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Electronic Payment Systems and Interchange Fees: Breaking the Log Jam on Solutions to Market Power

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Executive Summary

This paper addresses a supra-competitive payment card fee called interchange that Visa and MasterCard set, without competition, for the exclusive benefit of their card-issuing member banks, and impose directly on merchants and indirectly on all American consumers. The paper describes how card payment systems work and how the market distortions that have permitted Visa and MasterCard to accrue market power came about, but it focuses on the huge interchange fees themselves and the negative and unfair effects they have on consumers and merchants.

The paper highlights the symbiotic relationship between Visa and MasterCard and the nation's largest banks, which are their former owners and which continue to be the only parties that matter to both Visa and MasterCard in setting their interchange fee rates. The paper demonstrates the need for an effective solution to the one-sided imposition of

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immense and unfair interchange fees that unjustly enrich the biggest banks at the expense of U.S. consumers, merchants and market efficiency.

Although most of this paper is devoted to credit cards, there is one section that reviews the history of debit cards and their debit payment predecessors, i.e., checks. In 1913, Congress authorized the Federal Reserve to attempt to eliminate “exchange fees” that merchants were required to pay by some banks to cash their customers’ checks. The Federal Reserve adopted rules designed to ensure that all checks would exchange at par, i.e., their face value.² Based on this paper’s conclusion that there is no justification for companies with market power to impose any interchange fees on debit card transactions, the paper recommends that Congress eliminate all debit card interchange fees.

Because the interchange fee problem has existed for some time, both litigation and legislation are pending to redress it. This paper examines solutions that have been proposed, and it concludes that neither the litigation nor the bills that have been introduced in Congress are likely to quickly remedy the problem. Litigation takes too long and its results are too uncertain. And legislation that seeks to give merchants new tools to counter the market power amassed by Visa, MasterCard and their banks doesn’t go far enough. This paper asserts that Visa/MasterCard market power is too overwhelming and the market distortions too entrenched for legislated adjustments in the parties’ relationships to meaningfully affect interchange fees.

To find a solution that will work, the paper turns to precedents from abroad. The payment card networks and their banks have amassed market power not only in this country but around the world; and competition bureaus and central banks in many jurisdictions, including the European Union, Australia and New Zealand have called for either the elimination of interchange fees or their radical reduction. The Reserve Bank of Australia cut interchange fees there in half. The government of New Zealand prohibited MasterCard and Visa from setting any interchange fees. The European Commission also called for the elimination of MasterCard’s cross-border interchange fees although it has agreed to a fifty percent fee reduction pending MasterCard’s appeal. In virtually every case, the interchange fees in the United States substantially not only exceed the ones that foreign governments have reduced or eliminated, they also exceed the unregulated interchange fees of all developed economies.

This paper concludes that the restoration of balance to the U. S. credit card market requires Congress to establish guidelines for permissible interchange fees, and to then charge an agency such as the Federal Reserve with establishing modest, maximum interchange rates based on necessary services of demonstrable value that the card companies and their card-issuing banks provide to the merchant community in a manner that could not be efficiently provided in a more competitive way. This could reduce current interchange rates to 25 basis points from today’s average of nearly 2 percent on all transactions. The paper also recommends numerous changes in the rules of MasterCard

² See Alan S. Frankel, *Monopoly and Competition in the Supply and Exchange of Money*, 66 Antitrust L.J. 313, 335 (1998). See also, Glyn Davies, *A History of Money From Ancient Times to the Present Day* (1994).

and Visa that restrict merchants from effectively managing their payment card operations. The result would be an immediate reallocation of many billions of dollars from banks (that are not lending money) to consumers and merchants – an important economic stimulant at a time of heavy unemployment.

I. Introduction

A. The Problem

American consumers pay more than we should for virtually all our retail purchases, and the less well-off we are the more we are likely to be overcharged. How can this be when the United States has the world's most competitive retail sector and our current recession has put nearly everything on sale? The answer: abuse of market power³ in the payment card markets. Visa and MasterCard and their large card-issuing banks control these markets and extract a supra-competitive, privately imposed "tax" (they call it an "interchange fee") that consumers must pay to card-issuing banks through merchants on all their credit and debit card transactions. MasterCard and Visa require merchants to pay these interchange fees (approaching 2 percent of each transaction on average)⁴ to Visa and MasterCard, which distribute them mostly to their card-issuing bank members. Because Visa and MasterCard prohibit merchants from recovering this hidden tax directly or effectively steering customers to less expensive forms of payment, this tax on merchants (reportedly in excess of \$48 billion per year and growing) becomes a significant part of the prices all consumers pay for goods and services.⁵

Take a brief look at how the credit card system works. In the United States there are four significant credit card networks: Visa, MasterCard, American Express and Discover. Together, by 2007, they had issued 694 million credit cards to American consumers, who made 27 billion transactions that year with a value of nearly two trillion dollars. Visa and MasterCard are by far the largest of these networks with a joint market share of over 80 percent.⁶

³ An entity that can raise prices at will without fear of losing market share is said to possess "market power." The presence of market power is associated with factors in the marketplace such as a limited number of competitors and conditions that can create barriers for other businesses attempting to enter into the particular marketplace. GAO Report to Congressional Addressees, Credit Cards, GAO-10-45 (November 2009) at 13. (hereafter GAO Report 10-45).

In both *In re Visa Check/MasterMoney Antitrust Litigation*, 2003 WL 1712568 (E.D.N.Y.2003) and in *United States v. Visa U.S.A., Inc.*, 344 F. 3d 229 (2d Cir. 2003) both courts found that Visa has market power in the credit card market in the United States. MasterCard settled *In re Visa Check/MasterMoney Litigation* by paying \$1 billion before the question of its market power could be submitted to a jury. *Id.*

⁴ See GAO Report 10-45, at 16.

⁵ See Section II(B) *infra*.

⁶ Over 80 percent of the credit card market measured by outstanding balances belongs to Visa and MasterCard. Fifty-two percent of those balances are held by the three largest issuers of Visa and MasterCard credit cards: JP Morgan Chase, Bank of America and Citibank. Between 1993 and 2007, the value of U.S. credit

In addition to Visa or MasterCard themselves, there are four parties involved in each Visa and MasterCard credit card transaction. They are the card-issuing bank, the cardholder, the merchant and the merchant's bank (known as the acquiring bank). Acquiring banks charge merchants a "discount fee" to process and settle their transactions. Acquiring banks, or their agents, compete to sign up merchants in large part by offering them more attractive discount fees than their competitors. For example, one acquirer might offer to remit 97.5 percent of each MasterCard or Visa sale, but another might get the merchant's business with an offer of 98 percent.

Despite acquirer competition for processing and handling, the fixed interchange fee dictated by MasterCard and Visa on each transaction comprises the vast majority of the discount fee acquirers deduct from merchant credit card sales. For example, the GAO's recent interchange fee report to Congress illustrated the effect of interchange in a \$100 Visa or MasterCard consumer credit card transaction. Assume that Visa has set a 1.7 percent interchange fee rate for this type of transaction and that the acquirer has agreed to a 2.2 percent discount fee with the merchant. After authorizing the transaction, the issuing bank will deduct the interchange fee of \$1.70 before crediting the account of the acquiring bank through the Visa network with the balance of \$98.30. The acquirer will then deduct its fee of \$0.50 from the \$98.30 it was credited with by Visa and pay the merchant \$97.80. No matter how competitive the acquiring bank wants to be, interchange fees set a high floor under acquirer prices to merchants, which is arbitrarily fixed by Visa and MasterCard for the benefit of their issuers.⁷

B. Visa, MasterCard and their Big Banks Have Broken the Card Payment Markets

In a free and competitive market unconstrained by fixed interchange fees and the network rules that support them, these card companies and their card-issuing banks would be unable to impose supra-competitive fees on merchants because competing card companies would charge less, and overcharged merchants would stop either accepting MasterCard and Visa cards, or would steer their customers to less costly forms of payment. But today's payment card markets are not free and competitive; they are broken. MasterCard and Visa in the United States were created, and were owned and controlled for a very long time, by the country's biggest banks, which operated them as a cartel.⁸ Once the banks convinced nearly all merchants to accept their cards,⁹ they were able to dictate

card transactions increased in constant dollars from less than \$700 billion to nearly \$2,000,000,000,000. GAO Report 10-45, at 5-6.

⁷ The European Commission determined this to be true in its decision in its MasterCard investigation. See Commission Decision of 19 December 2007 in case COMP/34.579 MasterCard, COMP/36.518 EuroCommerce and COMP/38.580 Commercial Cards.

⁸ See note 18, *infra*.

⁹ In their early years, before MasterCard and Visa had a substantial share of merchants, some of their big banks attempted to build a cardholder base by mass mailing live credit cards to consumers who had not even requested them. Congress put an end to this abuse when it enacted the Unsolicited Credit Card Act in 1970.

terms and prices to the merchants because the dominance of these brands makes it virtually impossible for a merchant to reject them and survive. It would be like refusing to accept U.S. currency.

Now MasterCard and Visa, which have already paid \$3 billion to settle antitrust claims involving abuse of market power,¹⁰ have converted themselves into public companies in attempts to avoid future liability for price fixing.¹¹ But as we shall see, the banks appear to retain important controls over these companies.¹² Moreover, even without formal control, the big card-issuing banks are the only Visa and MasterCard customers with the power to influence the card companies' prices. *Ironically, the competition this creates between Visa and MasterCard is not toward lower prices, but higher ones.* The price that matters to the card-issuing banks is interchange, which comes to them as revenue on every transaction, so the banks will favor the bankcard network that requires merchants to pay the card-issuing banks the most. Therefore, year after year, MasterCard and Visa raise their interchange fee tax rates on merchants, and merchants can do nothing about it but complain because virtually no one can do business in America without accepting these dominant brands.

C. Interchange Fees Are an Unjustified Bank Tax on Merchants and Consumers

The bankcard networks have a theory to justify their interchange pricing. Under their theory, Visa and MasterCard claim that they don't arbitrarily set interchange pricing to enrich their issuing banks; instead they claim to carefully adjust interchange to balance merchant and card issuer demand.¹³ Visa and MasterCard assert that payment card markets are "two-sided" (*i.e.* merchants and cardholders) and that fixing the price charged to one side of the market should be permitted so long as the price charged to the other side of the market is competitive. Economists for Visa, in particular, have argued that other markets are also "two-sided", and they point to markets for newspapers (subscribers and advertisers) and real estate sales (sellers and buyers of houses). But antitrust enforcers have often brought actions challenging price-fixing among real estate agents and other anti-competitive conduct associated with multiple listing services, or newspaper mergers where prices to advertisers would increase post-merger. Calling a market "two-sided" is not, as Visa and MasterCard argue, a "get out of jail free" card.¹⁴ Indeed, the harm Visa and

Once a significant number of a merchant's customers carry a card, it is difficult for a merchant to refuse to accept it.

¹⁰ See Visa and MasterCard settlement agreements at www.inrevisacheckmastermoneyantitrustlitigation.com/court.php3.

¹¹ See *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, First Amended Supplemental Class Action Complaint, filed February 20, 2009, U.S. District Court for the Eastern District of New York, MasterFile No. 1:05-md-1720-JG-JO. Pleadings and other materials from the merchant litigation are available at https://ecf.nyed.uscourts.gov/cgi-bin/DktRpt.pl?195337008909721-L_942_0-1.

¹² *Id.*

¹³ See generally, Benjamin Klein, Andres V. Lerner, Kevin M. Murphy and Lacey L. Plache, *Competition in Two-Sided Markets: The Antitrust Economics of Payment Card Interchange Fees*, 73 *Antitrust L.J.* 571

¹⁴ This argument also runs afoul of the long-standing rule first announced by the Supreme Court in *United States v. Philadelphia Nat'l Bank & Trust Co.*, 399 U.S. 350 (1970) that parties to challenged anticompetitive

MasterCard are able to inflict was acknowledged in testimony to the European Commission by MasterCard Associate General Counsel Carl Munson who characterized MasterCard's method for setting interchange fees by posing this question: "How high could interchange fees go before we would start having serious problems [with] merchants?"¹⁵ Interchange fees do not balance demand between card issuers and merchants. They are simply a device to extract as much revenue as possible from merchants and their customers. Interchange fees are unfair because the people who benefit least, or not at all, from them subsidize rewards and other benefits that go to the card issuers and their most affluent cardholders.

The bankcard networks also seek to rationalize their interchange tax as necessary to avoid what they call a "hold-up" problem. Because both Visa and MasterCard have "honor all cards" rules which require any merchant who wants to accept Visa credit cards to accept *all* Visa credit cards, no matter what the price, and MasterCard has similar rules, Visa and MasterCard acknowledge that this makes every Visa and MasterCard issuer a monopolist because only Chase, for example, can authorize and pay on a transaction on a Chase Visa or MasterCard credit card.¹⁶ Visa and MasterCard then argue that default interchange fees are necessary to prevent individual issuers from setting monopoly prices. Curiously, however, Visa and MasterCard deny that Visa and MasterCard and their banks have any market power at all.

More recently, Visa and MasterCard have argued that higher interchange fees are a necessary incentive for card-issuers to enhance their systems by, for example, issuing premium credit cards with benefits like frequent flier miles. But consumers who do not have premium credit cards pay just as much hidden interchange tax at the point-of-sale as do more affluent premium cardholders. The difference is that "plain vanilla" cardholders and cash customers tend to be the less affluent, who are least able to afford the banks' interchange fee tax.

All of the justifications for merchants paying high interchange fees to card issuers and the rates the card companies impose on merchants are unreasonable. While the costs of processing payment card transactions (the most significant service MasterCard and Visa provide for merchants) have continually gone down in this age of electronic fund transfers, the interchange fee rates that Visa and MasterCard require merchants to pay their member banks have consistently gone up in the United States.

This is the opposite of what has been occurring in most of the rest of the industrialized world, including Europe, the United Kingdom, New Zealand and Australia. Almost nowhere in the developed world do merchants pay MasterCard and Visa interchange rates as high as in the United States. Why? In the rest of the world, governments have intervened to prevent Visa, MasterCard and their banks from obtaining

conduct cannot defend by asserting that, while they perhaps have harmed competition in one market, they have promoted competition in another market.

¹⁵ Quoted in *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, First Amended Supplemental Class Action Complaint, filed February 20, 2009, ¶ 39.

¹⁶ *See*, Klein et al, *supra*. fn. 13.

supra-competitive interchange fees. In this country, however, these dominant card networks are unregulated by our federal government. They can charge merchants whatever the market will bear, and, given their market power, that price is pretty much whatever these networks – acting solely for the benefit of themselves and their member banks – decide it will be.

Not only have Visa and MasterCard unfairly used their market power to raise their interchange fees year after year, they unjustifiably charge small merchants, who must struggle the most to remain competitive, more than they charge their big box competitors.¹⁷ In effect, Visa and MasterCard offer the largest merchants volume discounts, as if the issuing banks' costs – that the interchange fees supposedly defray – decrease with volume. *They do not.* Why should small merchants pay more than big ones for issuing banks to solicit new cardholders, or offer rebates and frequent flier miles to their premium cardholders, or offset the cost of settling with a merchant bank during a cardholder's "grace period?" Unequal interchange fee rates are unfair, but the market power of Visa and MasterCard puts all the cards in the hands of the bankcard networks and their card-issuing banks. This unjustified and anti-competitive behavior is a problem for the efficient operation of the American economy and especially for consumers and small and mid-sized merchants.

D. Litigation Takes Time and Current Legislative Proposals Are Inadequate

Is anything being done in the United States to redress this problem? Yes, but the process is exceedingly slow and the results may or may not ultimately correct all the abuses. A group of merchants and their trade associations have brought an antitrust class action lawsuit against Visa and MasterCard and their card-issuing banks alleging that their uniform interchange fee rate schedules are illegal price fixing and that their collectively imposed restrictions on merchants are illegal restraints of trade.

This suit follows previous antitrust class actions against Visa and MasterCard and a suit by the Department of Justice that found MasterCard and Visa guilty of restraining trade by prohibiting its member banks from issuing American Express and Discover credit cards¹⁸, and another suit by merchants that alleged an unlawful tying arrangement between their credit cards and debit cards. MasterCard and Visa paid \$3 billion to settle the latter case shortly after the courts rejected all the card companies' summary judgment motions and ruled that Visa has market power in the credit card market in the United States.¹⁹ Although the current merchant case appears to be strong, major antitrust litigation takes years to resolve (the previous merchant case took seven years) and even settlements and judgments do not always solve all the underlying problems, especially where the defendants retain market power even after the case is resolved.²⁰

¹⁷ GAO Report 10-45, at 10.

¹⁸ *United States v. Visa U.S.A., Inc.*, n. 3, *supra*.

¹⁹ *In re Visa Check/MasterMoney Antitrust Litigation*, n. 3, *supra*.

²⁰ For example, few would argue that Microsoft does not still have substantial market power in its operating system even after fifteen years of litigation, including both consent and litigated judgments.

Congress is the only entity that has the ability to create a regulatory scheme that would end once and for all the card companies' abuses of their market power and bring the fees merchants must pay for accepting MasterCard and Visa cards in line with the costs of the services those networks and their banks provide to merchants. Congress is currently considering two separate approaches to regulate merchant access to these market-dominant brands.

The Credit Card Fair Fee Act of 2009, S. 1212, sponsored by Senator Durbin (D-IL), would grant Visa, MasterCard and merchants a limited exemption from the antitrust laws to negotiate voluntarily the terms of access to those card systems. Failing agreement, the terms of access would be set by a three-judge panel appointed by the Attorney General and the Chairman of the Federal Trade Commission. A bill in the House of Representatives, H.R. 2695, sponsored by Rep. Conyers (D-MI) would also provide a limited antitrust exemption to negotiate rates but would not backstop this with a government panel. It would, however, require that any rates and terms voluntarily negotiated be the same for all merchants regardless of their type or transaction volume.

Representatives Welch (D-VT) and Shuster (R-PA) are co-sponsors of H.R. 2382, the Credit Card Interchange Fees Act of 2009. It offers a different approach. It would leave rate setting in the hands of the card companies, but it would prohibit various current network practices. For example, card networks could not charge higher interchange rates for premium card transactions.²¹

The Welch-Shuster bill has a number of desirable features. It would give merchants the right to route their MasterCard and Visa credit card transactions through processors less expensive than MasterCard and Visa. It would require MasterCard and Visa to charge small and large merchants the same interchange rates. It would make it easier for a merchant to offer discounts for cash. It would permit a merchant to steer customers to a preferred form of payment. It would permit a merchant that accepted a network's cards to nonetheless refuse to accept ones the merchant deems too expensive, and it would permit a merchant to accept a network's cards in some of its locations but not in others. It would also permit a merchant to set minimum and maximum amounts for credit transactions.

The Welch-Shuster bill would also empower the Federal Trade Commission to ensure that network rules, terms and conditions are not unfair, deceptive or anticompetitive. And, it would direct the Federal Reserve to collect and publish information on card network fees and rules. But the bill does not deal directly with the problem of interchange rates.

²¹ In 2005 MasterCard and Visa began converting credit cards of their most affluent cardholders into so-called "premium cards" for which they charged merchants higher interchange rates. From 2005 to 2009, the networks have increased premium card interchange rates by 24 percent. GAO Report 10-45, at 16.

E. The Federal Reserve Should Determine Appropriate Interchange Fees for the MasterCard and Visa Credit Card Networks Based on Legislative Guidelines.

Each of the interchange bills now pending in Congress is well intentioned and could improve the current situation somewhat, but neither goes far enough to provide ordinary American consumers and merchants with the fair deals other governments around the world are now providing. The dominance of Visa and MasterCard gives them enormous opportunities to adjust their tactics while continuing to extract supra-competitive profits for themselves and their bank members.²² Given the state of the payment card markets, fair interchange fees are likely only if Congress limits the fees that MasterCard and Visa can charge merchants to the recovery of costs that are demonstrably necessary and efficient for the good of all users, including merchants and cardholders.

A fair interchange fee law would recognize that neither MasterCard and Visa nor their large member banks will ever set fair interchange rates if they don't have to. Because so many customers will only pay with their MasterCard or Visa card, retail merchants cannot realistically terminate their relations with either card network, whose market power has removed all free market restraints. In the absence of competition, only the government can establish and enforce a fair interchange rate system. Therefore, a federal agency, such as the Federal Reserve Board, should determine and enforce maximum interchange fee rates for MasterCard and Visa based on legislative guidelines, which are discussed in Section V.

II. Credit Cards and Interchange

A. From Better-than-Barter to Credit Cardholder Abuse

Money is essential to modern society. By easing the transfer of value, money encourages commerce. It lubricates the wheels that keep our economy rolling. Money comes in various forms. Cash was king for a long time, and it was a great advance over barter, but for large transactions cash is impractical. It is dangerous for a consumer to carry it in large amounts, and it creates deposit management issues for merchants and banks.

In the last century, checks became a popular point-of-sale supplement to cash when consumers made large purchases. Properly handled, checks are safer for consumers to use and relatively efficient for merchants. Checks eased value transfer but limited consumer spending to current accounts. A consumer could spend only what a consumer had in the bank.

²² For example, when the settlement in the Wal-Mart class action litigation required the bankcard networks to reduce their signature debit card interchange fees, they simply raised their PIN debit fees so they would continue to reap supra-competitive profits regardless of which debit card method prevailed.

In recent memory, we have witnessed a radical change in the means of monetary transfer at the point of sale away from cash and checks to credit cards and more recently to debit cards. Credit cards were revolutionary. They were relatively fast and convenient, and they enabled cardholders to purchase goods and services with money they did not yet have by paying over time. In moderation, the consequences were good for consumers, who could live better today by paying a little more over an extended period. They were also good for the merchants and banks who issued them. For merchants, they enhanced customer loyalty, and for all issuers they generated income. Even for consumers who paid their balances in full at the end of each month, credit cards were an efficient payment convenience. Credit cards per se are not the problem this paper addresses; the problem is the abuse of consumers and merchants through unreasonable interchange fees and rules imposed by companies with market power.

Modern credit cards began as non-revolving charge cards offered primarily by retailers in the late 1950s. The cardholder was required to pay off his account each month. In the 1960s, department stores and gasoline brands developed their own credit cards to encourage consumers to shop with them. Consumers could pay off their balances at the end of the month, or they could let their debts revolve. Properly managed, these cards enabled their issuers to profit from consumer loyalty and some interest on outstanding debt. More recently, banks have played a role in financing these credit operations for retailers and in managing their programs.

Revolving credit cards that enable a cardholder to pay many merchants with one card took hold in the late 1950s when Bank of America launched its BankAmericard program. Many banks in the United States and in other countries joined, and BankAmericard eventually became the international Visa card system controlled by the country's largest banks.²³ In the mid-sixties, another set of large banks formed a competing credit card system they eventually called Mastercharge, and which is now the international MasterCard network. Although Visa and MasterCard have recently become "public" companies, selling shares on the New York Stock Exchange, their new charters may make it difficult, if not impossible, to change the system of interchange fees, which has made credit card lending a big bank bonanza, without the consent of those banks or a legislative mandate.²⁴

Initially, many thousands of banks issued MasterCard and Visa credit cards. But competition among issuing banks for cardholders and a relentless series of bank mergers have, over the last decade, consolidated the bank card issuing market dramatically. Today,

²³ Visa and MasterCard boards, comprising representatives of the largest banks, which were generally members of both Visa and MasterCard, met periodically to set interchange fees that they would impose on merchants and pay to themselves. See MasterCard Form S-1 filed with the Securities and Exchange Commission on September 15, 2005, at 19, 83-84; see also Visa Form S-4 filed with the SEC on June 22, 2007, at 50, 147. See also European Commission Decision of December 19, 2007, relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement, at 47, ¶136.

²⁴ See discussion of MasterCard IPO ownership and control restrictions in Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, First Amended Supplemental Class Action Complaint, filed February 20, 2009, ¶¶ 135-140.

the top eight MasterCard and Visa credit card-issuers in the United States control over 70 percent of the entire credit card market²⁵ and a much higher percentage of the MasterCard and Visa credit and debit card markets.²⁶

According to testimony at congressional hearings on abusive bank credit card policies, these big banks that control the issuance of MasterCard and Visa credit cards make an enormous amount of money from their cardholders in ways that are unfair and foreign to the original credit card models. They do it with bait-and-switch credit offers and with an array of hidden penalties and fees that are designed to maximize the issuer's cash flow rather than encourage prudent cardholder behavior. Often banks offer consumers low, so-called teaser rates that only last for a short period of time. Then the annual percentage rate jumps to a market rate that today may be 18 percent. But that's not the end. If a cardholder misses a payment, his credit card issuer may jump his rate again to a default rate as high as 30 percent. And this jump often occurs not only when a cardholder misses a payment on the issuer's card but even on another credit card.²⁷

Moreover, credit card issuers sometimes raise rates on cardholders who have not defaulted in any way simply because the bank's review of credit reports suggests a greater credit risk or even for no discernable reason at all. In addition, banks seem to have designed their monthly payment schedules to encourage consumers to make late payments or over-limit charges for which banks often charge high fees. Once a consumer has run up a significant revolving credit balance, bank issuers don't want to lose him as long as the bank deems the consumer able to continue paying, so the banks often impose additional fees if a consumer wants to transfer his credit balance to another issuer who will charge less.²⁸

These and other alleged bank abuses of consumers have made credit card operations a cash cow of profitability for our biggest banks. And they led Congress recently to enact legislation that will make it more difficult for banks to take unfair advantage of their cardholders.²⁹ For example, credit card issuers will not so easily and quickly be able to switch from teaser rates to high ones or otherwise increase interest rates on outstanding balances. Late payment fees will not be allowed before there has been a reasonable time for payment, and the fees will have to be reasonable and proportional. Banks will have to apply consumer payments first to balances with the highest APRs, and fees for exceeding

²⁵ "In 2007, US consumers held more than 694 million credit cards from Visa, MasterCard, American Express and Discover, and ... the total value of transactions for which these cards were used exceeded \$1.9 trillion. ..." GAO Report, at 5. As reported in the recent GAO Report to Congress, "the concentration of participants in the credit card network market also has raised concerns over competition and pricing. Visa and MasterCard together accounted for over 80% of the U.S. credit card market by yearend 2008. ..." GAO Report, at 9.

²⁶ As of year-end 2008, JP Morgan Chase, Bank of America, Citigroup, Capital One, Wells Fargo, HSBC, US Bank and USAA owned approximately 72 percent of all outstanding credit card balances in the United States. GAO Credit Card Report, November 2009. GAO Report to Congressional Addressees, Credit Cards, GAO-10-45, 6 (November 2009).

²⁷ Testimony of Twelve Consumer and Community Groups On HR 627 and HR 1456 Before the Subcommittee on Financial Institutions and Consumer Credit by Travis Plunkett of the Consumer Federation of America and Edmund Mierzwinski of U.S. PIRG, March 19, 2009.

²⁸ *Id.*

²⁹ The Credit Card Accountability, Responsibility and Disclosure Act of 2009, Public Law 111-24.

credit limits will be prohibited without prior cardholder agreement. These and other new rules threaten to decrease the opportunities for banks to continue to extract the same huge profits directly from their cardholders each month.

Fortunately for the giant credit card banks, however, these banks and the credit card networks they founded devised the interchange fee as another, very profitable source of revenue that all consumers pay indirectly to these very same banks.

B. Credit Card Interchange: the bank-imposed tax we all pay

Interchange is the way Visa and MasterCard get all consumers to pay indirectly to subsidize credit and debit card systems that many of them will never use. It is easier to charge everyone a tax that's hidden in the price of someone else's goods and services, than to ask those who use your service to pay for all of it themselves.

Broadly speaking, there are two types of precedents for this kind of behavior. Government does it when, for example, it contributes to the building and upkeep of a toll road. The road's users pay direct fees, and the rest comes from taxes paid by citizens, many of whom never even see the road. In that case, however, government is exercising its legitimate function to spend money for what it perceives to be the public good. We elect legislators to make these tough decisions. However, no legislative body has found that paying with a credit card is more of a public good than paying with another payment vehicle, and certainly none has found that providing the credit card banks billions more in profits than competition would justify is a public good.

The second precedent is in the private sector. Monopolists and others with market power tend to impose direct and indirect charges in amounts that wouldn't be tolerated in a free market. That's the nature of monopolies and duopolies.³⁰ They dominate their markets, and their market power may enable them to get away with behavior that would not be tolerated in free and competitive business environments. They may make enormous, yet inefficient, profits from those who have no alternative choices. That's why we have antitrust laws to prevent the abuse of market power. And that is why government regulates rates when persistent market dysfunctionality cannot otherwise be avoided. Indeed, this is the basis for public utility regulation. When the function being provided is important to society but the dominant providers' grip on the market is too pervasive to readily correct, we rely on the government rather than the company with market power to establish fair prices.

Today Visa and MasterCard, which control more than 80 percent of the US credit card market, can set their interchange fees solely for the benefit of their bank patrons. Therefore, the banks were able to rake in an estimated \$48 billion in interchange revenue in 2008.³¹ Clearly, bankcard issuers could not make their extraordinary profits from

³⁰ "Duopoly" describes a market that is dominated by two players.

³¹ Unfair Credit Card Fees.com, "'Swipe Fee' Reform – International Lessons," 2, released September 17, 2009.

interchange if they did not have market power. But when MasterCard and Visa began banks didn't have market power, so how did they come to invent interchange?

Although interchange fees were a part of the bankcard systems from the outset, the original rationale for them is clouded in the veil of time, and in more recent times the proffered rationales have changed to meet objections. Banks that issue MasterCard and Visa credit cards often argue that a transfer payment from the merchants' banks ("acquirers") to card issuing banks ("issuers") has always been needed to support the issuance of a sufficient number of cards to make the systems successful. Others suggest this is nonsense, as most banks were in the beginning both issuers and acquirers.

The reason for interchange, they assert, is that the banks were creating a new system in which the issuing side revenue would initially be low and speculative, while costs would be high. For example, they say the banks chose to offer cardholders a "grace" period because they believed it was necessary to compete with travel and entertainment card companies like American Express that didn't charge interest on their cards. At the same time, the new networks were able to get merchants to pay more than the acquiring side needed to turn a healthy profit. By agreeing to pay merchants promptly, the payment card companies were able to convince merchants to accept a discount on their sales that was larger than the acquirers needed to make a profitable return. Therefore, the networks required the acquirers to pay part of this merchant discount to the issuers.

In a lengthy, scholarly discussion of interchange fees, Steven Semeraro concludes that "interchange fees may . . . have been originally adopted to ensure a revenue flow to issuers as they came to terms with the potentially profitable . . . business of extending revolving credit with a grace period. Now that card-based lending has proven to be immensely profitable, the interchange fees that may have been essential to get the system rolling might now be an unnecessary anachronism that simply enables issuers to exercise market power over merchants."³² Whatever the original rationale for interchange fees, they are hardly necessary today when issuers are making a fortune from their cardholders. The payment of merchant interchange to Visa and MasterCard and their issuing banks today can only be justified, if at all, to the extent it is based on the recovery of costs that are necessary and efficient for the good of all system participants.

III. Debit Cards and Interchange

A. History of Debit Cards and Their Interchange Fees

³² Steven Semeraro, "Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty," Thomas Jefferson School of Law, Legal Research Paper Series, March 6, 2007, at 36; see generally Lloyd Constantine, Gordon Schnell, Reiko Cyr and Michelle A. Peters, "Repairing the Failed Debit Card Market: Lessons from an Historically Interventionist Federal Reserve and the Recent Visa Check/MasterMoney Antitrust Litigation," NYU Journal of Law and Business, Feb. 6, 2006.

Widespread use of plastic debit cards, which transfer money directly from a cardholder's account and permit the cardholder to shop at multiple merchant locations, is a fairly recent phenomenon. They evolved from bank automated teller machine ("ATM") access cards. In the late 1970s, banks began to link their ATMs into networks that enabled each bank's depositors to use not only his or her own bank's ATMs to withdraw cash but ATMs of all the banks linked in their bank's network. Initially, banks formed competing local ATM networks – typically a couple in each large city. Later in the decade, regional ATM networks like Honor, Pulse, NYCE, STAR and Interlink swallowed the local ones, and it wasn't long before the banks in each region figured out that it would be most convenient, and profitable, if they could offer their cardholders ATM access anywhere in the country and then the world. The regional networks formed alliances, and the largest banks created the international Cirrus and PLUS ATM networks and licensed their use to the smaller banks. Before long, a cardholder could withdraw cash from an ATM anywhere in the world.

An ATM card is like a plastic check. It enables a bank's depositor to withdraw money from his or her checking account by entering a personal identification number (a so-called "PIN") instead of using a signature. ATMs were a real milestone in bank customer convenience, but they didn't exploit the full potential of plastic checks. They enabled cardholders to get cash, but a check can also be used for payment at the point-of-sale. The regional ATM networks, owned by large banks in each region, were the first to see the opportunity of turning their single-purpose ATM access cards into multiple purpose debit cards. It was a no-brainer because the "railroad tracks" to authorize and settle the transactions were already in place for the ATMs.

The economies that drove both ATM cards and early point-of-sale ("POS") debit cards were based on cost savings to banks. Processing paper checks was expensive as is hiring tellers to handle routine deposits and withdrawals. The PIN-based ATM/debit card drastically reduced these costs. But, just as ATM cards needed lots of ATMs to be truly convenient, and therefore successful, debit cards were useful only if they were accepted at most merchant locations. To induce merchants to accept their debit cards most of the regional networks charged the merchants nothing. In other words, the plastic check was exchanged at par just the way paper checks are. In fact, one network paid merchants a small fee for each debit card transaction. Later, when these POS, PIN debit networks became established, most regional networks imposed a very small, fixed fee on merchants to cover transaction processing.

ATM networks also developed a scheme of transfer payments for shared ATMs (*i.e.*, owned by one bank and used by the customers of many). Interestingly, payments in the shared ATM world did not flow from the place where the ATM card was used (merchant equivalent) to the bank that issued the card, although that concept was hotly debated among bankers. Instead, the card-issuing bank pays the ATM deploying bank an interchange fee. The rationale was that this would encourage banks to deploy more ATMs into the networks. After all, most banks had already issued debit cards for ATM access to most of their depositors.

Online, PIN-based, bank debit cards for use at the point of sale were one of the truly useful bank innovations. They worked well for all the players. Banks significantly reduced their costs of processing checks. ATM network volume and related fees increased. Online PIN-based user authentication provided maximum protection against fraud. Merchants had a payment vehicle that was cheaper than credit cards and more convenient than paper checks. Consumers had a convenient way to pay for merchandise from their checking accounts without going into debt, and they could conveniently get cash back from most merchants at the point of sale if they wanted.

Visa and MasterCard, however, were not among the satisfied POS debit card players. They had no interests in these ATM/PIN debit cards; they made no money on their transactions; and they feared that debit card transactions could eventually eclipse credit cards, their cash cow. Visa reacted aggressively. It bought a very successful California-based PIN debit card network called Interlink and proceeded to impose high merchant interchange fees, which it largely transferred to the card issuing banks, just as it does with credit cards. Although many of the largest banks were owners of the regional networks, they succumbed to large cash incentives from Visa to use Interlink exclusively as their online debit card network, and in turn they enjoyed the benefits of high debit card interchange paid with money from the merchants and their customers. The result was to force some regional debit card networks to raise their fees to merchants so they could also pay more to the banks. Most of the other regional networks went out of business or were acquired. Visa's Interlink PIN debit network has raised its interchange fee for small merchants to 90 cents for a \$100 purchase from 20 cents in 2002. The result? Interlink's share of PIN debit purchases rose to 47% in 2009 from 20% in 2002.³³

But Visa's ultimate goal was to steer everyone to another, less secure but far more profitable, debit card system. Visa and MasterCard offered an alternative method for conducting debit card transactions. Instead of using secure PINs to authenticate users, they used signatures, just like credit cards. Then these transactions were processed offline through the Visa and MasterCard networks, just like credit card transactions. Card-issuing banks loved this system because they made the same high interchange fees from merchants as they did with credit cards even though they did not have to find new cardholders or take risks on loans to them. Each bank's customers were its depositors and every transaction came right out of a depositor's own bank account. Visa, MasterCard and the large banks had found a gold mine even richer than credit card interchange.

One of the beauties of debit cards for Visa and MasterCard and their banks was that no consumer marketing was necessary to sign up new cardholders. When Visa and MasterCard made the proposition sufficiently lucrative for a bank, the bank simply reissued most its former ATM cards as debit cards, prominently displaying one of those brands on the front of the card so it would be indistinguishable from their credit cards. This confused both cardholders and merchants who often could not tell the difference between a credit card and a debit card. They looked the same, and cardholders signed for these debit transactions just as they did with credit cards. Moreover, the bankcard networks

³³ Andrew Martin, "How Visa, Using Card Fees, Dominates a Market," New York Times (January 5, 2010).

sought to force merchants to accept these high-priced, high-profit, low-security signature-based transactions. Both Visa and MasterCard had rules that required a merchant that accepted any of their cards to accept them all, effectively tying their new signature-based debit transaction system to their credit cards, a product market where they were dominant with about an 80 percent market share. It was a naked exercise of market power.

In 1996, Wal-Mart and other merchants brought a class action lawsuit on behalf of all merchants against Visa and MasterCard, alleging violations of the antitrust laws, including illegal tying of their signature debit cards to their credit cards. Visa and MasterCard were able to drag out the litigation for seven long years. Along the way the court found that Visa had market power in the credit card market and suggested it would likely find the same about MasterCard. Eventually, Visa and MasterCard settled the litigation by agreeing to pay merchants \$3 billion, permit merchants to accept credit cards without taking debit cards, differentiate their debit cards from their credit cards, and temporarily lower their debit card interchange fees.

The litigation was only partially successful, because it did not solve the debit card side of the interchange fee problem or significantly affect Visa and MasterCard's exercise of market power in payment card markets. While Visa and MasterCard temporarily lowered their fees for signature debit, they raised the price on PIN debit transactions and passed the funds on to their card-issuing banks.³⁴ On precisely the same date that they temporarily lowered their signature debit interchange fees, they also raised their credit card interchange fees by identical amounts, to more than offset whatever savings merchants saw from the lower signature debit interchange fees.³⁵

Visa and MasterCard dominate the signature debit card market and now have substantial market influence over PIN debit prices as well. Today Visa has 248 million debit accounts in the United States, and MasterCard has 118 million.³⁶ No one else has a significant signature debit share. Whether a consumer uses his debit card with a PIN or a signature, Visa and MasterCard continue to raise debit interchange fees at will to keep their banks happy. The merchants still have no competitive force in the debit card market and are left only with a Hobson's choice of paying ever-higher debit interchange fees or refusing cards that a substantial majority of their customers now carry.

In an address to a Kansas City Federal Reserve conference in 2005, Lloyd Constantine, the lead plaintiffs' attorney in the Wal-Mart litigation, provided a demonstration of Visa and MasterCard's signature debit card pricing policies:

"On May 29, 1998, Visa announced that it would raise signature debit interchange rates by roughly 20% effective April 1, 1999. On November 19, 1998, MasterCard, with one quarter of Visa's debit volume announced that it would continue to have higher fees than

³⁴ GAO Report, n.3, *supra*, at 10.

³⁵ *See*, Class Plaintiffs' Second Consolidated Amended Class Action Complaint, dated February 20, 2009 in MDL 1720.

³⁶ Andrew Martin, *supra*, note 30.

Visa, raising its April 1999 rates by roughly 9%. So two months later, Visa raised its April 1999 rates by another 6% and MasterCard countered with yet another increase five days later. At the end of this cycle, Visa's rates were up 26%, MasterCard's up by 17% -- and MasterCard, with one-fourth Visa's volume, still charged more. Perhaps . . . Visa's interchange guru will explain how this game of leapfrog on the backs of U.S. merchants and consumers was actually just a careful equilibration of merchant and cardholder demand."³⁷

Since then, the banks and their bankcard networks have continued to use their market power not only to handicap the superior PIN-debit system in favor of their preferred signature-debit system, but also to continually raise interchange fees on PIN debit transactions so that the bankcard networks and their bank members will win with supra-competitive interchange fees regardless of which debit system ultimately prevails.

*B. Debit Card Transactions Should Exchange "at Par"*³⁸

Unless government intervenes, it is likely that Visa and MasterCard will continue their convergence strategy until all interchange fees are the same for all types of debit cards and those fees are just as high as credit card interchange fees. That would seem unbelievable in light of the history of American debit payments going back to the history of checks. There is a long history in this country relating to so-called check "exchange fees" that in the past made the use of checks difficult and expensive. Supra-competitive check exchange fees, imposed on merchants by some banks with market power interfered with commerce, so Congress authorized the Federal Reserve at the time of its formation to abolish them and provide a system for all checks to exchange at par – the system with which we are all familiar today.

Although some bankers at that time loudly complained, "the usefulness of checks as a means of payment was not destroyed as a result of the system of par collection put into operation by the Fed. On the contrary, more than eight decades after the Fed began its efforts to 'impose' par collection, checking accounts now are offered by virtually all financial institutions, whether they are net payers or net recipients in the check settlement process Costs imposed by customers drawing checks or depositing checks, including costs associated with membership in and use of clearinghouses, are recovered through fees charged directly to those customers. There is no evidence that the check clearing market could operate more efficiently if banks were free to act collectively to impose exchange charges once again."³⁹

The testimony of a witness at a Senate hearing in 1945 on the check exchange fee controversy could be delivered today. Here it is as summarized by Melvin Miller:

³⁷ Lloyd Constantine, "The Need for Federal Reserve and Antitrust Intervention in the Failed U.S. Debit and Credit Card Markets," an address to An International Payments Policy Conference of the Federal Reserve Bank of Kansas City, May 5, 2005.

³⁸ "At par" exchange means that a party that presents an "at par" instrument to a bank for payment will receive 100 cents on the dollar. In other words, the bank cannot apply a discount or charge an interchange fee.

³⁹ Frankel, n.2 supra, p. 337.

The statement was made that a service charge is an open and above board proposition, that it is something that is arranged between the bank and the customer. If the customer does not like it, he can tell the bank so. On the other hand, an exchange charge is a hidden charge which is paid by someone in another city who cannot make any protest. And though this exchange charge is made, the bank's own customer, who drew the check, may not know anything about it.⁴⁰

Flash forward to the modern era, and we see that when the regional ATM networks created the PIN debit system for use at the point of sale, they recognized that their debit cards were plastic checks. The regional PIN debit networks eschewed interchange fees and instead exchanged their plastic check transactions at par. Visa and MasterCard, however, have reinstated check exchange fees for plastic checks under the name of interchange. There is no justification for such interchange fees, especially in these non-competitive markets. Like their check exchange fee predecessors, debit card interchange fees also interfere with commerce. This Congress, like its predecessor nearly a hundred years ago, should expressly authorize the Federal Reserve to end debit card exchange/interchange fees and require all plastic checks to exchange at par just like paper ones have since 1916.

IV. Interchange Fees in Other Developed Countries

As we in the United States seek to deal with Visa and MasterCard's payment card market distortions, we can learn from what is being done in many other countries. MasterCard and Visa operate throughout the world, and they and their large bank partners have amassed and abused market power in those countries just as they have here, although nowhere in the world are the MasterCard and Visa interchange rates as high as they are in the United States.

Foreign governments and their competition bureaus have done extensive studies of the ways the MasterCard and Visa systems operate and the conclusion reached over and over again is that the MasterCard and Visa interchange fees are unjustified and counterproductive to the welfare of their citizens and the flow of commerce. Governments in more than 30 countries are taking actions to address the lack of competition in their payment card markets and the inflated costs of payment cards.⁴¹ This paper will examine the solutions that have been chosen in a few societies similar to our own, namely, Australia, New Zealand, and the European Union.

⁴⁰ Melvin C. Miller, *The Par Check Collection and Absorption of Exchange Controversies*, 120 (citing 1945 Senate hearings at 80).

⁴¹ Those countries include Argentina, Australia, Austria, Brazil, Canada, Columbia, Denmark, Finland, France, Germany, Hungary, Israel, Italy, Mexico, New Zealand, Norway, Panama, the People's Republic of China, Poland, Portugal, Romania, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Turkey and the United Kingdom. GAO Report 10-45, n. 3 *supra*, at 43, citing Payments System Research Briefing, Federal Reserve Bank of Kansas City, April 2008 and GAO-08-558.

A. Australia

Australia began to seriously deal with bankcard pricing in 2003. When a government study found that banks were receiving interchange fees at levels that could not be economically justified, the Reserve Bank of Australia, or RBA, required Visa and MasterCard to cut their average interchange fee approximately in half. It went from 0.95 percent of each transaction down to 0.5 percent. Visa and MasterCard were also required to permit merchants to impose credit card surcharges, and starting in 2007, they had to remove their honor all cards rules so that a merchant could choose to accept their credit cards without accepting their debit cards and vice versa. Also, MasterCard/Visa were no longer allowed to prohibit merchants from steering their customers toward payment types that cost merchants less.

As is occurring here, MasterCard, Visa and their card-issuing banks predicted a payments card catastrophe if the Australian reforms were implemented. MasterCard predicted a “death spiral.” It didn’t happen. Australian credit card accounts and activity have both continued to rise. Credit card issuing has continued to grow at 5 percent per year. Debit cards grew even more. After further study, Australian regulators concluded in 2008 that the reforms had been successful in achieving their main objectives of improving competition in the payment card markets and providing consumers with more information about the costs of their various payment alternatives. Last year, therefore, the RBA announced that it would continue to regulate interchange rates and that the credit card rate would remain at 0.5 percent.⁴²

As early as 2005, the Payment Systems Board of the RBA stated, “the most notable impact of the reforms has been a marked reduction in merchants’ costs of accepting credit cards, which in turn, is flowing through into lower prices of goods and services for all consumers.”⁴³ In 2008, the RBA estimated the savings during the previous year to have been around 1.1 billion Australian dollars.⁴⁴

B. New Zealand

Both Visa, with 2.1 million cards, and MasterCard, with 900,000, have significant footprints in New Zealand. As of 2004, they represented 90 percent of the credit card billings in that country. As in the United States, those companies and their card-issuing banks had market power and dictated supra-competitive interchange fees. In November

⁴² GAO-10-45, n.3supra, at 43.

⁴³ Payments System Board Annual Report, Reserve Bank of Australia, 2005 at 10.

⁴⁴ Reform of Australia’s payment System: Preliminary Conclusions of the 2007/2008 Review, Reserve Bank of Australia, at 23.

2006, New Zealand's trade regulatory body ruled that they were engaged in collusive activities and price fixing.

In August of 2009, both Visa and MasterCard agreed to a series of reforms to improve interchange transparency and foster competition. Specifically, they agreed that each credit card issuer will negotiate its own interchange rates with acquirers rather than have networks set them. They agreed to make all rate information public, permit merchant surcharging of all credit cards or specific types of credit cards, and to permit merchants to steer consumers toward other payment methods by, for example, discounting.⁴⁵ After announcing the Visa and MasterCard agreements, the chair of the regulatory commission said, "The settlement can be expected to reduce the overall costs to consumers of payment systems by driving down interchange fees and facilitating merchant steering towards lower cost payment methods."⁴⁶

C. European Union

While regulatory bodies in the various European countries are currently investigating or instituting restraints on MasterCard and Visa interchange rates within their own borders,⁴⁷ the European Commission is charged with overseeing interchange rates relating to cross-border transactions. After a lengthy and thorough investigation of MasterCard rates, the European Commission, or EC, ruled in December 2007, that MasterCard's rates violate European antitrust law. In a 241-page decision, the EC rejected all of MasterCard's arguments, including that its IPO absolved it from price-fixing,⁴⁸ that the relevant market is broader than payment cards, and that collectively-fixed interchange fees are essential to a bankcard network like MasterCard.

In part, the EC concluded that MasterCard's "[Multilateral Interchange Fee] restricts competition between acquiring banks by inflating the base on which acquiring banks set charges to merchants, and thereby sets a floor under the merchant fee. In the absence of the MIF, the prices set by acquiring banks would be lower to the benefit of merchants and subsequent purchasers."⁴⁹

At the time of the decision, Competition Commissioner Neelie Kroes said, "Multilateral interchange fee agreements such as MasterCard's inflate the cost of card

⁴⁵ Id. at 9.

⁴⁶ Id. at 10

⁴⁷ The U.K. Office of Fair Trading, for example, concluded in 2005 (after a four year investigation) that MasterCard's domestic interchange fees violated its antitrust laws. It also found that MasterCard's interchange fee was used to extract extraneous costs – not necessary to the functioning of the system. Two such costs are reward programs and interest-free float. On January 4, 2007, the Polish Office of Competition and Consumer protection fined twenty banks a total of PLN 164 million (about \$56 million) for jointly setting MasterCard and Visa's interchange fees.

⁴⁸ MasterCard claimed that it was immune to price-fixing allegations after it switched from a bank-owned association to a public company.

⁴⁹ European Union MasterCard Provisional Decision, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/143&format=HTML&aged=0&language=EN&guiLanguage=en>, December 2007, at ¶ 664.

acceptance by retailers. Consumers foot the bill, as they risk paying twice for payment cards: once through annual fees to their bank and a second time through inflated retail prices paid not only by card users but also by customers paying cash. The Commission will accept these fees only where they are clearly fostering innovation to the benefit of all users.”⁵⁰

The 2007 EC decision addressed that issue. It said, “It is not disputed that payment card schemes such as MasterCard may represent, as such, economic and technical progress. The decisive question is, however, whether the MasterCard MIF specifically contributes to that progress.”⁵¹ The EC rejected MasterCard’s claim that its methodology for setting MIF favors setting the fees at an efficient level. In fact, the EC suggested it wasn’t clear whether an efficient interchange fee should go from acquirers to issuers (as it does) or the other way around.

Not only does the decision of the EC make it abundantly clear how anti-competitive the MasterCard and Visa interchange fee scheme is; it also highlights how economically useful it could be for governments to eliminate these overcharges at this time of worldwide economic contraction. As Unfair Credit Card Fees.com has recently pointed out, “European political leadership and market experts view the reform and reduction of hidden credit card interchange fees not only as pro-business and pro-consumer, but also as a painless way to put more money in the economy during a recession and to stimulate spending.”⁵²

The EC’s decision against MasterCard in December 2007 required MasterCard to eliminate its cross-border MIF. In April of last year, however, MasterCard and the European Commission agreed that, pending appeal, MasterCard will reduce its MIF by about half – to 0.3 percent.⁵³ The EC announced similar proceedings against Visa in 2008. Visa’s cross-border interchange rate is 0.7 percent. By way of comparison, the MasterCard rate that the EC found unacceptable was about one-third of the average credit card interchange rate in the United States. U.S. interchange rates are about six times as high as the cross-border rates Europeans will now be paying. In fact, MasterCard and Visa’s interchange fee rates in the United States are the highest in the world.

The actions of these and other governments around the world make two things plain. First, that the MasterCard and Visa card schemes impose supra-competitive interchange rates on merchants and consumers. And second, that governments around the world are convinced, despite the fear-mongering of the bankcard networks and their big banks, that correcting interchange fee abuses by capping interchange fee rates, will benefit consumers. In fact, we have the results in Australia as proof.

⁵⁰ Id., at 7, quoting “Antitrust: Commission Prohibits MasterCard’s Intra-EEA Multilateral Interchange Fee,” Press Release from European Commission, December 19, 2007.

⁵¹ European Union MasterCard Provisional Decision, n. 49 supra, at ¶ 710.

⁵² Unfair Credit Card Fees.com, n. 31 supra, at 7.

⁵³ European Union MasterCard Provisional Decision, n. 49 supra.

V. Curing the Interchange Fee Problem in the United States

A. *We Need a New Interchange Fee System, and We Need It Now.*

As discussed in the introduction, ending hidden interchange fee costs is too important to await the outcome of the merchants' price-fixing litigation against Visa, MasterCard and their big banks. We know that the savings from controlling those fees will redound to the benefit of consumers in merchant pricing, not because the merchants are all nice guys, but because they operate in the world's most competitive retail market. A new law from Congress reducing the average U.S. interchange fee from nearly two percent today to 25 basis points could put most of almost \$48 billion dollars back into consumers' hands for additional spending in the first year alone. It could be the second biggest economic stimulus package since the recession began. And it would continue from year to year.⁵⁴

Although there are two legislative approaches currently proposed in Congress, neither is sufficiently broad to deal decisively with the interchange fee problem. One approach provides a limited antitrust exemption for the networks and merchants to jointly agree on fees under threat of a three-judge panel making the decision for them. In theory, it is a step in the right direction because it recognizes the need for government intervention in a broken market. Also, requiring rates and terms to be the same for all merchants regardless of their type or transaction volume would be a positive step, but not enough to solve today's interchange fee problem. Moreover, the granting of antitrust exemptions raises policy concerns and could establish a problematic precedent.

Although measures that would strengthen merchant power vis-à-vis the banks and bankcard networks are positive steps, there does not appear to be a practical way for the very diverse merchant community to be represented by one group that would try to negotiate for them all. Moreover, the negotiations would be a distraction from what is really needed. MasterCard and Visa interchange fees should be simple and based entirely on necessary services of demonstrable value that the credit card networks and their card-issuing banks provide to the merchant community in a manner that could not be efficiently provided in a more competitive way. Congress should provide the guidelines for establishing credit card interchange fees. The time this bill would commit to voluntary negotiations will be better spent having an appropriate agency obtain, verify and analyze the data necessary to set maximum interchange fees for Visa and MasterCard.

The Welch-Shuster bill is also well-intentioned, but it is only a partial remedy that needs to be incorporated into a broader solution. The transparency of fee-setting methodologies it promotes is good; the uniform fees it promotes are good; the exclusion of certain items from interchange is another step in the right direction; relaxing some network anti-steering rules is good; and suggesting an enhanced role for the FTC is also reasonable. The problem is that the bankcard credit and debit markets today are so broken that these bills would fail to restore competition to those markets.

⁵⁴ Compare to MasterCard agreement to reduce cross-border interchange in the EU to 30 basis points.

Visa, MasterCard and the big banks are very powerful and resourceful, and they all work in concert toward a single goal of maximizing revenue and profits for themselves at the expense of merchants and consumers. They have in the past demonstrated their ability to adjust their tactics in response to government rule changes so that they continue to reap windfall profits.⁵⁵ We are past the time when adjustments to the current system might bring back competition. We need to change the system entirely. It is time for Visa/MasterCard and the banks to shoulder the overwhelming majority of their costs for the card systems they promote. The only way to restore balance to the U.S. credit card market is to remove the expectation of the banks and their bankcard networks that they can spend unlimited sums on projects like customer solicitation because they can always require merchants and all consumers to pick up the tab. It is time for Congress to establish the guidelines for interchange fees and to charge the Federal Reserve with setting modest maximum fees based on those guidelines. Here, then, is a prescription for what is needed.

B. The Federal Reserve Should Set Maximum Credit Card Interchange Fees for MasterCard and Visa.

Congress should legislate a solution to the broken credit card market that will prevent MasterCard and Visa from exercising their market power to the detriment of consumers and merchants. The legislation should be founded on the following core principles:

It should protect consumers from the hidden and unjust fees they currently pay through their purchases because of interchange. Merchants should be relieved of interchange fees except to the extent the fees represent the costs and a reasonable profit on necessary services of demonstrable value delivered to the merchant community in a manner that could not efficiently be provided in a more competitive way.⁵⁶ Interchange fees and related bankcard network operating rules should be simple to understand and transparent to merchants and the general public. Merchants should have the ability to encourage consumers to use credit cards in cost-effective ways including, for example, the ability to surcharge, discount, set minimum and maximum credit card purchase amounts, and accept credit cards at some but not necessarily all of the merchants' locations.

No interchange fee should be charged on a credit card transaction when a single bank is both the cardholder's bank (the "issuer") and the merchant's bank (the "acquirer"),⁵⁷ and nothing should prevent any Visa and MasterCard member from processing its MasterCard or Visa transactions through any processor of its choosing, especially one that competes with MasterCard and Visa. Interchange fee rates should be the same for merchants of all types and sizes regardless of transaction

⁵⁵ See note 22 supra.

⁵⁶ Stakeholders, including bankcard companies, banks and merchants should share transaction processing costs that benefit all parties.

⁵⁷ Such transactions are called "on us" transactions.

volumes, whether measured in items sold or dollar value. These principles would provide a strong foundation for an effective and just new interchange fee system.

The Federal Reserve Board is probably the most appropriate existing agency to implement these new principles and to set the separate, maximum interchange fees for MasterCard and Visa. It has more payments experience in both regulations and operations than any other federal agency. It promulgated and enforces Regulation Z, which implements the credit card rules of the Truth-in-Lending Act. It did the same for Regulation E, which implements the Electronic Fund Transfers Act. It is a primary clearing house for automated clearinghouse (“ACH”) transactions and its approval is required for ACH rules. The Fed is also the agency that has established the rules for prompt clearing of checks, and for processing check images instead of paper checks. The Fed also ran an alternative paper check processing system for many years. It is the agency that knows payment systems. In fact, it would be useful for Congress to study the feasibility of having the Federal Reserve establish and operate an alternative processing facility for credit card transactions. Doing so would give the Fed useful, hands-on experience in judging the appropriateness of processing fees claimed by the bankcard networks, and it would add an element of credit card processing competition.

There is a strong case for an active government role in the U.S. credit card payment system. From time immemorial, governments have viewed the issuance and exchange of money as one of their fundamental responsibilities right along with defense and public safety. Ever since the federal government in the nineteenth century replaced banks as the exclusive issuer of United States currency, our government has recognized that the creation and control of the nation’s currency is an essential governmental function. Our founders thought so too. Article I of the Constitution gives Congress the power to coin money and regulate its value.⁵⁸

Today, credit and debit cards are fast replacing dollars and cents as the coin of the realm. The Federal Reserve has recently estimated that since the 1990s the use of checks and cash has grown more slowly than the use of credit and debit cards. Indeed, checks and cash may be in absolute decline. Since 2005, more than half of total retail transactions have been paid for using credit or debit cards.⁵⁹ Visa, in fact, has begun to tout itself as “digital currency.” Until recently governments have been slow to recognize the serious legal and economic issues raised by allowing the control of the nation’s currency to revert to private hands. This privatization of the payment system was not the result of a public decision to deregulate, but something that was simply allowed to occur as new technologies and new marketing strategies advanced. Domination of payments by Visa and MasterCard for the benefit of their banks begs for the return of the United States’ government to its traditional role in supervising and actively participating in our national payment system, including credit and debit cards.

⁵⁸ Constitution of the United States of America, Article I, Section 8, cl. 5.

⁵⁹ GAO Report, n. 3, supra at 14.

The only Visa and MasterCard cost element that qualifies under the core principles announced above for being part of an interchange fee is credit card transaction processing, which includes the costs of authorization and settlement. Other costs that support the generation of bank profits (e.g., cost of funds, billing and collections) or that are intended to increase one bank's share of the credit card market over others (e.g. cardholder solicitations and rewards programs) or that promote one network over another (e.g. brand advertising) are of no benefit or concern to merchants and should not be factors in deriving or rationalizing interchange fees.⁶⁰

In a well-regarded, 2006 study of expenses in the credit card industry, A. Dawson and C. Hugener estimated the percentages of interchange fee revenue that banks applied to various expenses. They estimated that 13 percent of interchange fees went to processing.⁶¹ On that basis, a rough estimate is that the average interchange fee should be reduced from today's two percent to about 25 basis points.

This paper is unable to evaluate actual credit card processing costs or, for that matter, bank revenue, expenses and profits generally related to bank credit card operations because the big banks declined to make available such data to the GAO in its recent interchange investigation.⁶² The GAO suggests, however, that based on industry sources, MasterCard and Visa card issuer annual revenue totals around \$120 billion. The GAO notes that "large issuers of credit cards traditionally have been among the most profitable banking institutions."⁶³ In addition, the Federal Reserve issued a report in June 2009, indicating that earnings for large credit card banks have been consistently higher than for all other commercial bank activities;⁶⁴ and the FDIC confirmed that credit card lending has for a long time been one of the most profitable business lines.⁶⁵ In any event, under the regulatory system being proposed here each of the bankcard networks would have to disclose their processing costs to the Federal Reserve and justify them as necessary and efficient. In the meantime, Congress should instruct the Federal Reserve to adopt an interim maximum interchange rate or cap of approximately 25 basis points for each of the two bankcard networks.

Without getting into the fine points of a bill that might be drafted, here are some of the other key provisions that arise from this paper's core principles. Various restrictive network rules of the type mentioned in the principles above would become unenforceable.

⁶⁰ For example, MasterCard and Visa spend hundreds of millions of dollars to lure the largest card-issuing banks from Visa to MasterCard or vice versa. See, most recently, SunTrust Bank switching from Visa to MasterCard. Daniel Wolfe, "MasterCard Snatches SunTrust from Visa," *American Banker*, January 15, 2010.

⁶¹ A. Dawson and C. Hugener, "A New Business Model for Card Payments," Diamond Management & Technology Consultants, Inc. (2006).

⁶² GAO-10-45, n. 3, *supra*, at 23.

⁶³ *Id.*

⁶⁴ Board of Governors of the Federal Reserve System, "Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions" (Washington, DC: June 2009).

⁶⁵ Statement of Martin J. Gruenberg, Vice Chairman, Federal Deposit Insurance Corporation, "Credit Cardholders' Bill of Rights: Providing New Protections for Consumers" before the Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee, US House of Representatives, 110th Cong. 2nd Sess. 2008.

The networks would have to file their rules in advance with the Fed and post them on their websites. And the Fed would have the authority to nullify rules that it believed to be anti-competitive or unduly burdensome to consumers or merchants. The Fed would have the authority to enforce its rules with fines and injunctions, and merchants would have standing to sue after pursuing administrative procedures. The networks would be protected from future antitrust claims related to interchange fees if they conformed to the new law and its regulations. The new federal law should preempt conflicting state laws.

Transparency of interchange fees is important because it will give merchants and cardholders actionable information to pursue their own interests to further reduce interchange fees. If, for example, the Fed alters maximum interchange fees only once every three years, each bankcard network should have incentives during the intervals to work to lower its actual processing expenses so that it could become the lower-cost provider. Merchants in turn would have incentives to make their customers aware of the network with the lower fees by favoring it in one way or another, such as discounting that network's transactions or surcharging its competitor's transactions. Also, competition between the bankcard networks to lower their fees would put downward pressure on the fees of private networks like American Express, as has happened in Australia.

In its recent report to Congress on interchange, the GAO uncovered a wealth of information and useful data relating to the rising costs of card acceptance for merchants and the dysfunctional nature of the payment card markets. As is appropriate for the GAO, it did not reach conclusions regarding what Congress should do. After discussing four alternative solutions, the GAO concluded that each of these approaches could be an effective way to lower merchant and consumer costs, but each could present challenges of implementation and the ultimate effects on cardholders could be mixed if issuing banks reacted by increasing cardholder costs or curtailing credit. In the end, the report observed:

A significant advantage of capping or limiting interchange fees would be that it would reduce interchange fee costs most directly. The experience in Australia indicates that this option does lower merchant costs and Australian regulators and merchant representatives insist that consumers have also benefited, arguing that merchants in competitive markets generally lower prices. The main challenges to implementing this option are determining the right level of reduction . . .⁶⁶

Unlike the GAO, Congress can and does make policy choices. In view of the payment card market dysfunction, the market power of Visa and MasterCard and their banks, and the harmful and unreasonable costs of interchange on consumers and merchants, a cap on interchange is, as the GAO has observed, the most direct way to effect the needed change;

⁶⁶ GAO Report 10-45, at 48. It is possible that the issuer banks would react to the loss of income caused by a cap by attempting to impose new fees on their customers for credit cards, especially for premium cards. This would, however, be subject to the intensive competition that exists among card issuers as they reach out to potential cardholders and it would end the unfairness of customers without premium cards or who pay by cash or check being taxed through retail prices that reflect the unduly high interchange fees.

and it is fully consistent with the historical responsibility of government to manage the issuance and exchange of money for the good of the people.

VI. Conclusion

For too long MasterCard and Visa, each with market power in the card payment markets derived from decades of collusive conduct by the nation's largest banks, have used their market power to force merchants to pay them and their bank members outrageous sums of money which inevitably get charged to all consumers (including those who pay with cash, checks or government-funded welfare programs). And, as demonstrated by the hard lessons we have learned in the last few years, it is dangerous to blindly trust these financial institutions to make sound judgments and to treat their customers fairly. Congress must intervene.

Governments around the world have been taking actions to eliminate or severely reduce interchange fees based on studies and investigations that clearly establish that these fees are abuses of market power. Moreover, the results demonstrate that interchange fee regulation works. Despite the protests of MasterCard and Visa and their giant card-issuing banks, mandated interchange fee reductions have increased competition in foreign payment card markets and have benefitted consumers through lower prices. Also, credit card issuing and transaction volume in those countries have continued to rise.

Although there is on-going major interchange fee antitrust litigation and there are well-intentioned proposals pending in Congress, the MasterCard and Visa payment markets in this country are so broken that only a major system change can restore balance and protect merchants and consumers. Therefore, this paper has proposed a new federal law, consistent with the Constitutional allocation of authority over payment systems, that would limit credit card interchange fee rates to transaction processing expenses (including a reasonable profit) and give the Federal Reserve Board (or some other agency) the authority to gather and evaluate appropriate data and set maximum credit card interchange fees periodically. As for debit cards, the case is overwhelming that they should be exchanged "at par" with no interchange at all.

After nearly bringing down our country's economy, big banks have used taxpayer funds to again make themselves immensely profitable on the backs of main street and ordinary citizens. It is time for our biggest banks to once again try to get rich the old fashioned way. They should EARN it. Let's put an end to unjustified and unfair interchange fees.

