THE LAW AND ECONOMICS OF INTERCHANGE FEES

HEARING

BEFORE THE

SUBCOMMITTEE ON COMMERCE, TRADE, AND CONSUMER PROTECTION

OF THE

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WEDNESDAY, FEBRUARY 15, 2006

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:03 a.m., in Room 2123 of the Rayburn House Office Building, Hon. Cliff Stearns [chairman] presiding.

Members present: Representatives Stearns, Deal, Radanovich, Bass, Terry, Ferguson, Rogers, Blackburn, Schakowsky, Towns, Green, and Sullivan.

Staff present: Will Carty, Professional Staff Member; Chris Leahy, Policy Coordinator; David Cavicke, General Counsel; Brian McCullough, Professional Staff Member; David Vogel, Minority Research Assistant; Consuela Washington, Minority Counsel; Bruce Harris, Minority Counsel; and Billy Harvard, Legislative Clerk.

MR. STEARNS. Good morning, everybody. I think everybody in this room probably has a credit card, so that is a given here as we start. Surveys show that typically, every adult in the United States carries at least one or two credit cards. In the U.S. alone, credit cards, ATM cards and debit cards account for almost 42 billion transactions' worth, almost $3 trillion in the year 2004. And for those who do not have a credit card, you have either shown great financial discipline and you are paying with cash, or perhaps you just have this love of the money and you want to use it rather than put yourself at risk with some kind of credit card; you might not pay the bill and have to pay an interest fee on your balance. But everywhere we go, electronic transaction is commonplace, now outpacing check transactions. I think it is safe to assume, very few consumers understand or are even aware of electronic payments in a network; the transaction involved or of course, the related fees that go with these transaction. So the focus of today's hearing will be just on that.

People seem to like the convenience of paying by credit card, in many cases gathering more reward miles on airlines and other things; enjoy the membership that for many has its privileges; the convenience of having credit available, accepted almost everywhere frequently trumps any concern about fee structure. It is really quite a miracle that you can go anywhere in the world and use these credit cards, particularly, how those structures actually work are found in the obscure fine print that either the business owners or the consumers have to sign and they are just not aware of the obscure law review articles that exist on these different issues. The fees that help fund this convenience for consumers are known as interchange fees. Simply put, interchange fees are fees that merchants pay for access to the extensive global electronic payment infrastructure that has been built up over the last few decades.

Interchange fees are calculated as a percentage of a purchased transaction that banks, in turn, collect from merchants participating in the electronic payment network. Having owned a small business and operated motels and restaurants, I am well aware of the percentage they charge and different credit cards charge different fees, so there is a lot of incentive to use one over the other, if you can. This fee, along with any fees associated with a merchant's bank, which is called the acquire bank, are also known as a merchant's discount. Once a merchant's discount is deducted, the balance, of course, is paid to the merchant.

My colleagues, in an efficient market, these interchange fees should represent the cost of participating in the electronic payment system, as well as other factors like the premium and cost savings achieved from not having to keep a large amount of cash on hand. The interchange fee is part of the terms of the credit card agreement made with a merchant. Because it is a percentage, the size of the interchange fee increases, obviously, with the amount of transaction. Therefore as we saw in the aftermath of the hurricanes last year, if a merchant charges his customers more, the associated increasing interchange fee will correspond to the price increase. This becomes a bit more complicated when a merchant makes a certain margin based on the current cost of a bulk commodity, like gasoline, and the interchange fee starts to eat into the margin when the cost of that product goes up. This might not be true in some businesses, but in others, particularly in the gasoline industry, it is true. This is basic economics and, at least in theory, the terms associated with this scenario should be transparent and agreed to freely by everybody.

Now, with that in mind, the committee's focus, in my opinion, shouldn't be on what parties particularly agree to regarding these fees, although we can talk about it. It should be on ensuring that the market is given the freedom to function properly and efficiently, and efficiently distribute cost and benefits. As we have seen during the oil crisis in the 1970s, with the gas lines and rationing, imposing price or fee caps would inevitably lead to shortages, more cost, and certain inconvenience to consumers. I think our examination of this issue should, first of all, start with a better understanding of the anti-trust and anti-competitive concerns raised to determine if we are dealing with a system that involves collusion and any competitive market power, or one that involves transparency and choice.

I must say that I have not seen strong evidence that the electronic payment system is suffering from market failure. In fact, the system appears to be working and consumers seem to like access to low cost credit to fund their purchases. But a healthy free market also assumes the players are playing fair and the choice is plentiful. Now, some contend that this is not the case with interchange fees because, in part, as electronic payments grow, cost should come down. They point to data showing that interchange fees have actually increased, not decreased, as economies of scale would predict. So this will be a question we would like an answer on from our panel.

Others charge that big credit card companies have monopolistic power and can strong-arm merchants into accepting their terms, and that is another question that we could explore. On the other hand, those contentions are countered with the fact that these cost increases are due to the risks associated with the growing percentage of the U.S. population that has access to and is taking advantage of cheap credit. So we have talked on both sides here to try and put in perspective what the questions are and what we would like to explore, because I think when we talked about it, we are not sure who is right and there is litigation, obviously, in the courts on this.

I look forward to hearing the elements of each case from our panel of experts today so that we all can draw better conclusions. I would like to thank everyone for joining, especially the former FTC Chairman, Tim Muris. It is nice to see him again. The committee appreciates the panel's testimony today and its assistance in helping us learn more about these important issues and with that, the Ranking Member, Ms. Schakowsky.

[The prepared statement of Hon. Cliff Stearns follows:]

PREPARED STATEMENT OF HON. CLIFF STEARNS, CHAIRMAN, SUBCOMMITTEE ON COMMERCE, TRADE, AND CONSUMER PROTECTION

Good Morning. I'd bet that everyone in this hearing room today has a credit or debit card. Surveys show that a typical adult in the U.S. carries several credit cards. In the U.S. alone, credit cards, ATM cards and debit cards accounted for almost 42 billion transactions worth almost $3 trillion in 2004. And for those who don't have plastic, you are either showing great financial discipline or maybe you just love the feel of crisp dollar bills in your pocket.

Although electronic payment is now commonplace – now outpacing check transactions - I think it's safe to assume very few consumers understand or are even aware of the electronic payments network, the transactions involved, or the related fees - the focus of today's hearing. People just seem to like the convenience of paying by credit card, gathering more reward miles, and enjoying membership that, for many, does have its privileges. The convenience of having credit available and accepted almost everywhere frequently trumps any concern about fee structures, particularly when how those structures actually work are found in the obscure fine print, or in just as obscure law review articles.

The fees that help fund this convenience for consumers are known as “interchange fees.” Simply put, interchange fees are fees that merchants pay for access to the extensive, global electronic payments infrastructure that has been built up over the last few decades. Interchange fees are calculated as a percentage of a purchase transaction that banks, in turn, collect from merchants participating in the electronic payments network. This fee along with any fees associated with the merchant’s bank (the “acquirer” bank) are also known as the “merchant discount.” Once the merchants discount is deducted, the balance is paid to the merchant.

In an efficient market, these interchange fees should represent the costs of participating in the electronic payments system as well as other factors like the premium and cost savings achieved from not having to keep large amounts of cash on hand. The interchange fee is part of the terms of the credit card agreement made with the merchant. Because it is a percentage, the size of the interchange fee increases with the amount of the transaction. Therefore, as we saw in the aftermath of the Hurricanes last year, if a merchant charges his customers more, the associated increase in the interchange fee will correspond to the price increase. This becomes a bit more complicated when a merchant makes a certain margin based on the current cost of a bulk commodity, like gasoline, and the interchange fee starts to eat into that margin when the costs of that product go up. This is basic economics and, at least in theory, the terms associated with this scenario should be transparent and agreed to freely.

With that in mind, the Committee’s focus, in my opinion, shouldn’t be on what parties contractually agree to regarding fees, it should be on ensuring that the market is given the freedom to function properly and efficiently distribute costs and benefits. As we have seen during the oil crisis in the 1970s with its gas lines and rationing, imposing price or fee caps will inevitably lead to shortages, more costs, and certain inconvenience to consumers. Therefore, I think our examination of this issue should start with a better understanding of the antitrust and anti-competitive concerns raised to determine if we are dealing with a system that involves collusion and anti-competitive market power or one that involves transparency and choice.

I must say that I have not seen strong evidence that the electronic payments system is suffering from market failure; in fact, the system appears to be thriving and consumers seem to like access to low cost credit to fund purchases. But a healthy free market also assumes the players are playing fair and choice is plentiful. Some contend that is not the case with interchange fees because, in part, as electronic payments grow, costs should come down. They point to data showing that interchange fees have actually increased not decreased, as economies of scale would predict. Others charge that big credit card companies have monopolistic power and can strong arm merchants into accepting their terms. On the other hand, those contentions are countered with the fact that these cost increases are due to the risks associated with the growing percentage of the U.S. population that has access to and is taking advantage of cheap credit. I’m not entirely sure who’s right, and I look forward to hearing the elements of each case from our panel of experts today so we can better draw our own conclusions.

Again I’d like to thank everyone for joining us today, especially former FTC Chairman Tim Muris. The Committee appreciates the panel’s testimony today and its assistance in helping us learn more about this important issue.

Thank you.

MS. SCHAKOWSKY. Thank you, Chairman Stearns, for holding today's hearing on interchange fees, the charges that retailers pay the banks for consumers using debit and credit cards to make purchases. I appreciate the opportunity to learn more about this issue and to explore whether consumers, and in this case, I include the retailers in that, are being unfairly burdened by high credit card interchange fees. We are definitely entering the cashless society. The year 2003 marked the first time ever that businesses and consumers made more payments electronically than by check. Today, for every one payment in cash there are two made with bank cards. For merchants, banks and consumers, a swipe of the card is the way to go.

What most consumers don't realize is that each time a card is swiped an interchange fee is charged to the retailer. The interchange fee, a percentage of the total purchase, varies on whether a debit or credit card is used, the type of business at which the purchase is made, whether the business is big or small and whether the card offers bonus programs like frequent flyer miles. Although the varying fee is meant to mitigate the risk to the banks, it is not linked to the cost for Visa or MasterCard or the issuing banks for processing transactions. I am concerned that merchants offset the interchange fees they are charged by the credit card companies by raising the prices consumers have to pay for the goods on the shelves. The credit card industry also benefits from those higher prices because transaction fees are a percentage of product prices, so the more a product costs, the more money the banks make through fees and the transaction fee is based on the product price after tax. So in effect, consumers are charged a credit card tax because their costs come on top of the true product cost and sales taxes.

Consumers who spend and contribute to the economy should not be punished with higher fees. Americans are already struggling to contend with out of control energy and prescription drug prices and there is an article that was in the Washington Post after Katrina that said as the price of gasoline rides the storm tides of two hurricanes, one group is crying all the way to the bank. Americans, they should not have to empty their bank accounts just to fill their shopping carts or fill up their cars. We should be looking for ways to help working families get relief rather than enabling an industry that reaps billions in profits every year.

Considering that the retailers are also responsible for paying interchange fees on the local, state and Federal taxes of every card transaction on top of the purchase price, I think we are also seeing a credit card tax on retailers. Furthermore, most merchants, excepting a few big box stores like Wal-Mart, cannot simply negotiate interchange fees. There is nothing to stop the banks from setting whatever rate they choose. If the stores want to accept debit and credit cards, they have to accept the fees the card issuers set. It is estimated by the National Association of Chain Drug Stores that the interchange fee is the third largest expense for those stores after rent and labor. Because we see so many small businesses struggling to get by, we need to ask tough questions about whether these fees, which are completely unregulated, are putting an undue burden on the corner store.

The interchange fee is a golden goose for the credit card industry. Fifteen percent of issuing banks' profits come from the interchange fees, alone. Banks collected an estimated $30 billion in interchange fees last year, partially from switching consumers to more expensive cards like the ones loaded with perks that also carry more expensive rates for merchants. Currently, the merchants are fighting back. There are at least 47 lawsuits in the United States, many of which have been consolidated into one large suit concerning interchange fees. The suits charge a number of banks and Visa and MasterCard with engaging in collusive practices and setting the interchange fees at super-competitive practices.

Whatever the courts decide, I think it is our subcommittee's responsibility to make sure that consumers are not saddled with higher prices and that the slim profit margins of small businesses are not eaten up by interchange fees. Again, I am glad we are here today to learn more about interchange fees and I look forward to hearing our witnesses. Thank you.

[The prepared statement of Hon. Jan Schakowsky follows:]

PREPARED STATEMENT OF HON. JAN SCHAKOWSKY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Thank you Chairman Stearns, for holding today's hearing on interchange fees, the charges that retailers pay to banks for consumers using debit and credit cards to make purchases. I appreciate the opportunity to learn more about this issue, and to explore whether consumers, including retailers, are unfairly burdened by interchange fees.

We are entering into a "cashless" society. The year 2003 marked the first time ever that businesses and consumers made more payments electronically than by check. Today, for every one payment in cash, there are two made with bank cards. For merchants, banks, and consumers, a swipe of the card is the way to go.

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I'm concerned that merchants offset the interchange fees they are charged by the credit card companies by raising the prices consumers have to pay for the goods on the shelves. The credit card industry also benefits from those higher prices because transaction fees are a percentage of product prices. So, the more a product costs, the more money the banks make through the fees. And, the transaction fee is based on the product price– after tax. So, in effect, consumers are charged a Credit Card tax because their costs come on top of their true product cost and sales taxes. Consumers who spend and contribute to the economy should not be punished with higher fees. Americans are already struggling to contend with out-of-control energy and prescription drug prices. They should not have to empty their bank accounts just to fill their shopping carts or fill up their cars. We should be looking for ways to help working families get relief rather than enabling an industry that reaps billions in profits every year.

Considering that the retailers are also responsible for paying interchange fees on the local, state, and federal taxes of every card transaction – on top of the purchase price, I think we are also seeing a Credit Card Tax on retailers. Furthermore, most merchants, excepting a few big box stores like Wal-Mart, cannot simply negotiate interchange fees. There is nothing to stop the banks from setting whatever rate they choose. If stores want to accept debit and credit cards, they have to accept the fees the card issuers set. It is estimated by the National Association of Chain Drug Stores that the interchange fee is the third largest expense for those stores after rent and labor. Because we see so many small businesses struggling to get by, we need to ask tough questions about whether these fees, which are completely unregulated, are putting an undo burden on the corner store.

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Currently, the merchants are fighting back. There are at least 47 lawsuits in the United States, many of which have been consolidated into one large suit, concerning interchange fees. The suits charge a number of banks and Visa and MasterCard with engaging collusive practices and setting the interchange fees at supra-competitive practices. Whatever the courts decide, I think it is our Subcommittee's responsibility to make sure that consumers are not saddled with higher prices and that the slim profit margins of small businesses are not eaten up by interchange fees.

Again, I am glad we are here today to learn more about interchange fees. I look forward to hearing from our witnesses. Thank you.

MR. STEARNS. I thank the gentle lady. Mr. Sullivan, who is not on the committee, would be able to speak by unanimous consent agreement. Before I do that, I will go to the members first. Mr. Towns, for opening statement.

MR. TOWNS. Thank you very much, Mr. Chairman. I want to thank you for holding this hearing on the Law and Economics of Interchange Fees. I believe this hearing will help the public to better understand what these fees are, how payment systems are structured and how they affect consumers, small businesses and others. Last year this committee visited this issue during debate on the Gasoline for America's Security Act. At that time, we directed the Federal Trade Commission to study the role and overall cost of credit cards interchange rates on gasoline and diesel fuel retail prices.

As you know, Mr. Chairman, the very thought of conducting a study has prompted a considerable amount of attention from both the retail community and the banking industry, each representing a different position. The retail community says that interchange rates are too high, especially when compared to other nations; that competitors in the banking industry collectively fix prices in violation of the anti-trust laws and that the credit card system operates under a veil of secrecy with regards to their operating rules. The banking community claims that the system works just fine and the reform in other countries have not worked.

I hope this hearing will provide an opportunity for both sides to express their views on the issue. Only through full transparency can we truly determine if consumers are being treated fairly in this market. So again, Mr. Chairman, and also the Ranking Member, I really appreciate you holding this hearing. I think it is a very, very important hearing and I look forward to hearing from our witnesses. On that note, I yield back.

MR. STEARNS. I thank the gentleman. Is there a nanimous consent agreement that Mr. Sullivan would be able to have an opening statement? Sure.

MR. SULLIVAN. I ask unanimous consent.

MR. STEARNS. So ordered.

MR. SULLIVAN. Thank you, Mr. Chairman, and Chairman Stearns, I appreciate you holding this hearing. I think it is very important and this issue actually came to light when we were on the full committee and I, along with some others, offered an amendment to the Gasoline for America's Security Act directing the FTC to investigate the role of overall cost of credit card interchange rates on gasoline and diesel fuel retail prices. Since then, we have looked at it further and I think that the backbone of our economy today, 85 percent of the people that work in America work for, own or operate medium to small businesses and they are the ones that are affected by this. I am not saying that there is anything bad going on here, but I think it is very important that we get to shine the light of day on this process and get to see exactly what is going on. So I would like to thank our panelists for being here and I look forward to your testimony and I want to thank again the Chairman. He said he would do this and he did it and I thank you for that. I yield back.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. JOE BARTON, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

Good morning. I'd like to thank our distinguished panel for coming in this morning to talk about interchange fees. And I'd like to welcome former FTC Chairman Tim Muris back to the Committee and thank him for bringing his expertise to our discussion.

The purpose of this hearing is to explore how the "interchange fees" associated with payment cards affect consumers, small businesses, and the general economy.

Merchants in the U.S. began providing credit to customers in card form as early as the beginning of the 1900s, and in the 50s and 60s Diners Club and the American Express became the first widely used travel and entertainment cards. Nowadays, there are very few of us who don't have a Visa, a Mastercard, or both in our wallets. Payment cards—whether they're credit or debit cards—have become extremely important to commerce, and this has been to the benefit of the average consumer, the corner hardware store, and the global retailer.

Here's how the system works: If I buy a case Diet Dr. Pepper for 10 dollars and pay with a credit card, both my bank and the store's bank pay the credit card company a small fee for use of its network to make the transaction. These fees are usually a percentage of the purchase.

After Hurricane Katrina, the price of gasoline rose dramatically, responding to short-term market forces. Retail consumers now had to pay more than $3 for the same gallon of gasoline they had been buying for $2 or less. Even though the amount of gasoline purchased did not change, the proceeds from credit card transactions went way up. Some gasoline retailers told us in a post-Katrina hearing that these extra fees contributed partly to higher gasoline prices—a vicious circle that penalized the consumer. We do seem to need a sensible agreement during the next problem like Katrina, so that Congress does not have to come up with some solution likely to be clumsy.

Soaring gasoline prices in the aftermath of a killer hurricane is abnormal in the extreme, however. Congress and this Committee have an essential role to play in protecting consumers during normal times from abusive or unfair practices, and I want to hear more of what everybody thinks about the impact of these fees in everyday commerce.

I am pleased to have witnesses representing different opinions on the economics of Interchange fees and their impact on commerce. I am interested to learn why any disagreements cannot be resolved contractually or by the marketplace, given current laws.

Thank you, and I look forward to the testimony. I yield back the balance of my time.

Prepared Statement of Hon. Mary Bono, a Representative in Congress from the State of California

Chairman Barton, Chairman Stearns, Ranking Member Dingell, and Ranking Member Schakowsky, thank you and good morning. I would also like to extend a warm welcome to the distinguished panel as well.

As we all of know, credit and debit cards have become a significant form of payment in the United States. Whether someone is purchasing a meal or filling up the tank of their automobile with gasoline, the credit card is usually in hand, adding efficiency and security to the payment process. I use the phrase payment process, because it is in fact a process that is more complex than handing over a twenty dollar bill and waiting for change.

Paying with credit cards and other card payment products involves more than a consumer and a merchant. It is a complex coordination of different parties, which includes consumers, merchants, and often times multiple financial institutions.

Within this complex web of transactions are interchange fees. Recently, questions have been raised surrounding the necessity and level of such interchange fees. For instance, what is the consumer getting for this fee and is the process for determining interchange fees transparent? And if not, what are the reasons for confidentiality?

Over the last few years, with the increased focus on the privacy and the protection of consumer information, I applaud the credit card industry's commitment to decreasing the risk of fraud and the measures the industry has taken to reduce personal information and identity theft.

As I have previously stated, this issue involves a highly complex and technical aspect of the credit card industry. It is important to remember during this discussion that these fees were not established on a whim. They are there to cover the cost associated with doing business in a complex system. However, complexity alone does not justify placing unnecessarily high expenses on consumers. Today's hearing will help us better understand this process and I am looking forward to listening to all sides of the discussion about the necessity of such fees.

Moreover, because of the current robustness of our economy and the added power cards give to consumers it seems like any move towards regulation should be met with the strictness of scrutiny.

With that said, I look forward to hearing the panel's thoughts on interchange fees, the global trends surrounding interchange fees, and what the future holds for interchange fees in the United States.

PREPARED STATEMENT OF HON. MIKE FERGUSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

- Thank you, Mr. Chairman, for holding this hearing on interchange fees, the structure of payment systems and how they both affect the marketplace, merchants and consumers.
- Our economy is dynamic. Consumers enjoy a wide variety of choices in what to buy and also choices in how to pay for those goods and services.
- Ever increasingly, consumers choose to pay with credit cards and have the payment made electronically.
- They enjoy the convenience most of all, but they are also enticed by many other benefits such as loyalty and rewards programs through the card issuer.
- I believe in free, unfettered markets. I also believe that consumers will flock toward methods of payment that are more convenient and beneficial to them.
- It seems like the statistics point toward electronic payment being recognized by consumers as the most convenient and beneficial way to purchase goods and services. In 2003, businesses and consumers made more payments by electronic methods than by check for the first time.
- And as a believer in free markets, I am reluctant to even enter into a discussion that begins and ends with setting price controls – and would be equally as reluctant to discourage consumers to use a method of payment that they have selected as the most convenient option.
- That said, I think that merchants, many of them small businesspeople, have rights in this equation as well.
- They need the system to be fair, and they need the cost of participating in credit card system to not be overly burdensome.
- I look forward to hearing from the panelists today. Thank you, Mr. Chairman.

MR. STEARNS. I thank the gentleman. The gentleman from Georgia. There is no one else with opening statements, so we will welcome the panel here. The Honorable Tim Muris of Counsel of O'Melveny and Myers on behalf of The Electronic Payments Coalition; Mr. Armour, President and CEO of National Association of Convenience Stores, and we welcome you; Ms. Karen Kerrigan, President and Chief Executive Officer, Small Business and Entrepreneurship Council; and Mr. Edward Mierzwinski, Consumer Program Director, U.S. Public Interest Research Group. I welcome all of you and we will start with you, Mr. Muris. How are you? Good.

STATEMENTS OF THE HONORABLE TIMOTHY J. MURIS, OF COUNSEL, O'MELVENY & MYERS, LLP, ON BEHALF OF THE ELECTRONIC PAYMENTS COALITION; HENRY ARMOUR, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF CONVENIENCE STORES; KAREN KERRIGAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SMALL BUSINESS AND ENTREPRENEURSHIP COUNCIL; AND EDWARD MIERZWINSKI, CONSUMER PROGRAM DIRECTOR, U.S. PUBLIC INTEREST RESEARCH GROUP

MR. MURIS. Thank you very much, Mr. Chairman. It is indeed a pleasure to be back in front of this committee. This was the first committee that I testified before when I was Chairman and this committee, on both sides of the aisle, was always a great supporter of our work at the Federal Trade Commission. Let me make just a few points. First, we are here primarily because of efforts to cap the rates that merchants pay for the payment card networks. Such caps will inevitably increase card prices to consumers. The merchants' efforts to regulate prices, therefore, pose a direct threat to the American consumer. If consumers understood the threat that the merchants' campaign poses to the plastic in their wallets, I suspect that we would see nothing less than a revolt. I understand the full fury of the aroused American consumer. While Chairman of the FTC, we created the National Do Not Call Registry. I suspect that many Americans feel as strongly about their plastic as they do about their dinner hour.

My second point is that payment cards benefit both consumers and merchants. Electronic payments rank with the cell phone, micro chip and personal computer as one of the last century's great innovations. The simplicity of pulling a card from your wallet or purse, however, belies an extraordinarily complex technological infrastructure that supports these transactions and that literally cost billions of dollars to create and allow the transactions to occur securely, reliably and efficiently.

Third, a fixed interchange fee is essential. Economists classify payment systems as two-sided products, which means to succeed, the product has to appeal to two distinct sets of consumers and the value of the system to one group is largely a function of its attractiveness to the other. Normally, the side with attractive low-cost substitutes gets the better deal. Consider the newspaper that you read this morning. Readers pay little or nothing to enjoy their paper. Instead, the publishers collect the vast bulk of their revenue from advertisers. If the paper had to charge readers a price based solely on the cost of providing the paper to them, it would likely fail to get enough readers or advertisers. Without enough readers, there will not be enough advertisers for the paper to succeed financially.

Let me then address the role of the interchange fee. Within the Visa and MasterCard networks, as the Chairman was explaining, issuing banks provide cards to customers and acquirers process the payment card transactions. When a customer uses a card, the merchant transfers the billing information to the acquirer, which transfers it to the issuer. The issuer pays the acquirer the amount of the transaction less the interchange fee and another fee and posts the transaction to the customer's account. The acquirer then credits the amount charged to the merchant's account less the interchange fee plus a fee for the acquirer.

Now, this is very important; Visa first adopted an interchange fee, and MasterCard quickly followed, in 1970. This was in 1970, well before these credit cards had much penetration and anybody could claim they had market power. The set fee reduces the transaction cost of negotiating separate interchange fees between thousands of acquirers and issuers and moreover, for Visa and MasterCard to exceed as brands, the merchants have to honor cards from each of the thousands of issuers. A system-wide fee avoids the cost of a hold-up that could occur in that situation. Without the set fee, individual issuers could demand higher interchange fees if there were bilateral negotiations every time a card transaction was presented. And because of the need to honor all the cards, acquirers could not respond by refusing to accept cards from certain issuers. Again, this was in place decades ago, long before the significant penetration we have of electronic payments today.

Against this background, it is clear that the interchange fee price fixing litigation threatens the viability of payment cards as they exist today. The normal antitrust remedy for these 47 suits which allege price fixing, that allege a conspiracy and restraint of trade, the normal antitrust remedy would be, if found liable, would be to end the alleged price fix. That is, there could be no setting of interchange fees. The merchants who support these cases cannot possibly want the ending of interchange fees being fixed because it would harm consumers and for the reasons I discussed above, threaten the very existence of Visa and MasterCard. Instead, what they want is the government, the Congress, or the courts, to fix prices for the industry, but at a lower level. Yet, how could a Federal court mandate a reduction in interchange fees to a level deemed reasonable as a remedy to a price fixing claim?

One of the Antitrust's most fundamental maxims is that the market, not government, should set prices. Indeed, reasonableness is never a defense to a price fixing violation. Ordering a fixed interchange fee would run directly counter to these principles. Now, to conclude, I would say that the plaintiffs' lawyers and their merchant clients probably assume they will be able to extort a settlement. By the time these claims approach trial, the plaintiffs' stated damage could easily approach $1 trillion after troubling. They will argue for a pragmatic solution to the problem and they are betting that with your help they will succeed. Because American consumers would lose as a result of price controls in this industry, I urge you to refrain from such a drastic step. Thank you again, Mr. Chairman, for inviting me.

[The prepared statement of Timothy J. Muris follows:]

PREPARED STATEMENT OF HON. TIMOTHY J. MURIS, OF COUNSEL, O'MELVENY & MEYERS LLP, ON BEHALF OF THE ELECTRONICS PAYMENTS COALATION

Chairman Stearns, Ranking Member Schakowsky, and Members of the subcommittee, my name is Timothy J. Muris. I am George Mason University Foundation Professor of Law and former Chairman of the Federal Trade Commission. Although I am here today at the request of the Electronic Payments Coalition, a coalition of card networks as well as large and community banks and thrifts,[1] my views on the "Law and Economics of Interchange" are my own. I want to thank the subcommittee for giving me the opportunity to discuss this important subject.

I. Why Are We Here?

A group of merchants, plaintiffs' lawyers, and trade associations want some arm of the Federal government to cap the rates that merchants pay for access to the electronic payment infrastructure that the payment card networks and thousands of other financial institutions have built over the past fifty years. The inevitable consequence of allowing the merchants to cap the prices they must pay to accept payment cards will be to increase the price that consumers pay for their cards. The merchants' efforts to regulate prices, therefore, pose a direct threat to the American consumer. If consumers understood the threat that the merchants' campaign poses to the plastic in their wallets, I suspect that we would see nothing less than a revolt.

I have witnessed the full fury of the aroused American consumer. While chairman of the Federal Trade Commission, I led the agency in riding a wave of public resentment to create the National Do Not Call Registry. I suspect that many Americans feel as strongly about their plastic as they do about their dinner hour.

To explain why the actions of the critics of payment cards threaten their very existence, the remainder to this testimony makes four points:

- Electronic payments produce enormous benefits for consumers and merchants alike;
- A fixed interchange fee is essential to the existence of the electronic payment card market;
- As the recent experience in Australia demonstrates, federal, state, and local governments restructuring should not seek to regulate the price of interchange, and;
- The current interchange fee price fixing litigation threatens the viability of the electronic payment card system as it exists today.

II. Electronic Payments Produce Enormous Benefits.

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1 The full list of members of the Electronic Payment Coalition is attached to this testimony as ***Exhibit A***.

As I have written elsewhere, electronic payments rank with the cellphone, microchip, and personal computer as one of the great innovations of the twentieth century.[2] The simplicity of pulling a card from a wallet or purse belies the extraordinarily complex technological infrastructure that supports electronic transactions, connecting merchants, consumers, and financial institutions securely, reliably and efficiently.

The merchant campaign to impose price controls on the industry rests on a fundamental misconception. In supporting price controls, some claim that payment cards are overused relative to other payment methods. Cash, checks, and other forms of electronic payment may be cheaper for some merchants on some transactions than the services offered by Visa, MasterCard, American Express, and their financial institution partners. But they are not cheaper for society as a whole when the full benefits and costs of payment cards are considered. Electronic payments offer benefits to consumers and merchants that other forms of payment, particularly paper-based ones, cannot match.

Payment cards allow consumers to manage their money better by making it possible to anticipate, plan, and match their obligations to their available funds. Most households receive income in regular increments, biweekly or monthly paychecks, for instance, yet make purchases continually. Payment cards allow consumers to combine their bills into a single monthly payment card obligation. Payment cards also allow consumers to smooth out unexpected expenditures, such as car repairs or family emergencies, instead of holding sufficient reserves to cover such costs. Some commentators have estimated that the benefit to consumers of not having to set aside such reserves (and thereby earning interest on that money) is substantial, one that alone exceeds the cost of the annual fee on those cards that have them.

Electronic payments are also flexible enough to be used in almost any environment, facilitating transactions that otherwise would not be possible. Consider the symbiotic relationship between internet commerce and electronic payments. During 2002, Americans bought $43 billion worth of retail goods over the Internet, comprising 1.3% of all retail sales. By 2004, this figure had grown to over $100 billion. In the United States, 95% of internet purchases are made with payment cards. The development of e-commerce would have been stifled without consumer confidence in the security and usefulness of these cards. By increasing shopping convenience and permitting greater e-commerce, the widespread use of payment cards has helped enable the creation and expansion of new businesses in the economy, especially small and niche-focused firms that could not survive in traditional brick-and-mortar environments.

The campaign against the electronic payment industry also rests, at least implicitly, on the argument that consumers (and society as a whole) have suffered because of the easy access that payment cards provide to revolving credit. This claim is also misguided. From colonial times to the mid-twentieth century, bank credit was essentially limited to the economic and social elite. The vast majority of U.S. households had no access to bank credit. As a result, they were forced to borrow money from family or friends or unlicensed lenders such as pawn brokers and loan sharks.

Today, most adult Americans can obtain a revolving line of credit from a financial institution issuing a Visa, MasterCard, American Express or Discover card. In fact, more people have credit cards in their wallets than voted in either of the most recent presidential elections. Even many of the poorest households in the United States have participated in the consumer credit revolution. By the end of 2001, 38 percent of households in the lowest income quintile had acquired a credit card.

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[2] *See, e.g.*, Timothy J. Muris, *Payment Card Regulation and The(Mis)Applicaton of the Economics of Two-Sided Market*s, 2005 COLUMBIA BUS. L. REV. 515 (2005) (***Exhibit B***). For the Committee's convenience, I also attach an op-ed piece that I published in the Wall Street Journal last year. (***Exhibit C***)

Credit cards can be a superior form of credit for some consumers. Too often, those who scoff at this use of plastic do not need credit or are wealthier individuals with better credit options than many Americans. Compared to home-equity loans, for example, credit cards do not require that one own a home or that one further mortgage the home that he owns. Credit cards are clearly superior to and less expensive than traditional forms of credit such as pawnshops, payday lenders, and borrowing money from family and friends. In the last quarter of 2005, the average annual percentage rate on a credit card account was 12.36 percent.[3] Furthermore, personal-finance company loans can be more expensive and have much higher initiation fees than do payment cards.

The argument that credit-card debt is overused is simply misplaced. The use of revolving credit reflects almost entirely an offsetting decline in installment credit, such as from personal-finance companies and retail stores. From 1970-1995, installment credit fell steadily, offsetting the rise in revolving credit. Since 1995, revolving credit as a percentage of disposable personal income has been largely constant.

In addition to the benefits that consumers enjoy from the electronic payment infrastructure, merchants enjoy benefits as well. Merchants directly benefit from the faster throughput and enhanced record keeping features of electronic payments. Merchants also benefit from payment guarantees that have enabled financial institutions to assume the risk of non-payment and fraud from paper-based forms of payment. Merchants, particularly boutique merchants, benefit from the separation of the extension of credit from the retail transaction made possible by electronic payments. The system built by MasterCard, Visa, American Express, and others enables merchants to concentrate on delivering more and more unique goods to consumers and financial institutions to specialize in evaluating consumers' capacity to repay and reducing the costs associated with collection. Indeed, the benefit of all-purpose credit cards is demonstrated by the fact that many merchants have discontinued their own, proprietary cards.

III. Interchange, Merchant Fees, and Two-Sided Markets.

The merchants' core argument for additional regulation reduces to the claim that the payment networks charge merchants too much and provide them too little. When they present this argument in court, they dress it up, insisting that Visa and MasterCard provide a forum in which banks conspire to raise the price that merchants pay for payment. To understand why these theories are fundamentally flawed, and therefore why Congress and the Courts should not intervene in this industry, it is critical to understand the basic economics of payment cards.

Economists classify payment systems as two-sided products. To exist, a two-sided product must appeal to two distinct sets of customers, and the value of the system to one group of customers is largely a function of its attractiveness to another group of customers. This characteristic drives pricing strategy for all two-sided products, including payment systems. Normally, the side with attractive low cost substitutes gets the better deal. This is not a matter of fairness or cost recovery. It is simply the way that the supplier of the two-sided product maximizes the appeal and use of the product to both groups of customers.

Newspapers employ such a pricing strategy. Readers of newspapers pay little or nothing to enjoy the benefits. Instead, publishers collect the vast bulk (or all) of their revenue from advertisers. If a newspaper has to charge readers a price based solely on the direct marginal cost of providing the paper to them, it would likely fail to attract sufficient participation from either readers or advertisers. Most readers have many other sources of news and entertainment available at prices likely below the marginal cost of

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[3] *See* Federal Reserve Statistical Release G.19, Consumer Credit (Feb. 7, 2006), *available at* http://www.federalreserve.gov/releases/g19/current/default.htm.

supplying them with a newspaper. Without enough readers, there will not be enough advertisers for the paper to succeed financially.

Payment systems have followed a similar pricing strategy since their inception. When Diner's Club introduced its charge card in the 1950s, it needed terms that would provide consumers with a reason to use its new payment system instead of cheaply available substitutes—cash, check, and traveler's checks. Diners Club settled on a pricing strategy that featured a relatively modest annual fee, no per transaction charge, and a 30-day grace period. Although merchants received substantial benefit in the form of a payment guarantee, they paid a seemingly higher price. They accepted transactions made with Diner's Club cards at 4 - 5% discount of face value.

American Express and Discover continue to follow this model. Like Diner's Club in the 1950s, they price directly to both cardholders and merchants. They have settled on a pricing strategy that directs substantial value to cardholders (e.g., cash-back, rewards, a grace period, and low revolving rates) at low or no explicit price and that charges merchants a discount on all transactions.

The origin of Visa and MasterCard is somewhat more complex. Figure One (***Exhibit D*** in the Appendix) explains the four parties involved in a transaction that uses a MasterCard or Visa payment card. Within the Visa and MasterCard networks, "issuing" banks provide cards to customers and "acquirers" process payment card transactions for merchants. When a customer uses a card, the merchant transfers the billing information to the acquirer, which transfers the billing request to the bank issuer. The issuer pays the acquirer less the interchange fee, set by Visa and MasterCard, and posts the transaction to the customer's account. The acquirer then credits the amount charged to the merchant's account, less the interchange amount plus an additional fee. Thus, for Visa and MasterCard, interchange fees help perform the same balancing function as the direct payment from merchants to American Express, Discover, and Diner's Club.

In 1970, Visa first adopted a fixed interchange fee. A set fee reduces the transaction costs of negotiating separate interchange fees between acquirers and issuers and eliminates the difficulties that issuers had faced in monitoring the merchant discounts set by individual acquirers. Moreover, for Visa to succeed as a "brand," merchants need to honor cards from each of the thousands of issuers. A systemwide fee, set by Visa, avoids the costs of the resulting "hold up" problem that would exist if merchants have to accept cards from every Visa issuer. Without a set fee, individual issuers could demand higher interchange fees in any bi-lateral negotiation. Because of the need to honor all cards, acquires could not respond by refusing to accept cards from certain issuers.

Because they are currently joint ventures of banks across the country, MasterCard and Visa are subject to alleged conspiracy charges simply based on their structures. Visa and MasterCard exist as joint ventures in part because old anti-branching laws prevented banks from operating across state lines. When Bank of America began to franchise its card brand in 1966, the banking regulations prohibiting interstate banking prevented it from expanding beyond its home state of California.

In short, the essential interchange structure, comprising a merchant discount that provided revenues for the acquirer bank and included the interchange fee, was in place from almost the very beginning, long before Visa and MasterCard possibly had any market power. The early emergence of the interchange fee and its continued presence in the payment card industry testify to the inherent logic of interchange fees in equilibrating the two sides of the market, and not, as critics contend, to harm consumers.

Another important aspect of the interchange fee involves the intense competition among issuers. Consumers have many choices among payment cards, not just the different "brands" (MasterCard, Visa, etc.), but also among the numerous banks issuing MasterCard, Visa, and now American Express. No issuer has market power, and issuers respond to increases in interchange fees by enhancing card benefits to consumers.

IV. There's Nothing Broken About The Electronic Payments Industry: Do Not Seek To Control Its Pricing.

"Subsidies" are common in our complex economy. For example, Adobe gives away its popular Acrobat software to document recipients to increase the sales of its software to document senders. Likewise, consumers receive free refills on drinks in restaurants, free parking at shopping malls, goods below cost in supermarkets (via loss leaders), relatively inexpensive newspapers because advertisers pay most of the costs. To bring buyers and sellers together through such intermediaries as newspapers, shopping malls, and dating clubs, one side frequently receives inducements to participate. These inducements help maximize the joint value of the ultimate transaction for the parties. Rather than an inefficient "subsidy," these inducements are the lubricant necessary to make the economic machine work at its best.

The cross-subsidy within the pricing model of the electronic payments industry is no different. Consumers play a more active role in making a choice between payment forms at the point of sale than merchants. As a result, explicit benefits flow in their direction. But like "free" refills, deliveries, and toasters, any "subsidy" from merchants to consumers does not raise the sort of issue that the antitrust laws exist to correct. Nor should Congress or the Courts step in to regulate the price of payment in the United States as a few foreign governments have done. In fact, the outcome of rate regulation in Australia shows clearly why federal, state and local governments in this country should not regulate the price of payment and what might happen if they do.

The Reserve Bank of Australia announced an interchange rate formula for the bank owned systems, Visa, MasterCard, and Bankcard. In October 2003, the RBA's interchange rate regulation went into effect, cutting Bankcard's, MasterCard's and Visa's interchange rates on credit card transactions from approximately 95 to 55 basis points.

Although the effects of the RBA's restructuring of the payment card industry will play out for many years, the regulatory regime has already had significant effects. Cardholders have borne the brunt of the RBA's regulation. Since the imposition of the rate caps, credit card fees have increased substantially. In a paper discussed at a recent academic conference hosted by the New York Federal Reserve, economists Howard Chang , David Evans, and Daniel D. Garcia Swartz, analyzing Visa credit card data, estimated that Australia cardholders had seen their annual fees and finance charges increase by AU$148 million.[4] Chang, Evans and Swartz also reported that rewards programs were cut following the RBA regulation.

V. The Antitrust Cases.

There are now 47 merchant lawsuits challenging interchange that have been consolidated into a single proceeding in the District Court for Eastern District of New York. The plaintiffs' lawyers and the relatively few merchants they have attracted as clients allege that the setting of interchange fees is a conspiracy in restraint of trade. The normal antitrust remedy in this situation would be to end the allegedly fixed price. The networks then would no longer set interchange fees. But the plaintiffs and, more importantly, merchants as a whole cannot possibly want that relief. It would, for the reasons explained above, harm consumers and threaten the existence of Visa and MasterCard as we know them. Instead, the plaintiffs want the judge to himself fix prices for the industry, but do so at a lower level.

Yet, how could a federal judge mandate price fixing (a reduction in interchange fees to a level deemed "reasonable") as a remedy to a price fixing claim? One of antitrust's

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[4] Howard H. Chang, David S. Evans, Daniel D. Garcia Swartz, *An Assessment of the Reserve Bank of Australia's Interchange Fee Regulation*, The Federal Reserve Bank of New York Conference: Antitrust Activity in Card-Based Payment Systems: Causes and Consequences (Sept. 15-16, 2005).

most fundamental maxims is that the market, not government, should set prices. Indeed, "reasonableness" is never a defense to a price fixing violation. An order to set interchange at a reduced rate, however it was ultimately justified, would run directly counter to these core principles of antitrust. And, as we know from Australia, such an order would have only one certain effect—consumers would pay higher prices for access to electronic payments.

If these cases are litigated on the merits, the plaintiffs should lose. As an initial matter, unlike a true price-fixing case,[5] the purpose of the interchange fee is actually to *increase* output. The current system of interchange fees are a necessary part of an industry that provides enormous benefits to consumers. Nevertheless, the plaintiffs' lawyers and their merchant clients probably assume that these cases will never have to litigate these cases on the merits believing, instead, that they will be able to extort a settlement. By the time these claims approach trial, the plaintiffs' stated damage theory could easily approach $1 trillion after trebling. They will argue for a "pragmatic" solution to the problem, and they are betting that, with your help, they'll be able to succeed. Because American consumers would lose as a result of price controls in the industry, I urge you to refrain from such a drastic step.

Mr. Chairman and members of the Committee, that concludes my testimony. Thank you again for inviting me, and I will be happy to respond to questions.

[5] *See, e.g., Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1, 19-20 (1979) (in assessing a price fixing claim, "[the] inquiry must focus on whether the effect and . . . purpose of the practice are to threaten the proper operation of our predominantly free-market economy -- that is, whether the practice facially appears to be one that would always or almost always tend to restrict competition and decrease output").

Member List (as of February 2006)

EXHIBIT A

Electronic Payments Coalition

Advanta Corporation

America's Community Bankers

American Bankers Association

American Express Company

American Financial Services Association

Bank of America

Barclays Bank

Capital One Financial Corporation

Citigroup

Consumer Bankers Association

Financial Services Roundtable

HSBC North America

Independent Community Bankers of America

JPMorgan Chase & Company

MasterCard International

Ohio Bankers League

U.S. Bank

Visa USA

Wachovia

Washington Bankers Association

Washington Mutual

EXHIBIT B

Columbia Business Law Review
2005

Conference on Two-Sided Markets, Columbia Law School 2005

*515 PAYMENT CARD REGULATION AND THE (MIS)APPLICATION OF THE ECONOMICS OF TWO-SIDED MARKETS

Timothy J. **Muris** [FNa1]

I. INTRODUCTION

Plastic payment cards are one of the great innovations of the twentieth century. Like the microchip, the personal computer, and the cellular telephone, payment cards have become ubiquitous after only a few decades of use, transforming the way business is conducted.

The simplicity of pulling a card from one's wallet belies the extraordinarily complex technological infrastructure that supports payment card transactions, connecting merchants, *516 consumers, and financial institutions seamlessly, efficiently, and securely. This system benefits consumers and merchants alike--consumers enjoy convenience, speed, security, and accurate recordkeeping for their cards, while merchants benefit from the reliability of guaranteed payments, faster throughput at the point of sale, and access to tens of millions of customers who prefer to pay with plastic. Billions of dollars have been invested to produce the innovations necessary to make today's system function. Crucially, the enormous benefits of payment cards have developed through market competition, largely free from micromanagement by government regulators.

Yet payment card companies are increasingly under attack. In the United States, the industry has become an attractive target for the plaintiffs' bar. [FN1] Merchants throughout the world recognize the benefits of plastic, but have turned to lawsuits and regulators to reduce the associated costs. Australia and other governments have actually imposed controls on the price that some card issuers can charge merchants.

This article considers actions against payment card companies in light of the economics of two-sided markets. One side of the payment card market consists of the consumer and the card issuer, and the other consists of the acquirer (or an intermediary) and the merchant. For the system to function, consumers must carry cards and merchants must accept them. Neither side can be considered in isolation; rather, understanding the interrelation between the two is crucial. This two-sided feature dramatically expands the challenge for those attempting to formulate sensible regulations. Because participants on each side of the card transaction simultaneously generate costs and benefits for one another, pricing according to marginal costs and other traditional measures of market efficiency has little relevance. Unfortunately, most legal interventions in the *517 payment card industry to date have ignored the dynamics of this two-sided market.

Section II of this article briefly summarizes the relevant economic literature regarding two-sided markets. Section III provides an overview of the payment card industry, and Section IV discusses the many benefits of payment cards. Section V then considers one recent example of government intervention: Australia's regulation of the fees that certain card issuers charge for their services. Section VI offers concluding remarks.

II. THE ECONOMICS OF TWO-SIDED MARKETS

Two-sided markets are common in today's economy. [FN2] Newspapers, for example, link readers and advertisers and thus provide one example of a two-sided market. A newspaper without readers will not attract advertisers, and increasing the price of a newspaper to compensate for the absence of revenue from advertisers will turn away readers.

Three conditions must be present in a two-sided market: (1) two distinct groups of customers; (2) the value obtained by one group increases with the size of the other; and (3) an intermediary connects the two. Coordination of two-sided markets requires that this intermediary or "middleman" *518 create a platform for the groups to interact. The intermediary must ensure the existence of a critical mass on both sides. Which side of the market exists first is not crucial; what does matter is that "the product may not exist at all if the business does not get the price structure right." [FN3]

Coordinating the two sides can result in behavior that appears irrational when examined in isolation. For instance, one might argue that the price that readers pay for newspapers is too low because it fails to cover the cost of production. Indeed, some newspapers are provided free to readers, with revenues obtained solely from advertisers. The newspaper thus "subsidizes" readers to increase circulation, thereby making it more attractive to advertise in the newspaper, and increasing the demand for, and price of, newspaper advertising. Seeking to eliminate the "subsidy" to readers while ignoring the advertiser side of the market is not only incorrect, but it would harm all parties--readers, advertisers, and newspaper producers alike.

Such "subsidies" are commonly used to solve the "chicken and egg" problem of coordinating the two sides of the market. [FN4] These "subsidies" might be deemed inefficient because some users pay less than the product's full marginal cost. But this naïve analysis is incorrect--the relevant measure is the joint surplus obtained by coordinating the activities of the two groups, e.g., advertisers and readers. Increased readership raises the value of advertising in the newspaper, while increased advertising raises the value of the newspaper to each reader by reducing his search costs for information, and by increasing the likelihood that he will *519 find information he desires. Thus, advertisers and readers both benefit from the purported subsidy.

Although the marginal costs of supplying each side are relevant in pricing decisions, they are not dispositive. Two other variables are crucial in determining which side of a market "subsidizes" the other: the relative demand elasticities of the participants on each side and the relative importance of network effects. [FN5] First, in a two-sided market, the side with less elastic demand will typically face the higher price, because raising the price for those with more elastic demand will lead to more lost sales. Consider newspapers again--local advertisers have relatively few outlets for informing consumers. [FN6] By contrast, consumers have many other sources of news, including radio, television, and the Internet. Thus, at the margin, readers will be more likely to respond to changes in subscription prices than advertisers to changes in advertising rates. Second, firms selling in two-sided markets will tend to charge a lower price to the group with greater network effects, i.e., where increased demand has a larger effect on value on the other side of the market. With newspapers, the network effects of increased readership on the value of advertising are generally much greater than the effects of increased advertising on the value of the paper to readers. [FN7]

***520** Because of these dynamics, there is no reason why the price charged to the two sides in a two-sided market should, or would, equal marginal cost. The price charged to newspaper readers need not reflect the marginal cost of producing the paper. The concept of a "subsidy" or below-cost pricing makes no sense in this context given that each side of the market simultaneously creates benefits for the other side.

III. PAYMENT CARDS AS A TWO-SIDED MARKET

Payment cards, through their coordination of merchants and consumers, are another example of a two-sided market. Consumers will carry payment cards only if merchants accept them, and merchants will accept cards only if a sufficient number of consumers use them.

The United States has four major "brands" of payment cards--American Express, Discover, MasterCard, and Visa. These four are card systems that connect networks of businesses and merchants who process transactions, transfer funds, and provide billing information. American Express and Discover are integrated, proprietary systems that provide all of the financial services linking consumers to merchants that are necessary to effectuate payment transactions. Visa and MasterCard, by contrast, are joint ventures of the thousands of banks that issue their credit cards to consumers. The Visa and MasterCard systems provide the structure to clear transactions and coordinate billing information between consumers and merchants.

Within MasterCard and Visa, "issuers" provide cards to consumers, while "acquirers" process payment card transactions for merchants. [FN8] When a consumer uses a card, the merchant transfers the billing information to its acquirer, which then transfers the billing request to the bank issuer. The issuer then pays the acquirer, minus an amount called the "**interchange** fee," which is set by MasterCard and ***521** Visa, and posts the charge to the consumer's account. The acquirer then credits the amount charged to the merchant's account, less another fee for its services. The total difference between the amount that the consumer pays and the amount the merchant receives is called the "merchant discount." The average merchant discount on a Visa or MasterCard credit transaction is approximately 2.0% of the purchase price. The acquirer receives approximately 0.6% of the purchase price, and the issuer receives the remaining 1.4% in the form of an **interchange** fee. [FN9]

The **interchange** fee is the source of considerable academic and regulatory interest, as will be discussed below. MasterCard and Visa use the fee to attract issuing banks. Because competition between the issuers is so intense, [FN10] the issuers use the fee to provide benefits to consumers, including rebating some of it directly to the cardholder through a cash refund or providing additional benefits to cardholders, such as 24-hour customer service, car rental insurance, and ancillary benefits like frequent flyer miles or affinity card programs with nonprofit organizations.

Because American Express and Discover are unitary systems rather than joint ventures, they combine the functions of issuer and acquirer and thus capture the entire merchant discount directly. American Express charges a relatively high merchant discount rate, averaging 2.7%, whereas Discover charges a relatively low rate, averaging 1.5%. [FN11]

Payment cards thus simultaneously benefit two groups--consumers who use cards to pay for purchases and merchants who use cards to receive payment for their sales. The demands of the two groups are interdependent in that one values the product only if the other does as well. As ***522** discussed above, in two-sided markets the side with less elastic demand and lower network effects will generally "subsidize" the other side. With payment cards, merchants would be expected to pay more than consumers. [FN12] Although network effects are clearly present, the effects do not appear to be greater in one direction than the other--consumers and merchants both benefit substantially from payment cards. On the other hand, cardholder demand for a particular system's card is likely to be more price-sensitive than merchant demand, leading to merchant fees that are higher than cardholder fees. Cardholders are more price-sensitive because many consumers have multiple payment methods, including alternative payment cards. Most merchants, by contrast, cannot accept just one major card because they are likely to lose profitable incremental sales if they do not take the major payment cards. [FN13] Because most consumers do not carry all of the major payment cards, refusing to accept a major card may cost the merchant substantial sales. [FN14]

Credit card issuers have three streams of revenue. First, the acquirer pays the **interchange** fee whenever consumers use the issuer's card. (American Express and Discover receive the entire merchant discount.) Second, issuers gain revenues from consumers who revolve balances from one month to the next. These revenues consist primarily of interest paid on the balance, but also include penalties and charges, such as late fees and finance charges. Third, some issuers assess an annual fee for their cards.

Different issuers capture different shares of these revenues. American Express earns most of its revenues (approximately 82%) from its high merchant discount. [FN15] Visa and MasterCard issuers, by contrast, receive substantial revenue from consumers via revolving debt, as well as ***523** through other charges and late fees. Issuers of these cards earn only 15% of their revenue from **interchange** fees, with 70% of their revenue derived from finance charges, 12% from penalty and cash advance fees, and 3% from annual fees. [FN16]

These different price structures reflect, in part, different groups of cardholders. American Express receives higher merchant discounts because its cardholders are financially attractive--especially corporate card users and wealthy individuals. Moreover, corporate card accounts will not revolve, regardless of whether the corporate account is a charge or credit card. Thus, American Express, with a high corporate card user base, relies more heavily on revenue streams from merchant discounts and annual fees than on interest and penalties.

IV. THE BENEFITS OF PAYMENT CARDS

Payment card ownership grew dramatically at the end of the twentieth century. From 1970 to 1986, the proportion of families owning a general purpose bank card rose from 16% to 55%, [FN17] and by 2001, 73% owned a card. [FN18] Most of these consumers own more than one card; in 2003, the average cardholder held four or five cards. [FN19] Among households that own cards, 66% have more than one, accounting for almost 80% of credit card transaction volume. [FN20] These consumers can thus switch easily among different payment cards, depending on their relative costs and benefits. In addition, most consumers own a bank ATM card that can be used for debit transactions. This phenomenon, called "multihoming," refers to retaining access to several different networks simultaneously. Multihoming increases competition and ***524** consumer choice by permitting easy switching among networks. [FN21]

A. Benefits to Consumers

The dramatic growth of payment cards reflects their attractiveness to consumers over other forms of payment and credit. Payment cards offer consumers numerous benefits, including better management of one's expenses, improved recordkeeping, greater shopping convenience, reduction of the risk of theft, float for those who do not revolve balances, rewards from use of cards that are available for additional purchases, and, especially for debit cards, convenience in obtaining cash. I first discuss these benefits and then consider the benefits of payment cards when used to obtain credit.

1. General Benefits

Payment cards allow consumers to manage their money better by making it possible to anticipate, plan, and match their obligations to their available funds. [FN22] Most households receive income in regular increments, biweekly or monthly paychecks, for instance, yet make purchases on an ongoing basis. Thus, consumers benefit from combining their bills into a monthly payment card obligation rather than constantly holding sufficient funds in their wallets or checking accounts. Similarly, payment cards allow consumers to smooth out unexpected expenditures, such as car repairs or family emergencies. Again, the alternative would be for households to maintain sufficient reserves to cover such costs. Some commentators have estimated that the benefit to consumers of reducing precautionary balances (and thereby earning interest on their money) is substantial, ***525** one that alone exceeds the cost of the annual fee on those cards that have them. [FN23]

Payment cards also reduce the costs of recordkeeping versus retaining individual receipts. Checks also offer this advantage, but payment cards do not require the additional inconvenience of recording in, and then rebalancing, a checkbook. Payment cards also create written records for the merchant, which can aid the processing of product returns and refunds.

Moreover, payment cards can reduce the time and transaction costs associated with shopping. Advances in technology have dramatically increased the speed of processing card transactions, which are now substantially faster than writing checks. [FN24] Although it is unclear whether paying with cards or cash is faster, using cash requires the consumer to obtain it in the first place. This in turn requires a trip to a bank or an ATM, either of which requires planning to make the trip and can be time consuming. Moreover, if the ATM is outside of the consumer's network the consumer must pay a fee to withdraw the money. By contrast, transactional users of payment cards pay nothing to use their card. Transaction errors, such as receiving too little or too much change, are also probably higher with cash than with electronic payment card transactions. Moreover, once withdrawn, cash on hand is held interest free, thereby costing the consumer this foregone interest income.

Yet another advantage of payment cards is that payment cards can be used in a wide variety of outlets, helping both consumers and merchants. Some car rental transactions require payment cards. Perhaps the most important development related to payment cards has been internet commerce, which relies on electronic payments. Not only do cards provide convenient payment, but they also assist in ancillary functions such as age verification, when appropriate. During 2002, Americans bought $43 billion ***526** worth of retail goods over the Internet, comprising 1.3% of all retail sales. [FN25] By 2004, this figure had grown to over $100 billion. [FN26] In the United States, 95% of internet purchases are made with payment cards. [FN27] The development of e-commerce would have been stifled without consumer confidence in the security and usefulness of payment cards. By increasing shopping convenience and permitting greater e-commerce, the widespread use of payment cards has helped enable the creation and expansion of new businesses in the economy, especially small and niche-focused firms that could not survive in traditional brick-and-mortar markets.

Cash has a much higher risk of theft than payment cards. Empirical evidence indicates that people carry less cash in high crime areas. [FN28] When individuals carry less cash, they must visit an ATM more often. Moreover, out of pocket liability is limited by law for credit cards. [FN29] Payment cards also offer "float" to consumers during the period of time between the purchase and the card payment date. Payment on a credit card transaction is not due until the end of the billing period, and even then a grace period for payment of the bill continues. During this time consumers can invest their money in interest-bearing or revenue-producing assets, rather than in low-, or no-interest, checking accounts. [FN30] The ***527** opportunity to earn rewards such as frequent flyer miles or a cash back bonus is yet another benefit of payment cards. Like float, rewards are an advantage of credit and charge cards over debit cards.

Among debit cards, PIN or online cards allow consumers to withdraw additional cash beyond the price of the purchase for which the card is used, thereby saving a trip to the ATM. Nevertheless, many consumers prefer signature or offline debit, as signature debit provides dispute resolution procedures, more extensive merchant acceptance (because signature debit runs on the same machine as credit cards, whereas PIN debit requires a new machine), and more familiar use (because they are patterned after credit cards).

2. Payment Cards as a Form of Credit

Many payment cards also provide revolving credit, and credit cards are now an important source of consumer credit. The growth in credit card credit appears to have resulted primarily from the substitution of cards for alternative, less attractive forms of credit. For instance, many consumers who cannot obtain unsecured credit through credit cards are instead forced to rely on pawn shops and payday lenders. [FN31] Credit cards have also replaced informal sources of short-term credit, such as borrowing from friends and family. [FN32] ***528** Although home equity loans or lines of credit offer lower interest rates than other types of consumer credit, those who borrow with credit cards, or otherwise rely heavily on unsecured credit, often do not own homes. [FN33]

Most prominently, credit cards have displaced personal finance companies and retail stores as sources of unsecured credit. [FN34] Unsecured personal finance loans are expensive, with much higher initiation fees than credit cards. [FN35] In addition, finance loans are usually made in set amounts with regular payment terms, and often limit the borrower's ability to prepay. Therefore, for both cost and convenience, credit cards are attractive for consumers. General purpose credit cards have also substantially displaced retail store credit. [FN36] Purchases of household durables and apparel were ***529** traditionally made on credit, but credit cards now substitute for the in-house credit operations of retailers. [FN37]

Because of this substitution effect, most of the growth in credit card credit has not increased overall consumer debt. The use of revolving credit has risen, while consumer installment borrowing has fallen. [FN38]

B. Benefits to Merchants

Payment cards offer substantial benefits to merchants as well. Some of the benefits to consumers discussed above, such as speed of use and convenience, also aid merchants. Additionally, most acquirers offer useful and convenient billing operations that can reduce bookkeeping costs. Moreover, unlike bounced checks for which the merchant bears the risk, card issuers bear the risk of consumer nonpayment. [FN39] Compared to cash, payment cards also reduce the risk of employee errors and theft.

Most consumer credit was once tied to specific companies such as gasoline refineries and department stores. Singer Sewing Machine Company was the first large scale issuer of installment credit for consumer sales, beginning in 1850. [FN40] Oil company and hotel charge cards appeared relatively early as well, catering to businessmen who needed to transact while traveling. [FN41] Department stores issued credit to consumers, especially for appliances and other consumer durables. As early as 1930, almost as many purchases in department stores were made on "open book" revolving credit ***530** as were made with cash. [FN42] Historically, only large companies and department stores could afford the administrative expense and risk of providing in-house consumer credit. Even if credit was not particularly profitable, businesses such as department stores used their credit cards to build customer loyalty, enhance customer convenience, and track customer purchase patterns. Thus, credit operations furthered the larger goal of promoting sales.

The development of universal bank cards has especially aided small and "boutique" businesses by separating credit from the retail transaction. Rather than being forced to maintain the fixed cost and risk of a full-blown consumer credit system, small retailers may now make sales on credit while shifting the risk and most of the fixed costs to third parties. [FN43] Moreover, given the obvious comparative advantage and specialization of banks and financial institutions in evaluating consumers' repayment capacity, banks and financial institutions almost certainly bear the nonpayment risk at a lesser cost than most retailers. Thus, the development of universal bank cards has especially helped smaller businesses and increased competition and consumer choice.

V. GOVERNMENT INTERVENTION IN THE PAYMENT CARD MARKET

This section discusses an important example of regulation in the payment card market. The purported need for regulation is based on the claim that **interchange** fees are "too high" and, as a result, subsidize consumers to overuse payment cards. But regulators' failure to recognize the two-sided nature of the payment card market has resulted in ***531** flawed action. To help the reader understand the issues, I begin with some background on **interchange** fees.

A. The Origins and Role of **Interchange** Fees

Interchange fees arose from the structure of the Visa and MasterCard networks. Bank of America started a credit card business in 1958, but banking regulations prohibiting interstate banking prevented it from expanding beyond its home state of California. [FN44] Bank of America instead began to franchise its card brand in 1966, and initially required that acquirers pay issuers the entire merchant discount on a transaction. This procedure had obvious problems: it offered greater incentives to be an issuer than an acquirer, because the acquirer would receive no net revenues to cover its costs. Moreover, negotiations between the acquirers and the merchants set the discount rate, leading issuers to suspect that acquirers did not disclose and remit the full amount owed.

In 1970, Bank of America converted its franchise system into a member owned cooperative, which later changed its name to Visa. Since then, Visa has pursued an essentially open membership policy, growing to 21,000 member banks. [FN45] Facing the same restrictions on multistate banking, other banks formed MasterCard. Today, MasterCard comprises approximately over 25,000 issuers around the world. [FN46]

Soon after 1970, Visa adopted a fixed **interchange** fee, which was not linked to the merchant discount charged by individual acquirers. A uniform fee reduced the transaction costs of negotiating separate **interchange** fees between acquirers and issuers and eliminated the difficulties that ***532** issuers faced in monitoring the merchant discounts set by acquirers. Given the need for merchants to honor cards from each of the thousands of issuers, a systemwide fee also avoided the costs of the "hold up" problem created by individual issuers demanding higher **interchange** fees in any bilateral negotiation. [FN47]

Thus, the essential structure, comprising a merchant discount that provided revenues for the acquirer bank and included the **interchange** fee, was in place from almost the very beginning, long before Visa and MasterCard possibly had any market power. In fact, the early emergence of the **interchange** fee and its continued presence in the payment card industry testify to the inherent logic of **interchange** fees in equilibrating the two sides of the market. Indeed, both American Express and Discover use merchant discounts in the same manner as the cooperatives to solve the problem of simultaneously coordinating the two sides of the market.

In 1979, National Bancard Corporation sued Visa, claiming that setting the **interchange** fee fixed prices in violation of the antitrust laws. [FN48] Ruling for Visa, the Eleventh Circuit noted that there were two possible sources of revenue within the Visa system--cardholders and merchants--and that it was necessary to balance the two sides. "As a practical matter," the Court observed, "the card-issuing and merchant-signing members have a mutually dependent relationship . . . . In short, the cardholder cannot use his card unless the merchant accepts it and the merchant cannot accept the card unless the cardholder uses one." [FN49] The Court recognized the procompetitive role of **interchange** fees in coordinating the two sides and found that the competitive restraint was no broader than required.

As noted above, in two-sided markets, pricing incentives draw a critical mass of participants to one side of the market, which then calls forth supply on the other side. Unlike ***533** suppliers to one-sided markets, who focus on maximizing output at a minimum cost, suppliers to two-sided markets must balance both sides. The Visa and MasterCard systems coordinate the consumer and merchant sides of the market, and the **interchange** fee balances demand on both sides. The higher the fee, the greater the incentive for issuers to expand consumer demand for credit cards through lower prices. Because of the extraordinary level of competition in the consumer market--including some 21,000 Visa and 25,000 MasterCard issuers--there is an overwhelming incentive for issuers to pass increases in their **interchange** fees on to consumers. Thus, higher **interchange** fees (and correspondingly higher merchant discounts) expand the number of consumers carrying and using a given card. By contrast, lower **interchange** fees and lower merchant discount rates reduce the costs to merchants of accepting the card; thus, lower discounts increase merchant willingness to accept the card.

In a seminal 1983 article, William Baxter discussed how both demand and supply must be generated jointly in a Visa or MasterCard transaction. [FN50] Both the purchaser and the merchant consume the payment card services, which issuing and acquiring banks supply together (although in the American Express and Discover systems, one party performs both functions). Yet, none of the parties will participate unless the individual benefit to each exceeds its individual marginal cost. If the overall transaction produces sufficient benefits to cover the total transaction costs, there are many possible ways that the costs and benefits can be distributed among the parties while still allowing the transaction to occur. Although one bank or the other may perform certain services for one party or the other, the party receiving the services need not directly compensate the bank providing them.

While both merchants and consumers must participate in any payment system, different systems adopt different ***534** strategies to accomplish this goal. For instance, when Discover entered the market, it offered a low merchant discount to induce merchants to accept the card. On the consumer side of the market, Discover faced a less difficult problem. Because it grew out of the Sears financial network, Discover distributed its card with ease to many consumers. Thus, rather than the challenge of generating consumer use, Discover's challenge was to overcome the problem of merchant acceptance, which it achieved through a low merchant discount.

American Express has pursued a different strategy. The company has historically targeted high-end customers and merchants, especially through its corporate card. Initially, the attractiveness of its corporate card stemmed from the travel benefits and other services that American Express provided to its corporate clients. To fund these services, the company charged a high discount fee to merchants that were willing to pay to attract affluent and expense account customers, who are relatively insensitive to prices. [FN51] Thus, while Discover pursued a low discount strategy, American Express used a high discount. Although the details differed, both companies faced the same underlying problem--matching merchants with consumers.

The efforts of payment card systems to induce supermarket acceptance provides another illustration of the different strategies available to balance the two-sided market. To induce acceptance of their cards, American Express and Discover directly lowered their merchant discounts for supermarkets. [FN52] Similarly, Visa and MasterCard reduced the **interchange** fees charged to supermarkets, thereby reducing the merchant discount. [FN53]

***535** The proliferation of debit cards offers yet another example of the different strategies available to balance the two-sided market. So-called PIN debit systems originated in those banks that had large customer bases holding ATM cards. Because the systems already had cardholders, but not merchants, they charged a lower **interchange** fee. On the other hand, because MasterCard and Visa had a large merchant base but lacked debit card holders, they charged a higher **interchange** fee to induce issuers to seek card holders. [FN54]

B. The Attacks on **Interchange** Fees

Interchange fees have recently come under regulatory scrutiny. In 2000, the European Commission, acting on retailer complaints, preliminarily determined that Visa's fixed fee violated European laws against collective price setting. [FN55] Two years later the Commission determined that no feasible alternative to collectively determined fees existed, but nonetheless refused to allow Visa to set the fee alone. Instead, Visa agreed to lower its fee and conduct cost studies that the Commission would then review for conformity to cost-based benchmarks. [FN56] In 2002, the Reserve Bank of ***536** Australia ("RBA") determined that **interchange** fees were too high and decided that they should be based on certain costs, subject to governmental oversight. [FN57] The regulation became effective in October of 2003.

Critics argue that "high" **interchange** fees cause payment cards to be overused relative to less expensive payment devices. [FN58] As explained above, when **interchange** fees increase, issuers reduce the effective price charged to cardholders, whether through lower card fees or enhanced benefits or rewards. Because cards are now cheaper, more consumers will obtain them and those with cards will use them more. [FN59]

For merchants, a higher **interchange** fee increases the costs of accepting cards. If merchants are not willing or able to pass the higher charges directly on to customers using payment cards, or are unable to cease accepting cards, then critics contend that merchants will raise their overall prices with the resulting effect that consumers without cards will pay more without any corresponding benefits. As a result, the private incentives of card issuers and consumers to use payment cards are said to expand the level of card transactions beyond that which maximizes social welfare (in that cards externalize costs to merchants and other consumers). Ian J. Macfarlane, Governor of the Reserve Bank of Australia, recently referred to this phenomenon as Gresham's Law of Payments, because it can potentially lead to more expensive means of payment driving out less ***537** expensive means. [FN60] In these circumstances it is alleged that competition may not prevent card companies from setting an inefficiently high **interchange** fee. The RBA used this analysis to determine that credit cards were overused and to impose cost-based price caps on **interchange** fees.

This approach appears flawed. First, as discussed above, in two-sided markets there is no reason why each participant should necessarily pay a price related to his marginal cost. Instead, the "correct" **interchange** fee should account for the differential demand elasticities of cardholders and merchants. In fact, as also explained above, different payment cards follow different pricing strategies, with some imposing higher costs on merchants than others. Second, the RBA ignored both the marginal benefits that payment cards provide to consumers and the full cost of using alternative payment systems. The relevant policy question is not simply how to minimize the direct costs of conducting transactions using various payment forms; rather, the crucial policy concern is how to maximize the amount by which society's total benefits exceed its total costs. By this standard, the RBA's analysis is seriously incomplete.

Payment cards offer substantial private and social benefits that must be considered to calculate overall efficiency accurately. For example, payment cards offer many benefits to consumers relative to the alternatives. A recent AEI/Brookings paper attempts to quantify the relative costs and benefits to all parties associated with different payment devices to estimate the social cost of each system once the offsetting benefits are deducted. [FN61] The authors calculate the costs and benefits to four different parties in ***538** the system: merchants, consumers, the central bank, and commercial banks. They examine six different types of payment instruments: cash, non-verified check, verified check, credit/charge, signature debit, and PIN debit. In some cases, they also calculate the net marginal social cost for various card brands. Finally, they examine the relative costs and benefits in three different purchasing environments--grocery stores, discount stores, and electronics stores--for two sizes of purchase in each environment.

Any payment system has costs. One or both of the parties to the transaction-- consumers and merchants--bear some of these costs directly. Third parties also have costs, such as the Federal Reserve's cost of printing money and replacing worn cash, and the costs to consumers who wait in line longer when those in front of them use slower payment methods. All social costs should be considered.

Cash, for instance, imposes costs on retailers and consumers that electronic payment systems do not. One example is the labor cost associated with counting cash and reconciling the cash register drawer. As labor costs increase, the cost of cash payments to retailers becomes more expensive relative to electronic payments. In addition, cash has a higher risk of theft and loss for both consumers and merchants (from employee malfeasance). The costs associated with collecting and transporting cash safely, most notably armored cars, do not exist for payment cards. Moreover, commercial banks generally charge a fee for processing deposits. Banks incur additional costs to maintain and restock ATMs; similarly, consumers bear the costs associated with finding, and traveling to, an ATM. Consumers can withdraw more money per visit, but increased withdrawals also increase the risk of loss from theft. Finally, if the consumer draws the money from an interest-bearing account, increasing the amount withdrawn will reduce the interest earned, and thus further deter larger cash withdrawals.

Unlike the cost of the merchant discount associated with payment cards, these costs of using cash are less obvious. Nonetheless, they exist and can be substantial. In practice ***539** today, cash is used frequently only for relatively small transactions. For instance, in grocery stores the average size of a cash transaction is only $11.52, whereas the average size of a check transaction is $54.24. [FN62]

Checks also have many costs beyond those of the direct transaction between consumer and merchant. Consumers bear the cost of purchasing checks, which have to be printed. Banks pay the Federal Reserve to process and clear checks. Merchants bear the costs of bounced checks and collection costs; alternatively, merchants themselves will bear most of the costs of implementing more rigorous procedures to prevent bad checks, including the time required for closer inspection of identification.

Payment cards also have costs. Like currency, the magnetic strip on payment cards wears out with use. Banks levy a charge for processing payment card transactions, which becomes part of the merchant discount. Cards with reward schemes such as cash back or frequent flyer miles have processing costs. Merchants also bear the cost of credit card losses, i.e., chargebacks, for certain types of losses. Card issuers face the additional costs of providing "float" to consumers between the time a charge is made and the time that payment for it becomes due. For charge and credit cards, this period is 25 days; for signature debit it is two days. [FN63] Of course, float is a symmetrical benefit to consumers.

The various payment systems have benefits as well. For example, cash permits complete consumer privacy. Relative to cash, checks lead to better recordkeeping. The many benefits of payment cards, both to consumers and merchants, are discussed above. [FN64]

The AEI/Brookings paper, considering these relevant costs and benefits, estimates the net social costs of these different payment systems. It finds that contrary to conventional wisdom, payment cards generally, and ***540** charge/credit cards specifically, are not substantially more expensive than more traditional payment forms. The paper provides separate estimates for each transaction studied. For grocery stores, the net social marginal cost (i.e., social cost minus social benefit) of a small transaction is approximately the same for cash, verified check, credit/charge card, or PIN debit, is slightly higher for non-verified check, and is slightly lower for signature debit. [FN65] For larger grocery purchases, credit/charge cards unambiguously have the lowest net social marginal cost, cash has the highest, and the others fall somewhere in between. [FN66]

A calculation of net social marginal cost for "small" purchases in discount stores revealed no substantial differences among the various forms of payment, with the lone exception of checks, which are substantially more expensive. [FN67] As transaction size increases, however, cash again becomes inferior. [FN68] For electronics store purchases, checks are slightly better than other forms of payment, and cash remains the worst. For the average cash purchase in electronics stores ($64.98), checks have the lowest net social marginal cost; credit and charge cards are estimated to be ***541** slightly higher, signature debit is somewhat higher, and cash is by far the most expensive. [FN69] If the average electronics store purchase is increased to $124.66, however, checks and credit/charge cards converge to roughly the same net social marginal cost ($0.61 for MasterCard and Visa, $0.68 for Discover and American Express, and $0.66 for checks). In this scenario, signature debit is calculated to cost $1.06 and cash $1.56.

Because debit cards have lower **interchange** fees than credit cards, the RBA prefers the former to the latter. Yet credit cards have benefits that debit cards lack, including float, rewards, and the credit option. (Debit cards do allow one to get cash back at the register, however, a feature that most credit cards lack.) In measuring net social cost, the AEI/Brookings study finds that debit is not superior to credit. [FN70]

Overall, once the full benefits and costs of payment mechanisms are estimated, credit and charge cards do not appear to be at a systematic disadvantage to alternative payment systems. Because this is the best data currently available, it provides additional evidence that the RBA's attack on **interchange** fees is misplaced. Primarily, capping the **interchange** fees appears to change the wealth ***542** distribution between cardholders and merchants, without a positive effect on allocative efficiency.

Moreover, the RBA regulation is arbitrary. The RBA caps the **interchange** fees charged by the cooperative systems (Visa and MasterCard), but not American Express. [FN71] As with the Visa and MasterCard networks, American Express uses the merchant discount to balance the two-sided payment card market. The only difference between integrated systems and cooperative joint ventures is not the substance of the transaction--the merchant discount performs the same function in both--but the form of the corporate structure used and the fee charged. If the problem is that payment card use is improperly subsidized through these fees, then that concern applies with equal force to American Express. In fact, American Express' merchant discount is substantially higher than its competitors'; under the RBA's logic, the market distortion created by excessive merchant discounts should not be less for American Express. Thus, the decision by the RBA to regulate **interchange** fees for Visa and MasterCard, but not American Express, appears inexplicable. [FN72]

C. The Impact of Suppressing **Interchange** Fees

Regulating **interchange** fees will have harmful effects. First, losing these revenues will force card issuers to decrease their costs, either by reducing card benefits or increasing the revenues that they receive directly from consumers (e.g., through higher annual fees, finance charges, and penalty fees). Evans and Schmalensee illustrate the tradeoff between **interchange** fees and other issuer revenue streams as follows. In 1983, the Visa **interchange** fee was 1.6%, the average merchant discount rate was 2.3%, the average annual fee for cardholders was $16.86, and the charge volume per account was $1,720. If the **interchange** ***543** fee had been $0, then the merchant discount rate would have been 0.7% and the annual fee for cardholders would have had to almost triple to $44.38 to keep the average issuer's revenues constant. [FN73] Alternatively, issuers would have had to increase finance or other charges levied on consumers.

Of course, such dramatic increases would likely decrease card ownership, and especially multiple card ownership, which would thereby reduce competition in the payment card market. Given the presence of alternative payment methods, many consumers would avoid cards rather than pay more. As with price controls throughout history, this distortion would force issuers and consumers to make choices that they would have preferred to avoid.

Although the market is still adjusting to the regulatory change, the evidence from Australia thus far is consistent with the conclusion that the controls on **interchange** fees have harmed consumers directly and had a detrimental impact on competition. [FN74] If issuers receive less from merchants then they must receive more from consumers or reduce the benefits that consumers receive. In fact, issuers have increased annual and other fees. [FN75] Following the imposition of cost-based price caps on **interchange** fees, bank fee income from credit cards increased 30-35% in 2003, including a small increase in annual fees. [FN76] Issuers appear to have increased late payment fees and tightened their collection procedures. Banks have also reduced cardholder benefits. They have increased the spending levels required to obtain particular rewards and have capped the reward ***544** points available in a year (e.g., by increasing the miles necessary for free airline tickets and capping the number of miles that can be accumulated). [FN77]

Because the rule applies only to the cooperative systems, the evidence also reveals that Visa and MasterCard have been disadvantaged relative to American Express. The RBA dramatically reduced the **interchange** fee for the cooperatives, from 0.95% of the transaction value down to 0.55% of the transaction value. [FN78] The merchant discount declined by a similar amount, from 1.41% to 0.99%. By contrast, the discount rate for the major integrated system, American Express, fell only to 2.37% from 2.5%. Moreover, although issuers reduced the benefits available to MasterCard and Visa cardholders, there is no evidence that cardholders of the integrated issuers have suffered similar cuts. In fact, American Express' market share has increased significantly. [FN79]

As experience in the United States suggests, an adjustment as seemingly simple as raising annual fees can have profound effects. During the 1970s and early 1980s, high inflation increasingly caused credit card interest rates to bump up against state-imposed usury ceilings. Faced with the inability to charge market interest rates, credit card issuers turned elsewhere for revenues. [FN80] In particular, credit card issuers began to impose annual fees to supplement interest income. [FN81] Following the imposition of annual fees, ***545** however, consumers canceled over nine million credit cards, or roughly eight percent of the cards then outstanding. [FN82]

In 1978, the Supreme Court decided Marquette National Bank v. Omaha Service Corp., [FN83] which fostered a dramatic increase in competition within the payment card industry. Prior to Marquette, interest rates on unsecured credit such as payment cards faced strict usury restrictions in many states, with the state in which the cardholder resided setting the rates. Strict usury laws had severe effects. First, when lenders could not achieve a market rate of return they rationed credit, especially to high risk borrowers. The evidence demonstrates that these restrictions reduced the amount of unsecured credit available to consumers. [FN84] Second, and more important for the **interchange** debate, annual fees on payment cards were introduced to compensate for revenue losses from the banks' inability to charge market interest rates, thereby circumventing interest rate ceilings. [FN85]

***546** Marquette essentially deregulated interest rates on credit cards by holding that the bank's, and not the consumer's, home state would regulate applicable interest rates. In response, several states--notably South Dakota and Delaware--raised or abolished their interest rate ceilings, leading issuers to relocate to those states. [FN86] One result of the deregulation of interest rates and subsequent entry of new card issuers was the gradual elimination of annual fees on most cards as competition intensified. [FN87] Although credit card pricing remained relatively unchanged during much of the 1980s, eventually new entrants (mainly non-bank institutions such as AT&T, Sears, and General Motors) offered consumers lower interest rates, enhanced card features, and no annual fees. [FN88] Annual fee revenues declined rapidly, [FN89] and in their place issuers substituted new risk-based fees such as late fees, fees for exceeding one's credit limit, and cash advance fees. [FN90]

Moreover, the elimination of annual fees brought credit card pricing into line with consumer preferences. In a recent customer survey, "no annual fee" was the prime selection criterion for one-third of all consumers, more than any other feature. [FN91] More than thirty percent said that a low interest rate on purchases was their prime selection criterion. [FN92] Consumers appear to shop on the margins that best fit their needs. Transactional users want cards that are costless to carry and use, such as cards with no annual fee, or enhanced ***547** benefits such as 24-hour customer service, car rental insurance, or cash back on purchases. On the other hand, revolvers (or consumers who carry balances from month to month) are more interested in lower interest rates and presumably would accept some annual fee if necessary to receive a lower rate.

After the deregulation of interest rates, annual fees essentially disappeared for standard payment cards and have been retained only to defray the administrative costs for those cards offering ancillary benefits, such as frequent flyer miles. [FN93] Today, about eighty-five percent of bankcards have no annual fee. [FN94] Thus, the deregulation of interest rates allowed card issuers to respond to consumer preferences by eliminating annual fees.

Deregulating payment card terms had the additional and important benefit of increasing competition. Annual fees discourage consumers from carrying multiple payment cards because they increase the cost of owning additional cards, thereby helping commit consumers to a given card. Moreover, once paid, an annual fee discourages a consumer from switching mid-year and thereby paying another annual fee. [FN95]

The deregulation of the payment card market therefore had two predictable effects. First, it encouraged steady ***548** growth in payment card ownership across all income levels. [FN96] Second, it stimulated a steady increase in the number of payment cards held by each household--many households have Visa, MasterCard, and Discover cards, and some have even more than one Visa or MasterCard from different issuers. That many consumers hold multiple cards is a direct effect of the elimination of annual fees. Competition and consumer choice have increased as consumers can choose their preferred card each time they shop.

Thus, the de facto elimination of usury restrictions and deregulation of credit card interest rates increased consumer welfare, reduced prices, increased the quality of cards through enhanced benefits, and perhaps most importantly, increased competition. By imposing price controls on interest rates, the prior regime led to inefficient repricing of credit terms, in part by creating the need for annual fees and forcing convenience users to subsidize revolvers.

This experience with usury regulations thus provides important lessons for recent proposals to regulate **interchange** fees. Most notably, it demonstrates the need to recognize that different streams of card revenues are interrelated and that the curtailment of one stream will generate responses, from the repricing of other credit terms to a reduction in card benefits. More fundamentally, price controls have an important impact on competition. Based on the U.S. usury experience, the imposition of annual fees to compensate for the inability to charge market **interchange** fees would be an especially damaging adjustment since annual fees would dampen the incentive for consumers to switch among cards and thereby reduce competition and its pro-consumer effects.

Of course, the reduction in **interchange** fees may benefit merchants and consumers who use other payment forms. [FN97] ***549** No regulatory body in history has ever been able to assess confidently whether such gains more than offset the costs discussed in the preceding pages. The RBA itself does not purport to do so. Instead, its price controls rest on the inaccurate premise that credit cards are more expensive than other payment methods. Because that assumption is unsupported, this basis for the RBA's regulation fails. [FN98]

In summary, efforts to control **interchange** fees appear to be fundamentally misguided. Proposals for capping **interchange** fees fail to appreciate the complexities of regulating two-sided markets and the irrelevance of cost-based pricing in these markets. In seeking to force the internalization of an externality of dubious existence and questionable size, the RBA neglected to consider the full costs and benefits of payment card use, and thereby failed to appreciate the overall attractiveness of cards relative to other payment methods. Moreover, Australia drew an arbitrary and unsupportable distinction between **interchange** fees in the cooperative systems, Visa and MasterCard, and in the proprietary system, American Express. By regulating **interchange** fees, Australia has forced issuers to increase fees and reduce card benefits, all to the detriment of cardholders.

VI. CONCLUSION

Formulating sensible regulation is difficult under the best circumstances; regulating sensibly in ignorance of the ***550** relevant economic theory and evidence is nearly impossible. With payment cards, the two-sided nature of the market dramatically increases the challenges faced by regulators. Because the participants on each side of the market simultaneously generate costs and benefits for one another, traditional notions of setting prices according to marginal cost and other measures of market efficiency are irrelevant. Rather, the need to synchronize the two sides of the market may require one side or the other to bear a greater share of the expense to ensure the market's existence and its efficient operation. Costs will generally be imposed on the party with fewer network effects or more inelastic demand.

Recognizing the two-sided nature of the payment card market can help to identify errors in recent regulatory decisions. Thus, Australia's cap on **interchange** fees will likely lead to increased prices for consumers for holding and using payment cards, which in turn will likely decrease competition and consumer choice in the payment card market. The best evidence available to date rejects the fundamental premise of the Australian rationale and finds that cards are not overused. Instead, payment cards provide enormous benefits. They should be allowed to grow and thrive, not stifled through misplaced theories, unsupported by relevant evidence, that encourage unnecessary regulatory experimentation.

[FNa1]. Foundation Professor of Law, George Mason University School of Law. I thank Tom Brown, Schan Duff, Ben Klein, Christine Wilson, Todd Zywicki, and participants in the Columbia Law School symposium on two-sided markets for their many helpful comments. I have consulted with Visa U.S.A. on a variety of antitrust and consumer protection issues. The views expressed herein are mine alone.

[FN1]. See, e.g., Kendall v. Visa U.S.A, Inc., 2005 U.S. Dist. LEXIS 21450 (N.D. Cal. July 25, 2005) (motion to dismiss granted).

[FN2]. The literature on the economics of the payment card industry is voluminous. Many of the leading papers have been collected in two volumes of The Payment Card Economics Review. See Two-Sided Markets and **Interchange** Fees, 1 Payment Card Econ. Rev. (2003) and The Industry and Its Legal Challenges, 2 Payment Card Econ. Rev. (2004) and sources cited therein. See also David S. Evans & Richard Schmalensee, Paying with Plastic: The Digital Revolution in Buying and Borrowing 133 (2d ed. 2005); Benjamin Klein et al., Competition in Two-Sided Markets: The Antitrust Economics of Payment Card **Interchange** Fees, Antitrust L.J. (forthcoming 2005) (manuscript on file with authors); Jean-Charles Rochet & Jean Tirole, Cooperation Among Competitors: Some Economics of Payment Card Associations, 33 Rand J. Econ. 549 (2002) [hereinafter Rochet & Tirole, Cooperation Among Competitors]; Jean-Charles Rochet & Jean Tirole, Platform Competition in Two-Sided Markets, 1 J. Eur. Econ. Ass'n 990 (2003); Todd J. Zywicki, The Economics of Credit Cards, 3 Chap. L. Rev. 79 (2000) [hereinafter Zywicki, Economics of Credit Cards].

[FN3]. Evans & Schmalensee, supra note 2, at 4. The industries characterized by "network effects" are commonly two-sided markets because it is often the two-sided nature of a product that creates the network effects. Classic network industries, such as telephones and fax machines, require both parties to the transaction to use the product for it to have value to either.

[FN4]. Other two-sided markets utilizing subsidies include dating clubs, shopping malls, real estate, television, software, the yellow pages, and many more. See Evans & Schmalensee, supra note 2, at 133-58.

[FN5]. "[Specifically,] if a supplier wishes to increase price, it will be more profitable to do so on the side of the market where the demand response is likely to be less and where network effects are less important." Klein et al., supra note 2, at 16. The intensity of competition on each side may also be relevant. Id. at 17 n.31.

[FN6]. In relation to newspapers, television and radio are usually much more expensive forms of advertising for the benefit that local advertisers derive.

[FN7]. Klein et al., supra note 2, at 15 (arguing that relative network effects is the most important reason for low subscription prices). Klein et al. argue that these factors explain why the Adobe reader is distributed free, while the writer is not. Readers are likely to be more price-sensitive than writers because of the larger heterogeneity among readers. Many readers will use the software only occasionally and will value it little. By contrast, there are very large network effects to writers, in that there is great value in being able to reach everyone, including these low value users. "[M]any readers increase the value of writer software more than lots of writers increase the value of reader software." Id. at 17.

[FN8]. Id. at 6-7.

[FN9]. See United States v. Visa, 344 F.3d 229, 235 (2d Cir. 2003).

[FN10]. In 2002, the ten largest bank issuers of credit cards captured about 75% of the market. The top twenty-five issuers controlled about 85% of the market. Evans & Schmalensee, supra note 2, at 173. American Express and Discover raise the percentage controlled by the top ten to 78% of total charge volume. Id. at 214.

[FN11]. See id. at 236.

[FN12]. See Klein et al., supra note 2, at 18.

[FN13]. Id. at 5.

[FN14]. Klein et al. estimate that it would not be profitable for a merchant to drop Visa if the merchant lost just one in five of the sales that it otherwise would have made. Id. at 21.

[FN15]. David S. Evans, It Takes Two to Tango: The Economics of Two-Sided Markets, 1 Payment Card Econ. Rev. 3, 4 (2003).

[FN16]. Telephone Interview with Visa officials (April 20, 2005).

[FN17]. See Fed. Reserve Bd., The Profitability of Credit Card Operations of Depository Institutions 5 (1999), available at http:// www.federalreserve.gov/boarddocs/rptcongress/creditcard/1999/default.htm.

[FN18]. Evans & Schmalensee, supra note 2, at 95.

[FN19]. See Fed. Reserve Bd., supra note 17, at 4 (the precise average was 4.7).

[FN20]. Evans & Schmalensee, supra note 2, at 232.

[FN21]. See generally Rochet & Tirole, Cooperation Among Competitors, supra note 2.

[FN22]. Evans & Schmalensee, supra note 2, at 91. Households with payment cards maintain lower balances in their checking accounts than households without payment cards. Id. at 92-93.

[FN23]. See id. at 91-93.

[FN24]. Id. at 93 (estimating that payments take seventeen seconds using cards and seventy-three seconds using checks).

[FN25]. Id. at 305.

[FN26]. See ZDNET Research, Online Retail Volume Will Reach $100 Bln in 2004, Feb. 20, 2004, http://www.itfacts.biz/index.php?id=P766.

[FN27]. Evans & Schmalensee, supra note 2, at 84.

[FN28]. David B. Humphrey et al., Cash, Paper, and Electronic Payments: A Cross-Country Analysis, 28 J. Money, Credit & Banking 914, 934 (1996).

[FN29]. Although payment cards offer limited liability in the case of theft or loss, they do pose other security concerns, such as the risk of identify theft.

[FN30]. One recent paper estimated the value of float to be roughly eight to twelve times more valuable for credit and charge cards than for payment devices like debit cards that offer only a day or two of float, depending on the type of transaction and the size of the average purchase. On average, consumers have twenty-five days from the date of purchase to the date their card bill is due. Daniel D. Garcia Swartz et al., The Economics of a Cashless Society: An Analysis of the Costs and Benefits of Payment Instruments 52 (AEI-Brookings Joint Center for Regulatory Studies, Related Publication No. 04-24, 2004), available at http://www.aei-brookings.org/admin/authorpdfs/page.php?id=1048.

[FN31]. See Zywicki, Economics of Credit Cards, supra note 2, at 96; Richard L. Peterson & Gregory A. Falls, Impact of a Ten Percent Usury Ceiling: Empirical Evidence 15-20 (Credit Research Ctr., Working Paper No. 40, 1981), available at http://www.msb.edu/faculty/research/credit_research/pdf/wp40.pdf; Robert W. Johnson & Dixie P. Johnson, Credit Research Ctr., Pawnbroking in the U.S.: A Profile of Customers 47 (1998), http:// www.msb.edu/faculty/research/credit_research/pdf/mono34.pdf (finding that those who borrow money from pawnbrokers do so because their alternative sources of borrowing were family, friends, or check cashers).

[FN32]. Traditionally, this informal form of credit was the most common form. See Lendol Calder, Financing the American Dream: A Cultural History of Consumer Credit 60-64 (1999).

[FN33]. See Todd J. Zywicki, An Economic Analysis of the Consumer Bankruptcy Crisis 99 Nw. U. L. Rev. 1463, 1492-99 (2005) [hereinafter Zywicki, Bankruptcy Crisis]; see also Johnson & Johnson, supra note 31, at 47 (finding that 65.4% of Americans own their homes, but only 34.8% of those who borrow from pawn shops do so).

[FN34]. See Alan Greenspan, Chairman, Federal Reserve Board, Understanding Household Debt Obligations, Remarks Given at the Credit Union National Association 2004 Governmental Affairs Conference (Feb. 23, 2004), available at http://www.federalreserve.gov/boarddocs/speeches/2004/20040223/default.htm (noting that "the rise in credit card debt in the latter half of the 1990s is mirrored by a fall in unsecured personal loans"); Arthur B. Kennickell, A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989-2001 17 (Federal Reserve Board, Survey of Consumer Finances Working Paper, Sept. 2003), available at http:// www.federalreserve.gov/pubs/oss/oss2/papers/concentration.2001.10.pdf (noting that many lenders have stopped offering unsecured lines of credit).

[FN35]. See Dagobert L. Brito & Peter R. Hartley, Consumer Rationality and Credit Cards, 103 J. Pol. Econ. 400, 402 (1995). In addition, credit card applications are generally easier and more convenient than those for personal loans.

[FN36]. See Thomas A. Durkin, Credit Cards: Use and Consumer Attitudes, 1970-2000, 86 Fed. Res. Bull. 623, 623-24 (2000), available at http:// www.federalreserve.gov/pubs/bulletin/200/0900lead.pdf (observing that credit cards "have largely replaced the installment-purchase plans that were important to the sales volume at many retail stores in earlier decades," especially for the purchase of appliances, furniture, and other durables).

[FN37]. Evans & Schmalensee, supra note 2, at 118.

[FN38]. Zywicki, Bankruptcy Crisis, supra note 33; see also Wendy M. Edelberg & Jonas D. M. Fisher, Household Debt, 123 Chicago Fed. Letter 1, 3 (1997).

[FN39]. Between 1992 and 2001, Visa issuers wrote off $114 billion (about three percent of total charges) as uncollectible. See Evans & Schmalensee, supra note 2, at 102.

[FN40]. See James M. Ackerman, Interest Rates and the Law: A History of Usury, 1981 Ariz. St. L.J. 61, 95 (1981).

[FN41]. Id.

[FN42]. See Lewis Mandell, The Credit Card Industry: A History 17 (Twain Publishers 1990).

[FN43]. Some fixed costs do remain with the retailer, such as the costs of purchasing one or more card readers, buying phone lines, and training staff. Most costs to merchants of accepting payment cards, however, are variable. Evans & Schmalensee, supra note 2, at 122.

[FN44]. Howard H. Chang, **Interchange** Fees in the Courts and Regulatory Authorities, 1 Payment Card Econ. Rev. 13, 17 (2003).

[FN45]. Visa USA, http://www.usa.visa.com/about_visa/about_visa_ usa/index.html?it=f<<vertical bar>>/index%2Ehtml<<vertical bar>>About%20Visa% 20U.S.A. (last visited Oct. 25, 2005).

[FN46]. MasterCard Company Fact Sheet, http:// www.mastercardinternational.com/newsroom/company_fact.html (last visited Oct. 25, 2005).

[FN47]. See Klein et al., supra note 2, at 23-36.

[FN48]. Nat'l Bancard Corp. v. Visa U.S.A., Inc., 779 F.2d 592 (11th Cir. 1986).

[FN49]. Id. at 602.

[FN50]. See William F. Baxter, Bank **Interchange** Fees of Transactional Paper: Legal and Economic Perspectives, 26 J.L. & Econ. 541 (1983).

[FN51]. Chang, supra note 44, at 16-17.

[FN52]. Although many grocery chains do not accept American Express, it is the only card accepted at Costco.

[FN53]. The overall level of the discount has fluctuated. Over the past two decades, average merchant discount rates on all cards fell from about 2.7% in 1982 to 2.0% in 1994, before rising to about 2.3% by 2001. Evans & Schmalensee, supra note 2, at 126. The increase in the late 1990s appears to have resulted from increased competition between Visa and MasterCard for banks to dedicate themselves to one system or the other. See Klein et al., supra note 2, at 41-45. With higher **interchange** fees, credit cards with reward programs have increased dramatically. Id. at 45 n.87. The two integrated systems, American Express and Discover, charge the highest and lowest discount rates respectively, with the Visa and MasterCard systems in between.

[FN54]. See Klein et al., supra note 2, at 49 n.93. Although the low **interchange** fees characteristic of PIN debit discouraged PIN issuer promotion, the PIN debit networks benefited from the interest in debit that Visa and MasterCard generated.

[FN55]. Press Release, European Commission, Commission Plans to Clear Certain Visa Provisions, Challenges Others (Oct. 16, 2000), available at http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/00/1164&format=HTML&aged=1&language=EN&guiLanguage=en.

[FN56]. Press Release, European Commission, Commission Exempts Multilateral **Interchange** Fees for Cross-Border Visa Card Payments (July 24, 2002), available at http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/02/1138&format=HTML&aged=0&language=EN&guiLanguage=en.

[FN57]. Reserve Bank of Australia, Reform of Credit Card Schemes in Australia IV: Final Reforms and Regulation Impact Statement (Aug. 2002), available at http:// www.rba.gov.au/PaymentsSystem/Reforms/CCSchemes/FinalReforms/Impact_analysis.pdf.

[FN58]. See, e.g., Alan S. Frankel, Monopoly and Competition in the Supply and Exchange of Money, 66 Antitrust L.J. 313 (1998).

[FN59]. Given the benefits of card use that some issuers provide, the price to consumers may actually be negative.

[FN60]. See I.J. Macfarlane, Governor, Reserve Bank of Australia, Gresham's Law of Payments, Address Before the AIBF Industry Forum (Mar. 23, 2005), available at http://www.rba.gov.au/Speeches/2005/sp_gov_230305.html. Even the economist that the RBA hired to study the issue, Michael Katz, observed that focusing only on the cost of various payment mechanisms ignores the demand-side considerations of consumers and merchants and is therefore inappropriate. See Evans & Schmalensee, supra note 2, at 290.

[FN61]. See Garcia Swartz et al., supra note 30.

[FN62]. Id. at 40-41.

[FN63]. See id. at 44.

[FN64]. See supra Section IV.

[FN65]. Garcia Swartz et al., supra note 30, at 51. The transaction size was $11.54, the average cash purchase size for grocery stores. These statistics measure the cost of replacing the average cash transaction with alternative payment methods. The estimated net social costs were: cash ($0.83); verified check ($0.87); credit/charge card ($0.84); PIN debit ($0.83); non-verified check ($0.99); and signature debit ($0.76).

[FN66]. The transaction size for larger purchases was $54.24, which is the average purchase size for grocery stores when the purchase was paid by check. The statistics measure the cost of replacing the average check transaction with one of the alternative payment methods. The net marginal social cost of credit/charge cards was estimated as $0.74 and for cash at $1.79. Id. at 56.

[FN67]. For the average cash transaction in discount stores ($15.49), checks are calculated to have a net social marginal cost of $0.96, charge and credit cards are $0.60-$0.61, PIN debit is $0.64, cash is $0.57, and signature debit is $0.52. Id. at 62.

[FN68]. Id. at 63. For transactions of $43.93, the net social marginal cost for cash is calculated to be $1.55, for checks $1.06, for PIN debit $0.69, and for signature debit and all charge/credit cards $0.53-$0.55.

[FN69]. Id. at 67. For the average cash purchase of $64.98, checks have a net social marginal cost of $0.64, credit and charge cards are $0.76-$0.79, signature debit is $0.95, and cash is $1.74. The authors hypothesize that the surprising standing of checks relative to other payment forms in electronics stores may be attributable to an anomaly in the data set. The authors base their study on non-venue-specific check processing costs, but utilize venue-specific data on bank processing revenues. The relatively high per check revenue at electronics stores thus reduces the net social costs for checks when compared against average (that is, non-venue-specific) check processing costs. The authors hypothesize that venue-specific check processing data may reveal that banks actually incur higher fraud and insufficient funds risks with electronics store transactions, and therefore, charge these merchants higher fees for check processing. Higher check processing fees would, or course, increase the net social marginal cost of check transactions relative to other forms of payment.

[FN70]. Id. at 62.

[FN71]. Discover does not operate in Australia.

[FN72]. Garcia Swartz et al. find no systematic difference between Discover, American Express, Visa, and MasterCard in terms of net social cost. Garcia Swartz et al., supra note 30, at 62-63.

[FN73]. Evans & Schmalensee, supra note 2, at 156.

[FN74]. Reserve Bank of Australia Payment Sys. Board, Annual Report 11 (2004). The RBA also appeared to have failed in its goal of forcing consumers to face the marginal costs of credit card use. See Evans and Schmalensee, The Economics of **Interchange** Fees and Their Regulation: An Overview (AEI-Brookings Institute, Working Paper, 2005).

[FN75]. See Howard H. Chang, David S. Evans, & Daniel D. Garcia Swartz, An Assessment of the Reserve Bank of Australia's **Interchange** Fee Regulation (forthcoming), available at http:// www.newyorkfed.org/research/conference/2005/antitrust/chang_evans_garcia.pdf.

[FN76]. Id. at 31-32.

[FN77]. Reserve Bank of Australia, supra note 74, at 11.

[FN78]. See Chang et al., supra note 75, at 1.

[FN79]. See Klein et al., supra note 2, at 28-30 (American Express and Diner's Club shares increased from 14.6% to at least 16.5%). The corresponding decline in Visa and MasterCard shares when the **interchange** fee decreased is inconsistent with the argument that the higher **interchange** fee before regulation evidenced market power. Id. at 52-53.

[FN80]. Issuers also adopted stricter lending policies and rationed credit more tightly. Glenn B. Canner & Charles A. Luckett, Developments in the Pricing of Credit Card Services, 78 Fed. Res. Bull. 652, 654 (1992).

[FN81]. Id.

[FN82]. Id.

[FN83]. 439 U.S. 299 (1978).

[FN84]. See Christopher C. DeMuth, The Case Against Credit Card Interest Rate Regulation, 3 Yale J. on Reg. 201, 217 (1986); see also Donna Craig Vandenbrink, The Effects of Usury Ceilings: The Economic Evidence (Federal Reserve Bank of Chicago, Working Paper, 1982).

[FN85]. See Canner & Luckett, supra note 80, at 654; DeMuth, supra note 85, at 218 ("For example, if interest rates on credit cards are set at below the cost of funds but annual fees are not controlled, issuers may raise their fees in an effort to meet their costs. If such pricing responses are feasible, price controls will be circumvented. Consumers will be worse off than before, however, since the new pricing system will be less efficient and hence more costly than the one it replaced."). Early efforts to impose annual fees on credit cards were constrained by the feared competitive harm to the first institution to do so. To fight inflation, President Carter imposed a ban on the solicitation of new accounts by credit card issuers in 1980. This stifling of competition provided an opportunity for banks to circumvent usury restrictions through annual fees, with reduced competitive harm. Mandell, supra note 42, at 72. One effect of the annual fee was that convenience users subsidized revolvers. The annual fee was assessed equally against both types of users, even though its purpose was to offset losses from the inability to charge the market interest price to revolvers.

[FN86]. Between 1980 and 1985, fifteen states removed their ceilings, and many others raised theirs to levels that far surpassed those needed to cover costs. Canner & Luckett, supra note 80, at 654 n.4.

[FN87]. See Zywicki, Economics of Credit Cards, supra note 2, at 118.

[FN88]. Mark Furletti, The Debate Over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards, 77 Temp. L. Rev. 425, 444 (2004); Canner & Luckett, supra note 80, at 654.

[FN89]. Furletti, supra note 88, at 444.

[FN90]. Eliminating annual fees and replacing them with these alternative fees also eliminated many of the cross-subsidies that had previously been associated with annual fees. Id. at 444-45.

[FN91]. Evans & Schmalensee, supra note 2, at 218.

[FN92]. Id.

[FN93]. Id.; Lawrence M. Ausubel, The Credit Card Market, Revisited (Univ. of Md., Dep't of Econ., Working Paper, July 20, 1995). A survey of top issuers found that by 1998 only 14% percent of customers who had not enrolled in a rewards program (such as a frequent flyer miles program) paid an annual fee, and by 2002, only 2% had done so. The average annual fee charged on non-rewards cards has fallen from $3.31 in 1998 to $0.50 in 2002. See also Mark Furletti, Federal Reserve Bank of Philadelphia, Credit Card Pricing Developments and Their Disclosure 9-10 (2003).

[FN94]. Evans & Schmalensee, supra note 2, at 87.

[FN95]. See Zywicki, Economics of Credit Cards, supra note 2, at 143 (describing annual fees as a "tax" on switching cards mid-year because the fees require forfeiture of the value of the first annual fee and payment of a second.)

[FN96]. Id. at 87-114. The poorest quintile has especially benefited. In 1970, 2% had credit cards; in 2001, 38% had credit cards and 43% had debit cards.

[FN97]. As Klein et al. note, increased card usage has increased retail competition generally, which may have lowered overall price levels to the benefit of card users and non-card users alike. Klein et al., supra note 2, at 58 n.110.

[FN98]. A further irony is that merchants, who pushed for the price caps, believe that cards have positive overall benefits. A survey of Australian retailers found that 62% of merchants believed that their customers generally spend more when using credit cards than they do when using cash or electronic funds transfer; only 28% thought otherwise. See Chang et al., supra note 75, at 1. Another empirical issue involves the regulation's effect on the intensity of card usage and the overall growth of card ownership. Preliminary analysis indicates that the regulation may have decreased intensity, but may not have slowed the growth of ownership. Id.

END OF DOCUMENT

What's in Your Wallet? The Wall Street Journal June 24, 2005 Friday

EXHIBIT C

BYLINE: By Timothy J. Muris

BODY:

The plaintiffs' bar has discovered another golden goose to fleece. Merchants throughout the world recognize the benefits of credit and debit cards, but have turned to lawsuits and governments to reduce the costs. A class-action suit filed in Connecticut this week seeks billions from Visa, MasterCard, and their member banks for alleged "collusion" in setting prices. Australia and other countries have even imposed controls on the price that card issuers can charge merchants.

Many of these legal initiatives reflect a specious argument that cards are overused. Cash and checks, some claim, are cheaper methods for making payments. But cheaper for whom? Recent studies have shown that, when the full benefits and costs of card use to society as a whole are considered, credit and debit cards are not overused. In any event, in part because they recognize the adverse reaction that would result, merchants rarely force consumers to pay more when they use their cards.

The overuse argument often rests on a curious concern that consumers are "subsidized" to use cards by low prices for card ownership and reward and incentive programs. Such "subsidies" are common in any complex economy. Consumers receive free refills on drinks in restaurants, free parking at shopping malls, goods below cost in supermarkets (via loss leaders), relatively inexpensive newspapers because advertisers pay most of the costs, and many similar benefits.

To bring buyers and sellers together through such intermediaries as newspapers, supermarkets, and credit cards, one side frequently receives inducements to participate. These inducements help maximize the joint value of the ultimate transaction for the parties. Rather than an inefficient "subsidy," these inducements are the lubricant necessary to make the economic machine work at its best.

A second version of the overuse argument invokes credit-card debt. This argument, too, is misplaced. The use of revolving credit reflects almost entirely an offsetting decline in installment credit, such as from personal-finance companies and retail stores. From 1970-1995, installment credit fell steadily, offsetting the rise in revolving credit. Since 1995, revolving credit as a percentage of disposable personal income has been largely constant.

Moreover, credit cards can be a superior form of credit for some consumers. Too often, those who scoff at this use of plastic do not need credit or are wealthier individuals with better credit options than many Americans. Compared to home-equity loans, for example, credit cards do not require that one own a home or that one further mortgage the home that he owns. Credit cards are clearly superior to traditional forms of credit such as pawnshops, payday lenders, and borrowing money from family and friends. Furthermore, personal-finance company loans can be more expensive and have much higher initiation fees than do payment cards.

Given the enormous benefits of payment cards, government efforts to interfere with this market are taken at great risk. Consider the Australian price controls, which this week's class action may seek to emulate. Like such controls throughout history, these restrictions have adversely affected the product under control and interfered with consumers' ability to transact as they please. Today in Australia, cardholders are forced to pay more while getting less. Australians have seen higher card fees, fewer payment choices, and a reduction in loyalty and reward programs.

In our interconnected world, bad ideas, like viruses, are always in danger of crossing borders. The Federal Reserve is holding two conferences on the Australian experience and related issues this year. Because price controls are so foreign to our economic precepts, one hopes that neither the Fed nor American courts will import controls into the United States, and will instead continue to rely upon market forces as the driver of electronic payments.

Credit cards have transformed commerce. They should be allowed to grow and thrive, not stifled through misplaced theories encouraging regulatory experimentation.

Mr. Muris was chairman of the Federal Trade Commission from 2001-2004. He has consulted with Visa U.S.A. on a variety of antitrust and consumer-protection issues.

NOTES:
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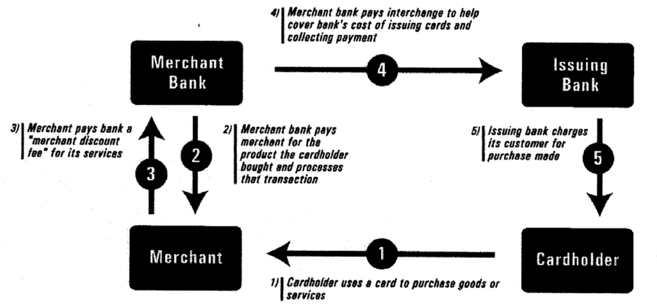
What is Interchange?

EXHIBIT D

Interchange Flow Diagram



MR. STEARNS. Thank you. Mr. Armour.

MR. ARMOUR. Good morning, Mr. Chairman. My name is Hank Armour and I am President and Chief Executive Officer, National Association of Convenience Stores. Prior to taking my current job, I owned and operated 59 retail facilities in Washington State, Oregon, and California.

MR. STEARNS. I don't know if your microphone is on, and just put it close to you, if you could.

MR. ARMOUR. Thank you. I appreciate that.

MR. STEARNS. We should have told you that, so it is not your fault. I should have told you so.

MR. ARMOUR. You never know where you have friends.

MR. STEARNS. But the value is, if you want to speak to your colleague, you can shut it off, too. Okay.

MR. ARMOUR. The International Trade Association representing the convenience store industry. The industry, as a whole, includes about 140,000 stores in the United States, sells over 70 percent of the country's retail motor fuels and employs about a million and a half workers across the nation. It is truly an industry of small businesses. Sixty percent of convenience stores are owned and operated by one-store operators. I would like to start by thanking you, Mr. Chairman, and the members of this subcommittee for holding a hearing on this topic.

In September we testified before the full committee regarding gasoline prices and the increasing amount of money that credit card companies are receiving from every gasoline purchase. Chairman Barton, in particular, expressed surprise at the magnitude of the fees being charged. Let me give you four points this morning establishing the problems with the interchange fees market. Point number one, retailers have no choice. Credit and debit transactions are a large and growing part of retailers' business. In the convenience store industry, about 60 percent of motor fuel sales are paid for with credit and debit cards and it is rising. In fact, across all industries in the United States, the number of electronic payments, most of which are credit and debit card payments, now exceeds the number of checks. Plastic transactions have simply become the most predominant method of payment. As a practical matter, my members have absolutely no choice but to take credit and debit cards.

Point number two, card associations drive up fees and keep them and their rules secret. The card association sets interchange rates for all of their member banks and all of those member banks must agree to charge the same rates. Of course, the boards of the card associations that make those decisions are made up of member banks. So this is nothing more than price fixing. Just to give you a sense of the magnitudes of the fees that we are talking about, we and our customers pay more than $27 billion in interchange fees each year in this country and this figure doesn't include the many other fees collected directly from consumers, such as annual fees, late fees, interest, and the like. Even more problematic is the length to which the credit card companies go to assure that consumers remain in the dark about these fees.

Another major problem is that Visa and MasterCard compete by raising, not lowering, their interchange fees. When they raise their rates, they compete to get their bank members to issue more of their cards. Higher interchange rates means those banks, in turn, get more money from transactions put on those cards. And it is not just consumers who are left in the dark. Visa and MasterCard refuse to fully disclose their operating rules to retailers. It is outrageous that they make retailers agree to abide by all of their operating rules in order to be able to accept their cards, yet they won't let retailers see those rules.

Point number three. These fees are bad for consumers. Not only is this a big concern for us, as retailers, but the current situation is tremendously unfair to consumers. Because these fees are hidden in the cost of virtually everything we buy, even cash paying customers ultimately pay for them. This results in a nasty, regressive charge. People who get the fewest benefits from credit cards subsidize those who get the most benefits.

And finally, point number four. The United States pays far more than its share of credit card fees. U.S. consumers are, in effect, subsidizing credit card company operations around the world. This chart, over to my left, your right, shows just how bad the situation is. We have the highest volume of transactions, the best technology and very low and decreasing rates of fraud. Our interchange rates ought to be the lowest in the world, not among the highest. Thank you, Mr. Chairman and committee members. This has been a brief overview of a very serious problem. I look forward to working with the members of this committee and the entire Congress to find solutions to this problem and I welcome your questions.

[The prepared statement of Henry Armour follows:]

PREPARED STATEMENT OF HENRY ARMOUR, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF CONVENIENCE STORES

Good morning, Mr. Chairman. My name is Hank Armour, and I am President and Chief Executive Officer of the National Association of Convenience Stores (NACS). Prior to taking my current job, I owned and operated fifty-nine retail facilities in Washington State, California and Oregon.

NACS is an international trade association representing the convenience store industry. The industry as a whole includes about 140,000 stores in the United States and employs about 1.5 million workers across the nation. It is truly an industry of small businesses; 60 percent of convenience stores are owned by one-store operators.

I would like to start by thanking you, Mr. Chairman, and the Members of this Subcommittee for holding a hearing on this topic. Credit card interchange fees dramatically impact consumers and are a top priority for the convenience store industry – and for merchants across many industries. These fees have actually been of concern for a number of years and have now escalated to the point that they are the third highest operating cost to my industry – behind only payroll and rent. In September, we testified before the full Committee regarding gasoline prices and the increasing amount of money that credit card companies are taking out of every gasoline purchase. Chairman Barton in particular expressed surprise at the magnitude of the fees being charged. The Committee followed up by asking for a study of this issue. While the credit card companies opposed that study, we think these efforts and this hearing are important steps toward informing the Congress and the public about these interchange fees. There has not been nearly enough information and discussion about these fees in the past and we applaud you for your willingness to examine them.

One of the reasons these fees are such a concern for my industry is that they are bad for our customers. Most consumers have no idea that they pay these fees which are hidden in the price of virtually everything they buy. Consumers search for low prices and hidden fees simply drive up the cost they must pay. This is particularly true in our industry. Gasoline prices are posted on the street and you would be amazed at what people will do – making U turns on busy streets and driving far out of their way – just to save a couple of cents on a gallon of gas. Well, right now credit card companies charge about 5 cents in interchange on a gallon of gas. I know from experience that that is a big number to our customers. Our concerns here are similar to our concerns about excise and sales taxes – but at least those taxes are publicly debated and our customers can vote based on their views about their relative costs and benefits. Credit card companies work hard to keep their fees hidden and even if our customers knew about them, they can't vote on them.

Because interchange fees have become such a large and unfair cost to our industry and our customers, we helped establish a broad coalition – the Merchant's Payments Coalition (or MPC) – to try to deal with this problem. The MPC includes 22 trade associations representing many of the retailers in your districts – grocery stores, drug stores, restaurants, bowling alleys and more. This is a very diverse group with members that do not always agree, but we have been drawn together because the costs of interchange fees affect all of us and our customers dramatically.

Interchange fees are levied in a market that is absolutely broken. The problems are so severe and numerous that NACS and a number of other trade associations and retailers are parties to more than 50 lawsuits that have been filed against the card associations and member banks for their violations of the antitrust laws in setting these fees. In fact, the United States Department of Defense has recently filed a claim for $100 million in a lawsuit that settled a couple of years ago based on related antitrust violations by the credit card companies for damages incurred when accepting credit card payments.

We only turned to litigation as a last resort, and contrary to what you might hear from the credit card companies or their surrogates, a great many concerned retailers and members of the MPC have not decided to take this issue to the courts. With that said, let me assure you that my purpose today is not to debate the merits of that litigation. Instead, I simply want to give the Committee some sense of the problems we face and the ways in which this market is broken.

With that in mind, there are four points illustrating the problems with the interchange fees market that I would like to cover in my remarks today. First, because of the market power of the card associations, retailers have no choice about whether they accept cards. Second, the card associations exploit their market power by driving up fees and by veiling these fees and their rules in secrecy. Third, these fees are bad for consumers – particularly some middle and many lower income consumers who do not have easy access to credit and debit cards. And fourth, consumers in the United States pay much more for interchange than other comparable countries.

1. Retailers Have No Choice

Credit and debit card transactions are a large and growing part of retailers' business. In the convenience store industry, around 60 percent of motor fuel sales are paid for with credit or debit cards. Across all industries in the United States, in fact, the number of electronic payments – most of which are credit and debit card payments – now exceeds the number of payments by check. Plastic transactions have simply become the most predominant method of payment. My members have to take credit and debit cards.

And most of the cards in the United States are from Visa and MasterCard. As recently as 2003, the Second Circuit Court of Appeals held in the U.S. Department of

Justice's case against Visa and Mastercard that the two card associations – both jointly and separately – had market power. This is consistent with other cases and with retailers' experience.

The average U.S. consumer carries a limited amount of cash at any given time. Consumers also have an average of 9 credit cards. So, what happens? When consumers want to buy something that costs more than about $20 – like filling up their tanks with gasoline which cost about $23 last year – that transaction is likely to go on a credit or debit card. This has played out in the gasoline retailing business. As gasoline prices increased and the cost of the average fill-up went above $20 or so, card usage rose dramatically.

Maybe this is because U.S. consumers receive well over 5 billion mail solicitations for credit cards each year. That is more than 20 solicitations for every man, woman and child of all ages every year – and that doesn't even count the phone calls. Many of us have anecdotal stories of minor children, deceased individuals and even family pets receiving those mailings – sometimes with promises of large preapproved credit lines. But whatever the reason for the boom in cards and card usage, it is clear that cards – particularly from Visa and MasterCard – are so ubiquitous that most retailers simply have to take them.

2. Card Associations Drive Up Fees and Keep them and their Rules Secret

The card associations set interchange rates for all of their member banks – and all of those member banks must agree to charge the same rates. Of course, the boards of the card associations that make those decisions are made up of member banks so this is nothing more than price-fixing. The fact that they get away with it amazes me, but the courts will decide whether their questionable legal basis for this practice is still valid.

Just to give you a sense of the magnitude of the fees we are talking about, we and our customers pay more than $27 billion in interchange fees each year in this country. When all of the other fees on credit and debit transactions are included, the tab increases to over $39 billion. And this figure does not include the many other fees collected directly from consumers such as annual fees, late fees, interest and the like.

We calculate that an average convenience store paid about $31,000 in interchange fees in 2004. That same store only made $36,000 in **pre-tax** profits in 2004. The fact that our members on average are paying almost as much to the credit card companies each year as they are making before they pay Uncle Sam gives you a sense of just how broken this market is.

Even more problematic is the lengths to which the credit card companies go to assure that consumers remain in the dark about these fees. This system is so complex it makes your phone bill seem easy to understand. But at least somebody tries to tell you about all of the fees that are tacked onto your phone bill every month. You don't even get that privilege with your credit card purchases.

Retailers are told by their banks that the rules prohibit them from telling consumers about the interchange fees charged for different transactions and about the operating rules. This conspiracy enforced by the credit card companies to keep information from consumers is a key element of the problems in this market. How can consumers possibly decide what is in their interest if the credit card companies keep this information secret?

Another major part of the problem is that Visa and MasterCard compete by raising – not lowering – their interchange rates. When they raise their rates they compete to get their bank members to issue more of their cards. Higher interchange rates mean those banks, in turn, get more money from transactions put on those cards. There is not a sufficient check against those rising rates because the market power of the credit card companies inhibits retailers from refusing to take a card with higher interchange rates and because consumers – who ultimately pay the fees – do not have good information about the charges.

Retailers are not given a comprehensible disclosure of the rates they are charged. The card associations have a complex matrix of interchange rates. These rates range from about 5 cents plus 1.15% for each transaction to 10 cents plus 2.7% of the transaction. But it is hard for retailers, particularly small mom-and-pop stores, to figure out why they fall into a particular rate category based on their supposed fraud risk and the like. Plus, a retailer may be charged different rates within the course of the same business day. If, for example, a card swipe doesn't work and the retailer needs to call to get authorization, the transaction then falls into a different risk category and a different interchange rate is charged. And if the phone call doesn't go through (such as in the post-hurricane situation) then a higher rate is charged.

It's not just consumers who are left in the dark; Visa and MasterCard refuse to fully disclose their operating rules to retailers. MasterCard has at least put a summary of its rules on its Website. But a summary is not the same thing as the complete set of rules – and the summary alone is more than 300 pages. It is remarkable that they make retailers agree to abide by all of their operating rules in order to be able to accept their cards, yet they won't let retailers see those rules. I find the lack of transparency by Visa and MasterCard to be outrageous.

One classic example of the way that Visa and MasterCard compete to drive up interchange occurred in 1998 through 1999. In May 1998, Visa announced that it would increase its offline debit interchange fee by about 20 percent. The increase was to take effect in April 1999. In November 1998, however, MasterCard announced a 9 percent increase (also to take effect in April 1999) that was enough to keep its fee higher than Visa's. In most competitive markets it would have been a chance for MasterCard to hold or lower prices to gain market share – but the reality is just the opposite when both card brands enjoy merchant acceptance of over 98 percent. In fact, those increases were just the start. In January 1999, Visa announced it would increase its fee by an additional 6 percent. Then MasterCard announced another increase five days later. All of these increases were made before the first rate increase even took effect. When the dust finally settled, Visa's rates went up 26 percent and MasterCard's went up 17 percent. Overall, these increases alone cost U.S. consumers an additional $300 million per year.

3. These Fees Are Bad for Consumers

Not only is this a big concern for us as retailers, but the current situation is tremendously unfair to consumers. Ultimately, consumers pay for all of this. The average American family pays $331 in interchange and related fees every year. And that is true whether or not that family uses a single credit or debit card. Because these fees are hidden in the cost of virtually everything we buy, even cash-paying consumers ultimately pay for them.

There are many particularly glaring examples of situations in which people have no choice but to accept credit and debit card payments even though the fees that are charged do not make sense or are directly contrary to the public policy that most people would support.

One example which has been of great concern to the retail community is what happens in the wake of hurricanes and other disasters. Retailers often go to great lengths to open their doors following disasters so that people in the affected area can get the basic goods that they need to survive. That was never more evident than in 2005. Not only the Gulf but parts of the State of Florida were hit with devastating hurricanes last year. In these areas, many retailers had to operate without (or with sporadic) electricity and phone service. The cruel and sobering reality for these retailers and their customers was that the credit card companies charged them among the highest interchange rates for their efforts because without electricity or phone service retailers could not swipe cards or call to get preauthorization before completing a transaction. Instead, they sometimes used the old fashioned method of running the card and a receipt with a carbon copy through a machine and getting a signature. But without a preauthorization the retailers – and, ultimately, the consumers who were hit so hard by the hurricanes – had to pay the exorbitant, higher rates because of the supposed risk of fraud – almost 60% more than the standard rate of 1.89% of the sale.

This results in a nasty, regressive charge. In short, people who get the fewest benefits from credit cards subsidize those who get the most benefits. This hidden regressive tax levied by an unregulated private monopoly should not be ignored. Consumers with fewer resources whose credit does not allow them to have credit cards or do not have debit cards pay this fee like everyone else – as do consumers with credit cards who pay high interest rates, annual fees and have no rewards or miles programs. And this is the *vast* majority of consumers.

One of the reasons this problem is so pernicious is that it is hidden. ATM fees are a good point of comparison. How much do we pay each year in ATM fees? About $4 billion. Interchange fees are almost 7 times as much – and when other, related fees are included the difference is far more than that. Why isn't there more of an outcry about interchange fees? Because while consumers see every ATM fee they pay and have some ability to choose an ATM that carries a smaller surcharge, the credit card companies go to great lengths to try to ensure that interchange fees remain hidden.

The credit card companies are often quick to point to rewards programs and airline miles as benefits to consumers. But those rewards don't look very good when you understand that consumers pay for each dollar of rewards with several dollars in interchange fees. It is also important to keep in mind that most credit cards do not come with rewards programs. Convenience store customers, in fact, only use a card that earns rewards for about 1 out of 7 transactions. And what about the annual fees, interest payments, late fees and multiple other charges that credit card holders must pay directly? Just more monopoly profits for the credit card companies who get consumers coming and going – and then they have the gall to tell their customers how great it is they get a few airline miles or rewards points for all of the extra money they have been charged. As you watch the credit card ads during the Olympics this week, make sure to enjoy them. You are paying dearly for them.

4. The United States Pays Far More than its Share of Interchange Fees

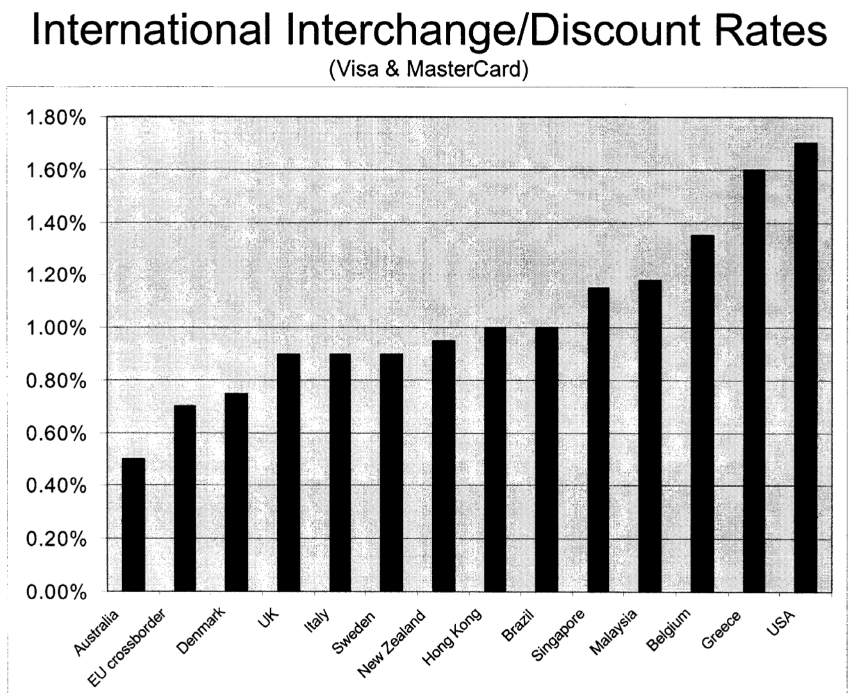
U.S. consumers are, in effect, subsidizing credit card company operations around the world. Interchange rates are far higher here than they are in comparable countries. They are also higher here than in several countries that we wouldn't even think of as remotely comparable in this area. You can take a look at the chart showing interchange in different countries to get a sense of just how bad this comparison is for us. And bear in mind that this chart was prepared before last year's dramatic effective increase in fees. We have the highest volume of transactions, which should lead to significant economies of scale and lower interchange rates. We also have the best technology for processing these transactions and we have very low, and decreasing, rates of fraud. Yet U.S. rates are higher than in other countries and they are rising – while the rates in most other countries are flat or declining. Our interchange rates ought to be the lowest in the world.

It is one thing for us to pay about double the rate paid in places like Great Britain, the European Union and Australia. The credit card companies will spend a lot of time complaining about the regulatory systems in those places. Of course, they typically don't mention that the rates were far higher here than in any of those places even before their regulators took action. But how can anyone think it makes sense for us to pay higher interchange rates than people in Malaysia, Greece and Brazil? Does the United States really have a riskier and costlier credit system than those countries?

The answer is that we don't, but because of their market power the credit card companies can get away with charging more here – so they do. It is that simple.

* * *

All of this is just a small part of the explanation of how the market for interchange fees in the United States is broken. Something must be done to fix it. I look forward to working with the Members of this Committee and the entire Congress to find the right solutions to this problem and I welcome your questions.



MR. STEARNS. I thank the gentleman. Ms. Kerrigan. And you've got your mike on, okay.

MS. KERRIGAN. I do.

MR. STEARNS. Okay.

MS. KERRIGAN. I am all set. Thank you very much. Chairman Stearns, Ranking Member Schakowsky and members of the subcommittee, I appreciate the opportunity to join you today to discuss the issue of interchange fees. Again, my name is Karen Kerrigan. I am President and CEO of the Small Business and Entrepreneurship Council. We are a nonprofit, nonpartisan, small business advocacy organization based here in the nation's capital with 70,000 members nationwide. For more than a decade, we have regularly expressed to Members of Congress, whether that be through our letters, our meetings with you, special reports, issue briefs or in hearings such as this one today, our concerns about the unintended consequences of legislation or regulatory initiatives that are proposed or advanced in response to, or with the aim of correcting inequities in the marketplace.

Small businesses have certainly experienced the fallout of many good intentions gone awry. In the areas of healthcare and taxation, to name two areas among many, we can point to a series of initiatives where government has intervened, resulting in costly burdens, inequities or new barriers limiting growth or entrepreneurial opportunities for small firms. In some, we are very cautious and circumspect about solutions that call upon government or the courts to intervene in the workings of the marketplace. And it is within this context and that experience that we approach the issue of interchange fees and more specifically, placing controls on such fees.

Our members do not like paying interchange fees, which is how they also feel about many, many other business costs. However, they recognize the benefits of electronic payment cards, and I have outlined those in my written testimony, benefits that have led to increased sales and increased business efficiencies. Many small businesses are, of course, succeeding; many members of my organization who do not currently use electronic payment cards, and that is the beauty of the system. If something does not work for you or your customers, if it is deemed too expensive you can simply opt out. But of course, even businesses and small businesses that may not take electronic payments have a stake in the stability and security of this sophisticated and important system. After all, small business owners use credit cards, either personally or to pay expenses or finance their businesses. No one can disagree that all parties have a major stake in its ongoing success, its efficiency and development.

And that is one of our key concerns, that government intervention or price controls would greatly reduce incentives to invest and innovate, which will not bode well for the enhancement, the expansion and the maintenance of a complex payment system, one that needs to become even better, given the growth of and the opportunities presented by the global economy. Along that same thought-line, regulation or court ordered remedies only hurt the environment for future competition, that is, a regulatory framework that may be established to deal with interchange fees may prevent the better mouse trap, if you will, from being developed; a system, a tool or an idea that could lower costs and provide better and more innovative services for small business owners and all consumers.

We and lawmakers have been strongly encouraged to look abroad to see how other nations are regulating interchange and are urged to emulate such models here in the U.S., but from what we see with respect to results in trends of fee setting by government in such countries, the law of unintended consequences is taking hold. Credit card holders are facing higher costs and getting fewer benefits. There has been a shift to credit cards that cost merchants more, not less, and this dislocation is begetting additional regulatory initiatives because the outcome is not what the authorities had planned or had desired.

Profits incentivize companies and if those are taken away, the incentive to widely market credit or payment cards are diminished. Or if card holders are faced with added costs or fewer benefits, that means a reduction in the use of cards. This is not a positive development for small merchants. In the end, we are concerned that both consumers and small businesses will pay a price for government intervention. Litigation raises costs for everybody and sets a precedent that will spread. When government or the courts set prices, service inevitably suffers, including, in this case, fewer cards issued, consumer rewards reduced and fees increased. Thank you. I look forward to your questions in our dialogue on this important issue.

[The prepared statement of Karen Kerrigan follows:]

PREPARED STATEMENT OF KAREN KERRIGAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SMALL BUSINESS AND ENTREPRENEURSHIP COUNCIL

Chairman Stearns, Ranking Member Schakowsky and Members of the subcommittee, I appreciate the opportunity to join you today to discuss the issue of interchange fees. My name is Karen Kerrigan, and I am President & CEO of the Small Business & Entrepreneurship Council (SBE Council), a nonprofit advocacy organization based in the nation's capital.

Caution on Price Controls as a Solution

The SBE Council is dedicated to supporting policies and solutions that encourage entrepreneurship, small business growth, innovation and the vitality of the U.S. economy. As you are well aware, government or regulatory intervention often carries the possibility of unintended consequences. Small firms have experienced such fallout with respect to policy implementation in the areas of health care and taxation, to name two areas among many, which have imposed new burdens, generated inequities or constructed artificial barriers limiting growth opportunities.

That is why the SBE Council remains cautious and circumspect of solutions that call upon government to intervene in the workings of the marketplace. It is with that backdrop that we approach the issue of interchange fees and the call for price controls on such fees.

Do small business owners and SBE Council members like paying interchange fees? Of course not. They would much prefer that these costs were lower or non-existent, similar to other external costs such as electricity and rent. At the same time that they may bemoan paying these fees, most SBE Council members, as well as various small business owners who have sent us comments on this issue, recognize that government regulation – whether directly, or through litigation -- has the potential to cause dislocation in a system that has generally served them well.

Acknowledging the Benefits of the Electronic Card Payments System

Those prescribing price controls on interchange fees, I believe, have been remiss in not acknowledging the benefits that electronic payments (credit cards and other forms) have provided. For small firms, these benefits are numerous, including:

- Access to consumer purchasing power – increased sales.
- Rapid and certain payment.
- Reduced costs and headaches in dealing with bounced checks.
- Reduced worries and losses with respect to theft issues.
- Enabler of internet commerce – undeniably a boon to e-commerce start-ups, and "store-front expansion" for existing firms in penetrating new markets.
- Costs associated with billing, collections, and taking credits risks are circumvented.
- A compliment to the mix of other payment choices like checks and cash – increased choices for consumers.
- Improved efficiency.

The value that payment cards bring to each business owner varies depending upon his or her business, industry or situation. And, of course, if it is perceived or believed that electronic payment cards are not beneficial, business owners can simply refuse to take payment in this form. Many small businesses are succeeding without utilizing payment cards.

Government or Legal Intervention Will Have Consequences: Small Businesses Express Concern

No one can disagree that small businesses, like all parties, have a major stake in the ongoing success, efficiency and development of the electronic payments system. Of course, it makes sense that retailers wish to reduce costs. However, as with other price control schemes that have been attempted in the past, incentives to invest and innovate are greatly diminished, which would not bode well for the enhancement, expansion, and maintenance of an extraordinarily complex payments system.

In addition, if incentives to widely market credit or payment cards are diminished, or if cardholders are faced with added costs or fewer benefits, that means a reduction in the use of cards. This will not be a positive development for small business owners either.

With respect to the SBE Council's concern over the unintended consequences of government intervention, or court-ordered solutions, that aim to set interchange fees, small firms throughout the nation share our apprehension as well. While, certainly, there are small businesses that would welcome intervention in this area (as long government or the courts do not tell them how to set prices, or run their businesses), others are more wary of such action. Here are just a few examples of the communications the SBE Council has received regarding this contentious issue:

Electronic Payments Fueled e-Commerce, Free Enterprise System Works Fine

"It's undeniable that the electronic payments made possible by credit cards have revolutionized retail sales. Without them, the incredible boom in e-commerce would almost certainly never have happened. Interchange fees are necessary to fund the expansion of electronic payments into new merchant venues, as well as the development of new products that will help buyers and sellers alike. Merchants derive many benefits from accepting credit cards – more customers, more sales and fewer hassles connected with getting paid. Credit cards are a perfect example of the free enterprise system at work, and we shouldn't bother it while it's working."

Larry Romero, Target Strategies, LLC, South Bend, IN

Courtroom or Boardroom?

"My company, Visionary Sports, operates on-line and we require payment by credit card. The system we have now works pretty well and is too valuable to our nation's business community to tinker with. If a company feels like the interchange fee is too high, they can always stop accepting the cards (although I doubt many of them would want to). No one is forcing me to accept credit cards. I just think it's the easiest and most cost effective way for my company to conduct business. If I change my mind at some point I'll simply stop accepting them, I won't need a judge to make that decision for me. The government does set prices in some countries, but America isn't one of them and I hope it never will be. This is a poorly thought out plan that could start us down the road to a time when prices will be negotiated in the courtroom instead of the conference room. I don't think any of us want to go there."

Rodney Grubbs, Visionary Sports, Brookville, IN

We Can Handle Pricing Issues

"Do I wish the fees were lower? Oh sure, the same as I wish my electric bill was smaller. But I understand that businesses need to charge for their services and I'm okay with that. As you can imagine, payment is a serious issue for us and we have found credit cards to be an extremely useful tool. With credit cards we're assured of payment, never have to deal with collection agencies and don't even have to generate an invoice. The fees charged by the credit card companies are worth the advantages we gain from their use. One of the things that make this country great is the chance everyone has to make their own decisions and run their affairs as they see fit. I hope the courts remember that and leave pricing issues up to the business community. We can handle it."

Peter Gavin, Polylok, Wallingford, CT

No One is Forcing Us to Take Credit or Payments Card: We Can Make Own Decisions

"My family has operated the Adams Pecan Company in Union Springs for over 60 years. I'm the third generation in the business and there's a fourth right behind me. These days our Alabama pecans are sold across the United States through our website. If the federal government sets an arbitrary limit on the fees card companies can charge, I fear it may make them less interested in promoting the use of their cards to new and existing customers. Fees are part of their profit structure and they need to make a profit to stay in business. Just as I am free to set what I think is a reasonable price for our pecans, credit card companies should be able to set their own prices too. That's the way we do business in America. No one is making us deal with the card companies. We can make our own decisions."

Kim Adams Graham, Adams Pecan, LLC, Union Springs, AL

Lawyers Win, We Lose

"There's no reason for the courts to get involved in credit card interchange fees. The only time the legal system should get involved in pricing is when a monopoly exists in a particular market. That's not a problem in the credit card business; not only are there several card companies there are also other ways to get paid including debit cards, checks and cash. Retailers get a lot of benefit from accepting credit cards and forcing the card companies into court over fees seems pretty short-sighted. If the card companies aren't allowed to make a reasonable profit they'll probably cut back on incentive programs and usage rewards that help generate sales. These lawsuits – like so much litigation – will end up making a lot of money for the attorneys involved and not accomplishing much else."

Ernie Del Giudice, MINUTEMAN PRESS, East Haven, CT

Conclusion

As with a wide range of legislation or regulatory initiatives that Congress, regulatory agencies, and state and local officials will consider this year and beyond, the SBE Council will continue to implore that the "first do no harm" precept be followed. Particularly within the context of enabling our businesses, and those who support them, to be more competitive in a global economy, intervening in an area where there is no market failure is indeed "pretty short-sighted."

In the end, the SBE Council is very concerned that both consumers and small businesses will pay a price for government intervention. Litigation raises costs for everybody, and sets a precedent that will spread. When government, or the courts, sets prices, service inevitably suffers, including, in this case, fewer cards issued, consumer rewards reduced, and fees increased.

As SBE Council Raymond J. Keating wrote in a recent piece on interchange fees: "Fundamental economics must be kept in mind regarding interchange fees. Profits made by credit card companies encourage them to market, expand cardholders and merchants in the network, and accept credit risks, which in turn benefit both consumers and businesses. As with other businesses, credit card companies and banks have every incentive to get the price right for their services so as to maximize their profits. Set interchange fees to high and businesses will not accept the cards; set them too low and fewer cards are issued. Those prices and profits act as signals in the marketplace to spur competition and innovation."

From the SBE Council's perspective, the market has worked extraordinarily well in developing and sustaining a complex and secure payment system that everyone is benefiting from. Government intervention has generally proven to be costly and filled with unintended consequences, and therefore we are wary of efforts to impose an extreme measure such as price controls on a system that has created significant benefits for small businesses and their customer base.

I look forward to your questions and our dialog on this important issue. Thank you Chairman Stearns, Ranking Member Schakowsky and members of the subcommittee for the opportunity to appear before you today.

MR. STEARNS. Mr. Mierzwinski.

MR. MIERZWINSKI. Thank you, Chairman Stearns, for the opportunity to testify. Representative Schakowsky, members of the committee, I am Ed Mierzwinski. I am Consumer Program Director for the U.S. Public Interest Research Group, a nonprofit consumer advocacy organization representing the state PIRGs around the country and I am also speaking today on behalf of The Consumer Federation of America, one of the nation's largest consumer groups.

We are here today to talk about whether interchange fees are fair and whether bank practices, in imposing those interchange fees, are the result of unfair market power. I want to stress that I think it is a critical hearing that the committee is holding. It is an important oversight function, that you are looking under a rock that I don't think the banks want you to look under, quite frankly. The banks have kept this rock down on the ground. The courts have looked at it; so has the Justice Department, by the way. They have looked at bank practices and the practices of their associations and I think it is important that the Congress is also looking at those practices, so we commend the committee for this important inquiry.

I want to make three basic points about interchange and about why consumer groups are here today to commend you for the hearing. First, all consumers, even those who pay with cash pay more at the store and more at the pump because the interchange fees that merchants pay banks are passed on to all customers. Some of those cash customers maybe can't even afford bank accounts because of some of the other unfair practices that banks have that leave 10 to 12 million American families unbanked and I personally don't think that Joe Cash Customer, who can't afford a bank account, should be paying for Jane Frequent Flyer's miles and that is what is happening, you could argue, with the way that these interchange fees are working.

Second, the success of the banks' legally suspect practices has given them tremendous market power. I don't think you can look only at the issue of whether or not we need price controls. You need to look at the broader issue of how banks have rolled out their credit card systems through their Visa and MasterCard associations; how they have looked at expanding the use of interchange from credit cards to debit cards, as well; how they have looked at trying to convince consumers to switch from cash transactions to credit transactions and how, as Mr. Armour has pointed out, they have forced merchants to take on these cards, and I encourage you to take a look at the issues in the Justice case and in the merchants' cases, as well as looking solely at the narrow issue of fixed interchange.

Third, the banks engage in a variety of deceptive practices to drive consumers to higher cost forms of payment. For example, many banks surcharge PIN debit transactions, even though those are safer transactions, less costly transactions, and have a lower opportunity for fraud. What we have seen is the banks trying to push consumers to signature debit, which is controlled largely by the big banks' national associations, as opposed to lower cost, less risky PIN debit, which has been controlled through smaller regional associations, primarily, over the years.

The other points I want to make are just to describe some of the banks' strategies to increase interchange fee income. Again, as I spoke earlier, they want to switch consumer behavior from PIN to signature and we have a study on our website of the New York PIRG that describes how banks charge you a fee if you use PIN debit in order to encourage you to go to signature debit. Banks frequently put on your bill--or excuse me, your monthly account statement that the merchant imposed a surcharge; in reality, it was a bank fee, not a merchant fee. They simply say well, it was imposed at this terminal, trying to infer that it was the merchant who imposed the fee, rather than the bank.

Second, the banks are definitely trying to switch consumer behavior from cash to plastic. They are encouraging us, through the use of rewards cards and other incentives, to not use cash anymore, but to use these cards which ultimately cost merchants more and may cause merchants to raise their prices for all consumers.

Third, as Mr. Armour has pointed out, they want to switch merchant behavior with unfair practices. That was essentially the gist of the so-called Wal-Mart lawsuit and the "Honor All Cards" rule forcing merchants to accept signature debit even when they didn't want to.

And finally, the banks are like the Godfather. The banks make offers the merchants can't refuse. They use contractual terms and market power to keep merchant interchange fees high and they force merchants to pay even higher fees when the customer uses a rewards card, even though the merchant has no idea that I am using a rewards card.

We make three recommendations in our testimony, PIRG and CFA. First, we urge you to call on both GAO and the Federal Reserve to do studies. Why two studies? I would like one study to be independent of the financial industry and the financial industry's general viewpoints, and I think the Fed is an independent agency, but it is a financial regulator, so do one at the GAO, as well.

Second, after you take a look at the results of those studies, consider regulations; consider all sorts of regulations, not just so-called price controls. That is not what we are here specifically to say. And finally, I do point out in my testimony that there are disparities in the consumer fraud protections; when you use a credit card, you have strong protections against fraud under the Truth in Lending Act. When you use a debit card, you have more modest legal protections under the so-called Electronic Funds Transfer Act. There is a growing market for payroll cards, gift cards and other cards. Sometimes those cards give you the weaker protections of the EFTA; sometimes you have no protections. And I believe that because some of these cards are issued by non-financial institutions, that your committee has jurisdiction. Thank you very much.

[The prepared statement of Edward Mierzwinski follows:]

PREPARED STATEMENT OF EDWARD MIERZWINSKI, CONSUMER PROGRAM DIRECTOR, U.S. PUBLIC INTEREST RESEARCH GROUP

Chairman Stearns, Representative Schakowsky and members of the committee:

My name is Edmund Mierzwinski. I am Consumer Program Director of the U.S. Public Interest Research Group, which serves as the federal advocacy office of the National Association of State PIRGs, which are non-profit, non-partisan public interest advocacy organizations active around the country. My testimony today is also on behalf of the Consumer Federation of America. Founded in 1968, CFA is an association of some 300 nonprofit consumer and cooperative organizations from throughout the nation with a combined membership exceeding 50 million people.

Summary

Skyrocketing bank fee income reported last summer was not due to any new or greater sophistication or marketing innovations on the part of bank executives. Rather, it was simply due to the spike in gasoline prices, which provided banks with massive returns on their long-term strategy to use legally questionable market power and anti-competitive practices to collect billions of dollars in excessive "interchange" fees from merchants accepting credit or debit cards.[1] Because many consumers, and perhaps even more consumers as gas prices skyrocketed, used credit or debit cards at the pump, bank income from fees imposed on merchants simply spiked.

Some time ago I saw an industry newspaper ad for a bank conference. The event's title was "Fee Income: The Holy Grail." They weren't kidding. As Margaret Pressler detailed in the Washington Post[2] in September:

> "So a year ago, when gas prices averaged $1.87, banks involved in credit card processing made about $12.5 million a day on fees. Now, with prices averaging $2.75 nationally, the credit card companies are raking in $18.4 million a day. That is $183 million more a month, or nearly $2.2 billion dollars on an annual basis in extra money paid to the nation's banking giants just because of rising gasoline prices."

Many merchants, particularly small businesses, assert that these bank fees – known as interchange fees and averaging as much as 1.6% or more of each transaction on a credit or debit card -- are among their highest costs of doing business (more than rent, salaries or utilities), are unfair and non-negotiable and raise the costs of goods for all consumers, not just those who use credit cards. Many of the estimated 10-12 million consumers who do not have credit or debit cards are unbanked due to the high costs of maintaining a bank account, yet these lower-income Americans are also paying more at the store and more at the pump due to high interchange fees.

We cannot stress three points enough. **First, all consumers, even those who pay with cash, pay more at the store because the interchange fees that merchants pay banks are passed on to all customers.**[3]

Second, the success of the banks' legally suspect practices has given them tremendous market power. In anti-trust terms this allows them to dictate the terms of trade: Merchants have no choice but to accept Visa and Mastercard products on the sellers' terms. Otherwise, they will lose customers and sales.

Third, the banks engage in a variety of deceptive practices to drive consumers to higher cost forms of payment. For example, many banks surcharge PIN-debit transactions even though those are safer, less costly, and have a far lower opportunity for fraud than signature-debit transactions. They engage in these tactics to maximize their interchange fee revenue.

Further, numerous studies have shown that interchange fees, averaging between 1.5-2% of purchase prices in the United States market, are much higher than interchange fees in other countries. Yet as the head of one retail association has pointed out:

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[1] Your debit and credit card purchases are processed through the retailer's bank and the bank that issued you the card. The issuing bank charges the retailer's bank a fee to process the transaction. The retailer's bank then adds its own fee for processing the transaction and passes on both of these fees to the merchant as the "interchange fee."

[2] See "Card Companies Are Filling Up At the Station," By Margaret Webb Pressler, Washington Post 25 September 2005; Page F01 http://www.washingtonpost.com/wp-dyn/content/article/2005/09/24/AR2005092400255.html, last visited 14 February 2005.

[3] And of course, while these interchange fees are hidden fees that consumers pay, consumers directly pay many other unfair credit card and bank fees and high interest charges imposed by credit card companies and banks. See testimonies of Edmund Mierzwinski, U.S. PIRG, Travis Plunkett, Consumer Federation of America and Linda Sherry, Consumer Action, at hearing of the U.S. Senate Banking Committee on unfair credit card practices, 17 May 2005 available at http://banking.senate.gov Also see the PIRG websites http://www.truthaboutcredit.org and http://www.stopatmfees.com

> We pay the highest fees in spite of the fact that our costs are the lowest. We have the greatest economies of scale, we have the lowest interest rates, and our fraud and bankruptcy liability has just been sharply limited. Yet the fees are being driven relentlessly higher.[4]

Hypothetically, if a U.S. merchant paid 2% in interchange fees and 50% of its customers paid with plastic, then, its costs, which must be recovered across all customers, have increased an average of 1%.[5] In retail, 1% is a big number. In effect, interchange is a hidden sales tax on all consumers.

So, we agree with merchants' concerns and commend the committee for its inquiry. We hope that the committee and the Congress will continue the investigations you have begun today of the impact on the economy of potentially anti-competitive bank practices that make prices higher for all Americans and may limit competition and entry in payment system networks.

It is encouraging that the Congress is today joining the courts, which are considering a variety of merchant class actions[6] and even the U.S. Department of Justice,[7] which has been involved since 1998 in litigation into whether bank payment card and network governance, membership and ownership practices are fair and in compliance with the antitrust and other consumer laws.[8] One major merchant class action involving signature debit cards has already settled[9] for an estimated $3.3 billion in compensatory relief.[10]

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[4] Tim Hammonds, President, Food Marketing Institute, "Interchange Fees," speech of 24 January 2006 available from author.

[5] While this is intended merely as an example, we have no seen no study that suggests any of these costs of business are merely absorbed by the business. Of course, some of the costs of accepting plastic offset other costs of accepting cash or checks. See November 2004, Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees, pages 9-11 for a discussion of costs for various payment types. See http://www.federalreserve.gov/-boarddocs/rptcongress/posdebit2004.pdf (last visited 14 February 2006).

[6] "Four major merchant associations have filed an antitrust, class-action lawsuit against most of the major credit card issuers in the United States over allegations of collusive behavior regarding interchange fees." See Retail group sues MasterCard, Visa, 4 October 2005, ATM Marketplace, http://www.atmmarketplace.com/news_story.htm?i=24148 last visited 14 Feb 2006. Those Associations include the National Association of Convenience Stores, the National Community Pharmacists Association, the National Grocers Association, The American Booksellers Association, the National Assocition of Chain Drug Stores, the Minnesota Grocers Association, and the National Cooperative Grocers Association.

[7] In a 1998 complaint, the U.S. challenged the interrelationships, governance structure and exclusionary rules between and among the VISA and Mastercard associations and the banks that own them as violations of the Sherman Antitrust Act. In 2003, the Second Circuit upheld a 2001 district court ruling in favor of the government's position that the exclusionary practices of the associations (essentially designed to prohibited entry by American Express or Discover into their payment networks) were illegal. See the DOJ's page containing documents relating to the United States vs. VISA U.S.A. Inc., VISA International Corp.,
MasterCard International Inc. litigation. http://www.usdoj.gov/atr/cases/indx57.htm(last visited 12 Feb 2006).

[8] It is also important to understand that while the banks may attempt to confuse the issue by claiming that 6,000 supposedly vigorously competing banks offer card choices, that particular comparison is irrelevant. The market under discussion is the market for network payment systems. Visa and Mastercard are the dominant national payment systems and there are only two others (American Express and Discover). Visa and Mastercard are alleged to have conspired together to keep prices high. Merchants generally have no choice in the marketplace that has developed; they must accept the two cards at the card associations' dictated terms.

[9] "In the Action, Plaintiffs claimed, among other things, that Visa and MasterCard, individually, and in conspiracy with each other and with their member banks, have violated the federal antitrust laws by forcing merchants who accept Visa and/or MasterCard-branded credit cards for payment also to

The important questions being raised in these cases concern whether the practices of the banks and their associations, VISA and Mastercard, have been purposely designed and implemented to assert market power, limit entry by potential competitors and fix prices for users, both consumers and merchants, at unfair or illegal levels. Interchange practices are only one element, but an important one, of the various investigations, lawsuits and inquiries.

How Interchange Fees Work

Banks collect interchange fees when merchants accept credit and debit cards. Credit card transactions are signature-based (off-line) and switched only through the national VISA or Mastercard payment network systems. Debit cards are enhanced ATM cards with VISA or Mastercard brands on them and can be used not only in ATM machines, but also can used in either on-line (PIN-based) or off-line (signature-based) transactions in-person at a store or over the phone or on the Internet, just like a credit card. Because debit cards withdraw money from the consumer's own deposit (savings or checking) account, merchants have argued, successfully, that the transactions do not involve a loan, and therefore that fees should be lower due to the lack of credit risk. Nevertheless, fees for signature debit – as much as 1.6% or more of the purchase -- are higher than for PIN-debit, and reflect a large part of the dispute before you today.

According to the Federal Reserve, "the interchange fees set by Visa and MasterCard for signature debit have been substantially higher than those set by the regional POS networks for PIN debit." The Board goes on to explain:

> Whereas the prices of PIN debit are capped at fixed levels, those of signature debit and credit increase with the purchase amount. For the average debit purchase amount (about $40), a signature debit transaction generates an interchange fee of about $0.57; for PIN-based networks, the fee is $0.34. The difference between the fees is even more substantial for purchases of $80, the amount of a typical credit transaction. For a purchase of this amount, the signature debit rate is about $0.99, more than twice the PIN debit rate of $0.44. The fees for signature debit and PIN debit are less than those for credit ($0.72 and $1.33 for the two purchase amounts).[11]

For every $100 purchased on either signature debit or credit, the merchant only receives approximately $98.40.

Bank strategies to increase interchange fee income have involved several tactics:

1) Switch consumer behavior from PIN to signature: Banks seek to grow the market for signature debit by offering incentives (rewards) to consumers for off-line

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accept Visa and/or MasterCard-branded debit cards for payment, and by conspiring and attempting to monopolize a market for general purpose point of sale debit cards. Plaintiffs claimed that Defendants' actions have caused merchants to pay excessive fees on Visa and MasterCard signature debit and credit transactions and on on-line PIN debit transactions, and have injured competition, merchants and consumers." See Wal-Mart et al vs. Visa and Mastercard.

[10] The case has also resulted in elimination of the so-called "honor-all-cards" rules of the associations. See Merchant Advisory on Final Approval and Payout of Settlement of Visa Check/MasterMoney Antitrust Litigation, Law Firm of Constantine Cannon, 29 June 2005, available at http://www.inrevisacheckmastermoneyantitrustlitigation.com/6_29_05.pdf (last visited 14 February 2005).

[11] November 2004, Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees, page 11 See http://www.federalreserve.gov/boarddocs/rptcongress/-posdebit2004.pdf (last visited 14 February 2006).

transactions but punishments (surcharges) for PIN-based transactions.[12] Banks frequently create the impression that the merchants are assessing these surcharges through deceptive billing practices.

2) Switch consumer behavior from cash to plastic: Similarly, banks use Rewards Cards with cash-back, miles or other incentives to convince consumers to switch from cash transactions to plastic transactions, further increasing fee income.

3) Switch merchant behavior with unfair practices: Banks force merchants to accept signature debit (e.g., not merely lower-cost PIN-debit) through anti-competitive contractual terms such as the so-called "Honor All Cards" rule successfully challenged in the Wal-Mart case.

4) Make offers the merchants can't refuse: Like the Godfather, the banks make offers "you can't refuse." They use contractual terms and market power to keep merchant interchange fees high. Further, they force merchants to pay even higher fees when customers offer to pay with Rewards cards (of course, the merchant doesn't even know it is a Rewards card) so that the merchant, and the rest of us who shop at that store, actually pay for the cost of the consumer's miles offered by the bank.

One of the most important elements of the rapid growth in fees is the growing use of plastic as a substitute for cash. According to the Federal Reserve[13]:

> In 2003, consumers in the United States conducted more transactions with debit cards than with credit cards for the first time in history. In 2004, consumers in the United States will conduct an estimated 18.6 billion debit card transactions at the point of sale, an amount that accounts for roughly 53 percent of all card-based purchase transactions. Consumers will secure roughly 11.8 billion debit transactions with a signature and the remaining 6.8 billion with a PIN.

A separate Federal Reserve study[14] analyzes the rapid growth in electronic payments and the decline in the use of checks and cash:

> Electronic payments grew rapidly between 2000 and 2003. There were 13.8 billion more electronic payments in 2003 than in 2000.7 During the same time period, checks paid declined 5.2 billion, suggesting that some check payments were replaced by electronic payments. Electronic payments are also likely replacing some cash payments or reflecting general increases in payment activity.

Further, perversely and paradoxically, the incentives, such as higher fees, that the two associations offer their member banks to market their particular card result in reverse competition, where prices go up, not true competition where prices decline.

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[12] As an example of the fee punishments, see "Pricey Plastic: A NYPIRG Survey of Plastic Card Fees," at http://www.nypirg.org/Consumer/cards/ (last visited 12 Feb 2006). The 2004 survey reported that 89% of the banks surveyed assess a debit card POS fee for PIN-based transactions. The average fee assessed is 70¢. The fees ranged from 10¢ to $1.50. Also see Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees (citation above).

[13] November 2004, Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees, page 4, See http://www.federalreserve.gov/boarddocs/rptcongress/-posdebit2004.pdf (last visited 14 February 2006).

[14] The 2004 Federal Reserve Payments Study, 15 December 2004, available at http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf (last visited 14 February 2006).

Interchange Fees Are Hidden, But Consumers Pay Other Fees Directly

Banks, especially bigger banks, have long had a policy of raising fees, inventing new fees and making it harder to avoid fees. A series of PIRG studies has further documented that big banks charge higher fees than smaller institutions.[15] Analysts estimate that banks impose as many as two hundred different fees on consumers and small business customers. Many of these are nuisance fees, such as the fee for unknowingly depositing someone else's check that bounces, or even for seeking to withdraw more than your daily ATM limit, even if you have the money in your account. Who knew?

A few of these consumer fees drive vast amounts of bank income, among them the ATM surcharge of $1.50-$2.00 (imposed on non-customers even though that ATM owner also receives a share of the $1.50-$2.00 "foreign" fee the customer pays his or her own bank), the $30-$35 so-called bounce-protection fee imposed as a "service" in lieu of actually "bouncing" your check and, finally, the $29-$39 credit card over-the-limit and late payment fees. Most studies estimate that **each** of these few fees drives billions, or tens of billions, of dollars of fee income annually.

While consumers, policymakers and the press are well-aware of how banks have nickel-and-dimed consumers with this wide and growing variety of fees for virtually every service that they provide except, so far, for breathing the air in the bank, many policymakers have been unaware of the stream of income derived from fees imposed on merchants for accepting credit and debit cards. Nor is the public generally aware that some of this growing stream of income may be obtained through anti-competitive practices.

Conclusion

As consumer advocates, we are gravely concerned about the fairness and legality of bank schemes to increase credit and debit card fee income, especially because an underlying bank goal is also to encourage greater consumer use of plastic payments. As more consumers pay with plastic instead of cash, due to bank incentives such as rewards cards, but merchant fee income is buoyed by potentially anti-competitive practices, all consumers will pay more than we should at the pump, and more than we should at the department store, even those of us who still pay with cash. This is especially troubling as a matter of public policy due to the estimated 10-12 million unbanked American families forced to absorb these higher costs even though they pay with cash.

> **Here's a complaint I received via email:** I own a small gas/convenience store in WA state. Recently a customer "told" me to process her debit as a credit since she got a small fee back from her U S Bank debit card. Now, I know how high the fees are for me to process her card as a debit and how much higher as a credit. And yet, I am not allowed to charge a processing fee. In other words, the dollar fountain drink costs me money instead of making the few cents I would normally make, since the consumer is making an offer to pay. Yes, I can refuse service, but I don't understand what is going on here-when is the merchant allowed to make any kind of profit at all with the use of credit/debit cards?

Is this small retailer a dinosaur whose store should die or is he a victim of predatory practices of his credit card payments systems suppliers? We believe the latter – and further that all consumers pay too much due to excessive interchange fees. We offer the following recommendations.

[15] See the PIRG website http://www.stopatmfees.com

Recommendations

1) Congress should require separate Federal Reserve and Government Account Office (GAO) studies of the impact of interchange on the U.S. economy, including a review of interchange practices in other countries, a review of the need for greater disclosure and the need for further regulation of or prohibition of certain practices of bank payment networks.

2) Based on the results of the studies, Congress should consider regulating interchange fees, especially debit card interchange fees. Regulation of the monetary supply is a traditional role of government and as plastic becomes the dominant form of tender, Congress should assure that the market is unencumbered by anticompetitive or deceptive practices.

3) A concomitant problem we also encourage the Congress to examine is the difference in legal protections for consumers, depending on which sort of plastic they use. Consumers are largely unaware that while their legal rights against fraud are strong when they use a credit card, these rights by law are substantially less so when they use a debit card and non-existent when they use certain other stored value cards, including gift cards.[16] Since some of these cards are not issued by financial institutions they likely come under committee jurisdiction. Further, as we know from the committee's inquiry into data breaches, many of the serious breach notifications being made under California's and now other states' security breach notification laws involve risks to debit card account numbers.

Thank you for the opportunity to provide our views.

MR. STEARNS. I thank you. Let me start you with a question here. You state that people without credit cards are paying more at the stores and more at the pump because of these interchange fees?

MR. MIERZWINSKI. Well, that would be my beliefs and here is how I would characterize it. To make the math easier, if you have a 2 percent interchange fee and 50 percent of customers are using plastic, that raises the store's costs by 1 percent across all their customers. The store has to either absorb those costs or recover them by increasing its prices. I don't see any other choices.

MR. STEARNS. When I was in my small business, if a person paid cash, I usually gave them a discount. I encouraged that in some way or the other if we were in a situation where I might give them a discount and so don't the merchants have the ability just to charge less by giving a discount for cash?

MR. MIERZWINSKI. I would ask if you would ask the other witnesses for their views on this particular issue, as well, but I am not sure that the banks' contracts allow a merchant to charge more for credit cards.

MR. STEARNS. Well, it is done all the time. I think you need to put your mike on.

MR. ARMOUR. I think it is a great question.

MR. STEARNS. Right.

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[16] We and other consumer organizations including Consumers Union discuss many of these disparities and related issues in comments to the Federal Reserve Board here http://www.naca.net/FDICLetterNov05.pdf and http://www.federalreserve.gov/SECRS/2005/-September/20050929/R-1210/R-1210_122_1.pdf and

MR. ARMOUR. If you look at gasoline right now, gasoline is almost all prepaid right now because of the high price of gasoline, the instance of gas theft and so forth, most retailers have gone to either pay at the pump or you have to go inside and prepay it. I think there is without question value, nobody is disputing that there is convenience value to a credit card, at all. By giving cash discounts, you are decreasing the convenience to a consumer who now has to go in and out of the store to buy their gasoline rather than simply paying at the pump. Furthermore, when you are making in-store payments, most State and local regulatory environments require you to post both the cash price and the credit card price, so if you have 3,500 items in your store, that means on every single one of those items you are going to have to be showing the credit price and the cash price, which I think you would agree, is a huge burden. It is not something that you can just say we will take 10 percent off.

MR. STEARNS. Mr. Armour, this wasn't clear to me, that we all understand there are antitrust cases before the courts. Just briefly tell me what relief your members are asking. What is the solution, what relief are your members asking, because Mr. Muris has mentioned that this is a possibility of a trillion dollar and he has used some strong language in terms of so forth and so on, extortion is the word he used and just--

MR. ARMOUR. That is a rather strong word there.

MR. STEARNS. I thought it was a rather strong word, but let me ask you what are the reliefs, just briefly.

MR. ARMOUR. Quite simply, to stop the anti-competitive behavior of price fixing that is going on today.

MR. STEARNS. Okay.

MR. ARMOUR. We have not advocated a new system.

MR. STEARNS. So are you asking for damages?

MR. ARMOUR. Absolutely.

MR. STEARNS. What you are saying is that you just think there is collusion here and monopoly practices is what you want to stop?

MR. ARMOUR. That is correct.

MR. STEARNS. Right, okay. Mr. Muris, I looked at that graph over there. I don't know where it went. It was just up a moment ago. But Mr. Armour makes a case that in Australia the international interchange fees are the lowest in the world and yet in the United States, they are the highest. And so when you look at that graph, would you agree that that graph accurately portrays what has happened here because if that is statistically correct, then the United States and its consumers are paying the highest interchange discount rates in the world and Australia is paying less and that would sort of buttress the case for Mr. Armour.

MR. MURIS. Let me respond to that and if I could, and also respond to the extortion point.

MR. STEARNS. Okay.

MR. MURIS. Let me submit, for the record, a study by IEK, which is an industry analyst group, which shows that of the 15 countries, that only two have merchant discounts, what the merchant pays, what you paid when you were in your small business. Only two countries have smaller merchant discounts of the 15 than the United States. Australia, interestingly, engaged in price regulation and they lowered interchange fees and the result was that consumers ended up paying more. Consumers paid more fees, consumers paid both the annual fees and otherwise. The reason I made the point--

MR. STEARNS. Just let me ask a question. You are saying that in Australia, that the state legislature stepped in or the Federal legislation stepped in?

MR. MURIS. It was the equivalent of the Federal Reserve.

MR. STEARNS. Okay, the Federal Reserve stepped in and did pretty much what Mr. Armour wants done?

MR. MURIS. What Mr. Armour suggested that he wants done is to--although, I think he might not fully understand how it works, if you end the price with the alleged price fix--

MR. STEARNS. Right.

MR. MURIS. --and you end the setting of interchange fees, the MasterCard and Visa systems could not work the way they work now, at all.

MR. STEARNS. But they are working in Australia, aren't they?

MR. MURIS. Well, they haven't ended the set fees. They just set a lower fee.

MR. STEARNS. But wouldn't you admit, though, that if the Federal Reserve in Australia stepped in and did this, that the fees did come down?

MR. MURIS. Oh sure, because what they said is we won't let the market work. We will impose price controls and the effect of the price controls is inevitable and that effect was that the consumers ended up paying more for their cards.

MR. STEARNS. I understand that, but they would argue that the price controls is not what they did.

MR. MURIS. Well, no. No, I think they would agree that it was a price control. What happened is the government said here is what the price is.

MR. STEARNS. Okay.

MR. MURIS. That sounds like a price control--

MR. STEARNS. So you are saying you agree with the graph, but the graph is stilted because the federal government in Australia--

MR. MURIS. No, no. I am saying that the relevant question is how much do merchants pay for their cards and that the statistics that I want to put in the record show that of the 15 countries surveyed, in only two countries did merchants pay less than they pay in the United States.

MR. STEARNS. Okay.

MR. MURIS. Now, can I address the extortion point?

MR. STEARNS. Yes, sure.

MR. MURIS. Yes, I think it is a strong word, but I think it is appropriate. We have a system in the United States where the plaintiff lawyers frequently file class actions and if the class is certified and the alleged potential damages are high enough, then it is only a very imprudent businessman who won't settle. These are very odd lawsuits because the lawsuits seek a remedy that the merchants can't possibly want. They seek an end to the price fixing and what the merchants want instead is a price fix, but a fix at a lower amount. That is not something that antitrust courts do, but they are betting, they being the plaintiffs and these merchants, they are betting on the fact that the potential damages will be so high that someone will step in to save credit cards because they understand that credit cards are a good thing. They just understandably don't want to pay as much as they pay now.

MR. STEARNS. So you still stand by your word extortion?

MR. MURIS. Oh, absolutely.

MR. STEARNS. Okay. Mr. Armour, I am going to ask you a tough question here that maybe Mr. Muris would like to have asked you. You don't necessarily have to answer this, but just to put it on the record, he mentioned the damages could be $1 trillion for the law firm that is going to take this and I understand that the law firm that is taking this on for you folks is doing it on a contingent fee basis. Is that true?

MR. ARMOUR. It is true.

MR. STEARNS. Do you want to tell us what the contingent fee amount is charged by this law firm in representing you in the antitrust case?

MR. ARMOUR. First of all, I am not sure it is appropriate for me--the agreement that I have with our--

MR. STEARNS. I have given you an opportunity to decline, too, because I told you in the beginning you don't have to answer this. Chairman Muris has made a pretty strong statement about this and I think, in light of the fact that the law firm that is leading this is getting contingent fee, it is probably quite a bit and Mr. Chairman has said it is going to be a trillion dollars, so it is a high incentive. We all have just been through the tobacco litigation, so we know what that is about and I guess--

MR. ARMOUR. Let me, perhaps, respond--

MR. STEARNS. Right.

MR. ARMOUR. --to the extortion charge.

MR. STEARNS. Okay.

MR. ARMOUR. I wouldn't characterize it that way, but let me talk about transparency. Visa and MasterCard, as I said in my testimony, requires retailers to sign merchant agreements. They refuse to fully disclose what the operating rules are, and when you ask them, they say no, we are not going to give you the full rules and as Ms. Kerrigan over here said, that the response is if you don't sign, you don't have to take our credit cards. And yet, I think in your introduction, it is quite apparent that plastic is the predominant method of payment in the United States today, so you are left really being extorted by Visa and MasterCard of having to sign, being forced to sign, an agreement or to give up the bulk of the transactions that take place in the United States today. So I would, just to balance the argument on who is extorting whom--

MR. STEARNS. So now you are using the word extortion on the other hand. Okay, my time is expired. We could go on, and I didn't mean to inflame it, but I think the issue is pretty important because there is quite a bit at stake here. Ms. Schakowsky.

MS. SCHAKOWSKY. Well, let me begin where you left off. You maybe have been reluctant to use the word extort, but hearing the take it or leave it attitude, really, of the credit card companies, I would say that if what is good for the goose is good for the gander and I would certainly say, in my opinion, that that is even a more coercive kind of extortion, particularly since the terms of those agreements, and I want to talk more about it. Mr. Muris, how long ago did you leave the FTC?

MR. MURIS. Eighteen months.

MS. SCHAKOWSKY. Eighteen months. You know, when someone who is, and that is me, has been a consumer advocate all my life, I just have to tell you there is something that feels not quite right about to me when someone who has been the chief champion for consumer rights, in my view, that is how I see the FTC, is now before the same committee and representing the Electronic Payments Coalition. I know that is just me, but I just wanted to say that.

MR. MURIS. Can I respond?

MS. SCHAKOWSKY. Actually, it was just a comment. You put in your testimony that in supporting price controls some claim that payment cards are overused relative to other payment methods and that that is the fundamental misconception, and I would say that is not what we are talking about. In fact, that is not at all what we are talking about. What we are talking about is more what Mr. Mierzwinski said is whether the interchange fees are fair and Ms. Kerrigan, you did the same thing, justifying the use of credit cards. We all love our credit cards. We all use our credit cards. It is not about that.

That is not the fundamental misconception and to sort of argue that--and also, the other part that sort of bothers me, a comment, also, is that you are telling us what is in the interest of consumers. I would rather hear from consumers about that. You are representing the interests of the Electronic Payments Coalition, fine. You should represent those interests, but not tell consumers, and in this case, also, the merchants, themselves, what is in their best interest. Clearly, your association is benefiting. I wanted to ask you if you have ever seen one of these operating agreements and if you could supply a copy of one of those to this committee?

MR. MURIS. Can I respond to your general points? When I was 17 years old I decided I wanted to be involved in public policy. I have had six jobs in the Federal government. I spent the rest of my life going in and out of the academic world and doing consulting. I am here on the normal basis that I am here that I say what I think and what I believe and I believe that consumers would be hurt by price controls. When you mention take it or leave it, when you go to McDonalds it is take it or leave it. I mean, you know, we have a world where when you deal with large institutions, you can't negotiate the individual price of your meal at McDonalds.

MS. SCHAKOWSKY. That is totally denying the reality of the marketplace right now, I think, where people use their credit cards. It is very different than whether I choose to go to McDonalds or someplace else. Right now, that is just what our society is about and forcing agreements, particularly--and I would really appreciate it if you dance with that. I am limited in time. Have you seen these operating agreements and can we get a copy of them?

MR. MURIS. I have seen various agreements. The point of transparency, which, as I take it, is the point that you are addressing, Mr. Armour's members have, they don't have a contract with Visa, they have a contract with their merchant bank. That contract is fully disclosed, the price is fully disclosed. If they want to see Visa's terms and MasterCard's terms, they, in fact, put them on their website. I do believe, however, that what the real issue here is Mr. Armour's business and his members used to be a cash business and indeed, they made significant amounts of money out of ATMs in their stores, but what has happened is, as you mentioned, is consumers now, many would prefer to pay with credit cards.

MS. SCHAKOWSKY. Could I just ask Mr. Armour to respond to this transparency argument that you are making?

MR. ARMOUR. To the best of my knowledge, MasterCard, but not Visa, has a 300-page summary of what their operating rules are. The summary is 300 pages. I am led to believe that the rules, themselves, are 1,200 pages long and none of our members have been able to get a copy of the 1,200 page operating rules after requesting them.

MS. SCHAKOWSKY. Can we get them?

MR. MURIS. Their contract is with their merchant bank. It is a competitive contract for merchant banks. If they don't like that contract with the merchant bank, they can ask for another merchant bank. There are numerous merchant banks.

MS. SCHAKOWSKY. Is that the case, Mr. Armour? That you can just ask for--

MR. MURIS. Just as when you--if I could be allowed to finish? Could I be allowed to finish, Mr. Chairman?

MS. SCHAKOWSKY. Well, you have made a statement. Let me ask him to respond to that.

MR. MURIS. Well, I was trying to answer a question, but I will defer to the Chairman's wishes.

MR. STEARNS. Well, Mr. Chairman, what I generally do is let Members interrupt, do what they want.

MR. MURIS. That is fine.

MR. STEARNS. Because these Members that work very hard, they represent the constituents. I don't represent her constituents, she doesn't represent mine.

MS. SCHAKOWSKY. And I am happy to come back to you and let you finish.

MR. MURIS. I appreciate it. Thank you.

MS. SCHAKOWSKY. You made a statement about what merchants can do and they can tell their merchant bank to, you know, that they want another one.

MR. MURIS. My statement was that it is a competitive market for merchant banks.

MR. ARMOUR. But Visa and MasterCard interchange is not the merchant bank. I mean, you can go from U.S. Bank as your merchant bank and ask for Visa and MasterCard rules; they will say no. You can then go to Wells Fargo and ask for them. No member of ours, and I assure you, we have had hundreds of members ask for the full operating rules from Visa and MasterCard.

MS. SCHAKOWSKY. Can you get a better deal from a different bank?

MR. MURIS. On processing you certainly can, but not on the interchange, because as I said in my testimony, the card associations' members are the banks and the rules of those require every merchant bank to charge the same interchange fee. But if you are talking about transparency on the issue, we are confusing a couple issues here. The interchange fee is disclosed, it is simple. It is disclosed. I think it is necessary to--

MS. SCHAKOWSKY. Well, the fee is disclosed, but is the--

MR. MURIS. The operating rules, I believe, are available. I am not speaking here today for individual merchant banks or individual Visa contracts. We have different kinds of payment cards. We have proprietary systems, American Express and Discover, and they don't use an interchange fee because they don't have merchant banks and acquirers. They just charge a merchant discount.

MS. SCHAKOWSKY. And we are talking about interchange.

MR. MURIS. But that merchant discount is what the merchant pays and that merchant discount is take it or leave it, as well. The reason that we have interchange fees is we have a historical accident. When MasterCard and Visa started, when the Bank of America in California started Visa, it couldn't have branches outside of California, so they had to have franchising. It was that historical accident that caused this system, a different system than the proprietary cards, American Express and Discover, use.

MS. SCHAKOWSKY. But I think we have a dispute about a fact here, whether or not information is available and--

MR. ARMOUR. I mean, I would urge you, and I wish you much better luck than our association and our members have in obtaining the operating rules, the full operating rules of Visa and MasterCard.

MS. SCHAKOWSKY. Can you help us with that, Mr. Muris?

MR. MURIS. I would be glad to go back and ask them, but if the hearing is about interchange and the complaint is about interchange--

MR. STEARNS. Your mike just went off.

MR. MURIS. I am sorry. There is no transparency issue on interchange. If that is what the issue is, they know what they are going to charge.

MS. SCHAKOWSKY. What the fee is.

MR. MURIS. Sure.

MS. SCHAKOWSKY. They don't know the operating rules. Well, okay.

MR. ARMOUR. A quick point. Interchange is more than just the fees. It is the operating rules around this.

MS. SCHAKOWSKY. Right. I just want, Ms. Kerrigan, I was a little bit surprised by, as a small business and entrepreneurial council, could I get a list of the members of your council? You have member organizations, right?

MS. KERRIGAN. Yes, we have 70,000 members nationwide.

MS. SCHAKOWSKY. Okay. Are the same people that Mr. Armour represents part of your organization?

MS. KERRIGAN. Our organization is more broad-based in terms of its membership. We don't have any of the large retail operations. We don't have the concentration of, you know, the retail or franchising.

MS. SCHAKOWSKY. Are members of the Electronic Payments Coalition members of your organization?

MS. KERRIGAN. I don't know who the members of the Electronic Payments Coalition are. I didn't even know there was one until this hearing.

MS. SCHAKOWSKY. I have so many questions, but I guess my time is up.

MR. STEARNS. I thank the gentle lady. We are going to go next to Mr. Deal.

MR. DEAL. Thank you, Mr. Chairman. Walk through some of these terms you have used because I am not necessarily following everything that you have used terms for. As I understand it, this hearing is primarily looking at interchange fees, but Mr. Armour says that knowing what the interchange fees are is not enough unless you know what the operating rules are. Now, the interchange fees are they, Mr. Muris, are they just a set, standard fee that is charged regardless of who is doing business in that regard?

MR. MURIS. There are, as I understand it, there are a wide variety of interchange fees charged, but because Visa and you know, depending on the type of transaction, depending, you know, some retailers have been able to negotiate different fees than others, but because there are thousands of issuers of Visa and MasterCard, they set the interchange fee for each issuer and because of the nature of this--

MR. DEAL. Who is they?

MR. MURIS. Who is they, I am sorry. Visa and MasterCard, themselves. Visa and MasterCard are joint ventures of banks, but they have various rules and they set the fees. The consumer--your card is not from any of our cards here if you have a Visa or a MasterCard are not from the Visa association. They are from an individual bank, an individual issuer.

MR. DEAL. So Mr. Armour, if you know what the fees are, what does the operating rules tell you or are disclosed to you that you don't already know?

MR. ARMOUR. Well, let me first say, great question. Let me give you an example that has come up with the tremendous increase in the price of gasoline. When you sign a merchant agreement, it is typically two pages, and there are some rules that they tell you about. You can't surcharge for credit, you can't set a minimum amount that a consumer has to buy to use a card and you can't set a maximum amount. Now, there are thousands more rules, one of which is called Error Code 96 that is not disclosed to you and what that rule is, is with respect to gasoline, this is to the best of my knowledge, what many of our members have told me, with respect to gasoline, if you accept a credit card charge more than $50, Error 96 allows Visa and MasterCard not to pay the merchant for that charge.

Now, they don't disclose that to you, but I have many members who have had what is called charge backs, Visa and MasterCard see a gasoline purchase on a credit card for more than $50 and refuse to pay the merchant for that purchase even though the consumer has paid their bank for that charge. Now, understand the conundrum that the retailer is in. A retailer, by the rules, can't restrict the purchase to $50. That is against one rule, specifically. On the other hand, there is another rule that says with respect to gasoline, Visa and MasterCard reserves the right not to pay you if it is over $50, so what is a retailer to do? So when you ask about interchange and interchange fee, there are the fees, but as you can see, the operating rules has a huge impact on the actual cost of accepting Visa and MasterCard and so forth, in general. I mean, that is just one example and you are not, that Error 96 is not disclosed to you. You find out when it happens.

MR. DEAL. Mr. Mierzwinski, would you like to comment on that, as well? And also, if you do, and I would ask you, if we used the terminology of merchant discounts and as I understand it, with the merchant discounts, those are through cards such as American Express and Discover, which you have made some allusions to about the cost being shifted to other consumers where you are having benefits that are being paid outside or simply for the use of the card.

MR. MIERZWINSKI. Well, first of all, Representative Deal, my reference in my testimony to American Express and Discover had to do with some of the other litigation over the practices of Visa and MasterCard associations and whether or not they kept them out of their payment systems. In terms of their particular payment systems, the so-called merchant discount is another term that is used for interchange. The interchange may average something like 1.6 percent or more, so the merchants sometimes refer to, in the industry trade papers, sometimes refer to that since the merchant only gets $98.40 out of every $100, that that is a merchant discount, but it comprises the interchange fees paid to the acquiring banks, the network, and to the other members of the system.

I would point out, in terms of the ability of the members of the merchant class, the merchants, to obtain information about their contracts, I think it is shocking that the banks won't give the information but then, again, the information they give consumers about our contracts, in fact, they do tell us, in our contract, what the rules are and the rules in our contracts to have a credit card say that if we want to change the rules, we can change them at any time for any reason including no reason, so I would be interested to see the operating contract that the merchants are subject to, to see whether it is the same rules that the banks have for consumers, which is take it or leave it. If you want a credit card, you have got to agree that we can change the rules at any time, even for no reason.

MR. DEAL. So you are saying, in effect, then, that the take it or leave it proposition is being put on the merchants. Ms. Kerrigan, do you agree with that? I mean, there is no negotiation about it, is there?

MS. KERRIGAN. No, you agree to certain terms and certain conditions if you take the card. It is like any other type of, you know, business deal that you may have. I mean, you do accept those conditions when you take the card.

MR. DEAL. And is there anybody else out there that would break this monopolistic climate to come in and say hey, you don't have to take theirs because you can't negotiate. I have got a better deal for you. Is that out there?

MR. MURIS. Well, I'm sorry.

MS. KERRIGAN. Well, I represent, you know, that is coming. In effect, that some way, shape or form, that small business owners and small merchants will be able to aggregate and collectively utilize, as a group, their transactions to negotiate better prices.

MR. DEAL. Have they been able to do that yet?

MS. KERRIGAN. No, that mouse trap has not been built, yet. But certainly there is the migration to debit cards, which are lower, you know, in terms of cost and merchants are not powerless. It is going to take time, obviously, to educate the consumers about debit cards and pushing them in that direction. It is cheaper. But from our perspective, we do not want the outcome of what occurred, and this goes back to our conversation on Australia, on what has happened there with respect to new costs that are being imposed on consumers and shifting to more expensive cards, the shifting of more expensive cards for merchants and business owners, the shifting to American Express, for example, and Discover. I mean, these cards cost more for small businesses, not less, so there has been some unintended consequences in the Australian model that I think we really need to look at before we go doing anything here.

MR. DEAL. So the merchant discount in those cases is greater than the aggregate cost, including the interchange fees on the other Visa/MasterCard approach? Is that what you are saying? I thought they were the other way around. I thought that the merchant discounts were actually a lower cost item for the merchant overall than signing one of the contracts that had the interchange fees in the traditional sense. Am I wrong?

MS. KERRIGAN. Well, American Express is, with respect to the merchant discount, is a higher cost than the combined of the other two.

MR. DEAL. I have been told it is generally a two percent charge to the merchant. Is that a ballpark figure, correct?

MR. ARMOUR. Well, a bigger magnitude.

MR. MURIS. Well, it varies significantly in this response to your point about monopolistic practices. I don't know what Wal-Mart and Target pay, but I am willing to bet that it is a lower amount than others pay. If you look at Costco, for example, you can't use your MasterCard or Visa credit card, but they have an arrangement with American Express. I don't know the terms. I would be very surprised. American Express is generally the highest merchant discount. I would be very surprised if it is not a special arrangement with Costco. These sorts of arrangements work throughout the economy and as Chairman Stearns pointed out, any merchant can discount for cash. Gas stations used to discount for cash. That was common 25 years ago. They don't do it, but the reason they don't do it is not because of Visa and MasterCard, it is because of consumers. We have a consumer driven economy and that is what happened to discounts for cash at gas stations.

MR. ARMOUR. There wasn't pay at the pump 25 years ago and Mr. Muris is quite correct. There is value to credit cards.

MR. DEAL. I am still mad about the last time I tried to fill up my pickup truck. They wouldn't let me just simply pump it in the middle of the day and go inside and pay cash, as I normally do, that I either had to use the credit card or I had to go pay in advance. I thought to myself well, I don't know how much it is going to take to fill my truck up, but I have to guess at it one way or the other and generally, you are going to guess on the low side because you don't want to go back in and ask for an exchange so you are actually selling less gas that way.

MR. ARMOUR. That is true.

MR. MURIS. Sure, but I don't think that was because of the payment cards, I think it was because unfortunately, some people would fill their tanks and drive off.

MR. DEAL. Agreed. That is the source of that problem.

MR. MURIS. Right.

MR. DEAL. Well, I don't know if we will have another round or not, but I have some other questions, if we get to it.

MR. STEARNS. We might, then. We might do that. Let me continue. Mr. Ferguson.

MR. FERGUSON. Thank you, Mr. Chairman. Thanks for holding this hearing. Our economy is dynamic and consumers currently enjoy a wide variety of choices on what to buy and also choices on how to pay for things, and the more that consumers choose to pay with credit cards, more and more people are choosing to use credit cards and those payments are made electronically. They enjoy convenience. I know I for one use my credit card all the time. I don't have a pickup truck that I fill up at the gas station because we wouldn't be able to fit our four little kids in a pickup truck; we have a minivan, and when I go to the gas station with four little ones in the back, I want to get in and out of that gas station as quick as I can, so I use a credit card and I use it everywhere because it is fast and it is convenient and, you know, I have a concern like any consumer would if we are paying high fees for that convenience, but I also believe in markets and I think information is good, transparency is good. They both help markets to work and they help markets to work better.

And I am just interested to hear from Mr. Muris or Mr. Armour or both of you. I am thinking about, you know, in a free market rate system where the costs of using a credit card were more transparent and more obvious to the consumers who use them. I am not as interested, in fact, I am very suspicious of government telling industry what prices they can charge. I think price controls tend to be a very bad thing. But I think information and transparency are a very good thing because it empowers a consumer to make decisions that they believe are best for them.

I haven't heard it discussed today, specifically, but has there been discussion of, you know, retailer--we have heard a lot about the contracts and extortion and everything else, but is there anything that would keep a merchant from simply, on every receipt that is printed out of a machine, just providing information to the customer that says some percent, I don't even know if you would attach a number to it, but some portion of the product you just bought is a little bit more expensive because we offer the convenience of you being able to use a credit card. Now, for me, I don't know if that would change my behavior, but for some folks it might and frankly, for the credit card companies, it might change their behavior, so I would like you both to address it. Mr. Armour, why don't you go first?

MR. ARMOUR. Congressman, yes, there is something to prevent that and that is the operating rules prevent retailers from disclosing to consumers the fees that they are paying.

MR. FERGUSON. What if you don't attach a number to it? What if you make a general statement; I am just sort of spit balling here, I don't know. But what if on every receipt that was printed out, every time I got my receipt out of the gas station or the supermarket or anywhere else that

I use my credit card, on that receipt was printed, just a little FYI, by the way, the product you just bought is a little bit more expensive because we want to offer you the convenience of using a credit card?

MR. ARMOUR. That would sure do that. I think what you are suggesting is the ultimate in consumer protection. Mr. Muris, I think, brought up in his comments ATMs and the amount of money that is made on ATM fees. There is huge transparency in ATM fees. You put your card in, you enter your PIN and it says hey, do you realize you are going to have to pay $1.50 or $2? Do you want to do that, yes or no? That is transparency.

MR. FERGUSON. And it is on your receipt.

MR. ARMOUR. Absolutely. There is no industry, I think, that is more transparent than mine in its pricing. We put it on the street corner, you know? So I just have a problem with why Visa/MasterCard is so secretive about their operating rules, why they prohibit retailers from disclosing fees and so forth. It just doesn't make sense to me. I am an economist and I believe in free markets, too. The problem is we don't have a free market here.

MR. MURIS. I am sorry. I think Mr. Armour is misinformed. There is nothing, I believe, in the agreements that prevent a merchant from doing exactly what you are saying and listing the price. In fact, I was--speaking of hotels, I was at a bed and breakfast in Pennsylvania last fall and they did exactly that. They said we have to pay, I don't remember what it was, 3 percent, 2 percent more if you use a credit card, please don't use a credit card. There is nothing that prevents that, but consumer convenience is what is driving this, your very point. Credit cards are a marvelous invention and they don't come free. There is enormous competition. Merchants, if they want, can steer, they can discount for cash, they could steer among credit cards. Some do, not many. Not many do and the reason is that because consumers want the convenience and the consumers would resent it.

MR. FERGUSON. Mr. Armour, is--or actually, Mr. Muris. Is that, that bed and breakfast that you cited, is that true of every agreement or are there some agreements where what Mr. Armour is saying is actually true, that they wouldn't be able to disclose a number?

MR. MURIS. I believe that you can disclose a number, if you want.

MR. FERGUSON. In any, every contract that you know about?

MR. MURIS. I don't know about every contract, but my understanding of the general rules is that you could disclose a number, but again, merchants respond to consumers and just why discounts for cash went out in gas stations, discounts for cash are not particularly prevalent, but it is because of consumers; it is not because of anything the credit card companies or the payment card companies do.

MR. FERGUSON. Mr. Armour.

MR. ARMOUR. We will certainly get back to the committee with a definitive response, but from what we understand and from what our members tell us about the operating rules when several of them have put up what fees that they are paying, they have been told by their banks that that is a violation of the operating rules.

MR. FERGUSON. Well, there is obviously a discrepancy, Mr. Chairman, in terms of what merchants are aware of, what they are allowed to do and what they are not allowed to do and I, for one, I am very hesitant to have the Federal government jump into an issue like this, but I am very much in favor of consumers having all the information that they need to make a decision. As I say, it maybe wouldn't affect my behavior, but there are many, many millions of people for whom it might affect their behavior if they knew exactly what they were paying for that convenience, for that service and perhaps encouraging industry to go in this direction is perhaps better than a law or a price control or whatever else.

MR. ARMOUR. If we had the operating rules, we could answer the question.

MR. STEARNS. Perhaps the gentleman is also indicating that he would like to see a complete description of the full operating rules on interchange fees. Now, Ms. Schakowsky has alluded to that. Maybe the member has an interest in seeing that. There is some talk that it is proprietary information, they don't want to reveal it. They have indicated it might be on a website you can get, but a lot of people say what is on the website cannot be understood, it doesn't have the complete rules, so I don't know. The Member must think about whether he wants to do that. I mean, as Chairman, I am also concerned about it.

MR. FERGUSON. Well, just to respond, Mr. Chairman.

MR. STEARNS. Sure.

MR. FERGUSON. I am not a lawyer. I am less interested in the legalese and the guts of these agreements that bunches of lawyers work out in corporate board rooms or meeting rooms, but what I am most interested in is are merchants allowed and do they have the ability, as we have heard at least one example of, are merchants allowed to tell their customers exactly what they are paying for, exactly how much they are paying for the convenience and it seems to me that ought to be able to happen. Again, I don't know, I don't pretend to understand all the intricacies of these agreements that are signed, but it seems to me that, at least, would be a better step than, perhaps, some new Federal law.

MR. STEARNS. Mr. Terry.

MR. TERRY. Thank you, Mr. Chairman. I have a question that was brought up by a business in my district and it says basically besides the collective setting of the interchange by Visa and MasterCard boards, do the card associations have other rules that restrict competition among payment types at the point of sale? Mr. Armour, are you familiar with whether, from what you are hearing from your merchants, your members, that they are restricting, at the point of sale, some of these unknown rules and procedures of what the payment type could be, whether it is debit card, which I understand has one set of rules in payment, versus credit card?

MR. ARMOUR. I think the Wal-Mart litigation addressed that. That was a steering case that Visa met, has been settled in the, to the benefit of retailers that prohibited the type of steering to lower cost cards that you just--

MR. TERRY. And that what, I think, this business and I am getting at is are there other ways that they are skinning the cat now to force the merchants to have to use a credit card versus another payment would have lesser charges?

MR. ARMOUR. Well, the gap between the cost of processing debit cards and credit cards have significantly narrowed, so that might be one indication of one of the things they are doing.

MR. TERRY. Mr. Muris.

MR. MURIS. Well, because of the nature of this market with consumers on the one hand and merchants on the other, we have some interesting phenomena. One of the reasons the interchange fees merchant discounts, when the Diner's Club started all this, in the 4 and 5 percent range; they have fallen considerably. In recent years, we have had more extensive competition, particularly between American Express which has gotten involved, MasterCard and Visa, and one of the ways they compete for banks is through interchange fees, but what happens, there is so much competition among issuers, the interchange fees are passed on to consumers in benefits.

Annual fees, there are far fewer annual fees than there used to be. The rewards cards, there is an enormous number of rewards cards. We all get the offers in the mail. It is an extraordinarily competitive business and consumers benefit from that and consumers have voted with their feet. And the result of the lawsuits that have been filed, if the relief requested, which is to end the price fix, I believe would seriously hamper the existence of Visa and MasterCard and your constituents can't possibly find that a result that they would be happy with.

MR. TERRY. Well, since the interchange fees have become substantially similar between debit and credit card, which baffles me, as a layperson that is not involved in the financial--I am more associated with those trial attorneys that extort people.

MR. MURIS. We have heard that word extortion here this morning, so--

MR. TERRY. But I am not familiar with the rules in the financial services market, but it seems odd to me that when I am using my debit card, which I almost use exclusively, I have no rewards, I have no other reward than I made a transaction at the gas station or at Target and that was deducted from my checking account. No one carried debt, it was just an electronic transfer for the ease of everyone involved, but that process is still, the charge is still substantially similar as if I used a credit card that did have rewards and somebody carried the debt for 30 days until they could bill me. Is that fair?

MR. ARMOUR. It is less, but the gap--

MR. TERRY. Is it that fair that they are similar?

MR. ARMOUR. It is not the same. It is less, but the gap is closing. But let me point something out because I think there is a huge misconception and you may be one of the rare people in this room that doesn't use a credit card that has rewards on it and yet you, in fact, are far more typical than anybody else in this room. We have done a study at NACS and less than one in seven of the Visa/MasterCards used in our members' establishments are reward cards. So over six out of seven are non-reward cards and as I said in my testimony, this presents some rather bizarre consumer things where the people, most of the people are subsidizing the rewards for very few people and I think many of us in this room think that everybody has a reward card. Actually, less than one in seven has reward cards.

MR. MURIS. There are significantly different users of credit cards. There are people like most of the people in this room, I suspect, who don't use credit cards as a form of credit and therefore they care a lot about the rewards, but there are people for whom credit cards are a much better source of credit than payday lenders, than having to borrow from their families, than loan sharks, you know, more traditional ways. It is a better form of credit than installment credit. Those people pay attention to the interest rate, to the APR, so you have got to remember we don't think, in this room, of credit cards as a form of credit, but for a lot of people, they are a very good form of credit and that is one of the reasons that explains these differences. In terms of the questions that you were asking, it is absolutely true that you pay more for credit, you know, those rewards cost more than the use of the debit cards, and if there was an implication that the numbers are close, they are not all that close. They may be a little closer than they used to be, but they are not all that close.

MR. MIERZWINSKI. Mr. Terry, if I could just briefly say that there are now debit rewards cards and in fact, it is the view of consumer groups that the banks are promoting the debit rewards cards as a way to switch people from cash to debit transactions so that they can increase the profits from interchange fees. And then the second part of that is it is my understanding that if I use a debit rewards card at a merchant, the merchant is forced to pay the bank higher interchange.

MR. ARMOUR. That's right.

MR. TERRY. I will yield back.

MR. STEARNS. Thank you, Gentleman. Mr. Rogers.

MR. ROGERS. Mr. Chairman, it has been an interesting discussion. I use credit cards as a matter of convenience, but when I, as a consumer, use a credit card, am I, in fact, and I am just going to open it up to the panel, I am borrowing money, am I not? Borrow money for at least 30 days or maybe longer? And isn't that the service that a credit card provides? General agreement on that, okay. So there is a service to the consumer up front, that in fact, that I get to borrow that money until I determine to pay it back. Is that correct? Okay, I just want to make sure I understand the business here, as well. And I guess my concern, Mr. Chairman, is--and it has been a great discussion. I believe in transparency, I believe in competition. I think all those things will serve us better than Federal intervention. And I want to ask Mr. Mierzwinski--by the way, I want to compliment your child safety issues. Your State of Michigan chapter does a fantastic job on child safety issues with--

MR. MIERZWINSKI. Thank you, sir.

MR. ROGERS. Yes, they do great work. I have worked with them. I am a little concerned on this issue, however, and I just want to quote you something out of a Brookings study and then maybe Mr. Armour can help me answer this, as well, because this is my concern when you have a national or a Federal intervention. And they actually did a study on the Australian experience. "The study of the experience in Australia preliminarily confirms cooperative network issuers in Australia indeed did cut their cardholder benefit packages and raised fees. Merchants have benefited from lower discounts, but merchants have not lowered their prices. If cardholders have lost benefits, pay higher fees and have not gained from lower merchant prices, then they have not benefited." And I will start with you, Mr. Mierzwinski. You are obviously advocating on behalf of the consumer. It sounds like in Australia the consumer, with a lot of good intention, ended up paying a lot more money.

MR. MIERZWINSKI. I have not yet read the Brookings or American Enterprise Institute's study, but I would point out that this particular issue isn't only about credit cards, it is also about debit cards and so in fact, the consumer is not borrowing any money from the bank when he or she is using a debit card in this transaction and that is, in fact, one reason that some of the fees have finally started to go down on debit interchange. But even within debit interchange, there is also the issue of unfair practices where there is PIN debit, which is cheaper and less risky and then there is signature debit, where the profits primarily accrue to the big banks, where the primary owners of the Visa and MasterCard association, because they have more volume and whether the practices of the industry are designed to migrate consumers first, from cash to plastic and second, from PIN plastic to signature plastic, so that is all occurring. As for the Brookings study, I am going to take a look at it and I will get back to you on its results, but I want to point out one more thing, Congressman, and that is simply that the consumer groups, I think the industry has rolled out, they have got banners in the back room. Whenever Congress talks about regulation, they always bring out the price control banner. Price controls are bad for America. The consumer group's issue here is how does the merchant discount or the interchange fee get to be fixed at such a high level and is it fixed at such a high level because the companies are asserting market power? Are they asserting market power, which is illegal, because of a series of illegal practices, so it is not just the market setting this price, are illegal practices setting this price?

MR. ROGERS. And I think that is a fair question to ask, but I would argue and I believe you would argue, as well, that if at the end of the day a proposed intervention from the Federal government caused higher consumer fees, you would probably be opposed, would you not?

MR. MIERZWINSKI. We would be opposed, probably, but we would want to look at it. That is why we have suggested the committee continue this. We think it is a good rock to be looking under.

MR. ROGERS. Thank you. Mr. Armour.

MR. ARMOUR. We would certainly oppose that, yes. I mean, we are retailers and our mission, really, is to take value to consumers. But let me address a couple things. First of all, I hear other people talking and most ask me about the Australian model, we are not talking about any--I also hear about price controls and caps; we are not talking about price controls or caps, we are talking about way, way earlier in the cycle, how about some transparency here? How about disclosing some rules here and then how about looking into what is behind that graph over there?

I mean, we are not advocating that Australia has skinned this cat successfully. What we are advocating is that looks really odd over there. And by the way, Australia was paying lower interchange fees before regulatory intervention, than the United States. What is happening in this country? We have the highest volume of transactions, the best technology, low fraud rates, and decreasing fraud rates, and yet, we are paying among the highest interchange fees in the world. We would like help. We would like you all to help us and consumers to really shine the light on what is going on in this marketplace that causes market pricing to result at the levels that it is. So don't mistake Mr. Muris and Ms. Kerrigan saying that we are asking for price control or price caps, because we don't know.

MR. ROGERS. Yes. But you are, in fact, asking for government intervention and I always say be very careful for what you ask for. When the government intervenes, we will intervene. It is the old story about picking about the steak and walking down the block and no question.

MR. ARMOUR. But I believe in the light of day. I believe in free markets and I believe in consumers--

MR. ROGERS. I appreciate that. Mr. Muris, would you like to respond?

MR. MURIS. Yes, could I respond to the point about benefits? Your point about borrowing the money for 30 days is an excellent point and you don't have to pay for that. You get the float if you pay it back immediately, one of the many benefits of cards. I think one of the things we are missing are the benefits to Mr. Armour's members. Before general all-purpose payment cards, the large retailers had cards and the small stores couldn't afford the fixed cost and the other costs of having those cards. Because the banks and the proprietary associations are more efficient at assessing the risk, we now have cards, and I am old enough to remember when you had, in your wallet you had cards from all the different department stores and a lot of people didn't have the general all-purpose cards. Those general all-purpose cards represent a tremendous benefit that aid the small businesses. Look at the Internet. The Internet has been facilitated enormously by the confidence everyone has in these general all-purpose payment cards. Now, because of fraud and other risks, the interchange fees are actually higher on the Internet. But again, it reflects the marketplace and consumer demand.

MR. ROGERS. It is not just fraud, though. It is non-payment, isn't it? Isn't that a part of--

MR. MURIS. Sure, sure.

MR. ROGERS. The fraud may be going down, but non-payment, that is probably why--

MR. MURIS. Well, whatever one calls non-payment, sure. I am willing to accept that addendum, sure.

MR. ROGERS. Well, is that--

MR. MURIS. Sure, sure.

MR. ROGERS. I mean, the risk, is that not a factor of some of your interchange? It is kind of risky.

MR. MURIS. Right. Well, and it is the problem we were discussing with the gas station. It is unfortunate. It is unfortunate that you can't fill your gas and then go inside and pay if you are going to do a cash transaction, but because so many people would, you know, I mean, a significant enough percentage abuse that. Retailers, like Mr. Armour's members, had to come up with a different strategy.

MR. ARMOUR. No one is disputing the value of--

MR. ROGERS. Sir, if you may, Ms. Kerrigan, I think was raising her hand. I see I have gone over my time, but if you don't mind, Mr. Chairman, to allow her to answer the question?

MR. STEARNS. Sure. Ms. Kerrigan, we will let you finish the question.

MS. KERRIGAN. Thank you. You know, from what I have seen that has come from the merchants who are calling for some type of government intervention, I mean, they are pointing to and have asked and have urged to look at what has been done overseas and they point to these as success stories. But I think the more and more we look at what has happened in Australia and everything that has happened overseas with respect to interchange has been price controls, that this is not a good deal for consumers and is certainly not a good deal for small merchants. And in fact, in Australia they continue to re-regulate or fix, or try to fix-up, the mess that has already been caused there. So we can't go down that path and I do believe that if you are looking for the government to do something, you do have to watch out what you ask for, because you may get it and certainly, price controls are not the solution.

MR. ROGERS. Okay, thank you.

MR. STEARNS. I thank the gentleman. I would just add within that graph there might be something of question because Americans have so much consumer debt and lack of savings in the country. I would be curious to see how that skews this graph, too, because so many people have a huge amount of credit card debt, but with that, the gentle lady from Tennessee is recognized.

MS. BLACKBURN. Thank you, and I thank our panel for a great discussion on this issue. Ms. Kerrigan, coming to what you were saying about the Australian experiment, I think that you would agree and Mr. Mierzwinski, I think, what I am hearing you all say is that the customer is the one that lost out in the Australia agreement because higher fees were charged. They lost a lot of the bonus or the rebate programs and it did not seem to be of benefit to the consumer, is that correct?

MS. KERRIGAN. Well, correct, and we would never mandate or you know, I think it would be wrong to mandate that the merchants who have been able to save money have to pass those on to consumers; we would not be for that. But also, I think, in the long run, maybe in the mid-term, that merchants are going to be on the losing end, as well, if there are less cards in the system and if you have consumers paying higher prices for their cards, they are going to use them less.

MS. BLACKBURN. Okay, then let me ask--

MS. KERRIGAN. And in addition, you do have the migration to the more expensive cards--

MS. BLACKBURN. Okay. All right.

MS. KERRIGAN. --which, again, is going to be costly for merchants.

MS. BLACKBURN. Okay. Mr. Armour and Mr. Muris were speaking a little bit about the way the marketplace responds and you talked about how they respond at the point of purchase. If you don't have price controls, then merchants respond at the point of purchase with saying please do not use a credit card; we have to pay an extra fee, or not allowing the use of certain credit cards or as in some of the small stores where I shop, they only will use a credit card with a purchase that is over a certain amount, $10 or $20 amount, so thereby they are changing the behavior of the customer, whether they like it or not. So let me ask you this, I had read the January 12 article from the Wall Street Journal on "Credit Where Due." I don't know if any of you read it, if not, I would recommend that you do take a peak at it.

And in reading that, it was talking about merchants having recourse, another recourse, which is to offer, to look at banding together and starting their own credit card competitor to Visa and MasterCard and I thought well, that is a pretty good concept, and I remembered when I was in the State Senate in Tennessee. We had a program with a card called Fuel Man and this was for state cards, automobiles, vehicles, and you took your Fuel Man credit card to the service station and you swiped it and you filled it up and it was charged back on a specific account; all done magna-strip, all done right there at the pump; the pumps were geared to take that. What would happen if merchants were to band together and start their own credit card competitor? Mr. Armour, what if your members were to do that?

MR. ARMOUR. In fact, we have had those discussions for over six years and much like Ms. Kerrigan testified, and these are with very, very large retailers and the economics of it are just cost-prohibitive to launch a competitive product against two associations with common ownership that has upward of 70 percent market share. I mean, that is a very, very tough deal. We continue to look at that as Visa and MasterCard continue to raise their interchange fees and the final thing, Congresswoman, if you like the store that you are shopping at, that says they can, you have to buy so much in your hometown to use a credit card, please don't tell anybody about it because it is against the operating rules and Visa and MasterCard will cancel their contracts.

MS. BLACKBURN. I will dare not say another word, how is that?

MR. ARMOUR. Very good.

MS. BLACKBURN. Okay. Ms. Kerrigan, I wanted to come to you. Looking at the growth of e-commerce, and that is something that we have done in other hearings here in this committee, do you think that forcing a price cap on credit card interchange fees could prohibit or affect e-commerce advancement and the growth of that sector of our retail economy?

MS. KERRIGAN. I do, but if I can first, on this whole aggregation issue that you talked about, if I--

MS. BLACKBURN. I would rather you answer the second question first.

MS. KERRIGAN. Okay.

MS. BLACKBURN. We are almost out of time.

MS. KERRIGAN. Okay. I do. I think any type of price control, any type of regulation will hurt innovation in that industry, whether it is enhancements, improvements, you know, making the system bigger and better. It is going to have to be that way as our global economy continues to expand and to allow small firms and e-commerce to take advantage of opportunities. So again, you know, price controls do quell investment and innovation and that would be one of the things that we would be concerned about.

MS. BLACKBURN. Okay. Go back to the aggregation now.

MS. KERRIGAN. On the aggregation, I was going to say it goes back to regulation and establishing any type of regulatory framework. What you are doing is you are setting up, you know, if we do that with interchange now, you are establishing bars and barriers, if you will, again to more innovation and potential entrance into that market, so we feel it will deter competition and deter innovation.

MS. BLACKBURN. Excellent. Thank you. I yield back.

MR. STEARNS. The gentle lady's time has expired. Mr. Bass.

MR. BASS. Mr. Chairman, are we in recess?

MR. STEARNS. We are in recess right now.

MR. BASS. It is an interesting hearing and I must apologize for being late and I have read the committee memoranda here. I am trying to figure out what the problem is. Is the problem that different card companies are charging different interchange fees or that the problem is that some, that it isn't sensitive to the size of the transaction or the amount of business that occurs in a specific area, thereby giving favorable treatment, if you will, in terms of bottom line to big businesses versus little? What are we trying to solve? Anybody want to address that? What is the problem that we are trying to solve?

MR. ARMOUR. Sure. I think there are two major problems. There is a huge lack of transparency, so that retailers really don't know what rules they are supposed to abide by until they break them and then they are told; that is problem number one. Problem number two is why is America paying the highest interchange fees or among the highest in the world when we have the most sophisticated credit system, the highest volume of transactions that should drive economies of scale cost reductions and so forth. And when you look at that and you look at the way the card associations arrive or fix their prices and they require all member banks to charge the same interchange fee, one looks at that and it looks like there is abnormally high market power leading to higher than competitive interchange rates.

MR. BASS. Can anybody tell me why America is charging the highest fees in the world?

MR. MURIS. It is not true and I have asked to put a study in the record that shows that in a 15 country study, there are only three countries lower than the United States. The reason we are here, quite frankly, is that many merchants like credit cards, in fact, all merchants, they want to pay less for them and they have convinced--there is a group of plaintiffs' attorneys who have convinced them to file 47 suits. The implication of those suits, and I believe what they want, is it is not that the prices are fixed, they want the prices fixed less. I don't blame anyone for wanting to pay less, but I believe that in our market economy, that that sort of government intervention is inappropriate, but I think that is quite frankly the simple reason why we are here.

MR. BASS. If I could follow up on that. In a market economy, if there lacks transparency in the transaction process, how does the consumer go about getting those fees lower outside of the judicial system?

MR. MURIS. Well, I think transparency is a smoke screen. I think everyone knows, if the issue is the interchange fee, they know what the interchange fee is and indeed, there are numerous interchange fees and they are negotiated. As I mentioned a little while ago, some very large merchants, I don't know the exact numbers; I would be willing bet that they pay lower interchange fees. I mentioned American Express is the only credit card that you can use in Costco and I would be surprised--American Express normally has the highest merchant discount. I don't know what the arrangement with Costco is. I would be very surprised if it is not a substantial discount. That is the way the market works.

MR. MIERZWINSKI. Mr. Bass, if I could just add, the consumer groups are here for different reasons than the merchants. We are here to see whether or not this system is fair, whether these prices are being set by, these fixed prices are being set by the market or by market failure, and we are hoping the committee will continue its examination and oversight of this industry.

MR. BASS. And what do you think as to your own--

MR. MIERZWINSKI. Well, I think what we think there are a lot of reasons that you should be looking under the banks' rocks, as I have said several times, because the banks don't want people to know how much money they are making on interchange and whether all consumers are paying too much. That is the real question, are all consumers paying too much because of unfair practices of banks? And I am talking about consumers who pay with plastic and consumers who pay with cash and it is a very significant amount of money that we are talking about and it is a very significant cost to the merchants. Transparency in the marketplace would help a great deal.

MR. BASS. Are the margins in credit card commerce very large or are they not?

MR. MIERZWINSKI. Well, bank regulators at the Federal Reserve are required to produce for Congress an annual report on the profitability of credit cards. In fact, credit cards are the most profitable form of banking bar none. This marketplace includes credit cards and debit cards to be fair.

MR. BASS. Is most of the profit, though, associated with the interest rates that are charged versus the transaction fees?

MR. MIERZWINSKI. The consumer groups, our review of studies is that interest made tremendous profits for banks for many, many years, but banks wanted those profits to be even higher and so fee income is their growing source of increased revenue. They have set the bars higher, they have imposed fees on consumers. The biggest fees, probably, in the consumer marketplace are bounce protection fees on service accounts, that is the new name for bounced check fees, bounce protection fees; ATM-related fees and of course, late fees and penalty fees associated with credit cards. But then there is the hidden tax, the hidden fee and that is the fee imposed on merchants, the interchange fee we are here to talk about today.

MR. MURIS. But if we put a little reality into this, if there is any market where consumers have enormous number of choices, it is for credit cards, payment cards. Every day in the mail, everyone in this room, I suspect, gets numerous solicitations with a wide variety of terms. It is an extraordinarily competitive market and the benefits are passed on to consumers by this myriad forms of payment cards they can receive.

MR. ARMOUR. Even my minor children get those solicitations.

MR. BASS. Mr. Chairman, this is an important subject, interesting. There is one other issue, however, that I hope this subcommittee can address and that is the issue of gift cards and their regulation and their relationship with the state regulation, and Mr. Barton and I have written the Federal Trade Commission asking them to give us a full accounting of how the gift card system works and whether or not there are issues that need to be addressed by Congress because if there was ever an instance where there is no accountability, it is in the gift card business and where the potential for mischief exists is in that market which is now a very large or significant part of the total gift market, if you will, in the country, especially around the Christmas season, so I am hopeful, Mr. Chairman, that we can address that issue at a future date.

MR. MIERZWINSKI. If I could add, the consumer groups, Mr. Stearns, Mr. Bass, the consumer groups strongly support that effort and as I point out in our testimony, you have strong rights with credit cards, somewhat fewer rights with debit cards and some other stored value cards; virtually no rights with gift cards and it is a very important endeavor you are engaged in.

MR. STEARNS. And we will just wait for the Federal Trade Commission, I guess their letter should be forthcoming. And I thank the gentleman. By unanimous consent, if no objection, then, Mr. Sullivan, who has been patiently waiting, is recognized for questions.

MR. SULLIVAN. Thank you, Mr. Chairman. I know we are in, are we voting now, I guess? Or are we in--oh, okay. Mr. Armour, we have talked about this a lot today, but I still don't quite understand it. Let us say that my convenience stores, headquarters in my district, Quik Trip, for example, and other convenience stores. Let us say I have a little convenience store and I want to take credit cards, of course, because so many people have them, and I call, I guess, a representative would come out to me and meet with me or they would mail an application in or something like that, right?

MR. ARMOUR. There is, really you would go to a merchant bank. You would go to one of your local banks and ask if they provided merchant credit card services.

MR. SULLIVAN. Would I sit down with the person to talk about that?

MR. ARMOUR. You could very well sit down with that person.

MR. SULLIVAN. So then I would fill out that application?

MR. ARMOUR. Bear in mind, that is not Visa/MasterCard, okay, because that is another entity that is behind the bank, so you are going to negotiate a processing agreement.

MR. SULLIVAN. Yes, whatever. I want to start accepting Visa and MasterCard to fill up, get gas and buy candy bars and so I want to get that done and I am filling out whatever I have to fill out to get that done, now you are telling me if I ask that person, I say hey, this interchange fee, what is it? What would they say to me?

MR. ARMOUR. Well, you are going to get a merchant agreement from that local bank that says okay, under the terms of our processing agreement, you have to abide by Visa/MasterCard interchange rules.

MR. SULLIVAN. And what are those?

MR. ARMOUR. They will say, in that agreement, a limited number of them, as I said earlier, you can't restrict the amount of money, either minimum or maximum on a charge, you can't credit surcharge and you have to abide by all of the other operating rules of Visa/MasterCard that you don't get a copy of.

MR. SULLIVAN. And if you ask for a copy of it, I am sure someone has, what do they tell you?

MR. ARMOUR. They say you can't have it. At Quik Trip, your constituent has asked for the Visa/MasterCard operating rules and have not been able to acquire copies of those rules.

MR. SULLIVAN. Can you tell me what the industry, as a whole, pays yearly in these interchange fees? Do you know?

MR. ARMOUR. About, I think, $27 billion.

MR. SULLIVAN. $27 billion. And how does that affect, you know, with gas prices and all that, how did that play--on a transaction, let us say, of a car, 20 gallons, what would that cost in interchange fees?

MR. ARMOUR. Roughly, 1.9%, but let us use 2% because it is easier to multiply.

MR. SULLIVAN. All right.

MR. ARMOUR. So at $3 a gallon, that is six cents a gallon.

MR. SULLIVAN. Almost $2, it is a $30 dollar transaction?

MR. ARMOUR. Right.

MR. SULLIVAN. Okay. And Ms. Kerrigan, have you surveyed your members about this at all, of your organization, and if you have, or talked to them or anything, can you tell me what results you have had or discussion?

MS. KERRIGAN. Well, we talked with many members of our organization about the issue, itself, and some of their comments and communications have been provided in the testimony. This has not been a hot button issue yet. I mean, the biggest issues really are healthcare costs, taxes, regulation, energy costs, things of that nature. Obviously, we are more broad based, so we don't have the type of membership as the retailers, of the concentration of those type franchise or retail operations, but by and large, you know, what we have heard and just the general thrust of our mission and our purpose is that there is concern that intervention will mean price controls.

They certainly have no faith in the trial attorneys straightening this out for us in the business community, and that there will be unintended consequences in terms of fewer consumers using cards, more costs on their end, and that it won't turn out well, let us just put it that way. So obviously, they don't like paying interchange fees; no one does, and they feel that way about many of their business costs. But they don't see government intervention as being something that is going to be, you know, drive those prices lower or help fix the system. They believe strongly in the power of the market and that innovation and the evolution in the market will eventually drive these prices lower and they will get better service out of all payment cards.

MR. SULLIVAN. Well, thank you, Mr. Chairman. I yield back.

MR. STEARNS. Okay. Thank you, Gentleman. I thank him for his patience for staying. We appreciate his contribution. I think we are ready to conclude. I think I am going to ask a few more questions and Ms. Schakowsky has indicated she has a few more, so we will do that. Mr. Mierzwinski, you mentioned in your opening statement that you thought one of the things that should be done is a GAO audit. Now, I don't quite understand; could you explore why you think that has to be done?

MR. MIERZWINSKI. Oh, I am sorry, a GAO study of the issues.

MR. STEARNS. Yes. And what would be the reason for that?

MR. MIERZWINSKI. Well, I think the reason I simply pointed out, we thought that it would be useful to have two studies, have the Fed do one, have the GAO do one, and then compare them.

MR. STEARNS. Oh, okay. So it is more or less just to get an objective view between the two?

MR. MIERZWINSKI. Sure, exactly.

MR. STEARNS. Okay, Mr. Muris. Mr. Armour has said that all the banks must charge merchants the same interchange fee. Is that true?

MR. MURIS. The interchange fees are fixed by the association.

MR. STEARNS. Right.

MR. MURIS. But many merchants negotiate different fees. I mentioned that in terms of some of the large merchants, Costco, etc.

MR. STEARNS. An example is Costco with American Express.

MR. MURIS. Right. But because of the way this system works, because of this historical accident that you couldn't have interstate branch banking, we have joint ventures and the joint ventures have thousands of issuers. So assume everybody in this room was an issuer and if you could, the reason they have to set a fee is obviously, a Visa card from any one issuer is a Visa card to consumers, so you want the merchants to be required to accept any card that says Visa on it. Well, once you set that rule, if you don't fix the fee, you put everybody in this room, as an issuer, in the position of saying pay me a lot, okay. And to avoid that hold-up problem and to avoid thousands of individual negotiations, Visa and MasterCard set a fee, but the fee might be different for different merchants.

The proprietary systems, American Express and Discover, you know, they went a different route. They don't have banks, although American

Express has started to have banks, so they just deal directly with the merchants and charge the merchant discount. But the function is the same between the merchant discounts that are charged in both associations. So the bottom line is that if these lawsuits actually succeed in preventing the fee to be fixed. MasterCard and Visa can't exist the way they exist now and the plaintiffs' lawyers and the merchants can't want that. What they want is somebody to fix the fee at a lower level.

MR. STEARNS. Mr. Armour, this goes back to what I asked you earlier and Mr. Muris' testimony, what you would really like to see done; would you like to see a lower fixed interchange fee or do you simply prefer to have the ability to negotiate the fees based upon your particular business?

MR. ARMOUR. I think we want a free market, so it is the latter, but let me also kind of refer to his last question. Interesting that American Express, not Visa/MasterCard, has negotiated fees with Costco. Visa/MasterCard, I am unaware of, has ever negotiated a lower interchange fee because that fee is between the association and the banks, themselves. It is not with the retailer.

MR. MURIS. That is simply wrong.

MR. ARMOUR. And as Mr. Muris said, if there is a free market, everybody is going to say pay me more, gee, it seems to me that most free markets, a lot of people say pay me less and become my customer, so--

MR. STEARNS. Well, Mr. Muris doesn't agree with you on that?

MR. MURIS. It is simply wrong that individual retailers haven't negotiated and I assume that to get the arrangement with Costco, again, I am not speaking for American Express. I don't know what their fee is. I would be very surprised that if American Express' average fee, which is higher, the average merchant discount which is higher because they have a different business model, a very successful business model. I would be surprised if they didn't make an exception in negotiating individual fees with Costco.

MR. STEARNS. Mr. Armour, just as a former businessman, I would think that if American Express is the sole card that Costco uses, I think that American Express cut some deal.

MR. ARMOUR. Well, I think that is absolutely what has taken place, but they are not Visa/MasterCard. They are not part of the interchange fee system. They are a small competitor on the side that is saying pay me less, pay me less to Costco and Costco has said oh, okay.

MR. MURIS. Such arrangements exist with Visa and MasterCard and other large retailers. Again, I don't know the fees, but very large retailers don't pay the same because they are in a different position.

MR. STEARNS. Okay, I am going to conclude with this last question, Mr. Armour, for you. Isn't it true, though, that all your members, convenience stores, all these gas stations, don't they sign a contract? Don't they put their name on this contract, and by signing aren't they agreeing to this and so, and you are saying that they have nowhere to go and they don't know what the contract they are signing?

MR. ARMOUR. No. You are absolutely right. My testimony, I said they virtually have no choice because plastic transaction is the dominant form of currency in our economy today. I mean, it is the same thing when you sign up for electricity to your house. You don't need to do that.

MR. STEARNS. But they could go to Diner's, they could go to Discover, they could go to Visa, they could go to MasterCard, they could go to American Express.

MR. ARMOUR. But when 70 percent of the transactions are Visa/MasterCard transactions and you don't take that card, you are giving away, you are not appealing to 70 percent of the consumers in the United States.

MR. STEARNS. Do you have any trouble finding this agreement, this complete agreement? I mean, is it on the Internet?

MR. ARMOUR. To the best of my knowledge, MasterCard has a 300-page summary of their operating rules.

MR. STEARNS. So the full operating rules on the interchange fees is available on the Internet or not?

MR. ARMOUR. No, it is not.

MR. STEARNS. Have you ever seen it?

MR. ARMOUR. No, and none of my members have ever seen it.

MR. STEARNS. In your litigation have you asked for it?

MR. ARMOUR. We have asked for it.

MR. STEARNS. And what do they say to you?

MR. ARMOUR. I think there are discussions now to provide it under protective orders.

MR. STEARNS. Okay, Mr. Muris, if this committee wanted it, is there any problem us getting it? Is it proprietary information?

MR. MURIS. I assume it is proprietary information. I obviously can't speak for the association on that issue.

MR. STEARNS. Okay. Ms. Schakowsky.

MS. SCHAKOWSKY. First of all, Mr. Chairman, may I ask for unanimous consent to submit a statement from the rental car companies and for all members to have reasonable time to submit questions for the record?

MR. STEARNS. Unanimous consent. So ordered.

STATEMENT OF

**CENDANT CAR RENTAL GROUP, INC.
DOLLAR THRIFTY AUTOMOTIVE GROUP, INC.
ENTERPRISE RENT A CAR COMPANY**

TO THE

**SUBCOMMITTEE ON COMMERCE, TRADE AND CONSUMER PROTECTION
COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES**

HEARING ON

"THE LAW AND ECONOMICS OF INTERCHANGE FEES"

February 15, 2006

Mr. Chairman and members of the Subcommittee, Cendant Car Rental Group, Inc. (parent company of Avis, Inc. and Budget Rent-A-Car Corporation), Dollar Thrifty Automotive Group, Inc., and Enterprise Rent A Car Company respectfully submit this joint statement on the occasion of the Consumer Protection Subcommittee's hearing on "The Law and Economics of Interchange Fees." We ask that this statement be included in the official record of the hearing.

The issue of credit card interchange fees is of significant interest to the nation's car rental industry and we congratulate the Subcommittee for taking the lead in examining these issues. Shining the spotlight of congressional scrutiny on credit card interchange fees is long overdue. The car rental industry anticipates that the members of the Subcommittee will be sufficiently uncomfortable with the information received during today's hearing that this will be the first of many hearings on this issue. The nation's car rental industry and the hundreds of thousands of business and leisure travelers welcome this scrutiny and pledges to work with the Subcommittee and your colleagues in the House and Senate on this important issue.

Credit card interchange fees, which are set by private credit card associations that recently have been found by federal courts to have sufficient market power to increase these fees unilaterally and arbitrarily, are burdening American consumers and businesses with billions of dollars in hidden fees every year. At a minimum, Congress must shed light on these association's practices. Perhaps, Congress may conclude that increased federal regulation of these associations' practices is necessary.

The car rental industry had revenue of $17.6 billion in 2004, the latest year for which data is available. If credit card interchange fees averaged 2 percent of the value of each transaction, that means that our industry paid over $350 million in credit card interchange fees that year. As with all businesses, to the extent we are able, we attempt to pass along our costs to our consumers through the price of our products and services. As a result, car rental prices in the United States must be at a level that our industry can recoup these interchange fees and other expenses if we are to be profitable. Thus, ultimately, it is our customers that bear the burden of these high credit card interchange rates.

Our industry has no choice but to accept credit cards as part of our thousands of rental transactions with our customers every day. Virtually all of the thousands of cars rented by consumers across the nation every day are paid for by credit cards. Simply stated, the car rental industry could not do business if our companies did not take credit cards to secure payment of the rental charges, to provide an additional measure of identification and creditworthiness for our customers, and to assure the return of the vehicle after the rental period is over.

And yet, despite the billions of dollars in transactions that our industry conducts with the credit card associations every year, there are virtually no negotiations between the card companies and our industry's individual companies regarding interchange rates. Instead, the associations secretly decide on these fees, force their member banks to abide by these fees, and prohibit any member bank from offering a car rental company, or any other business, a volume discount or any other type of negotiated reduction in these fees for being a large customer. The card associations keep their operating rules (which all banks must sign in order to offer a Visa or MasterCard) secret, and while our companies are permitted to view an "executive summary" of the rules, to our knowledge no company outside of the card associations has ever viewed the full text of the operating rules. One has to wonder what the card associations are hiding when they go to such extraordinary lengths to keep these operating rules secret.

American consumers and businesses paid over $37 billion in interchange fees in 2005 -- more than 60 percent of the interchange fees paid across the world. On average, American interchange rates are approximately two percent of the value of each transaction. By way of comparison, interchange rates in other industrialized countries such as Great Britain and Australia are well under one percent of the value of the transaction. Even interchange rates in countries such as Brazil and Indonesia are far below those charged to consumers and businesses in the United States. Clearly, the credit card companies are reaping enormous profits from their business in the United States.

And it is American consumers and businesses that are paying for these profits in the form of higher consumer prices for many products, including car rentals.

The car rental industry acknowledges that the credit card companies perform an important function in facilitating credit card transactions and should be compensated for their services. If credit card interchange fees were based on the actual costs incurred by credit card companies in processing these card transactions, plus a reasonable profit margin and a modest cushion for potential credit card fraud, then the car rental industry would not be filing this statement with the Subcommittee. But it is not at all clear that these fees are based on legitimate levels of compensation for services provided. Are the associations' costs in the United States twice or three times their costs in other industrialized countries? Or are these associations taking advantage of their acknowledged market power and past lack of congressional scrutiny and regulatory scrutiny to arbitrarily fix these fees at a level far beyond a reasonable profit margin? These are the questions which we hope this Subcommittee and your colleagues in the House and Senate will focus on during this hearing and future scrutiny of this important issue.

Thank you for the opportunity to submit this statement. The car rental industry looks forward to working with the members of the Subcommittee in the future in its efforts to shed light on credit card interchange fees and the practices of the credit card associations.

MS. SCHAKOWSKY. Thank you. Mr. Muris, just a couple of more comments I want to make. This notion that Mr. Armour and his organization were, somehow the plaintiffs' lawyers convinced these people. I realize you are perfectly capable of defending yourself, but this offended me, that the plaintiffs' lawyers convinced these retailers to file 47 lawsuits and then later on in your testimony that these retailers simply somehow don't understand the benefits of these interchange fees and then the notion that retailers want these fees to be lower, bottom line. One could also argue that your client, who you are here to represent, want these fees to be higher or want these fees to be whatever they want them to be. So the characterization here, I think, is inappropriate, really. I mean, I understand, again, that you are representing your client. That is fine. But to say that it is because somehow these, Mr. Armour's members, are too stupid and they are convinced by plaintiffs' lawyers, I think is misrepresenting what is going on here. This is an honest difference and we are going to discuss exactly that. That was a comment.

I wanted to again ask about this issue of disclosure. I mean, is it a factual dispute here and in which case, I think it would be, we need to get to the bottom of this. Either these operating rules are transparent or they are not. You know, clearly we need to get to the bottom of it. I am not sure how, but one way would certainly be to have the General Accounting Office take a look at this. Would anyone at this table object to the notion of the GAO doing a study of this?

MS. KERRIGAN. Specifically what?

MS. SCHAKOWSKY. Of interchange fees.

MS. KERRIGAN. Oh, interchange. I am sorry. I thought you wanted something more specific than that.

MS. SCHAKOWSKY. Of interchange fees.

MR. MIERZWINSKI. Oh, absolutely; interchange fees including looking at all of the information they would need to do the study. Absolutely.

MS. SCHAKOWSKY. All right. Is there anybody who would object to that?

MR. MURIS. There is enormous literature on interchange fees. It is obviously up to Congress. If I could just state, I believe you have mischaracterized some of what I said and every word I have uttered is my own. I am here on condition that I speak what I believe and that is the condition that I use with everyone that I represent. I spent my entire life in public policy and I believe I might have my obviously difference of opinion in terms of what is best for consumers, but every word I have uttered is what I believe is best for consumers and not because of what some particular client told me to say.

MS. SCHAKOWSKY. There is one other thing I wanted to get to. My understanding is that interchange fees are a percentage of the total cost of purchase and that includes any applicable taxes to the purchases. Is that right, Mr. Armour?

MR. ARMOUR. Yes, that is correct.

MS. SCHAKOWSKY. So is there any--these taxes don't pose a risk to the credit card companies in any way, do they, Mr. Muris?

MR. MURIS. The fees, the $27 billion, I think the actual total merchant discounts in the United States are something like $30 billion and in an economy that is, I believe, over $12 trillion, and those interchange fees are, after a reasonable and normal profit, are given back to consumers in enormous benefits and what I was saying the $27 billion, the $30 billion is not interchange fees, it is what merchants pay for all cards. I believe it is an extremely good bargain.

MS. SCHAKOWSKY. I don't know. I think I may be missing something here. So is it not true, then, that Visa and MasterCard are making a profit off the taxes that the corner store collects for the government?

MR. MURIS. Sometimes yes, sometimes no. As a point I have tried to make, there are probably hundreds, at least dozens of different--probably hundreds of interchange fee arrangements negotiated, depending on the industry, depending on the firm. Sometimes yes, sometimes no, I think, is the answer to your question.

MS. SCHAKOWSKY. Okay. Mr. Armour, when you talk about disclosure, do you know why you fit into a certain category and why you would get those particular fees?

MR. ARMOUR. No, and as you are probably aware, the convenience store industry has always been an evolving industry. A couple decades ago, it was gasoline stations and then a corner store and they evolved together to become a convenience store. Now there is a great deal of food service going on. And the food service industry has a different interchange fee. Why is that? We don't understand why they have a different interchange fee. Grocery stores have a different interchange fee, even though many grocery stores now are starting to sell gasoline. So it is baffling from this lack of transparency, how are these card associations that are owned all by the same banks are together setting fees and they insist that they be charged the same, every bank has to charge the same fee in this little matrix, but we have no idea how they arrived at--

MS. SCHAKOWSKY. Well, we need to understand that, I think, or at least--Mr. Mierzwinski, from the consumer point of view, can you think of any other example where a business, in this case I am talking about the credit card companies, make a profit off of state, local and perhaps, Federal taxes?

MR. MIERZWINSKI. You know, we are a consumer group and a citizen group, and you represent citizens and consumers, so I think I agree with you that this is a big problem that the banks are going to have to answer to. I see no reason, with the sophisticated computers that the banks have, the ability that they have to characterize consumers in hundreds of different profiles and to charge differential prices to all these different categories of consumers and different categories of merchants, that they should not be gouging tax payers and making a profit off of this, so I don't know of anyone else doing it and I am not sure the banks should be allowed to do it.

MS. SCHAKOWSKY. Talking about the taxes?

MR. MIERZWINSKI. The tax, charging a fee on taxes.

MS. SCHAKOWSKY. Yes.

MR. MIERZWINSKI. I don't know if anyone else is doing it. I don't know why they have to do it and I don't know if anyone else is doing it.

MS. SCHAKOWSKY. Well, this has been a really wonderful hearing, I think, and I think the various points of view have been well expressed, but there is a lot of information that we simply don't have and I am glad to see that no one would object to a wider investigation, perhaps, by the GAO and I appreciate all the testimony.

MR. STEARNS. Thank you, Gentle lady. The gentleman from Texas has just arrived.

MR. GREEN. I apologize, with everything else going on, but I would like to place a statement in the record and the questions I have, have already been asked.

MR. STEARNS. So ordered. You are welcome to ask questions, if you want. The House is in recess right now, subject to the call of the chair, so--

[The prepared statement of Hon. Gene Green follows:]

PREPARED STATEMENT OF HON. GENE GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Good morning. I'd like to thank Chairman Stearns and Ranking Member Schakowsky for holding this hearing today.

This issue first came up when the Full Committee was holding hearings on the increase in gas prices surrounding Hurricanes Katrina and Rita.

We've all seen the Washington Post article that revealed an increase of just over three million dollars a day in payment card fees as a direct result of the price of gas moving from $1.87 to $2.75.

One of the issues I'd like to see the committee discuss is that of the large variance in interchange fees.

These fees vary depending on the type of credit card the consumer uses, the type of business where the transaction is taking place, and sometimes, the rate larger retailers and merchants have been able to negotiate with the card companies.

I understand the frustration of the millions of Americans that own an independent convenience store. They do not have the bargaining power Wal Mart does.

However, the open network association that sets these fees are also trying to maintain a network that almost all Americans use to conveniently pay bills, make purchases and keep track of their spending.

While there are clearly two industries impacted by this issue, I believe it is the responsibility of this committee to look out for the consumer.

The long-term impact of the Australian model which set caps on these fees is uncertain. However, we do know that consumers do not have as many options for cards with rewards, and many are now paying annual fees to keep their credit cards.

There are no easy answers to this issue. However, it is clear that interchange fees have an impact on our economy that is invisible to the consumer.

The average consumer in this country does not know that Wal Mart is paying lower interchange fees on a sale than say Amazon.com or their local convenience store.

At this time, we know interchange fees are based on a variety of variables and that sometimes, it is difficult for small business owners to navigate the lengthy contracts that enable them to accept cards such as Visa and Master Card.

We also know that electronic payments are gaining in popularity. In 2003 the electronic debit card was used more frequently than writing a check and trend continues today.

I look forward to learning more about this issue and hearing from our panel this morning. And again, I urge my colleagues that as we learn more about this issue, we keep the American consumer in mind.

Thank you.

I yield the balance of my time.

MR. GREEN. I understand. But again, I know this is our second panel and they have been done, so, but again, the questions I had have been asked and answered.

MR. STEARNS. Okay. Well, thank you. Well, we will conclude this hearing and I would just say it has been a healthy discussion. We appreciate your patience here and I would say to my good friend, Mr. Muris, who I believe has impeccable credentials and character, has served in six policy positions and we appreciate his patience here, so with that note, we will adjourn the committee.

[Whereupon, at 12:13 p.m., the subcommittee was adjourned.]

RESPONSE FOR THE RECORD BY HON. TIMOTHY J. MURIS, OF COUNSEL, O'MELVENY & MYERS LLP, ON BEHALF OF THE ELECTRONICS PAYMENTS COALITION

March 20, 2006

The Honorable Janice D. Schakowsky
Ranking Member
Subcommittee on Commerce, Trade and
Consumer Protection
House Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

Dear Representative Schakowsky:

Thank you very much for giving me the opportunity to answer your questions about the electronic payments industry. Although I feel strongly that Congress should not intervene in this robustly competitive industry, I believe that further discussion of the issues is productive.

Before turning to your specific questions, let me address an issue that is important to understanding why the attacks on interchange are flawed. Merchants that accept cards issued on multi-party payment systems like Visa, MasterCard, American Express, and ATM/PIN-debit systems such as Star, NYCE, and Interlink do not pay interchange rates. They pay Merchant Discount rates. On the Visa, MasterCard and ATM/PIN-debit systems, the bank that contracts the merchant to accept the cards issued on those systems, and only that bank, sets the merchant discount rate. American Express, which as the only acquirer on its system does not have interchange, sets the discount rate that merchants pay to accept its cards.

Interchange is the term used to describe the rate of exchange that will apply to transactions taking place on multi-party payment systems. The various networks set interchange rates in different ways. Visa's Board of Directors, consisting of representatives from Issuing and Acquiring organizations, currently sets the interchange rates on its system. MasterCard's management sets interchange rates on its system in the United States.

1. Testimony at this hearing indicated that interchange fees are charged after federal, state and local taxes. Is there any other example you can think of—outside of tax preparers, accounting firms, and attorneys who assist people with their taxes—where a business makes a profit on top of Federal, State and local taxes?

When a merchant properly authorizes a transaction on an electronic payment system such as Visa, MasterCard, and American Express, it shifts the risk of non-payment on that transaction—including whatever tax it might owe to the relevant local, state or federal authority—to the payment network. The price that a merchant pays to accept electronic payment quite appropriately reflects this risk.

This practice of paying to shift the risk of non-payment for taxes owed on a particular transaction is quite common. For example, many states apply sales tax and other fees to the sale of automobiles. When consumers finance the purchase of an automobile, they typically finance the taxes and fees as well as the cost of the car. The lender then assumes the risk of non-payment, and it typically charges the consumer interest on the total amount, including the taxes and fees. Likewise, retailers that offer credit terms to their customers typically include sales tax in the amount financed. The retailer assumes the risk of non-payment, and like the auto lender, it typically charges the consumer interest on the total amount financed, including the sales tax.

2. I understand that the U.S. Internal Revenue Service (IRS) can charge a convenience fee to cover the interchange that would be charged when a taxpayer pays his or her taxes with a credit card, while private retailers and merchants are not afforded this opportunity. Is this true? If so, why was the IRS given a break on interchange fees and small business, which contribute mightily to the national economy are not?

Visa, MasterCard, American Express and the other members of the Electronic Payments Coalition (EPC) believe that merchants should not be permitted to surprise consumers with undisclosed fees when they seek to use an electronic form of payment to make a purchase. Rather, merchants believing that cash and other forms of paper-based payment are truly cheaper to accept than electronic payments should induce consumers to use those forms of payment through discounts and other benefits.

All the members of the EPC recognize the value associated with the introduction of new channels of commerce. All merchants, including the IRS, that open new channels of payment for consumers are free to charge consumers for the privilege of paying through that channel. Such convenience fees are not unique to the IRS. Ticketmaster, many movie theaters and a host of other merchants, large and small, charge such fees. As I understand it, each of the major electronic networks has different rules and policies regarding such fees. To the extent that you have questions about specific practices, I encourage you to raise the issue directly with the payment networks.

3. It is my understanding that credit cards with "rewards" programs, like frequent flyer miles, have a higher interchange fee associated with them than a card with no rewards programs. Is this true? If so, why?

On this issue, the distinction that I drew above between interchange rates and Merchant Discount is quite important. Merchant Discount rates for the vast majority of merchants do not vary depending on the particular type of card presented for payment on a given payment system. A typical small business accepting Visa cards for payment generally pays a single Merchant Discount rate for all Visa transactions regardless of the type of card used. This is generally true for MasterCard and American Express as well.

By contrast, the interchange rates on payment systems do often vary from transaction to transaction reflecting a number of factors. For example, the interchange rate on a particular transaction might reflect the type of card used, the type of merchant at which that card was used, the method in which the transaction was authorized (*e.g.*, key-entered or full capture of the magnetic stripe on the back of the card), and the time between authorization and settlement. There are sound reasons why these factors trigger different rates. Higher interchange rates often reflect increased risk of loss on particular types of transactions. Lower interchange rates often apply to new categories of merchants to encourage expansion of the network.

Competition between payment systems plays a key, though often misunderstood role, in driving interchange rates. To remain competitive with other forms of payment and, more particularly, other forms of electronic payment, a given system must present a competitive value proposition to issuers. At the moment, rewards programs appear to drive consumer preference between different forms of payment. If one network offers higher rates of compensation to issuers to encourage them to offer rewards to consumers, then another network will likely increase rates for rewards program to maintain its position in the competition for card issuance.

4. On February 21, 2006, MasterCard International, a member of the Electronic Payments Coalition submitted a copy of MasterCard's Merchant Rules, a copy of which is also available on the Internet. Has Visa made such a document available? If not, why not? Can you supply for the Subcommittee a representative sample of all the various interchange fees charged by both MasterCard and Visa? Understanding that such fees may vary over time, please use figures for the year 2005.

The rules and rate structures of the various electronic payment networks are, obviously, important to competition between the networks. The various networks have very different policies related to the disclosure of this information, and I encourage you to raise this particular question with each network. For general information about prevailing rates across all three major electronic networks, you should consult the paper, Interchange Fees in Various Countries: Developments and Determinants, presented by Stuart Weiner at last year's conference at the New York Federal Reserve. (Available at http://www.ny.frb.org/research/conference/2005/antitrust/WeinerWright.pdf.)

With regard to Visa, it has made an acceptance guide for merchants available on its website. Visa has also disclosed considerable information to various third-parties about its rates and rate structures. For more information about particular Visa rates and its overall rate structure, see the report published by UBS about Visa last year. Although I believe from the members of the EPC that your office received a copy of this report prior to hearing, I have attached a copy to this response for your convenience.

5. Interchange Rates and Rates of Fraud.

[Complete text of the question submitted for the record follows: 5. One of the justifications given for an interchange fee is to cover the risk and losses due to fraud that banks assume with each transaction. For the most recent year in which figures are available, please detail the losses incurred by Visa and MasterCard due to fraud (and other members of the Electronic Payments Coalition) in terms of dollar amounts, and in percent of total annual profits. Please indicate how these figures relate to past years. For instance, are they higher or lower? Has the amount of fraud increased or decreased since 1990? Have interchange rates risen or fallen since 1990? Please include an explanation for the answer given. In addition, please include total profit from interchange fees for the most recent year in which figures are available.]

Rates and rules related to the exchange of transactions have been an important element of competition between electronic payment networks since such networks were first conceived more than three decades ago. As discussed above, interchange rates reflect a range of factors. Only some of these involve cost. Risk is one of the factors that contribute to differences in rates that apply to specific transactions. Even more critical, however, is the consideration of the value products bring relative to other brands and forms of payment, including back office efficiencies through data capture, faster payment at the point-of-sale and settlement, and a payment guarantee.

As a historical matter, electronic payment networks have used interchange rates to encourage innovations on both sides of this very competitive business. In the late 1970s, for example, Visa devised an interchange rate specific to electronic transactions. Using these and other tactics, Visa managed to reduce fraud on its system by 7% on an annual basis between 1990 and 2004 while dollar volume on the Visa system grew by 16% per year over this same period. (*See* Bill Sheedy, *Interchange Reimbursement Fees: Delivering Value and Driving Innovation* May 2005 (available at http://www.kansascityfed.org/FRFS/PSR/PDF/SheedyPanelRemarks.pdf).) Likewise, the American Express and MasterCard payment systems are seeing volume hit all time highs, while fraud rates are at historic lows.

Thank you again for allowing me to answer your questions on this important topic. If I can further help you or the other members of your committee analyze these important issues, please let me know.

Sincerely,

Timothy J. Muris

cc: The Honorable Cliff Stearns
The Honorable Nathan Deal
The Honorable George P. Radanovich
The Honorable Charles Bass
The Honorable Lee Terry
The Honorable Michael A. Ferguson
The Honorable Michael D. Rogers
The Honorable Marsha Blackburn
The Honorable John Sullivan
The Honorable Edolphus Towns
The Honorable Gene Green

RESPONSE FOR THE RECORD BY KAREN KERRIGAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SMALL BUSINESS AND ENTREPRENEURSHIP COUNCIL

March 17, 2006

The Honorable Cliff Stearns
Chairman
Subcommittee on Commerce, Trade and Consumer Protection
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Stearns,

As requested, please find attached my answers to questions submitted by Congresswoman Jan Schakowsky as a follow up to the hearing entitled "The Law and Economics of Interchange Fees" held on February 15, 2006.

Please feel free to contact me additional questions you may need. Thank you for the opportunity to participate in this important hearing.

Sincerely,

Karen Kerrigan
President & CEO

Answers to Follow Up Questions on
"The Law and Economics of Interchange Fees"
held on February 15, 2006

Submitted by:
The Honorable Jan Schakowsky

To:
Karen Kerrigan
President & CEO
Small Business & Entrepreneurship Council (SBE Council)

1. Your testimony did not endorse any government involvement in interchange fees and seemed to cast doubt about the ability of the court system to help resolve many of the disputes that have arisen around interchange fees. Do you believe that rising interchange fees are an issue for small businesses at all? If so, what is your proposed solution to this problem?

Indeed, I did not endorse -- and continue to be unenthusiastic -- of government or court-ordered intervention in setting or regulating interchange fees. Government intervention, for example, in Australia is leading to unintended consequences for merchants and credit card consumers. Credit card holders are facing higher costs and getting fewer benefits. There has been a shift to credit cards that cost merchants more not less, and such dislocation is begetting additional regulatory initiatives as the outcome is not what the authorities had planned or desired.

The SBE Council is also concerned about the impact that regulatory intervention or court-prescribed solutions may have on the millions of small business owners who use credit cards as finance tools for their business. Paying higher finance charges or cutting back on benefits will hurt small business owners as consumers of credit cards, while a drop in the use of cards (or other forms of electronic payments) by customers cuts on the revenue end. What impact electronic payments regulation will have on the availability of credit for small firms is also an unknown. I believe these are issue that we need to explore.

With respect to interchange fee impact on small businesses and whether I believe it is an issue for them, of course rising costs and operational costs in general squeeze the bottom line, particularly for businesses with thin profit margins. From the small businesses owners we have heard from on this issue, those who found credit or debit cards uneconomical or unnecessary, of course, do not use them. For those who have embraced electronic payments in their businesses, such a decision has largely been driven by necessity. That is, there is growing consumer demand to take such payments, and/or the business model is better served by electronic payments (online storefronts, for example). However, the general consensus is that electronic payments, particularly credit cards, help drive and increase sales. The cost-savings, efficiencies and guaranteed payment that come with electronic payments is also highly valued. But as I made clear in my testimony, no small business owners enjoy paying external costs – particularly if they are rising.

We hope that legislators continue to study the issues (as noted above) and let the market work. I am hopeful that solutions will be driven by demand (for lower interchange fees), and that the evolution of the electronic payments system, technology, innovation and entrepreneurs respond accordingly. It would be an error to construct artificial barriers such as regulations or price controls, which may hamper innovations (or solutions) in the market.

I think the National Association of Convenience Stores (NACS) Card Processing Program is the early development of a paradigm shift in interchange fees – that is, they have developed a program with First Data "designed to reduce card processing fees for convenience and petroleum marketers." NACS members and non-members can participate in the program (thus the power of aggregation is tapped), with members receiving deeper discounts. The average store, according to the NACS website, "can save an estimated $4,257 per year" in the program. According to the NACS website, the program started in late 2003. I would be interested in learning more about the successes, shortfalls, restrictions and challenges of such a program as it would appear that it would have mass appeal to small business owners who want to lower their interchange fees.

I think we have to allow the market and innovation to work as tinkering with a highly complex and well-constructed payments system could very well do more harm than good.

2. Have you conducted a survey of your members on the issue of interchange fees? If so, can you share the results with this Subcommittee?

The SBE Council has not conducted a formal survey of our members on the issue of interchange fees. But as with the broad range of issues we address as an advocacy organization, we certainly seek their advice and input. As an organization devoted to the market innovation in resolving problems, we do not believe that government intervention should be the first course of action, if at all. Small business owners and entrepreneurs join our organization because of our limited government approach.

If the Subcommittee reviews the policy positions or solutions that we support or advocate on a range of issues, it will find we are consistent in this regard. That is certainly the case with interchange fees, as credit and debit cards are working very, very well for many small businesses and it would not be beneficial to those who are experiencing greater sales and better efficiencies to upset the applecart because of the unforeseen or unintended consequences of legal or regulatory intervention.

It would be beneficial from our perspective to review the results of the surveys of the other organizations that are suing the credit card companies or those that support some type of government intervention. That way, we may be able to learn how the conclusion was reached to move solutions out of the private sector and into the courts, and whether these business members support the fee-setting policy advocated by certain organizations. As I mentioned in my testimony before the Subcommittee, interchange fees has not emerged an issue that we hear about from our members. The SBE Council also hears from hundreds of non-member small business owners and entrepreneurs each month about their concerns. Again, interchange fees is not an issue we hear about. This simply may be the nature of our broad-based membership. In our regular interaction and collaboration with other broad-based small business groups in working on issues, I don't hear this issue mentioned either.

The SBE Council has heard the views of a diverse range of small business owners on the interchange issue. As is the case with other issues, we regularly receive letters and email communications on a variety of issues. I hope the Subcommittee finds these comments useful on the interchange fee issue:

- "Restaurants have the highest rate of failure among small businesses. I am proud that I have built a successful bistro, and developed a loyal clientele. One of the many reasons that I am successful is that I accept credit cards. The flexibility that credits cards provide consumers, along with the assured payments that the business receives, makes doing business easy, fast, and profitable. I pay the interchange fees because this investment in my business brings me larger returns that if I did a cash-only business. By accepting credit cards, I lower my risk of theft by not having large amounts of cash on hand." (Montgomery, AL)

- "We are a full service restaurant and bar that accepts credit cared because our customers expect it. Frankly, I don't have a problem with the cost of credit card interchange fees and I don't believe price fixing has occurred. I look at it this way: Visa and MasterCard are businesses that offer merchants like me the ability to accept electronic payments for a reasonable fee. I am not required to use their services. I choose to use them because it has proven to boost my business." (Mishawaka, IN)

- "I own a travel agency that relies heavily on credit cards to facilitate client travel plans. There is no better way to do what we do. Without credit cards, our cost of doing business would be much greater than it is today. I oppose such abuse of our legal system and I oppose any change in the system that works so well." (Anaheim, CA)

- "I own and operate a small retail store in Dublin, Ohio. I know from experience that customers who pay with a credit care are more likely to make higher dollar purchases than those who pay with cash. Accepting Visa and MasterCard also makes my business run more efficiently because I have guaranteed payments, easy

tracking of receipts and customer check-out is fast and simply. All of which is worth the small interchange fee that I must pay."
(Dublin, Ohio)

● "…demanding our courts or the government impose price controls to reduce interchange fees or charging customers a check-out fee when they use their credit or debit card is ridiculous. Shifting the entire cost of interchange fees onto consumers…will result in consumers making a conscious effort to carry cash and selectively use their plastic. That also means a decrease in consumer spending at all businesses."
(Washington C.H., OH)

Again, we have not conducted a formal survey of the SBE Council membership. The views expressed above were taken from the fifty or more comments we have received on the issue to date.

3. Do you believe that the members of your organization should be allowed to negotiate the interchange fees they are charged as part of the Visa and/or MasterCard networks?

Larger retailers and other types of businesses have the transaction volume to negotiate fees, and unfortunately, most of the time; we simply do not have the volume to cut deep into these fee costs. Like other business costs – supplies, shipping, health insurance, etc. – sometimes small firms have the ability to negotiate and other times they do not. The issue of negotiating leverage obviously ties into how small firms can better aggregate, collectively use our numbers and transactions to build volume on the system in order to deal for lower interchange fees. Perhaps, as technology develops, or the electronic payments system evolves, or if someone "builds a better mousetrap" so to speak the playing field will be more leveled. Obviously, technology has done that for small businesses in so many other operational areas of their business. We hope the result will be the same for interchange fees as the electronic payments system develops and matures.

RESPONSE FOR THE RECORD BY HENRY O. ARMOUR, PRESIDENT AND CEO, NATIONAL ASSOCIATION OF CONVENIENCE STORES

NACS®

March 14, 2006

The Honorable Cliff Stearns
Chairman
Subcommittee on Commerce, Trade and Consumer Protection
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

The Honorable Jan Schakowsky
Ranking Member
Subcommittee on Commerce, Trade and Consumer Protection
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Stearns and Ranking Member Schakowsky:

I am writing this letter in response to the questions contained in your letter dated March 6, 2006. I request that you enter this letter into the hearing record. I should also note that all of the trade associations listed below supported my testimony at the hearing you held on February 15, 2006, titled "The Law and Economics of Interchange Fees" and concur in this response. Those groups include:

- National Association of College Stores
- National Association of Chain Drug Stores
- Petroleum Marketers Association of America
- Retail Industry Leaders Association
- Food Marketing Institute
- National Restaurant Association
- National Grocers Association
- National Retail Federation
- Society of Independent Gasoline Marketers of America
- National Association of Truck Stop Operators

In your letter you asked about the operating rules of the card associations and merchants' ability to obtain them. As stated during the hearing we have never been able to obtain a complete set of the operating rules of MasterCard or Visa. At several points during the hearing this and related points led to differences regarding basic factual questions. We have enclosed some documents with this letter that should address many of those questions. We have attached the following documents: 1) The Table of Contents and some sample pages from the summary of the MasterCard operating rules that is available on MasterCard's website; 2) A sample agreement between an acquiring bank and a merchant (with the names of the particular parties redacted); 3) A schedule of interchange fee rates; and 4) A passage from the operating rules preventing merchants from informing consumers about the fees they are paying.

Each of these documents is instructive. First, you will see from the sample of the rules posted on MasterCard's website that almost every page of the text has a header that begins "Excerpts from…" We could certainly provide you with a copy of the 300+ page document on the website and

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you would find the same thing – they make clear throughout that there are additional rules that are not part of that document. It is our understanding that the full, not the excerpted, rules run about 1,200 pages in length. We have never been able to obtain a copy of those full rules even though our members must agree to abide by them in order to accept MasterCard credit and debit cards. At one point during the hearing, Mr. Muris said that merchants did get a copy of the rules (though he later backed away from that statement). It was also reported that following the hearing MasterCard insisted that its complete rules were available on its website. Even a cursory review of the repeated header on each page insisting that the document only includes "Excerpts" should end this factual dispute and demonstrate that MasterCard is not making the complete rules available.

As a result of the hearing, for the first time, Visa posted some information regarding their operating rules on their web site. Again, we appreciate this information and your role in making it available to us, but it is by no means a complete copy of the operating rules that merchants must adhere to. Not only are hundreds of pages redacted from the Visa document, but there is a security coding on the document that prevents it from being printed from the web site.

There are many rules not available to merchants that are never addressed in the excerpted rules that appear on MasterCard's and Visa's websites. For example, the "error 96" situation that Mr. Armour described during the hearing is never addressed. This particular rules snafu is particularly glaring because it makes gasoline retailers liable for the entire purchase price of a consumer's purchase of motor fuel if it exceeds $50 – even though the retailer is not allowed by the rules to stop the transaction prior to reaching this arbitrary ceiling. This rule amounts to a license to pick the pockets of a retailer – and it is not disclosed anywhere until retailers unwittingly break the rule.

Second, the sample merchant agreement that is attached is a common form used by acquiring banks. In the "Merchant Handbook" section of the agreement you will note that it requires the merchant to abide by rules which are explicitly defined to include the operating rules – which are not made available and which can be changed "from time to time." The merchant agreement, which is the contract that a merchant must sign, is an entirely separate and much shorter document than the complete operating rules.

Third, we were able to convince someone to provide this schedule of interchange rates to us. We believe it to be a current schedule of rates. Contrary to the testimony provided by Mr. Muris, many merchants are not informed of the interchange rate they will pay. Merchants pay many different interchange rates at different times depending upon the particular type of card being used (in addition to the brand, i.e. Rewards Card, Corporate Card) and the particular way that the transaction is processed (those conducted during power outages such as with Hurricane Katrina are the most expensive). Most merchants are not provided this complex schedule of rates. In fact, merchants typically learn what they are charged only by conducting an analysis of what is missing from their bank accounts. Mr. Muris claimed that very large retailers negotiate a lower interchange rate from Visa and MasterCard. The fact is that merchants, with perhaps a very few exceptions, cannot negotiate interchange rates. It is also worth noting that Mr. Muris' contention that there must be a centrally set and agreed upon interchange fee would be seriously undercut if the impression he gave regarding negotiations (i.e., that a significant number of merchants can negotiate interchange rates) was accurate. In fact, that impression is not accurate. No significant number of merchants (if there are any at all) can negotiate their interchange rates on Visa and MasterCard transactions.

Fourth, Mr. Armour testified that NACS members have been told by their banks that they cannot show the interchange fees consumers are charged on their receipts or otherwise inform them of the fees they are being charged. Mr. Muris disputed this fact. In fact, merchants have been told they cannot inform customers of the interchange fees they are being charged. We were able to obtain the attached excerpt from the Visa operating rules. You will note that each page of the operating rules is marked "Confidential." While these rules are not at all clear, we were informed by our source that the banks read these rules as providing that only certain pieces of information may appear on a receipt. Because this rule does not allow for interchange fee information to appear on a receipt (though it specifically allows for ATM fee information to appear) the banks so instruct their merchants that they are not allowed to print interchange fee information.

In response to your question about solutions to this problem, we think the hearing that the Subcommittee held was an excellent step toward determining the proper solutions. Particularly, in light of the information about how uninformed the credit card companies keep all of us regarding interchange fees, we all need to learn a lot more about this market and its operation to design the right solution.

Thank you for your willingness to hold a hearing and look into this issue. We look forward to the opportunity to work with you in the future to find public policy solutions to the problems that abound in this market. We certainly believe that the review that you and this Committee have begun will continue to have a positive impact on the lack of transparency of these fees and their impact on consumers. While there was not enough time to have a host of witnesses representing the retail perspective, there were several associations who wished to provide testimony to be included for the record. We are attaching that testimony to this letter.

Sincerely,

Hank Armour

Henry O. Armour
President and CEO
National Association of Convenience Stores

Attachments.

RESPONSE FOR THE RECORD BY EDWARD MIERZWINSKI, CONSUMER PROGRAM DIRECTOR, U.S. PUBLIC INTEREST RESEARCH GROUP

Rep. Schakowsky: Thank you again for the opportunity to testify on this important issue. Please have your staff contact me if you have further questions.

Question No. 1

We've heard a lot about the benefits of low interest rates, reward programs, and convenience that credit and debit cards offer consumers. Although our hearing focused on interchange fees, interest rates and interchange fees seem to work in tandem to influence the ultimate price paid by consumers. Can you submit some information on credit card interest rates and how they affect consumers? With regard to rewards programs, how beneficial to consumers have these programs been? Do you have any estimate of how interchange fees affect consumers and how much these fees contribute to prices for consumer goods in the United States? Do you have solutions to the issue of high interchange fees that you and your organization would like to submit to the Subcommittee?

Response

Consumers ultimately pay the costs of credit card services regardless of the form these costs take (fees or interest paid by consumers or fees paid by merchants). There is significant evidence that high credit card interest rates impose a significant cost on consumers. Those consumers who revolve end up paying a very high interest rate for the credit card transactions-- significantly above the interest rate that can be secured in other types of transactions. Excessive interest rates and fees make credit cards the most profitable form of banking. When interest rates generally (mortgages, car loans, etc) fell to their lowest levels in 50 years in the early part of the decade, credit card rates remained high due to the market power of the associations and their largest members, and many lower and moderate income customers were forced to, and still do, pay penalty rates well over 25% APR. As we noted in testimony[1] to the Senate Banking Committee in 2005, we support a variety of credit card industry reforms, including a cap on credit card interest rates. Some of the other credit card reforms we believe would be helpful include the following:

• A cap on all other charges, whether considered a finance charge or not, to an amount the card issuer can show is reasonably related to cost.
• No unilateral change-in-terms allowed.
• No retroactive interest rate increases allowed (when rates are increased, it should only be for prospective purchases, not previous balances)..
• Ban on late fee penalties when payments postmarked before due date and require a minimum 30 days to pay bill
• No penalties allowed for behavior not directly linked to the specific card account at issue.
• No over limit fees allowed if issuer permits credit limit to be exceeded.
• No improvident extensions of credit –require real underwriting of the consumer's ability to pay.
• Meaningful penalties on issuers for violating any substantive rule or disclosure that provide real incentives to obey the rules.
• A private right of action to enforce section 5 of the Federal Trade Commission Act, which prohibits unfair or deceptive practices by businesses, including banks.

However, in the matter of credit card interest rates and annual fees, the costs of the credit card -- even if unfair, deceptive, changeable at will or even draconian -- are at least confined to the user of the credit card. And although the level of disclosure of interest rates and annual fees is far from adequate, there is at least some government-compelled disclosure of these fees. Based on these disclosures, we suppose you could argue that consumers could at least attempt to make choices between different credit card programs, which can have some impact on the price consumers pay. (Unfortunately, many consumers have been tricked by deceptive practices into having bad credit or too much credit, limiting their further choices, but the market probably works for some consumers.)

Interchange fees are different than interest rates or annual fees in two respects. First, the fees are not at all transparent. Consumers often do not know that merchants and ultimately consumers pay a fee for credit card transactions. The rules of the credit card associations prevent the merchants from disclosing the amount of the fee or effectively attempting to steer consumers to lower-priced payment mechanisms. This lack of transparency along with what amounts to monopolistic practices of price fixing/setting by Visa and MasterCard has essentially removed competitive forces. Put simply, the card associations can easily increase interchange fees without suffering any loss of volume.

The other fundamental difference is that interchange fees affect all consumers, not just those using credit cards. The card association rules require that the predominant price advertised by merchants be the "credit card" price. As a practical matter this means that virtually all posted prices include an extra markup to accommodate Visa and

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[1] See PIRG's testimony before the Senate Banking Committee on 17 May 2005, available at http://www.senate.gov/~banking/_files/mierzwin.pdf. Also see testimony of Travis Plunkett, Consumer Federation of America, for a more detailed analysis of historic credit card interest rate trends http://www.senate.gov/~banking/_files/ACF1448.pdf.

MasterCard. Merchants try to average it, but it means that interchange fees raise the costs of all goods, regardless of whether the consumer pays with credit card, check, cash or debit. We believe that the average U.S. family pays over $250 a year in credit card interchange fees, and statistics show interchange expenses are more than 7 times higher than what consumers pay in ATM fees. Under Visa and MasterCard rules, retailers and consumers have no real choice.

The card associations will suggest that interchange fees go to a variety of things that benefit consumers, including reward programs. Reward programs may rebate some modest amount of the interchange fee to some consumers. However, only some credit card users benefit from rewards programs, while all customers ultimately pay for interchange fees. Therefore, even if this were the case, it would amount to a subsidy from low and modest income cash-and-check-paying customers to higher income rewards card-paying customers.

Ultimately, credit card interchange fees are paid for by all consumers. They subvert market forces through their lack of transparency, and to the extent that they contribute to reward programs, they essentially function as a regressive tax.

Question No. 2.

The United States has the greatest technology in the world, the largest number of credit card transactions, and some of the lowest fraud rates, yet we have some of the highest interchange fees. Why are our interchange fees so high if we have low fraud rates and such a technologically advanced communications network?

Response

Good question! In the limited public debates that have occurred over interchange, credit card interchange fees have been justified time and again based on the alleged need to compensate card issuers for a variety of costs that they incur in issuing credit cards. Some of those costs include "the cost of fraud and the cost of transaction processing." However, each of these costs has decreased substantially over the past decade. It is quite striking that interchange fees have continually increased even though these costs have decreased substantially. This is further evidence that the market is not behaving competitively with respect to interchange fees. The bottom line is that Visa and MasterCard are duopolists. Their cards are ubiquitous and their fees are hidden. So long as they operate in relatively close concert (a fact made easier by their overlapping bank memberships) there is no effective market mechanism to restrain what they charge. In other words, they charge high fees just because they can.

As we suggested in our testimony, we believe that the appropriate next step for Congress is to sponsor an extensive review of interchange fees, focusing in particular on the impact of those fees on consumers and how transparency and choice might be harnessed to the benefit of all consumers.

Please let me know what else I can do to assist the committee.

Sincerely,

Edmund Mierzwinski

Consumer Program Director
U.S. PIRG

SUBMISSION FOR THE RECORD BY THE HON. SUSAN MOLINARI, CHAIRMAN, AMERICANS FOR CONSUMER EDUCATION AND COMPETITION

Statement of the Honorable Susan Molinari

Chairman, Americans for Consumer Education and Competition

House Energy and Commerce Subcommittee on Commerce, Trade and Consumer Protection

February 15, 2006

Chairman Stearns, Ranking Member Schakowsky, members of the Committee, my name is Susan Molinari. I am the national Chairman of Americans for Consumer Education and Competition (ACEC), an organization dedicated to improving the financial literacy of young people and to educating consumers about their rights and choices in a free market. Thank you for the opportunity to submit this statement.

I applaud the committee for holding a hearing on interchange and its economic impact. It is a complex issue to wade through but one that is critical to synthesize in terms of its impact on consumers.

And that is where ACEC's concerns lie – the impact of merchant imposed check out fees on consumers. These check out fees, often unnoticed by consumers, are a method practiced by some merchants to recoup the interchange fees they pay for the advantage of offering credit and debit options to their customers. Merchants attract a higher volume of customers by offering credit and debit and higher transaction amounts from purchases paid for with plastic. Retailers and consumers enjoy a secure electronic system that quickly processes transactions. But a disturbing trend is on the rise and the consumers ACEC communicates with have reported evidence of the trend - merchants charging check out fees to consumers who pay with plastic.

Myriad surveys indicate consumers use their debit cards for purchases than any other method of payment. However, to further explore how pervasive the practice of charging check out fees might be, ACEC last month conducted a national poll of adult consumers. Our survey sampled 1,000 Americans and revealed that an overwhelming majority of consumers believe imposing check out fees on those who pay with plastic is an unfair practice and would not purchase goods from merchants who penalize debit and credit card users.

ACEC's survey also determined that nearly 29 million Americans may have been surcharged in the last few years. Notable beyond general consumer sentiment around check out fees is the fact that most credit card companies ban merchants from surcharging and several states have laws that ban merchants from surcharging plastic paying customers. Many consumers aren't sure when they have been charged check out fees and so consumer awareness and enforcement of surcharge bans in those states that have laws is not at the level it must be. Credit card companies must also do their share in educating their cardholders, especially with regard on how to identify a check out fee on a card receipt.

The media has not been silent on this issue. American Banker reporter Lavonne Kuykendall quotes in her May 18, 2005 article on interchange National Retail Federation senior vice president and the general counsel Mallory Duncan as saying merchants have always wanted the right to surcharge. A November 4, 2005 Boston Herald story looked at local restaurants surcharging card paying customers in Massachusetts, one of the states that bans the practice of check out fees. When contacted by Herald reporters, restaurateurs said they were unaware of the law. A spokesperson with the Massachusetts state Office of Consumer Affairs and Business Regulation was quoted in the article saying, "It's a retailer's choice to contract with a credit card company - with that choice, comes a cost." Consumers agree - a cost to the retailer – not to them.

Finally, I would like to conclude my testimony with a quote from a January 12, 2006 Wall Street Journal editorial that I believe sums up the surcharge issue for consumers. In reference to the discussion on interchange, a WSJ editorial writer notes this: "The worst option is the one retailers seek most fervently: price controls. We now have several years of evidence from Australia and other nations that have gone this route. Studies indicate that lower retail prices haven't materialized. Instead, retailers have mostly pocketed the savings, while Visa and other card companies have withdrawn the popular rebates and bonus awards while increasing the annual fees they charge to card holders. In other words, consumers were the loser, which is what inevitably occurs when governments intervene in markets that aren't broken."

ACEC is a consumer advocacy organization and we believe to be pro consumer is to advocate for and support consumer preferences and freedom of choice in the marketplace. ACEC was created by VISA USA in 2001 in response to a national survey that found that 81% of adults wanted solid, personal finance courses taught in their children's schools. The same survey indicated that less than 1 in every 5 adults believed their children's schools were adequately teaching personal money management skills. As we found out in most of our surveys, adults themselves were not highly literate in financial management issues and therefore, not prepared to pass on to their own children personal money skills.

Given the statistical evidence available that indicates adults lack of financial literacy and consumer awareness, ACEC has acted as a clearinghouse on a number of issues and regularly communicates with more than 25 thousand consumers interested in learning more about financial planning, data security, and more recently, the issue of merchant check out fees.

I strongly and respectfully urge the committee to look through the lens of the consumer when exploring the facets of interchange. We are in a technological age where consumers want to streamline the process of purchasing, better track their own expenses, and maintain a certain amount of security – which becomes challenging when they carry cash as opposed to one plastic card.

Thank you for the opportunity to submit this testimony before the committee.