of multiple equilibria, as in models of network externalities where there is no interconnection, such as Katz and Shapiro (1985).

### 3 Effects of price regulation

The Regulation on cross-border payments in euro means that the price discrimination is not anymore possible. In our model this indicates that the prices of domestic and cross-border payments must be equal,  $p_i = \hat{p}_i = \bar{p}_i$ . We first analyse the pre-regulation discriminatory pricing case and then compare it to uniform pricing case that prevails under the Regulation. We discuss the welfare implications of the regulation at the end of the Chapter.

#### 3.1 Discriminatory pricing case

##### **Market sizes**

As mentioned at the end of Chapter 2, the existence of network externalities in our model can lead to the possibility of multiple equilibria. Therefore, we assume, as eg in Shy (2001), that consumers have a perfect foresight and can thus correctly anticipate how many consumers will be subscribing each network. In other words, the expected network sizes will correspond to equilibrium network sizes as in fulfilled expectations equilibrium used in Katz and Shapiro (1985). Accordingly, when assuming  $\alpha_i^e = \alpha_i$ , we are able to circumvent multiple equilibria problem and get unique market sizes.

Let  $x_1$  denote a customer who is indifferent between using network 1's payment services and not using payment services at all. Similarly, let  $x_2$  denote a customer who is indifferent between using network 2's payment services and not using payment services at all. This means that consumers between 0 and  $x_1$  use network 1 (located at 0) while those between  $x_2$  and 1 use network 2 (located at 1). The corresponding market sizes (denoted by  $\alpha_1 = x_1$  and  $\alpha_2 = 1 - x_2$ ) are determined by the consumers' net utilities



$$\begin{aligned} \text{Network 1} \\ v_0 + w(p_1, \hat{p}_1) - t\alpha_1 = 0 \end{aligned}$$

$$\begin{aligned} \text{Network 2} \\ v_0 + w(p_2, \hat{p}_2) - t\alpha_2 = 0 \end{aligned}$$

which, when utilising Equation (2.1), become

$$\begin{aligned} v_0 + \alpha_1 v(p_1) + S\alpha_2 v(\hat{p}_1) - t\alpha_1 = 0 & \quad v_0 + \alpha_2 v(p_2) + S\alpha_1 v(\hat{p}_2) - t\alpha_2 = 0 \\ \alpha_1 = \frac{v_0 + S\alpha_2 v(\hat{p}_1)}{t - v(p_1)} & \quad \alpha_2 = \frac{v_0 + S\alpha_1 v(\hat{p}_2)}{t - v(p_2)} \end{aligned}$$

Accordingly, the market sizes of payment networks can be written as

$$\begin{aligned} \alpha_1 &= \frac{v_0(t + Sv(\hat{p}_1) - v(p_2))}{(t - v(p_1))(t - v(p_2)) - S^2v(\hat{p}_1)v(\hat{p}_2)} \\ \alpha_2 &= \frac{v_0(t + Sv(\hat{p}_2) - v(p_1))}{(t - v(p_1))(t - v(p_2)) - S^2v(\hat{p}_1)v(\hat{p}_2)} \end{aligned} \tag{3.1}$$

To simplify notations, we let  $m \equiv \frac{a - c_0}{c}$  denote the markup on access relative to the total cost of a payment. Furthermore, we also assume that, like in LRT, ‘a proportionality rule’ holds for the relation between domestic and cross-border payment prices.<sup>4</sup> The proportionality rule means that the ratio between cross-border and domestic payment prices reflects the relative markup on access  $\frac{\hat{p}_i}{p_i} = 1 + m$ .

The proportionality rule can be used to reduce price competition to the choice of a single price  $p_i$  per network. Under the proportionality rule, customers’ variable net surplus (Equation (2.1)) becomes

$$\begin{aligned} w_i &= \alpha_i v(p_i) + S\alpha_j v(\hat{p}_i) = \alpha_i v(p_i) + S\alpha_j \frac{v(p_i)}{(1 + m)^{\eta-1}} \\ &= (\alpha_i + S\alpha_j) v(p_i) \end{aligned} \tag{3.2}$$

where

---

<sup>4</sup> In the following, we constrain our analysis to the cases where the proportionality rule holds. The validity of the proportionality rule under constrained optimisation is shown in Appendix 1.

$$k \equiv \frac{1}{(1+m)^{\eta-1}}$$

When further utilising the proportionality rule, the market size equations (3.2) can be written as

$$\alpha_1 = \frac{v_0(t + Skv(p_1) - v(p_2))}{(t - v(p_1))(t - v(p_2)) - S^2k^2v(p_1)v(p_2)}$$

$$\alpha_2 = \frac{v_0(t + Skv(p_2) - v(p_1))}{(t - v(p_1))(t - v(p_2)) - S^2k^2v(p_1)v(p_2)}$$
(3.3)

Finally, when we denote the index of access to banking services as the inverse of the transportation cost,  $\sigma = 1/t$ , the market sizes become

$$\alpha_1 = \frac{v_0\sigma[1 - \sigma(v(p_2) - Skv(p_1))]}{1 - \sigma(v(p_1) + v(p_2)) + \sigma^2v(p_1)v(p_2)(1 - S^2k^2)}$$

$$\alpha_2 = \frac{v_0\sigma[1 - \sigma(v(p_1) - Skv(p_2))]}{1 - \sigma(v(p_1) + v(p_2)) + \sigma^2v(p_1)v(p_2)(1 - S^2k^2)}$$
(3.4)

Differentiating (3.4) we can see that the effect of network 1's price on market size is (similarly for network 2's price)

$$\frac{\partial \alpha_1}{\partial p_1} = \frac{-v_0\sigma^2q(p_1)(1 + Sk)(1 - \sigma v(p_2))}{\{1 - \sigma(v(p_1) + v(p_2)) + \sigma^2v(p_1)v(p_2)(1 - S^2k^2)\}^2} \cdot [1 - \sigma v(p_2) + Sk\sigma v(p_2)]$$

$$\frac{\partial \alpha_2}{\partial p_1} = \frac{-v_0\sigma^2q(p_1)(1 + Sk)Sk\sigma v(p_2)}{\{1 - \sigma(v(p_1) + v(p_2)) + \sigma^2v(p_1)v(p_2)(1 - S^2k^2)\}^2} \cdot [1 - \sigma v(p_2) + Sk\sigma v(p_2)]$$

*Remark 1.* The effect of network  $i$ 's price on market size goes in the same direction for both networks. This is in contrast with LRT results and is due to our segmented markets assumption.

In the pre-regulation discriminatory pricing case, the profit function of network  $i$  can be written as

$$\pi_i = \alpha_i \left[ \alpha_i(p_i - c)q(p_i) + S\alpha_j(\hat{p}_i - c(1+m))q(\hat{p}_i) \right] + S\alpha_i\alpha_j mcq(\hat{p}_j)$$

domestic
cross-border payments
access revenue

(3.5)

Accordingly, payment network  $i$ 's profit is composed of revenue from domestic and cross-border payments as well as access revenue (assuming that  $m > 0$ ) it receives for terminating other network's cross-border payments.

Under the proportionality rule, the profit function for network 1 (similarly for network 2) can be written as

$$\pi_1 = \alpha_1 [(\alpha_1 + Sk\alpha_2)R(p_1)] + S\alpha_1\alpha_2 \frac{kmc}{1+m} p_2^{-\eta} \quad (3.6)$$

where  $R(p_1) = (p_1 - c)q(p_1)$ .

The first order condition for profit maximisation for network 1 is (similarly for network 2)

$$\begin{aligned} \frac{\partial \pi_1}{\partial p_1} = & \frac{\partial \alpha_1}{\partial p_1} [(\alpha_1 + Sk\alpha_2)R(p_1)] + \alpha_1 \frac{\partial \alpha_1}{\partial p_1} R(p_1) + \alpha_1 Sk \frac{\partial \alpha_2}{\partial p_1} R(p_1) + \alpha_1 (\alpha_1 + Sk\alpha_2) R'(p_1) \\ & + \frac{\partial \alpha_1}{\partial p_1} S\alpha_2 \frac{kmc}{1+m} p_2^{-\eta} + \frac{\partial \alpha_2}{\partial p_1} S\alpha_1 \frac{kmc}{1+m} p_2^{-\eta} = 0. \end{aligned}$$

Under symmetry,  $\alpha_1 = \alpha_2 = \alpha$ ,  $p_1 = p_2 = p$ , and from the proportionality rule  $\hat{p}_1 = \hat{p}_2 = \hat{p} = (1+m)p$ , and denoting  $v = v(p)$ , the first-order condition can be written as

$$\begin{aligned} \frac{p-c}{p} = & \frac{\hat{p}-c(1+m)}{\hat{p}} = \\ & \frac{1}{\eta} \left[ 1 - \frac{\sigma(1-\sigma v)}{(1-\sigma v)^2 - S^2 k^2 \sigma^2 v^2} R(p) \left( 2 + Sk + \frac{S^2 k^2 \sigma v}{1-\sigma v} \right) \right] \\ & - \frac{1}{\eta} \frac{\sigma(1-\sigma v)}{(1-\sigma v)^2 - S^2 k^2 \sigma^2 v^2} \frac{Skmc}{1+m} p^{-\eta} (1-\sigma v + Sk\sigma v) \\ = & \frac{1}{\eta} \left[ 1 - \frac{\sigma(1-\sigma v)}{(1-\sigma v)^2 - S^2 k^2 \sigma^2 v^2} \left( R(p) \left( 2 + Sk + \frac{S^2 k^2 \sigma v}{1-\sigma v} \right) + \frac{Skmc}{1+m} p^{-\eta} (1-\sigma v + Sk\sigma v) \right) \right]. \end{aligned} \quad (3.7)$$

The first-order condition equation (3.7) is complicated but it implicitly gives the optimal prices for domestic and cross-border payments in the discriminatory pricing case.

### 3.2 Uniform pricing case

The Regulation means that both domestic and cross-border retail payments must be priced equally. In our model this means that  $p_i = \hat{p}_i = \bar{p}_i$ , ie only one uniform price is charged for both type of payments. In the following, we refer this case as the uniform pricing case.

#### Market sizes

The procedure to define market sizes follows similar steps as in the case of price discrimination. Accordingly, under perfect foresight assumption  $\alpha_i^e = \alpha_i$ , market sizes are determined by the consumers' net utility expressions

Network 1

$$v_0 + \alpha_1 v(\bar{p}_1) + S\alpha_2 v(\bar{p}_1) - t\alpha_1 = 0$$

$$\alpha_1 = \frac{v_0 + S\alpha_2 v(\bar{p}_1)}{t - v(\bar{p}_1)}$$

Network 2

$$v_0 + \alpha_2 v(\bar{p}_2) + S\alpha_1 v(\bar{p}_2) - t\alpha_2 = 0$$

$$\alpha_2 = \frac{v_0 + S\alpha_1 v(\bar{p}_2)}{t - v(\bar{p}_2)}$$

and we can solve the market sizes to be

$$\alpha_1 = \frac{v_0(t + Sv(\bar{p}_1) - v(\bar{p}_2))}{(t - v(\bar{p}_1))(t - v(\bar{p}_2)) - S^2 v(\bar{p}_1)v(\bar{p}_2)}$$

$$\alpha_2 = \frac{v_0(t + Sv(\bar{p}_2) - v(\bar{p}_1))}{(t - v(\bar{p}_1))(t - v(\bar{p}_2)) - S^2 v(\bar{p}_1)v(\bar{p}_2)}$$
(3.8)

If we denote the index of access to banking services as  $\sigma = 1/t$ , the market sizes become

$$\alpha_1 = \frac{v_0\sigma[1 - \sigma(v(\bar{p}_2) - Sv(\bar{p}_1))]}{1 - \sigma(v(\bar{p}_1) + v(\bar{p}_2)) + \sigma^2 v(\bar{p}_1)v(\bar{p}_2)(1 - S^2)}$$

$$\alpha_2 = \frac{v_0\sigma[1 - \sigma(v(\bar{p}_1) - Sv(\bar{p}_2))]}{1 - \sigma(v(\bar{p}_1) + v(\bar{p}_2)) + \sigma^2 v(\bar{p}_1)v(\bar{p}_2)(1 - S^2)}$$
(3.9)

In the post-regulation uniform pricing case, the effects of network 1's price on market sizes are (similarly for network 2)

$$\frac{\partial \alpha_1}{\partial \bar{p}_1} = \frac{-v_0 \sigma^2 q(\bar{p}_1)(1+S)(1-\sigma v(\bar{p}_2))}{\{1-\sigma(v(\bar{p}_1)+v(\bar{p}_2))+\sigma^2 v(\bar{p}_1)v(\bar{p}_2)(1-S^2)\}^2} \cdot [1-\sigma v(\bar{p}_2)+S\sigma v(\bar{p}_2)]$$

$$\frac{\partial \alpha_2}{\partial \bar{p}_1} = \frac{-v_0 \sigma^2 q(\bar{p}_1)(1+S)S\sigma v(\bar{p}_2)}{\{1-\sigma(v(\bar{p}_1)+v(\bar{p}_2))+\sigma^2 v(\bar{p}_1)v(\bar{p}_2)(1-S^2)\}^2} \cdot [1-\sigma v(\bar{p}_2)+S\sigma v(\bar{p}_2)]$$

*Remark 2.* The effect of network  $i$ 's price on market sizes goes in the same direction for both networks. This is in contrast with LRT results and is due to our segmented market assumption.

In the uniform pricing case, the expression for network  $i$ 's profits is

$$\pi_i = \alpha_i \left[ \alpha_i (\bar{p}_i - c) q(\bar{p}_i) + S \alpha_j (\bar{p}_i - c(1+m)) q(\bar{p}_i) \right] + S \alpha_i \alpha_j m c q(\bar{p}_j) \quad (3.10)$$

domestic                      cross-border payments      access revenue

The first order condition for profit maximisation is for network 1 (similarly for network 2)

$$\begin{aligned} \frac{\partial \pi_1}{\partial \bar{p}_1} &= \frac{\partial \alpha_1}{\partial \bar{p}_1} [\alpha_1 (\bar{p}_1 - c) q(\bar{p}_1) + S \alpha_2 (\bar{p}_1 - c(1+m)) q(\bar{p}_1)] \\ &+ \alpha_1 \frac{\partial \alpha_1}{\partial \bar{p}_1} (\bar{p}_1 - c) q(\bar{p}_1) + \alpha_1 \alpha_1 q(\bar{p}_1) + \alpha_1 \alpha_1 (\bar{p}_1 - c) q'(\bar{p}_1) + S \alpha_1 \frac{\partial \alpha_2}{\partial \bar{p}_1} (\bar{p}_1 - c(1+m)) q(\bar{p}_1) \\ &+ S \alpha_1 \alpha_2 q(\bar{p}_1) + S \alpha_1 \alpha_2 (\bar{p}_1 - c(1+m)) q'(\bar{p}_1) \\ &+ \frac{\partial \alpha_1}{\partial \bar{p}_1} S \alpha_2 m c q(\bar{p}_2) + \frac{\partial \alpha_2}{\partial \bar{p}_1} S \alpha_1 m c q(\bar{p}_2) = 0 \end{aligned}$$

Under symmetry,  $\bar{p}_1 = \bar{p}_2 = \bar{p}$ ,  $\alpha_1 = \alpha_2 = \alpha$ , and denoting  $v = v(\bar{p})$ , the first-order condition becomes

$$\frac{\bar{p} - c(1 + \frac{S}{1+S}m)}{\bar{p}} = \frac{1}{\eta} \left[ 1 - \frac{\sigma(1-\sigma v)}{(1-\sigma v)^2 - S^2 \sigma^2 v^2} R(\bar{p}) \left( 2 + S + \frac{S^2 \sigma v}{1-\sigma v} \right) \right] \quad (3.11)$$

The Equation (3.11) implicitly gives the optimal price in the uniform pricing case.

### 3.3 Welfare effects of price regulation

In this section, effects of price regulation are examined by comparing the discriminatory and uniform pricing cases. Fixing the reciprocal access charge  $a$ , effects of price regulation are now studied in the case when the index of access to banking services,  $\sigma = 0$ . The results hold by continuity for small  $\sigma$ . It should be noted that low  $\sigma$  corresponds to large transportation cost  $t$ , and the case  $\sigma = 0$  would in fact mean infinite transportation costs. Therefore, as in LRT, we have to assume that fixed surplus of being connected to a payment network,  $v_0$ , increases as  $\sigma$  tends to zero so that the equilibrium market size of payment networks remain unchanged. In fact, the ‘case  $\sigma = 0$ ’ is defined by taking the limit as  $\sigma \rightarrow 0$  and  $v_0$  increasing.

We define  $p_u$ ,  $p_d$  and  $\hat{p}_d$  to denote the equilibrium prices under uniform pricing and under discriminatory pricing for domestic and cross-border retail payments. For  $\sigma = 0$ , the optimal pricing equations (3.11) and (3.7) can be written as follows

$$\frac{p_u - \left(1 + \frac{S}{1+S}m\right)c}{p_u} = \frac{1}{\eta} \quad (\text{uniform pricing})$$

$$\frac{p_d - c}{p_d} = \frac{1}{\eta} \quad (\text{discriminatory pricing})$$

and

$$\frac{\hat{p}_d - (1+m)c}{\hat{p}_d} = \frac{1}{\eta}$$

Accordingly, the uniform price will be a weighted average of discriminatory prices

$$p_u = \frac{1}{1+S}p_d + \frac{S}{1+S}\hat{p}_d \quad (3.12)$$

where the degree of home-bias in making payments,  $S$ , is the weight. Clearly, when there is an extreme home-bias ( $S=0$ ) the post-regulation uniform price is exactly the pre-regulation domestic price. Respectively, when there is no home bias in making payments, ie  $S=1$ , the uniform price will be the average of the pre-regulation discriminatory prices.

## Welfare comparison

When looking at the global welfare by summing up the consumer and producer surpluses (for complete calculations, see Appendix 2), we get the following expressions for global welfare for the case of very high access cost to banking services ( $\sigma = 0$ ).

Uniform pricing (post-regulation)

$$W^{\text{uniform}} = 2\alpha_u^2(1+S) \left[ \frac{\eta}{\eta-1} p_u^{-(\eta-1)} - c p_u^{-\eta} \right] - t\alpha_u^2 \quad (3.13)$$

Discriminatory pricing (pre-regulation)

$$W^{\text{discriminatory}} = 2\alpha_d^2 \left[ \frac{\eta}{\eta-1} p_d^{-(\eta-1)} - c p_d^{-\eta} \right] + 2S\alpha_d^2 \left[ \frac{\eta}{\eta-1} \hat{p}_d^{-(\eta-1)} - c \hat{p}_d^{-\eta} \right] - t\alpha_d^2 \quad (3.14)$$

For simplicity, the transportation cost terms ( $t\alpha_i^2$ 's) are first dropped out and we concentrate on the gross welfare comparisons

$$\begin{aligned} & W_{\text{gross}}^{\text{discriminatory}} - W_{\text{gross}}^{\text{uniform}} \\ &= 2\alpha_d^2 \left[ \frac{\eta}{\eta-1} p_d^{-(\eta-1)} - c p_d^{-\eta} \right] + 2S\alpha_d^2 \left[ \frac{\eta}{\eta-1} \hat{p}_d^{-(\eta-1)} - c \hat{p}_d^{-\eta} \right] \\ & \quad - 2\alpha_u^2(1+S) \left[ \frac{\eta}{\eta-1} p_u^{-(\eta-1)} - c p_u^{-\eta} \right] \\ &= 2\alpha_d^2 W(p_d) + 2S\alpha_d^2 W(\hat{p}_d) - 2\alpha_u^2(1+S)W(p_u). \end{aligned} \quad (3.15)$$

Accordingly, we can establish the following inequality (stating that gross welfare is higher under discriminatory pricing) and examine whether it holds

$$\begin{array}{cc} \text{uniform} & \text{discriminatory pricing} \\ 2\alpha_u^2(1+S)W(p_u) \leq & 2\alpha_d^2 W(p_d) + 2S\alpha_d^2 W(\hat{p}_d) \end{array} \quad (3.16)$$

By rearranging we get

$$W(p_u) \leq \frac{\alpha_d^2}{\alpha_u^2} \left( \frac{1}{1+S} W(p_d) + \frac{S}{1+S} W(\hat{p}_d) \right) \quad (3.17)$$

The validity of the equation (3.17) is checked in two steps

(i) First examining the market size terms ( $\alpha_d^2/\alpha_u^2$ ):

In symmetry, the equilibrium market sizes under discriminatory pricing  $\alpha_d$  (Equation (3.4)) and uniform pricing  $\alpha_u$  (Equation (3.9)) can be written as

$$\alpha_d = \frac{v_0\sigma}{1 - \sigma v(p_d) - Sk\sigma v(p_d)} \quad \text{and} \quad \alpha_u = \frac{v_0\sigma}{1 - \sigma v(p_u) - S\sigma v(p_u)}$$

Accordingly, we get

$$\frac{\alpha_d}{\alpha_u} = \frac{1 - \sigma v(p_u) - S\sigma v(p_u)}{1 - \sigma v(p_d) - Sk\sigma v(p_d)} = \frac{1 - \left(\frac{1+S}{1+S+Sm}\right)^{\eta-1} \sigma v(p_d) - \left(\frac{1+S}{1+S+Sm}\right)^{\eta-1} S\sigma v(p_d)}{1 - \sigma v(p_d) - Sk\sigma v(p_d)}$$

**>1 when  $m>0$  (positive access charge,  $k<1$ )**

=1 when  $m=0$  (zero access charge,  $k=1$ )

< 1 when  $m<0$  (negative access charge,  $k>1$ ), not relevant case here

(ii) Secondly, examining the term:  $W(p_u) \leq \frac{1}{1+S} W(p_d) + \frac{S}{1+S} W(\hat{p}_d)$

By Jensen's inequality it strictly holds when  $m>0$  and  $S>0$  because the gross welfare function  $W(p) = u(q(p)) - cq(p) = \frac{\eta}{\eta-1} p^{-(\eta-1)} - cp^{-\eta}$  reaches a maximum

at  $p = c$  and is convex for  $p$  greater than  $(\eta+1)c/\eta < p^M$ . Because all prices weakly exceed the monopoly price, a mean-preserving price spread raises gross welfare.

When combining (i) and (ii), we get

$$2\alpha_u^2(1+S)W(p_u) < 2\alpha_d^2W(p_d) + 2S\alpha_d^2W(\hat{p}_d)$$

In other words, for high access cost to banking services (high transportation costs) and for positive markup on access ( $m>0$ ) and no extreme home bias ( $S>0$ ), gross social welfare is higher under price discrimination than under uniform pricing prevailing under price regulation. The reason for this is that price discrimination alleviates the double-marginalisation effect that arises when the access charge exceeds marginal cost. Price discrimination decreases the double markup for domestic payments and raises it for cross-border payments. This price dispersion benefits customers whose net surplus function is convex. Similarly as in LRT, in the second-best context in which prices are already distorted by a double-marginalisation, the distortion due to price discrimination may actually be beneficial.



The above results are reversed if we look at the total welfare comparison and include the transportation cost terms ( $t\alpha_i^2$ 's) as well

$$W^{\text{discriminatory}} - W^{\text{uniform}} = 2\alpha_d^2 \left[ \frac{\eta}{\eta-1} p_d^{-(\eta-1)} - c p_d^{-\eta} \right] + 2S\alpha_d^2 \left[ \frac{\eta}{\eta-1} \hat{p}_d^{-(\eta-1)} - c \hat{p}_d^{-\eta} \right] - 2\alpha_u^2 (1+S) \left[ \frac{\eta}{\eta-1} p_u^{-(\eta-1)} - c p_u^{-\eta} \right] - t\alpha_d^2 + t\alpha_u^2$$

In this case the transportation cost terms would be dominating the welfare comparison because  $\alpha_d > \alpha_u$  for positive access charges ( $m > 0$ ). However, the meaningfulness of the analysis is in this case questionable because we are looking at the case in which  $\sigma \rightarrow 0$  (ie transportation cost  $t$  approaches infinity) and  $v_0$  increases simultaneously so that payment market sizes in each country remain unchanged.

By continuity, we can argue, as in LRT, that the above results hold for small  $\sigma$ . However, the analysis of the general case  $\sigma > 0$ , based on the equations (3.7) and (3.11), is difficult and would require simulations or modifications to modelling framework.

In conclusion, the above analysis showed that the welfare effects of price regulation in retail payment systems are difficult to be comprehensively evaluated. We were able to draw analytical results only in a special case. However, according to Laffont-Rey-Tirole, it is well known that welfare effects of price discrimination are ambiguous, both in monopolistic and competitive environments (see eg Lederer and Hurter (1986), Thisse and Vives (1988), Holmes (1989), Armstrong and Vickers (2001)). Therefore, it is not very surprising that that our model, at least in its present form, was not capable of producing clear-cut analytical welfare results. In order to quantify the possible welfare effects of price regulation in retail payments, simulations of the present model could be employed.

## 4 Discussion on policy implications

For potential policy implications, the findings of our theoretical model must be assessed against the real-life phenomena. It is no doubt that the Regulation adopted by the European Parliament and the EU Commission on cross-border retail payments in euro has proved to be a strong regulatory measure to foster the integration process in the European retail payment markets. In essence, the Regulation has eliminated the price discrepancy between comparable domestic and cross-border retail payments provided that certain conditions for the payment

are fulfilled<sup>5</sup>. From purely integration policy perspective, the Regulation has expanded the Single market concept also to the retail payments area at least in the Euro area. According to the European Commission (2003), the Regulation has contributed to a considerable reduction in the price of cross-border payments in the Internal Market. Even more importantly, it has also provided an incentive for the payment industry to cooperate and modernise their EU-wide retail payment infrastructures. In general, the Commission sees the Regulation as an important step in the process of achieving a Single Payment Area for non-cash payments in the Internal Market.

Naturally, the real quantitative effects induced by the Regulation can be assessed only over time when long enough time series have been gathered eg by the means of comprehensive pricing surveys. The Commission has been conducting such studies even earlier on and has recently contracted out two studies.<sup>6</sup> In general, the results suggest that prices of cross-border payments have reduced and that there have not been considerable increases in the domestic payment prices. However, there is also a potential caveat to reliably assess the effects of the Regulation because it may prove to be cumbersome to detect ‘the pure regulation effects’ on retail payment prices because other factors like different pricing conventions (eg bundling of banking services) and technological developments (eg internet banking) have also influence on price developments over time.

When viewing the Regulation from the theoretical perspective, the following observations are worth stressing. As a regulatory measure, the Regulation is strong and somewhat peculiar since it regulates directly the final retail prices. In many other network industries (like eg telecommunications, electricity etc.), the focus of regulation has been on the intermediate prices (access prices). In fact, it has been stressed (see eg Mason and Valletti (2001)) that access pricing and its regulation are very important in the network industries where the interconnection conditions among networks are crucial. In order to solve the potential interconnection disputes, different types of rules have been put forward in many network industries: Long-Run Incremental Cost (LRIC), Cost-based rules,

---

<sup>5</sup> A cross-border retail payment is subject to the Regulation and must be priced in a similar way as a comparable domestic payment, when the payment information provided by the payment originator fulfils criteria stipulated in the Regulation. For example, in cross-border credit transfers, the IBAN (the International Bank Account Number) and BIC (the Bank Identifier Code) must be employed. Therefore, in order to fully benefit from the Regulation, customers should consistently use these international retail payment standards, because otherwise the payment service providers are not obliged to price equally the comparable domestic and cross-border payments. For more practical information, see eg the web pages of the European Committee for Banking Standards ([www.ecbs.org](http://www.ecbs.org)), the European Central Bank ([www.ecb.int](http://www.ecb.int)), the Commission ([www.europa.eu.int](http://www.europa.eu.int)); or for the Finnish case, the Finnish Bankers’ Association ([www.pankkiyhdistys.fi](http://www.pankkiyhdistys.fi))

<sup>6</sup> For recent assessments of the impact of the Regulation, see Retail Banking Research (2005a, b) published in the European Commission’s website.

Efficient Component Pricing Rule (ECPR), and Ramsey Charges and Global Caps. All these rules are used to determine the optimal access prices but, on the other hand, they also require the regulators to have an extensive and comprehensive knowledge of the cost structure of the industry in order for them to implement the rules properly. Accordingly, applicability of these rules to payment service industry may prove to be difficult because the real cost structure is ‘private information’ of the payment service providers. Therefore, these access pricing rules – at least as such – are difficult to implement in the payment service industry.

Even though the welfare effects of price regulation were difficult to quantify in our theoretical framework, we are able to draw some theoretically-based predictions from our model and compare them with real-life observations. *Firstly*, we are able to say something on the reactions of the retail payment prices when looking at the optimal pricing decisions suggested by our model. In the simplified case analysed at the end of the Chapter 3, our model indicated that the uniform price under the regulation would be a weighted average of discriminatory prices in the segmented retail payment markets. In real-life, conducted price studies suggest that the post-regulation cross-border prices have indeed converged towards pre-regulation domestic payment price levels. In fact, when letting the home-bias factor  $S$  in making payments (Equation (3.12)) to be small ie  $[0.01, 0.02]$  because currently 1–2% of all retail payments are cross-border payments in the EU, the uniform price predicted by our model would be very close to pre-regulation domestic payment price which then seems to be in line with the real life developments. In our model, the driving force for this result is the assumed home-bias in making payments ( $S$  very small). However, it should be noted that without any home-bias ( $S=1$ ), the optimal uniform price suggested by our model would be the arithmetic average of pre-regulation domestic and cross-border prices.

This real-life convergence of prices towards pre-regulation domestic price level is not surprising even when looking at the price-setting behaviour from purely economic and business policy perspectives: the cross-border payments are more expensive to produce because the proper infrastructure has been lacking, but at the same time they represent such a minor fraction of the total retail payments that the payment service providers can possibly treat them as loss-leaders and cross-subsidise them using revenues from other banking services. This situation may change in the future as the deepening financial integration and increasing cross-border trade is likely to bring about also the increasing need for cross-border retail payments and thereby reduce the present home-bias in making payments. Were the infrastructures for cross-border payments not to be improved accordingly, the cost-cutting pressures for payment service providers would increase considerably. However, at least in the credit transfer area, the activation by the service provider sector seems to result in the improved infrastructure. For example, the launch of the Euro Banking Association’s STEP 2 -system for

processing cross-border bulk retail payments is likely to mitigate this problem by providing a Pan-European Automated Clearing House (PEACH) for cross-border payments. While a PEACH, if successfully and widely enough adopted, clearly facilitates the utilisation of the inherent economies of scale in retail payment service provision, a potential ‘access problem’ can emerge: if only the biggest players in the field are directly participating in the system and medium and smaller players act as indirect participants and buy their retail payments services from the bigger players. This may re-introduce the access pricing problem also in the retail payments area, and in this respect, guidance from regulatory principles used in the traditional network industries can then prove to be useful.

*Secondly*, in our segmented market model general welfare implications of price regulation on retail payment prices were found to be ambiguous. Due the complexity of the optimal pricing equations, we had to limit our welfare analysis to the special case where costs of access to banking services (transportation costs) were assumed be high. In this case, the gross social welfare excluding transportation costs was found to be higher under pre-regulation discriminatory pricing than under post-regulation uniform pricing. However, when transportation costs were also taken into account, the results were exactly the opposite. Accordingly, based on our model set-up, strong policy stance on the desirability of regulation cannot be taken.

*Thirdly*, a further implication we are able to draw from our theoretical model deals with the transportation costs (in our model interpreted as costs associated with access to banking services) and the related segmentation of the payment service market. When assuming that access costs to banking services would be declining as a result of deepening economic and financial integration and technological progress in providing banking services, the current segmentation of the retail payment markets is very likely to be reduced. At the end of such a development, our theoretical model set-up would be similar to the original Laffont-Rey-Tirole model where the markets are fully-served and service providers compete directly with each other. Accordingly, in such a situation we can then directly apply and re-interpret their results. In general, the LRT-results suggest that allowing price discrimination is more beneficial for social welfare than imposing uniform pricing by regulation. However, it should be noted that also their welfare results were obtained in a similar simplified case (high transportation costs) as ours, and therefore, their generalisation should be done in a cautious way. Anyway, the LRT-results suggest that, when markets are fully served, regulation of prices by imposing a uniform price is welfare reducing.

Concerning the real-life, comprehensive analysis of welfare effects induced by the price regulation on retail payment services is even more difficult because of numerous interlinkages in banking and payment operations (eg bundling of different banking services using ‘package’ pricing). Our theoretical modelling already ended up with ambiguities and real-life analysis is even more likely to do

so. However, a clear merit of the Regulation is the fact that, after its adoption, the payment service provider sector has been forced to act to improve infrastructure. The establishment of the European Payments Council as a common decision-making body and the set-up of the STEP 2 -payment system as a potential candidate for a Pan-European Automated Clearing House are nice examples of this ‘regulation-induced’ activation of the service providers. Naturally, only the coming years will tell how successful – in terms of welfare improvements for EU citizens – the Regulation on cross-border payments in euro finally was.

All in all, it can be concluded that, given the controversies in the price regulation question and the scarcity of studies on the pricing of retail payment services in general, future research on the topic is warranted. In this context, the rather extensive literature on the interconnection pricing in the telecommunications industry could serve as a good background. One direct possibility would be to modify and simplify the framework of the model presented above so that more tractable and general results could be obtained.

## References

- Armstrong, M (1998) **Network Interconnection in Telecommunications**. The Economic Journal 108, 545–564.
- Armstrong, M – Vickers, J (2001) **Competitive Price Discrimination**. RAND Journal of Economics, Vol. 32, No. 4, 579–605.
- Dessein, W (2003) **Network Competition in Nonlinear Pricing**. RAND Journal of Economics, Vol. 34, No. 4.
- European Commission (2003) **Communication from the Commission to the Council and the European Parliament concerning a New Legal Framework for Payments in the Internal Market**. (Consultative Document), COM(2003) 718 final, Commission of the European Communities, Brussels, 2.12.2003.
- European Payments Council (2002) **Euroland: Our Single Payment Area!** White Paper, <http://www.europeanpaymentscouncil.org>.
- Holmes, T (1989) **The Effects of Third-Degree Price Discrimination in Oligopoly**. American Economic Review, Vol. 79, No. 1, 244–250.
- Katz, M – Shapiro, C (1985) **Network Externalities, Competition and Compatibility**. American Economic Review, Vol. 75 (3), 424–444.
- Kemppainen, K (2003) **Competition and Regulation in European Retail Payment Systems**. Bank of Finland Discussion Papers 16/2003.
- Laffont, J-J – Rey, P – Tirole, J (1998a) **Network Competition: I. Overview and Non-discriminatory Pricing**. RAND Journal of Economics, Vol. 29, No.1, 1–37.
- Laffont, J-J – Rey, P – Tirole, J (1998b) **Network Competition: II. Price Discrimination**. RAND Journal of Economics, Vol. 29, No.1, 38–56.
- Lederer, P – Hurter, A (1986) **Competition of Firms: Discriminatory Pricing and Location**. Econometrica, Vol. 54, 623–640.

- Mason, R – Valletti, T (2001) **Competition in Communication Networks: Pricing and Regulation**. Oxford Review of Economic Policy, Vol. 17, No. 3, 389–415.
- Retail Banking Research (2005a) **Regulation 2560/2001: Study of Competition for Cross-border Payment Services**. Final Report, Project No. MARKT/2004/11/F, prepared for the European Commission, Internal Market and Services Directorate-General, Retail Banking Research Ltd, London, September 2005.
- Retail Banking Research (2005b) **Study of the Impact of Regulation 2560/2001 on Bank Charges for National Payments**. Final Report, Project No. MARKT/2004/11/F – LOT 2, prepared for the European Commission, Internal Market and Services Directorate-General, Retail Banking Research Ltd, London, September 2005.
- Schiff, A (2001a) **Modeling Demand for Two-Way Communications**. Mimeo, University of Auckland.
- Schiff, A (2001b) **Two-Way Interconnection with Partial Consumer Participation**. Mimeo, August 2001, Department of Economics, University of Auckland.
- Shy, O (2001) **The Economics of Network Industries**. Cambridge University Press, UK.
- Thisse, J-F –Vives, X (1988) **On the Strategic Choice of Spatial Price Policy**. American Economic Review, Vol. 78, 122–137.
- Weinberg, J (2002) **Imperfect Competition and Pricing of Interbank Payment Services**. Federal Reserve Bank of Richmond, Economic Quarterly, Vol. 88, No. 1, 51–66.

# Appendix 1

## Proportionality rule

The proportionality rule means that the ratio between cross-border and domestic payment prices reflects the relative markup on access  $\frac{\hat{p}_1}{p_1} = \frac{\hat{p}_2}{p_2} = 1 + m$ . Under constrained optimisation, the validity of the proportionality rule can be checked in a similar way as in LRT.

### Proof

The proportionality rule is obtained by considering network  $i$ 's optimal price structure when keeping its market size constant. To keep its market size constant, network  $i$  must offer a constant average net surplus to its customers. In the discriminatory pricing case, the program can be written as

$$\max_{p_i, \hat{p}_i} \{ \tilde{\alpha}_i (p_i - c)q(p_i) + S\tilde{\alpha}_j (\hat{p}_i - c(1 + m))q(\hat{p}_i) \}$$

s.t.

$$\tilde{\alpha}_i v(p_i) + S\tilde{\alpha}_j v(\hat{p}_i) = \tilde{w}_i$$

where tildes indicate that the variable is kept constant.

The problem can be solved by using the following Lagrangean expression

$$\max_{p_i, \hat{p}_i} L = \{ \tilde{\alpha}_i (p_i - c)q(p_i) + S\tilde{\alpha}_j (\hat{p}_i - c(1 + m))q(\hat{p}_i) \} - \lambda [ \tilde{\alpha}_i v(p_i) + S\tilde{\alpha}_j v(\hat{p}_i) - \tilde{w}_i ]$$

The first-order conditions are

$$\frac{\partial L}{\partial p_i} = \tilde{\alpha}_i (q(p_i) + (p_i - c)q'(p_i)) - \lambda \tilde{\alpha}_i v'(p_i) = 0$$

$$\frac{\partial L}{\partial \hat{p}_i} = S\tilde{\alpha}_j (q(\hat{p}_i) + (\hat{p}_i - c(1 + m))q'(\hat{p}_i)) - \lambda S\tilde{\alpha}_j v'(\hat{p}_i) = 0$$

$$\frac{\partial L}{\partial \lambda} = \tilde{\alpha}_i v(p_i) + S\tilde{\alpha}_j v(\hat{p}_i) - \tilde{w}_i = 0$$



Assuming that the two payment services have the same elasticity,  $\eta$ , and utilising  $q = p^{-\eta}$  and  $v'(p) = -p^{-\eta}$ , we get

$$\frac{p_i - c}{p_i} = \frac{1 + \lambda}{\eta}$$

$$\frac{\hat{p}_i - c(m+1)}{\hat{p}_i} = \frac{1 + \lambda}{\eta}$$

Therefore,  $\frac{\hat{p}_i}{p_i} = 1 + m$ , and the proportionality rule thus holds.

## Appendix 2

### Welfare analysis

#### A2.1 Discriminatory pricing

##### Producer surplus (PS)

$$\alpha_1[\alpha_1(p_1 - c)q(p_1) + S\alpha_2(\hat{p}_1 - c)q(\hat{p}_1)] + \alpha_2[\alpha_2(p_2 - c)q(p_2) + S\alpha_1(\hat{p}_2 - c)q(\hat{p}_2)]$$

which becomes under symmetry ( $p_1 = p_2 = p_d$ ,  $\hat{p}_1 = \hat{p}_2 = \hat{p}_d$ ,  $\alpha_1 = \alpha_2 = \alpha_d$ )

$$\begin{aligned} & \alpha_d[\alpha_d(p_d - c)p_d^{-\eta} + S\alpha_d(\hat{p}_d - c)p_d^{-\eta}] + \alpha_d[\alpha_d(p_d - c)\hat{p}_d^{-\eta} + S\alpha_d(\hat{p}_d - c)\hat{p}_d^{-\eta}] \\ & = 2\alpha_d^2(p_d^{-(\eta-1)} - cp_d^{-\eta}) + 2\alpha_d^2(\hat{p}_d^{-(\eta-1)} - c\hat{p}_d^{-\eta}) \end{aligned}$$

##### Consumer surplus (CS)

$$\alpha_1[\alpha_1 v(p_1) + S\alpha_2 v(\hat{p}_1)] - t\left(\frac{\alpha_1^2}{2}\right) + \alpha_2[\alpha_2 v(p_2) + S\alpha_1 v(\hat{p}_2)] - t\left(\frac{\alpha_2^2}{2}\right)$$

which becomes under symmetry ( $p_1 = p_2 = p_d$ ,  $\hat{p}_1 = \hat{p}_2 = \hat{p}_d$ ,  $\alpha_1 = \alpha_2 = \alpha_d$ )

$$\begin{aligned} & \alpha_d[\alpha_d v(p_d) + S\alpha_d v(\hat{p}_d)] - t\left(\frac{\alpha_d^2}{2}\right) + \alpha_d[\alpha_d v(p_d) + S\alpha_d v(\hat{p}_d)] - t\left(\frac{\alpha_d^2}{2}\right) \\ & = 2\alpha_d^2 v(p_d) + 2S\alpha_d^2 v(\hat{p}_d) - t\alpha_d^2 \\ & = 2\alpha_d^2 \frac{p_d^{-(\eta-1)}}{\eta-1} + 2S\alpha_d^2 \frac{\hat{p}_d^{-(\eta-1)}}{\eta-1} - t\alpha_d^2 \end{aligned}$$

##### Total welfare (PS+CS)

$$\begin{aligned} W^{\text{discriminatory}} & = 2\alpha_d^2(p_d^{-(\eta-1)} - cp_d^{-\eta}) + 2\alpha_d^2(\hat{p}_d^{-(\eta-1)} - c\hat{p}_d^{-\eta}) + 2\alpha_d^2 \frac{p_d^{-(\eta-1)}}{\eta-1} + 2S\alpha_d^2 \frac{\hat{p}_d^{-(\eta-1)}}{\eta-1} - t\alpha_d^2 \\ & = 2\alpha_d^2 \left( \frac{\eta}{\eta-1} p_d^{-(\eta-1)} - cp_d^{-\eta} \right) + 2S\alpha_d^2 \left( \frac{\eta}{\eta-1} \hat{p}_d^{-(\eta-1)} - c\hat{p}_d^{-\eta} \right) - t\alpha_d^2 \\ & = 2\alpha_d^2 W(p_d) + 2S\alpha_d^2 W(\hat{p}_d) - t\alpha_d^2. \end{aligned}$$

## A2.2 Uniform pricing

### Producer surplus (PS)

$$\alpha_1[\alpha_1(\bar{p}_1 - c)q(\bar{p}_1) + S\alpha_2(\bar{p}_1 - c)q(\bar{p}_1)] + \alpha_2[\alpha_2(\bar{p}_2 - c)q(\bar{p}_2) + S\alpha_1(\bar{p}_2 - c)q(\bar{p}_2)]$$

which becomes under symmetry ( $\bar{p}_1 = \bar{p}_2 = p_u$ ,  $\alpha_1 = \alpha_2 = \alpha_u$ )

$$\begin{aligned} & \alpha_u[\alpha_u(p_u - c)p_u^{-\eta} + S\alpha_u(p_u - c)p_u^{-\eta}] + \alpha_u[\alpha_u(p_u - c)p_u^{-\eta} + S\alpha_u(p_u - c)p_u^{-\eta}] \\ & = 2\alpha_u^2(1+S)(p_u - c)p_u^{-\eta} \\ & = 2\alpha_u^2(1+S)\left(\frac{p_u - c}{p_u^{-\eta}}\right) \end{aligned}$$

### Consumer surplus (CS)

$$\alpha_1[\alpha_1 v(\bar{p}_1) + S\alpha_2 v(\bar{p}_1)] - t\left(\frac{\alpha_1^2}{2}\right) + \alpha_2[\alpha_2 v(\bar{p}_2) + S\alpha_1 v(\bar{p}_2)] - t\left(\frac{\alpha_2^2}{2}\right)$$

which becomes under symmetry ( $\bar{p}_1 = \bar{p}_2 = p_u$ ,  $\alpha_1 = \alpha_2 = \alpha_u$ )

$$\begin{aligned} & \alpha_u[\alpha_u v(p_u) + S\alpha_u v(p_u)] - t\left(\frac{\alpha_u^2}{2}\right) + \alpha_u[\alpha_u v(p_u) + S\alpha_u v(p_u)] - t\left(\frac{\alpha_u^2}{2}\right) \\ & = 2\alpha_u^2(1+S)v(p_u) - t\alpha_u^2 \\ & = 2\alpha_u^2(1+S)\frac{p_u^{-(\eta-1)}}{\eta-1} - t\alpha_u^2 \end{aligned}$$

### Total welfare (PS+CS)

$$\begin{aligned} W^{\text{uniform}} & = 2\alpha_u^2(1+S)\left(\frac{p_u - c}{p_u^{-\eta}}\right) + 2\alpha_u^2(1+S)\frac{p_u^{-(\eta-1)}}{\eta-1} - t\alpha_u^2 \\ & = 2\alpha_u^2(1+S)\left[\frac{\eta}{\eta-1}p_u^{-(\eta-1)} - cp_u^{-\eta}\right] - t\alpha_u^2 \\ & = 2\alpha_u^2(1+S)W(p_u) - t\alpha_u^2. \end{aligned}$$

**BANK OF FINLAND RESEARCH  
DISCUSSION PAPERS**

ISSN 0785-3572, print; ISSN 1456-6184, online

- 1/2005 Patrick M. Crowley **An intuitive guide to wavelets for economists.** 2005. 68 p. ISBN 952-462-188-6, print; ISBN 952-462-189-4, online.
- 2/2005 Tuomas Saarenheimo **Ageing, interest rates, and financial flows.** 2005. 30 p. ISBN 952-462-190-8, print; ISBN 952-462-191-6, online.
- 3/2005 Timo Vesala **Relationship lending and competition: Higher switching cost does not necessarily imply greater relationship benefits.** 2005. 27 p. ISBN 952-462-192-4, print; ISBN 952-462-193-2, online.
- 4/2005 Johanna Sinkkonen **Labour productivity growth and industry structure. The impact of industry structure on productivity growth, export prices and labour compensation.** 2005. 88 p. ISBN 952-462-196-7, print; ISBN 952-462-197-5, online.
- 5/2005 Matti Virén **Why do capital intensive companies pay higher wages?** 2005. 23 p. ISBN 952-462-198-3, print; ISBN 952-462-199-1, online.
- 6/2005 Maritta Paloviita – Matti Virén **The role of expectations in the inflation process in the euro area.** 2005. 33 p. ISBN 952-462-200-9, print; ISBN 952-462-201-7, online.
- 7/2005 Marketta Henriksson **Productivity differentials and external balance in ERM II.** 2005. 32 p. ISBN 952-462-202-5, print; ISBN 952-462-203-3, online.
- 8/2005 Matti Virén **Government size and output volatility: is there a relationship?** 2005. 24 p. ISBN 952-462-204-1, print; ISBN 952-462-205-X, online.
- 9/2005 Karlo Kauko **Bank interest rates in a small European economy: Some exploratory macro level analyses using Finnish data.** 2005. 44 p. ISBN 952-462-206-8, print; ISBN 952-462-207-6, online.
- 10/2005 Essi Eerola – Niku Määttänen **The optimal tax treatment of housing capital in the neoclassical growth model.** 2005. 30 p. ISBN 952-462-210-6, print; ISBN 952-462-211-4, online.
- 11/2005 Karlo Kauko **The mixed oligopoly of cross-border payment systems.** 2005. 31 p. ISBN 952-462-212-2, print; ISBN 952-462-213-0, online.

- 12/2005 Patrick M. Crowley – Jim Lee **Decomposing the co-movement of the business cycle: a time-frequency analysis of growth cycles in the euro area.** 2005. 67 p. ISBN 952-462-214-9, print; ISBN 952-462-215-7, online.
- 13/2005 Jarmo Pesola **Banking fragility and distress: An econometric study of macroeconomic determinants.** 2005. 95 p. ISBN 952-462-216-5, print; ISBN 952-462-217-3, online.
- 14/2005 Karlo Kauko **The demand for money market mutual funds.** 2005. 29 s. ISBN 952-462-218-1, print; ISBN 952-462-219-X, online.
- 15/2005 Matti Virén **Fiscal policy in the 1920s and 1930s. How much different it is from the post war period's policies?** 2005. 27 p. ISBN 952-462-220-3, print; ISBN 952-462-221-1, online.
- 16/2005 Alistair Milne **What's in it for us? Network effects and bank payment innovation.** 2005. 27 p. ISBN 952-462-223-8, print; ISBN 952-462-224-6, online.
- 17/2005 Hilde C Bjørnland – Kai Leitemo **Identifying the interdependence between US monetary policy and the stock market.** 2005. 43 p. ISBN 952-462-225-4, print; ISBN 952-462-226-2, online.
- 18/2005 Juha Tarkka – Mika Kortelainen **International economic spillovers and the liquidity trap.** 2005. 86 p. ISBN 952-462-227-0, print; ISBN 952-462-228-9, online.
- 19/2005 Kari Kemppainen **Assessing effects of price regulation in retail payment systems.** 2005. 32 p. ISBN 952-462-231-9, print; ISBN 952-462-232-7, online.