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The Worm in Apple Pay

The ballyhooed new payment system is still reliant on your having a credit card. That's not exactly revolutionary.

By Lyle Beckwith
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No company can compete with Apple when it comes to releasing new products, and last month the tech giant brought some attention and excitement to how we pay for things with the introduction of Apple Pay. That's a good thing, as the payments system is an often-overlooked but crucial part of the economy and how it functions.

For years professionals have looked for ways to put payments systems on mobile phones, with limited success. Apple made it happen, and now the technology allows you to make purchases in stores and on apps without credit cards or a wallet, by simply swiping your finger on your iPhone. The company also built in some nice security features by including, for example, fingerprint-recognition technology. Mobile payments are convenient for consumers and are more secure than credit cards, both wins for everyone.

But Apple fell short of revolutionary change—because it built its product on the flawed credit-card payment system. Apple Pay works by linking existing credit- or debit-card accounts to mobile phones. Those accounts use an antiquated system dominated by two giants— Visa and MasterCard —that set "swipe fees" that merchants must pay every time a customer pays with a card.

Absent real competition, the swipe fees continue to grow. The average U.S. swipe fee of 2% is the highest of any industrialized country, and the U.S. spends more on swipe fees—more than $50 billion a year—than the rest of the world combined, according to the payment industry news source the Nilson Report.

MasterCard demonstrates Apple Pay at the launch of MasterCard's NYC Tech Hub on October 20, 2014 in New York. *ASSOCIATED PRESS*

The fees, which have tripled over the past decade, are the second-highest operating expense for merchants. Convenience stores paid $11 billion in fees last year, according to a recent report by the National Association of Convenience Stores, where I work. The fees often exceed the profits made by grocers and others that operate on narrow profit margins—

so the fees are passed onto consumers in the form of higher prices.

All of this has led to multiple Justice Department and state attorney general enforcement actions, many private antitrust suits and frenzied legislative battles. The Justice Department filed an antitrust suit against Visa and MasterCard in 1998, alleging that the two had adopted exclusionary rules to make it difficult for banks to do business with other credit-card networks. Justice won in 2001. Private plaintiffs sued for similar reasons and settled with the companies for a record $3 billion in 2003. Such efforts are not over.

Apple’s innovation resembles that of a company called Pay By Touch. Several years ago, Pay By Touch came up with technology that allowed shoppers to pay in stores by touching a pad at checkout. The technology used fingerprints and was installed in several grocery stores. Like Apple Pay, the Pay By Touch model connected existing payment cards to finance the transactions. It was innovative technology and meant you could leave your purse at home and still buy what you needed.

What happened? Pay By Touch went out of business in 2008 because it didn’t give merchants a reason to use the technology and didn’t offer consumers value beyond leaving their wallets in the car. It didn’t change the fundamental problems with the payment system.

Apple’s technology is better. With Pay By Touch, merchants had to buy a finger-print reader, whereas Apple already has that function inside a phone. But that’s not enough. The fundamental point of payment technology is to make transactions more efficient and cheaper. Indeed, that’s the reason people invented money—to make it cheaper and easier to pay for things. Any payment innovation must at least do that to be worthwhile.

Credit and debit cards are undercutting the purpose of payments by making them expensive. Cash is cheaper than electronic payments because of the inflated, price-fixed fees the card companies foist on merchants. Electronic payments ought to be cheaper than cash, though they won’t be if they are built entirely on the system that’s propping up Visa and MasterCard. There is room for mobile payments to be the cheapest, most secure and most innovative payment technology on the market.

This will require real change. A mobile-payments system could link directly to an individual’s checking account, or transactions could be completed over the Internet, for example. A payments system could even connect directly to a mobile-phone bill. But mobile-payments providers need to be willing to jettison the baggage of price-fixed payment cards. That would be a real revolution in the payments system.

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