Overview: Credit Card Case

• Market Definition
  – Review
  – Market Participants
  – Pricing Discussion

• Other Issues in Case
  – Timing and Strategic Interaction
  – Market Power
  – ...

Market Definition : Review

• Definition: collection of buyers and sellers that, through actual or potential interactions, determine the price of a product

• Point of departure:
  `If I try to raise (lower) prices, where will current customers go (new customers come from)?`

• Remarks:
  – Always relative to a specific question
  – Important for business strategy, pricing, anti-trust
Market Definition

Current Suppliers → Market → Current Customers

Substitutes

Potential Entrants → Potential Customers

U.K. Credit Card Industry

- Who are the players?

- What are the issues?
The Product 'Credit Card'
Direct Substitutes

Longer-range Substitutes

• Note: Lecture 7 discusses network effects
Increasing the Interest Rate

- Note: Lecture 19 discusses adverse selection

Important Consumer Characteristics
Charging a Fixed Fee

• Note: Lecture 9 and 10 discuss pricing schemes
Profitability: Assumptions

- APR: 26.8%
- Cost of Money: 10%
- MSC: 2% of sales
- Cost: 3.1% of sales (Exhibit 5)

Note: Lecture 4 discusses economic costs

Measuring Substitutes

- Cross-price elasticity
- Correlation of Prices
- Correlation of Market Shares
Payment Mechanism Substitution

Evolution of $ volume shares of different payment mechanisms in US (in %)

Timing

- Should Barclays go first?
- Barclays payoffs:

<table>
<thead>
<tr>
<th>Move now</th>
<th>Wait until other moves</th>
</tr>
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<tbody>
<tr>
<td>Barclays</td>
<td>Other Bank</td>
</tr>
<tr>
<td>Move now</td>
<td>Move now</td>
</tr>
<tr>
<td>+2</td>
<td>-4</td>
</tr>
<tr>
<td>Wait until other moves</td>
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- Note: Lectures 12 and 13 discuss game theory and prisoner's dilemma
Further Issues

- System level and market power

- Market of retailers: Incentives in negotiating

- What happened in the U.K.?

System Level & Market Power

- What if Visa imposes the annual fee on all the issuers?

- Definition of market power (US DoJ):
  "ability of one or more firms profitably to maintain prices above competitive levels for a significant period of time"

- Does Barclays have market power? Visa? Visa and MasterCard?

- Note: Lectures 14 and 15 discuss collusion and anti-trust
Market of Retailers

MSC are negotiated by acquiring banks but get passed on to issuing banks
- Do these banks have the right incentives in negotiation? More or less, because they are also issuers.
- With specialized acquirers as in U.S, you need different system: MSC goes to acquirer (who now pays interchange fee)
- BUT, the acquirer still does not take into account the effect on the whole system. The choice of interchange fee is key to this.

• Note: Lectures 18 and 20 discuss incentives and externalities

What Happened in the U.K.?

- Feb '89: Barclays considers an annual fee
- Aug '89: Lloyds announces annual fee, Barclays waits
- Feb '90: Annual fee takes effect; Lloyds estimates loss of 10% of its credit card customers
- Mar '90: Lloyds loss of 20% of its customers; Lloyds credit card profits declined substantially relative to other banks
- Apr '90: Barclays announces annual fee, to take effect in June
- During '91: Midland and Natwest also introduce annual fees
Take Away Points

• Market Definition can be complex
  – be clear about the question
  – be clear about the product (function)
  – consider both supply and demand

• Economics is directly relevant to business decisions
  – economic cost
  – pricing
  – sorting
  – game theory
  – incentives

For Next Time

– Sugar Industry Case:
  • Study the case
  • No need to prepare answers to the questions in the case