TESTMONY OF DOUG KANTOR

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STEPTOE & JOHNSON LLP

ON BEHALF OF

FUEL MERCHANTS ASSOCIATION OF NEW JERSEY

NEW JERSEY FOOD COUNCIL

NEW JERSEY GASOLINE C-STORE AND AUTOMOTIVE ASSOCIATION

NEW JERSEY RETAIL MERCHANTS ASSOCIATION

BEFORE THE

NEW JERSEY ASSEMBLY CONSUMER AFFAIRS COMMITTEE

MARCH 7, 2013

Chairman Moriarty, Vice-Chair Diegnan and members of the Committee, I am honored to appear before you today and appreciate the opportunity to share my views on credit card swipe fees. My name is Doug Kantor. I am a partner in the law firm of Steptoe & Johnson LLP and provide counsel to a wide range of the merchant community with respect to the issue of swipe fees. I am testifying today on behalf of the Fuel Merchants Association of New Jersey, the New Jersey Food Council, the New Jersey Gasoline C-Store and Automotive Association, and the New Jersey Retail Merchants Association.

Swipe fees are a critically important issue to businesses and consumers across the nation, and the economy as a whole. The centralized setting of the swipe fees charged by banks that issue credit cards as well as the conditions for acceptance of those cards amounts to nothing less than price fixing and an illegal restraint of trade. Many of the rules imposed by the major credit card companies also constrain the marketplace to prevent competition in violation of the antitrust laws. To the extent that this Committee is looking into these fees and how they can be dealt with, these anti-competitive structures should be central to the conversation.

My testimony today will address several major points. First, I will describe the current competition policy problems with the swipe fee system in the United States. Second, I will detail the impact caused by these problems. Third, I will discuss a potential reform getting at the heart of these problems. Finally, I will address some of the myths that have at times been raised in the context of this issue in order to set the record straight.

I. The Problem with Swipe Fees

There is broad international consensus that swipe fees pose unacceptable anti-competitive and anti-consumer problems. Indeed, after many years of study and debate, regulators from Australia, the European Commission, Great Britain, Spain, New Zealand, Hungary and others have reached this conclusion and taken action. The most egregious problems these countries and many in America have found are described below.

A. Centrally Setting the Fees

Swipe fees collectively deprive businesses that accept credit cards as well as consumers of the benefits of competitive market forces because they are centrally set by Visa and by MasterCard. These two companies have been found by the U.S. Court of Appeals for the Second Circuit to have market power under the antitrust laws both individually and collectively.[1] Each of the two credit card giants decides upon a schedule of default fees for the banks that issue their cards to charge for transactions. Note that these fees are not charged by Visa and MasterCard themselves. Instead, they are fees that banks that are supposed to be competing with one another charge – and some of those banks sit on the boards of Visa and MasterCard to help decide the fees they and their competitors will charge.

[1] *United States v. Visa USA, Inc.*, 344 F.3d 229 (2d Cir. 2003).

That is a profound problem. Banks including Bank of America, JP Morgan Chase, Citi, Wells Fargo/Wachovia and others compete with one another in the other aspects of their businesses. Yet when it comes to swipe fees, they collectively agree to charge the same schedule of fees. The result is just what you would expect to happen if another industry did the same thing. If, for example, grocers all agreed to charge the same prices for milk as their competitors, we would all expect the price of milk to be much higher than a competitive market would produce. Our antitrust policy prohibits this type of central price-fixing because it takes away the primary benefit of our economic system – the incentive for competitors to try to gain market share through price competition.

This activity cannot be excused because Visa and MasterCard have changed their corporate form. Until a few years ago, both Visa and MasterCard were simply associations of their member banks. Even they realized, however, that setting prices for their association members created potentially serious legal liabilities. So, they both became corporations offering their shares to the public. This change, however, was nothing more than an attempt to put form over substance. Each company still serves as the price-setting body for its member banks (including member banks with ownership interests in the credit card companies). The change in corporate form does not change the reality – the banks agree to let the major credit card giants fix their prices for them.

The fact that the card companies say their rate schedules are "default" rates and that banks are free to depart from them is little more than rhetorical posturing. There is no incentive for banks to depart from the schedule of inflated fees that their competitors follow and we are not aware of such departures.[2] In fact, retailers have been told many, many times by their bankers that the bankers cannot depart from the agreed upon rate schedule. As with other price-fixing examples, the banks know that they are better off sticking to the collective pricing rather than departing from it.

B. Rules that Hide the Fees

The major card companies not only centrally set prices, but they establish the rules for the credit and debit card systems. These rules and the manner in which the system operates keeps fees hidden and insulated from competitive pressures.

The U.S. Department of Justice sued Visa and MasterCard to overturn their longstanding rules that prevented merchants from giving their customers discounts for using cards with lower fees. While Visa and MasterCard agreed to end their indefensible restrictions on discounts, unfortunately, American Express still maintains rules that prevent this practice. The Department continues to litigate against American Express, but for the time being merchants that accept American Express (and most do) cannot discount for cheaper cards.

[2] While JP Morgan Chase has announced that it may do this in theory (perhaps to drive business to its merchant processing arm) as far as we are aware that has not happened. And, a few departures from the general practice would simply be the exceptions that prove the rule – millions of merchants would still be subject to centrally price-fixed fees.

The result is that no card company has any incentive to reduce its fees. The reason companies reduce prices is to get more customers, but card company rules ensure that the consumers who decide what card to use cannot get a benefit from reduced fees and that any fee reduction a card network might make will have no impact on transactions or market share. This is just like if Coca-Cola and Pepsi, to take one example, were to tell stores that they could never have a sale and price their competitor's products lower than their own. With that rule in place, how many discounts do you think we would see for Coke or Pepsi? The answer is none and prices would steadily rise as a result. That is just what we face here and it is one key leg of the table artificially propping up swipe fee prices.

The card companies have related rules that make it very difficult for merchants to give their customers other types of discounts. Discounts for cash, checks and debit cards, for example, might bring some market pressures to bear on the size of interchange fees. But Visa and MasterCard both have byzantine sets of rules regarding the way merchants can display any such discounts. The rules have at times contradicted state consumer protection laws and forced merchants to decide to either violate the Visa/MasterCard rules or violate state law. The result, as the card companies know well, is that merchants typically choose a third option – don't give any discounts because it is not worth the risk.

Typically, merchants quickly back down from the Visa/MasterCard threats about discounting, but a controversy over their heavy-handed tactics made its way into the press in California a few years ago. Visa threatened a couple of gas station owners – including a single store operator – if they continued to offer cash discounts. And, in that instance, Visa instructed the station owners that they should display their prices and discounts in a way that would violate California law. When asked about this by the publication *Oil Express*, Visa spokeswoman Rhonda Bentz reacted in a way that is incredibly revealing of Visa's hubris and the way it treats merchants. She said, "It's great if they have a contract with the state, but they don't. They have a contract with Visa and if they don't want to abide by that contract, they shouldn't have signed it."[3]

California Weights and Measures Director Dennis Johannes saw Visa's tactics for what they were. He said Visa was "heavy handed" and noted, "They probably don't want dual pricing because it discourages the use of their credit card." Of course, that is precisely the type of market pressure that the economy normally depends on to keep prices down. If Visa doesn't want people to be discouraged from using their cards, they should lower their prices rather than threatening merchants who offer cash discounts.

Yet another rule that helps erase any semblance of competition requires that merchants accept every single type of Visa or MasterCard no matter how high the fees are for that card – or accept no cards at all. The upshot of this rule is that when new cards come into the market, the card companies do not need to seriously consider whether the prices they set will cause people not to take the card. To take the soft drink example again, when companies come out with a new flavor of Coke or Pepsi, those companies need to think about the price point and whether merchants will carry the new product and consumers will buy it. If the price is too high, then the

[3] *Oil Express*, April 23, 2007.

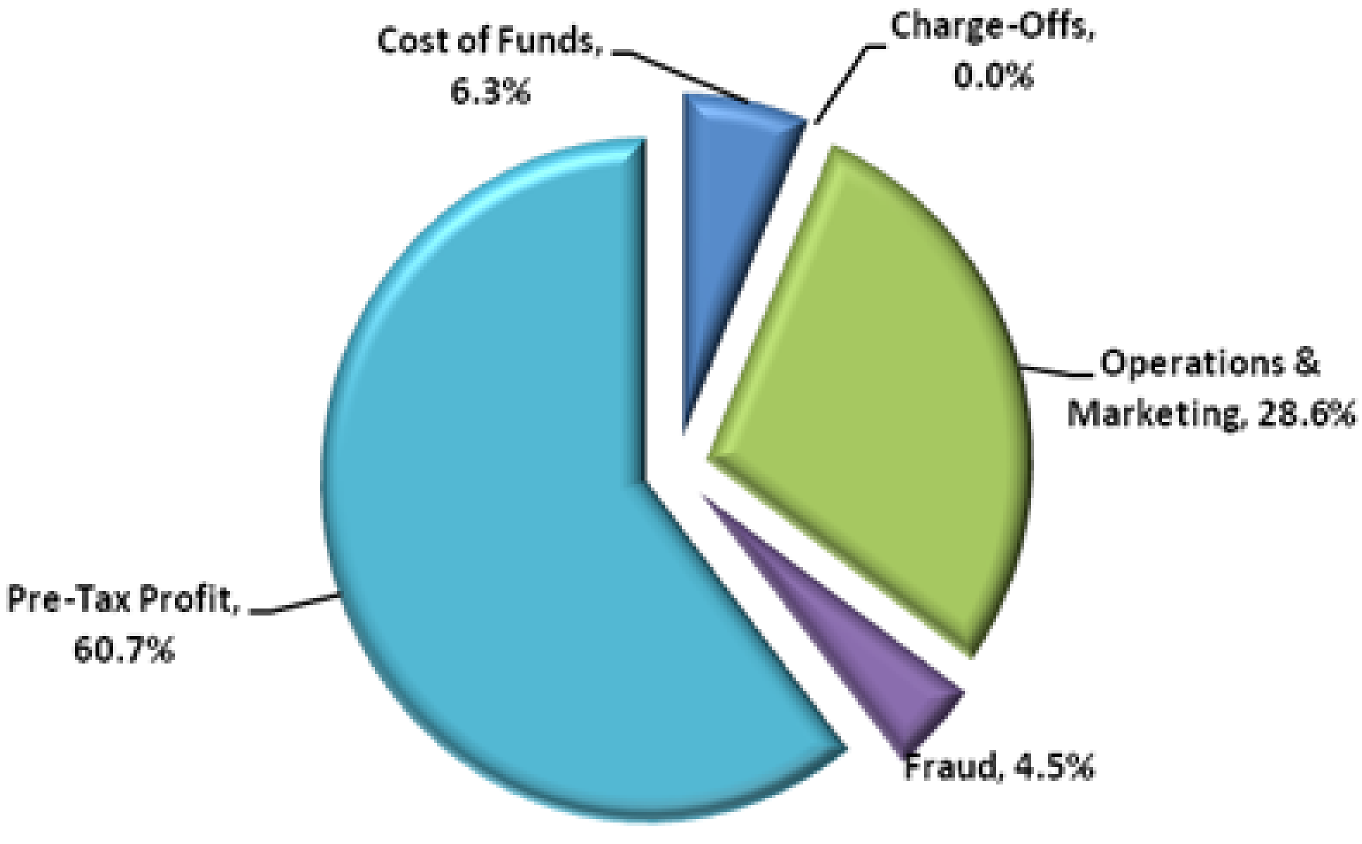
product won't be successful. If they had a rule saying that every store had to buy all of their products no matter the price or be prohibited from carrying any of their products, that would raise the problem of product tying under the antitrust laws. But Visa and MasterCard both have this type of rule. The origin of this rule was well-intentioned – that merchants treat different bank issuers of cards in the same way and not refuse a consumer's card because the bank was unfamiliar to the merchant. This rule, however, has gone beyond all reasonable bounds and no longer just ensures that bank issuers are treated fairly. It now prohibits merchants from taking any action to protect themselves against rapidly escalating fees on card products.

II. The Impact of Swipe Fees

A. The Impact on Business

For retailers across the country, on average, swipe fees are their second highest operating expense after labor. That means swipe fees cost these businesses more than rent on their stores, utilities, and other overhead. Retail profit margins are very, very narrow. The retail sector of the economy is highly competitive and if costs go down for those businesses, then their prices go down. Retail profit margins are consistently narrow in the United States. The numbers show that retail consistently ranks near the bottom of all industries in terms of profitability and has very stable profit margins each year (many other industries are lower in particular years but fluctuate more). Retail profit margins tend to vary between 1 and 4 percent industrywide.

The difference between the narrow profit margins of the retail industry and the huge profit margins for banks on swipe fees is dramatic. The chart below shows that the profit margins on swipe fees are more than 60% based on data from *Cards & Payments*.



Card Issuer INTERCHANGE Profitability
Avg '06 to '08

These fees continue to escalate and business owners do not have a way to control them. They can take action to deal with utility costs, they can negotiate their rent and labor costs, but they can't deal with these cost increases. The inability to go to a competitor to get a better deal is simply devastating. In fact, economists with the Kansas City Federal Reserve have found that merchants cannot realistically refuse to accept Visa and MasterCard even though interchange costs far exceed any benefits those merchants receive by accepting cards.[4] While the card companies sometimes argue that merchants could stop accepting cards, the cards are so dominant now that that is not realistic. Visa, in fact, has promoted itself as "currency" in its marketing. Telling merchants they don't have to take cards, then, is like telling them they can refuse to take cash. While theoretically possible in some niche businesses, it is generally not realistic.

The dramatic jump in card rates – both in dollar terms and in terms of the rates charged – takes its toll on merchants. According to the Government Accountability Office (GAO) this is not just due to more people using cards but is the result of Visa and MasterCard increasing their fees. GAO wrote, "Visa and MasterCard officials told us that their average effective interchange rates applied to transactions have remained fairly constant in recent years when transactions on debit cards, which have lower interchange fee rates, are included. **However, our own analysis of Visa and MasterCard interchange rate schedules shows that the interchange rates for credit cards have been increasing and their structures have become more complex,** as hundreds of different interchange fee rate categories for accepting credit cards now exist."[5] Let's be clear about this, GAO concluded that what Visa and MasterCard told them about their rates remaining flat was false.

The increases in the rates set by Visa and MasterCard, along with increased card usage, has led to a huge increase in fees paid by merchants. The chart below shows how those fees have grown over time for the convenience store industry and shows industry profits per year as well. It is not a coincidence that as the amount of card fees jumped past the amount of profits the industry made, profits fell. The fact that fees have been more than profits for 6 years in a row demonstrates the difficulties these fees cause for business.

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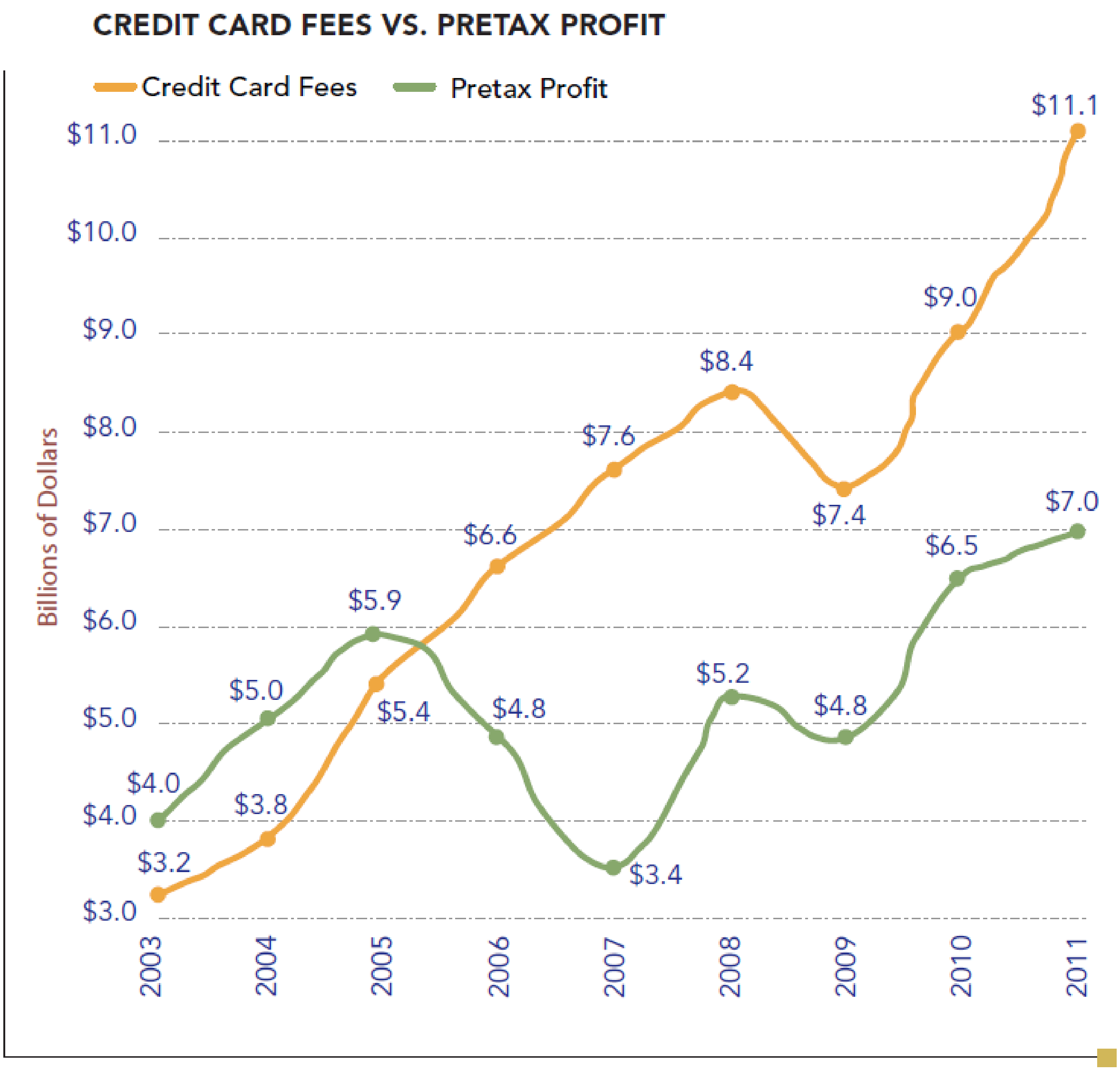
[4] "A Puzzle of Card Payment Pricing: Why are Merchants Still Accepting Card Payments?," Fumiko Hayashi, December 2004.

[5] "Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges," GAO-10-45, Nov. 19, 2009 ("GAO Report") at 14 (emphasis added).

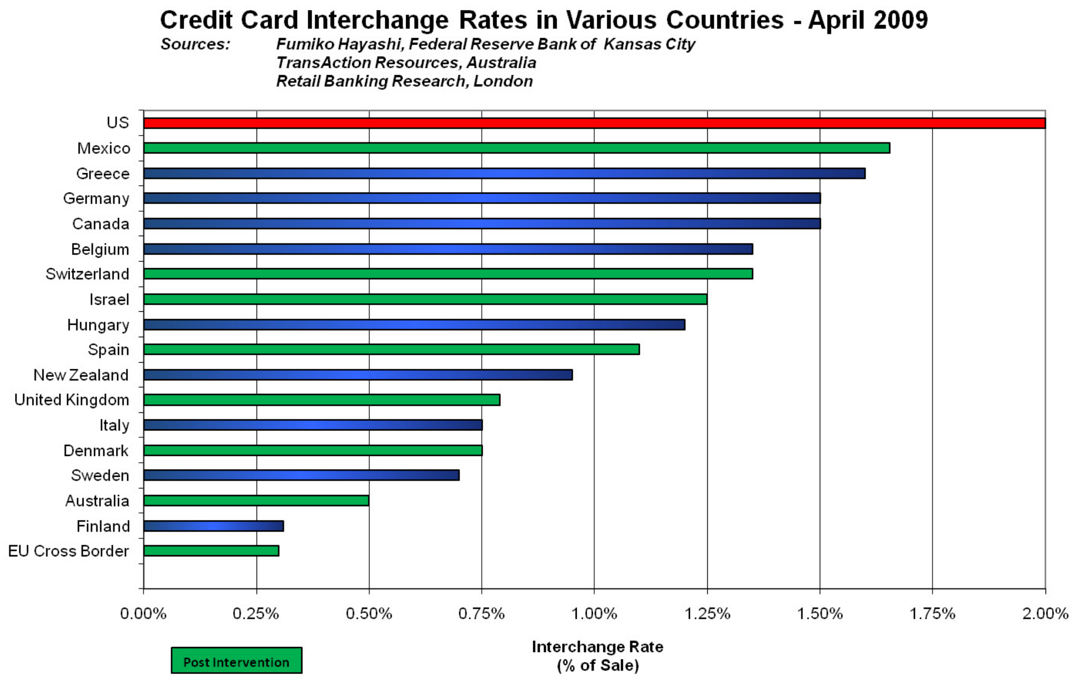
Card Fees and Pre-Tax Profits in the Convenience Store Industry



And these fees hit small businesses the hardest. While the card companies like to talk about the large retailers that might be helped by policy solutions to deal with swipe fees, the current system that they defend gives large retailers a decided competitive advantage over small businesses. The GAO found, "Merchants with large volumes of card transactions generally have lower interchange fee rates. Visa categorizes some merchants into three tiers based on transactions and sales volume, with top-tier merchants receiving the lowest rate."[6] That simply should not be. Unlike situations in which product needs to be manufactured and delivered to stores, there are no cost savings that justify better deals for large merchants.

These out of control fees disadvantage the U.S. economy. Interchange fees in this country are among the highest in the industrialized world as shown by the chart below.

[6] GAO Report at 10.



It is interesting to note that while some countries with lower interchange rates have taken action to deal with these fees, several countries that have done nothing pay lower rates than Americans do. The reason for that is straightforward. The two major card companies have such dominant market power here that they can engage in the anticompetitive practices that I have described without fear of too many merchants leaving the network.

B. The Impact on Consumers

The impact of anticompetitive swipe fees on consumers is dramatic. American consumers pay inflated prices for virtually everything they buy because of these fees. And they pay these funds without even knowing it. Consumers never get a disclosure from their card issuer telling them any swipe fees are charged – not to mention how much they are. This is the card companies' model. By hiding their fees they can keep charging more and consumers won't notice. In 2009, the Hispanic Institute studied this phenomenon. They found that the business model by which fees are embedded in retail prices without disclosure combined with the rewards that some cardholders get leads to a regressive transfer of wealth from low income consumers to high income consumers. This regressive wealth transfer is more than $1 billion every year.[7] And this did not even take into account the 27 percent of U.S. families who do not even have credit cards – but are still paying inflated prices due to swipe fees.[8]

Retailers are not the only ones who have come to the conclusion that swipe fees hurt consumers. John Blum testified on behalf of the National Association of Federal Credit Unions (NAFCU) before the Antitrust Task Force of the Judiciary Committee of the U.S. House of Representatives on May 15, 2008: "Further, interchange is a cost that retailers can and do pass onto their customers in the final price of the goods and services they sell."[9] It appears then that NAFCU agrees with the Hispanic Institute – consumers are paying interchange fees right now, but the fees are hidden in the price of goods and services those consumers buy.

The card companies have strenuously argued that if anything at all happens to reduce swipe fees, then other fees paid by consumers will increase and consumers will be in a worse position than they are today. This is false. In fact, the European Commission's Directorates for Competition and Financial Services jointly conducted a comprehensive study into the European payment card industry in general, and Visa and MasterCard in particular. The Commission found no evidence to support the card systems' arguments in favor of benefits to consumers of the high fee levels associated with the existing swipe fee mechanism. In particular, the Commission rejected arguments that lower interchange fees to merchants would result in higher fees to consumers:

> There is no economic evidence for such a claim. Firstly, the inquiry's data suggests that in most cases card issuers would remain profitable with very low levels of interchange fees or even without any interchange fees at all. Secondly, the international card networks have failed to substantiate the argument that lower interchange fee would have to be compensated with higher cardholder fees The evidence gathered during the inquiry rather suggests that the pass-through of higher interchange fees to lower cardholder fees is small. Consumers already pay the cost of the interchange fee without knowing it. This cost is now hidden in the final retail price and is therefore non-transparent.

Similarly, the Australian experience has refuted claims that decreases in interchange fees would undercut the viability of card systems. In fact, after several years' experience with reduced interchange fees, the Australian central bank has concluded that card issuers have responded to

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[7] "Trickle Up Wealth Transfer: Cross-subsidization in the payment card market," The Hispanic Institute, November 2009 at 5.

[8] Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances, Federal Reserve Bulletin, February 2009, at 46.

[9] Testimony of John Blum, Vice President of Operations of Chartway Federal Credit Union, before the House Judiciary Committee Antitrust Task Force, May 15, 2008 at 8.

lower merchant fees by offering consumers a choice: Low cost cards with low interest rates and fees and no rewards, and rewards cards with higher interest rates and annual fees.

Indeed, this resulting *price competition* is precisely the outcome the card systems feared: For example MasterCard had complained to the Australian Reserve Bank about having its members forced to compete on price:

> MasterCard does not disagree that there is, at present, strong competition amongst issuers of credit cards. Such competition has been enhanced by the fact that, at present, issuers have been able to recover eligible costs…. One distinct characteristic of the product offerings in recent times, however, has been the increase in the number of "low cost" credit card offerings. While MasterCard believes that it is beneficial for there to be "low cost" credit card products being offered, it also believes that, with the common benchmark interchange fee, in the future there will be fewer "fully featured" credit card offerings and the competition between issuers will be based on increasingly homogeneous "low cost" credit card offerings.

That is precisely the result that would be best for consumers. Once the card companies in Australia stopped competing for market share by raising the fees their banks would earn (which the bank could in some small measure plow back into enticing rewards for consumers), they had to compete on interest rates in order to attract consumers directly. That is what Australian consumers really wanted and what they have been getting since their system was reformed. Interest rates on credit cards fell precipitously after the reforms and even though the overall rates in that country have fluctuated over time, the spread between their benchmark rates and the rates consumers get on their credit cards is consistently narrower than it was prior to Australia's reforms. U.S. PIRG and other consumers groups educate consumers that the most important thing to look at when evaluating cards is the interest rate. Once Australia took some of the confusing subterfuge out of the system by reducing the hidden fee-reward cycle, consumers there were able to focus on interest rates and get better rates.

The dramatic impact on consumers and the economy is difficult to comprehend. Robert Shapiro, former UnderSecretary of Commerce for Economic Development, issued a study and concluded that without the higher prices caused by fees above and beyond costs plus a reasonable rate of return, consumers would have an additional $26.9 billion to spend and the economy could add 242,000 jobs.[10] Those are staggering figures. For New Jersey alone, it would mean more than $900 million in consumers' pockets and 8,000 jobs just from having a competitive, transparent swipe fee system.

III. Solutions

The root of the problem with swipe fees is the central price-fixing of the fees by the card networks – Visa and MasterCard. This price-fixing needs to stop. New Jersey and other states

[10] "The Costs of 'Charging It' in America: Assessing the Economic Impact of Interchange Fees for Credit Card and Debit Card Transactions," Robert Shapiro and Jiwon Vellucci, 2010.

have the ability to pass just that sort of antitrust law in order to ensure that price-fixing cannot be used to disadvantage their own merchants and consumers. The result of such a prohibition is that banks that issue cards would have to set their own fees and negotiate with processors and banks that accept card transactions (often referred to as merchant or acquiring banks) to come to agreement on a reasonable price. The processors and acquiring banks would be incentivized to negotiate low fees because merchants could move their business to the ones with the best deals. Such a reform would, in fact, move the system to one that actually follows what the card companies claim it to be – a fee between banks. To date, that is not what swipe fees have been. They have been direct fees on the merchants and imposed based on the merchant rather than on the processor/acquirer's full book of business.

And this type of reform would work. New York University professor Nicholas Economides has written about just this type of reform and found that the concentration of large companies on both the issuing and acquiring side would mean that only 90 contracts could cover more than 75 percent of all credit card transactions.[11] That is easily doable and belies the card companies' contentions that such a system would be unworkable.

In fact, this reform might even be enhanced by allowing some collective action by small banks while ensuring that large banks have to stand on their own two feet with respect to pricing. Legislative language like the below would both end price-fixing for large banks and provide small banks some protection by maintaining a vestige of the card companies' honor all cards rule (while ending it for the 100 or so biggest banks).

> Section __ – Prohibition on Cartel Price-Setting by Credit Card Companies
>
> No electronic payment system may set required, suggested, or default rates for the fees to be charged by any issuer of its credit cards, agent, processor or member of the system unless such issuer, agent or processor is the electronic payment system itself and not a separate legal entity.
>
> Section __ – Ensuring Free Market Negotiations
>
> An electronic payment system shall not directly or through any agent by contract, requirement, condition, penalty, or otherwise prevent any merchant or financial institution on behalf of a merchant from deciding not to accept any credit card of such electronic payment system that was issued by a financial institution which, together with its affiliates, has assets of more than ten billion dollars ($10,000,000,000) while still accepting other credit cards of that electronic payment system.
>
> Section __ – Penalties

[11] "Competition Policy Issues in the Consumer Payments Industry," New York University School of Law, Law & Economics Research Paper Series Working Paper No. 08-56, November 2008.

(1) Any electronic payment system found to have violated Section __ of this chapter shall reimburse all affected merchants for all fees collected from affected merchants directly or through any agent, processor or member of the system during the period of time in which the electronic payment system was in violation and be liable for a civil penalty of $10,000 per fee levied in violation of Section __.

(2) Any merchant whose rights under this Act have been violated may maintain a civil action for damages or equitable relief as provided for in this Section.

(3) The Attorney General may maintain a civil action for damages or equitable relief as provided for in this section to protect against violations of this chapter.

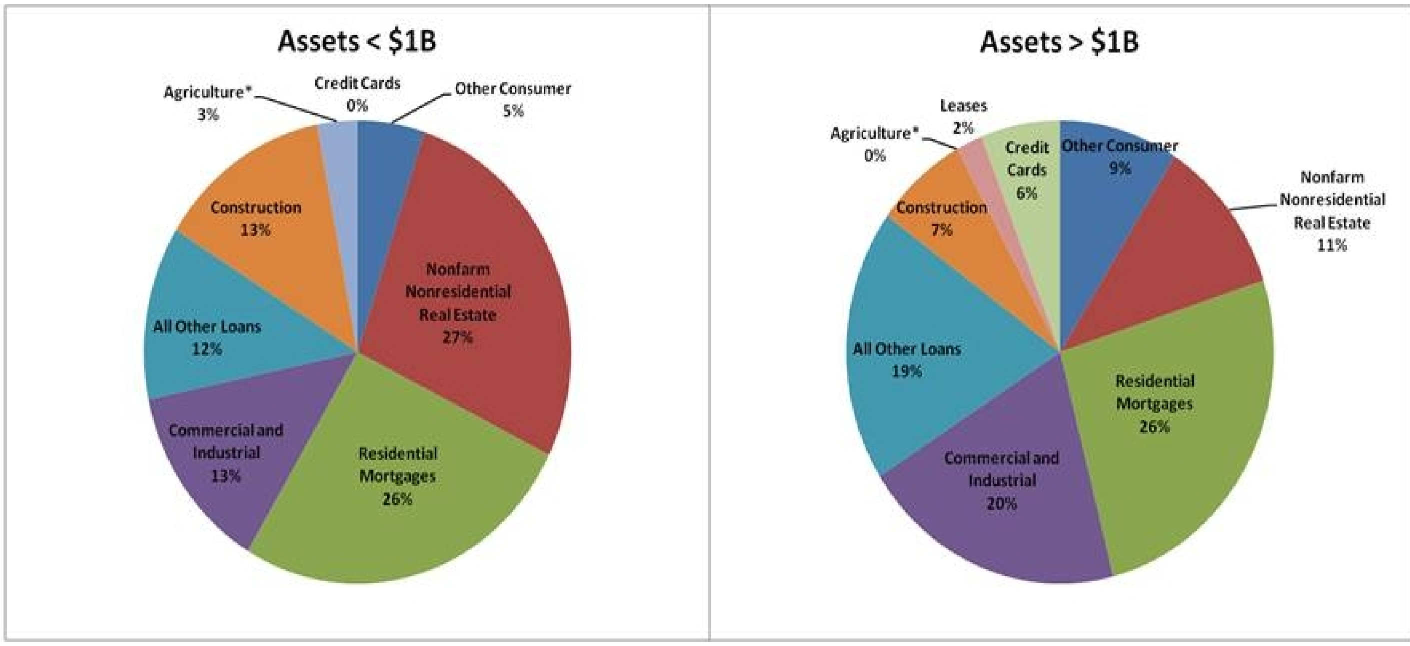
IV. ADDRESSING THE MYTHS

Unfortunately, there are several myths that have obscured the debate of the unfair way in which the swipe fee system operates. I suspect that several Members of the Committee have heard these myths. In light of this, I would like to address some of the major ones and provide you with the facts.

Myth: *Small banks and credit unions will suffer if the swipe fee system is reformed.*

Reality: The current swipe fee system overwhelmingly benefits a very small number of very large banks. Only 10 large banks collect more than 80 percent of interchange fees. Let me make that clear. That's not the top 10 percent of banks – I am just talking about 10 banks. No one after those 10 banks even has 1 percent of the market.

In fact, as the charts below show, small banks make almost no money from credit card issuing. This is a big bank business. Institutions with less than $1 billion in assets (which is a pretty large institution), do not even make 1% of their revenues from credit cards as shown below.



* OTS – supervised savings associations do not identify agricultural loans

Source: FDIC, Quoted in American Banker, 3/20/09

I urge everyone when they hear from small banks about this issue to make sure they get the answer to one simple question – what percentage of that small bank's total revenue comes from swipe fees. If they can't or won't answer that simple question, then it is hard to take their complaints about reform seriously.

Small banks argue that they have higher costs for issuing cards and so they must be able to charge the same fees as their larger competitors. Of course, if that is true, then those larger competitors are making a huge windfall by fixing their prices with small banks. And clearly, as previously discussed, 60 percent profit margins certainly look like a windfall.

Small banks make only a tiny portion of total swipe fees and will not be hurt by real competition. They compete with big banks in every other part of their businesses – why not here?

Myth: *The credit card system works fine now. There is no need for legislation.*

Reality: The current system is broken. Visa and its member banks fix interchange fees in violation of the antitrust laws. MasterCard and its banks do the same. The result is that interchange fees are rising fast and cost the U.S. economy more than $50 billion each year. That is more than triple what the fees were in 2001.

Not only are the fees skyrocketing so that merchants and consumers pay too much, but these fees change the nature of the credit card business in a way that hurts consumers. As Georgetown Law professor Adam Levitin observed in testimony before the Judiciary Committee of the U.S. House of Representatives, the huge fee revenue the banks earn from credit card transactions taking place has created bad incentives. He testified, "The card industry's business model is the heart of the problem and needs to change. Just as with subprime mortgages, the credit card business model creates a perverse incentive to lend indiscriminately and let people get into so much debt they can't pay it back."[12] Others have clearly observed this trend as well. For example, Acting Comptroller of the Currency Julie Williams said in March 2005, "Today the focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset . . . it's not repayment of the amount of the debt that is the focus, but rather the income the credit relationship generates through periodic payments on the loan, associated fees, and cross-selling opportunities."[13] These changes mean that banks are less worried than they should be about consumers' welfare. It should be in the interest of banks for consumers to do well and be able to pay back credit card loans. But the huge fee income the banks generate through swipe fees and other means gives them another incentive – milk consumers for all they are worth and don't worry about the money getting paid back.

The bottom line is that abuse of consumers by banks will continue as long as they have the incentive to treat people that way. Swipe fees are the key incentive with which Congress has not yet dealt. The abuses of consumers and using credit cards as predatory lending vehicles will continue until something is done about swipe fees.

Myth: *We shouldn't reform swipe fees because merchants will just pad their profits.*

Reality: Congressman Peter Welch made an insightful observation on this point when he spoke with Politico and noted that this is an odd argument because the credit card industry is essentially saying "let us keep ripping people off or someone else will." The role of the state and federal governments is to stop the card industry from engaging in rip-offs and then, if someone else is doing something wrong later, deal with that.

This argument also ignores the basic tenets of economics. Economics say that in the absence of a market failure higher business costs result in higher prices and lower business costs result in lower prices. The retail sector of the economy is highly competitive and if costs go down for those businesses, then their prices will go down. Retail profit margins in the United States are consistently narrow. This means that regardless of conditions in the economy the competition across

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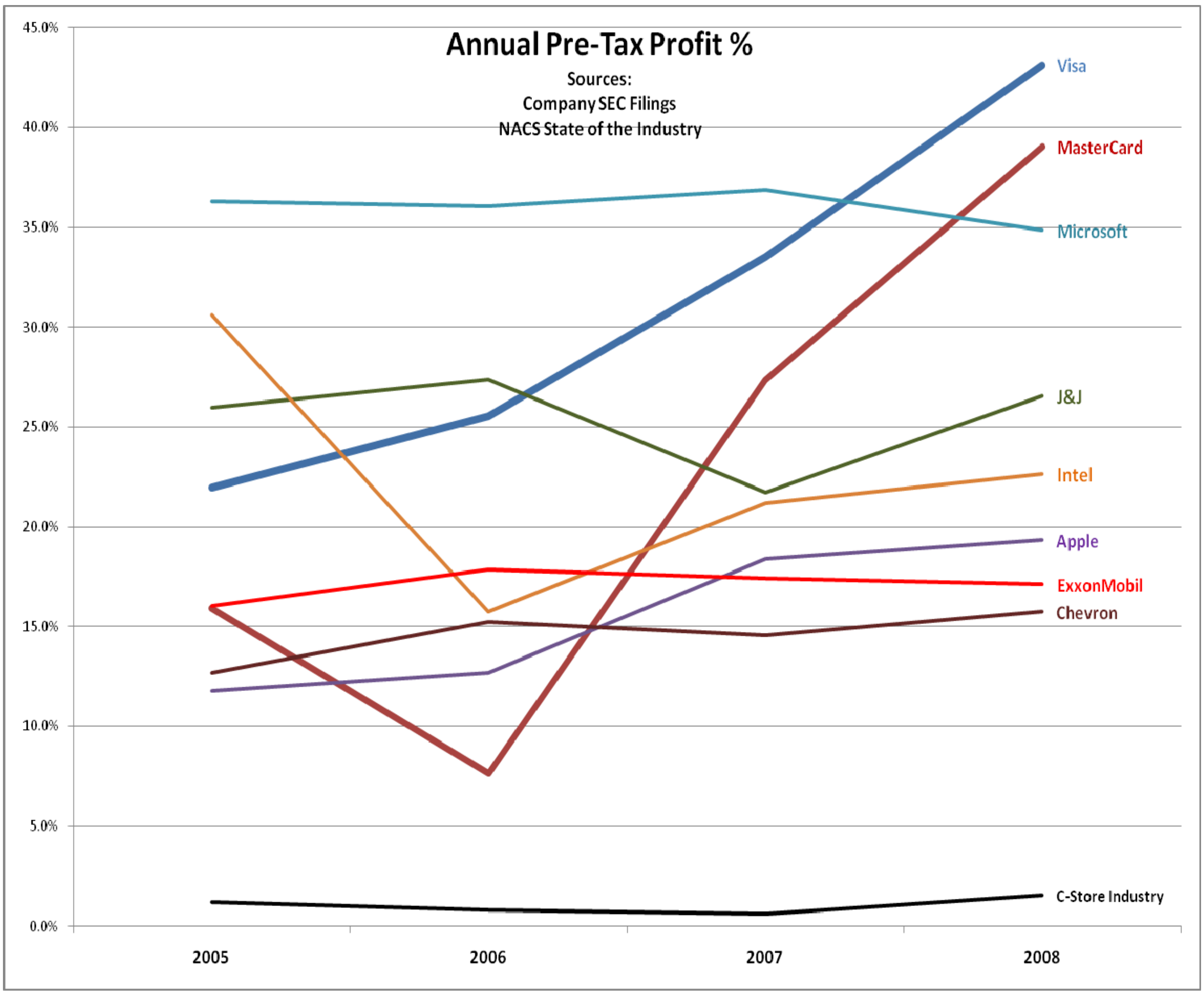
[12] Adam J. Levitin, Testimony before the House Judiciary Subcommittee on Commercial and Administrative Law, "Consumer Debt – Are Credit Cards Bankrupting Americans?" April 2, 2009.

[13] Remarks by Julie L. Williams, Acting Comptroller of the Currency, Before the BAI National Loan Review Conference, New Orleans, LA, March 21, 2005, at http://www.occ.treas.gov/ftp/release/2005-34a.pdf.

retail businesses is such that revenues can never exceed costs by much – whether costs are rising or falling. And, as noted earlier, industry average retail profit margins tend to stay in the 1 to 4 percent range.

To put this in perspective, let's look at the profit margins for some large U.S. corporations. Note that Visa's profit margins are more than 40 percent and MasterCard's are close. Microsoft comes close to them but many other household names don't. Some major oil companies are between 15 and 20 percent. And way down at the bottom, one retail industry – convenience stores – have about 2 percent profit margins. Now, the credit card industry has accused these retailers of ripping off their customers. This chart makes clear who is ripping off who.



I would also note that the Department of Energy has studied how retailers that sell gasoline do or do not pass through costs into retail prices. They found that for both cost increases and cost decreases there is 100 percent pass through of costs into retail prices.[14] That means, without question, whether interchange fees increase or decrease, consumers will see those changes reflected in the cost of gasoline – for better or for worse.

The Hispanic Institute studied this question in its report issued in 2009. It found that "the data shows that lower interchange fees result in lower prices for consumers and higher interchange fees result in higher prices for consumers."[15]

Myth: *There is no need for reform because merchants can already negotiate fees.*

Reality: This claim is purposely misleading. Merchants cannot negotiate swipe fees. They negotiate with their local bank or processor on their processing fees, but those processing fees are much smaller than the swipe fees merchants pay. In most cases, processing fees are only about 10% of what the merchant pays. They are an add-on to what the merchant pays in swipe fees. Swipe fees are much larger – the more than $50 billion paid each year is more than all of the credit card fees charged directly to consumers combined. The swipe fees get passed through to merchants and, ultimately, to consumers. Merchants also have no ability to shop for better swipe fee deals. Visa's banks all charge the same schedule of swipe fees and MasterCard's banks do the same. The result is that there is no competitive market for swipe fees – just price fixing.

Myth: *There is no need for reform because credit card fee rates have remained flat.*

Reality: This is simply false. As noted previously, GAO found, "Visa and MasterCard officials told us that their average effective interchange rates applied to transactions have remained fairly constant in recent years when transactions on debit cards, which have lower interchange fee rates, are included. **However, our own analysis of Visa and MasterCard interchange rate schedules shows that the interchange rates for credit cards have been increasing and their structures have become more complex,** as hundreds of different interchange fee rate categories for accepting credit cards now exist."[16]

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[14] U.S. Department of Energy, "Gasoline Price Pass-through," by Michael Burdette and John Zyren, January 2003.

[15] "Trickle Up Wealth Transfer: Cross-subsidization in the payment card market," The Hispanic Institute, November 2009 at 6.

[16] GAO Report at 14 (emphasis added).

The Kansas City Federal Reserve published a presentation on April 3, 2008 showing that average interchange fee rates rose from less than 1.3% to more than 1.6% between 1996 and 2005. And, according to Kansas City Federal Reserve economists, that rate was nearly 2% in 2009. Today, it is well over 2%. The American Banker on March 1, 2006 reported on Visa's "long-standing pattern of regular increases" in its interchange fees and said that "According to the credit card industry newsletter The Nilson Report, interchange rates for Visa and MasterCard International have risen steadily every year since 1997." At the same time, transaction volume has increased dramatically, so the absolute amount of interchange fees collected rose even more dramatically. And, credit card companies have consistently moved more cardholders to new corporate and rewards cards that carry higher swipe fee rates. While they sometimes don't change the rates for a given type of card – that doesn't matter if many of the people who had been using that card are now using a card with a higher rate. By moving people to rewards cards, the card companies continue to pretend that they don't raise rates even though the rates merchants pay consistently increase. The combination of all of these factors means that in less than a decade swipe fees tripled and were the single-fastest growing operating cost for merchants.

Myth: *There is no need for reform because merchants can simply stop accepting credit cards.*

Reality: Economists have found that due to the market power of Visa and MasterCard, this is not true. This argument would be like AT&T claiming in the 1980s that no one should worry about its monopoly because people could choose not to have a telephone. Accepting cards is essential for most businesses. The Kansas City Federal Reserve studied this issue in a 2004 report titled, "A Puzzle of Card Payment Pricing: Why Are Merchants Still Accepting Card Payments?" and concluded, "Only monopoly merchants who are facing an inelastic consumer demand may deny cards when the fee exceeds its transactional benefit. . . Merchant competition allows the network to set higher merchant fees. The network can always set higher merchant fees in more competitive markets. Moreover, in competitive markets the merchant fees in the long run may exceed the sum of the merchant's initial margin and the merchant's transactional benefit. . . . As long as the merchant fee does not exceed the level that gives merchants negative profits, merchants may have no choice but to continue accepting cards." The courts also agree that Visa and MasterCard both have market power which means they have the ability to raise their prices above what would be sustained in a competitive market.[17]

Myth: *Reform will hurt consumers and result in them paying higher fees.*

Reality: Policymakers around the world have found that reform has benefited consumers. In Australia, for example, the Reserve Bank of Australia reviewed the interchange

[17] *U.S. v. Visa U.S.A., Inc.*, 344 F. 3d 229 (2d Cir. 2003).

reforms instituted there and concluded, "Overall, consumers are benefiting from this greater competition and lower merchant costs . . . one group of consumers clearly better off are those who regularly borrow on their credit cards. They are now able to obtain a card with an interest rate of 10 to 13 per cent, rather than the 16 to 18 per cent payable on traditional cards. For many consumers the resulting savings can run into hundreds of dollars per year . . . Consumers who do not use credit cards at all are also benefiting from the reforms as they are paying lower prices for goods and services than would otherwise have been the case. For many years, these consumers have helped subsidise the generous reward points of the credit card issuers through paying higher prices for goods and services. The reforms have helped unwind some of this subsidy."[18] The Reserve Bank of Australia reconfirmed this view in 2008 when it wrote, "One issue that has attracted considerable attention since the reforms were introduced is whether the cost savings that merchants have received from lower merchant service fees have been passed on to consumers in the form of lower prices for goods and services than would have otherwise been the case. The [card] schemes argue that there has been no, or little, pass-through, while the merchants argue that the cost savings have been passed through. The Bank's estimate is that over the past year, these cost savings have amounted to around $1.1 billion . . . . Despite the difficulties of measurement, the Board's judgement remains that the bulk of these savings have been, or will eventually be, passed through into savings to consumers. This judgement is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge. A similar conclusion was reached by the House of Representatives Standing Committee on Economics, Finance and Public Administration when it considered the Bank's payments system reforms in 2006."[19]

The credit card industry has repeatedly stated, or perhaps threatened, that lower swipe fees will mean higher consumer credit card fees. This argument has been thoroughly researched and rejected. As noted previously, for example, the European Commission's Directorate of Competition reviewed this claim and found, **"**There is no economic evidence for such a claim. Firstly, the inquiry's data suggests that in most cases card issuers would remain profitable with very low levels of interchange fees or even without any interchange fees at all. Secondly, the international card networks have failed to substantiate the argument that lower interchange fee would have to be compensated with higher cardholder fees."

The flip-side of this argument proves its shallowness. Swipe fees in the United States have tripled since 2001 – have consumer credit card fees been cut by one-third? Absolutely not. Simply asking the question makes the absurdity obvious. In fact, consumer card fees have been rising too. Credit card fees are not a zero sum

[18] Payments System Board Annual Report, *Reserve Bank of Australia*, 2005 at 14.

[19] Reform of Australia's Payment System: Preliminary Conclusions of the 2007/2008 Review, *Reserve Bank of Australia,* at 23.

game in which the industry has a God-given right to a set amount of revenue – as they would like you to believe – but instead are a reflection of the card industry's insatiable hunger for fees aided by their unfair and deceptive practices in charging them.

Myth: *Reforms will make it more complicated for consumers. The current system works well for them.*

Reality: The current system fools consumers by hiding the large interchange fees that are built into the cost of their purchases. To quote an advocate for consumer, Ed Mierzwinski of U.S. PIRG, "Interchange fees are hidden charges paid by all Americans, regardless of whether they use credit, debit, checks or cash. These fees impose the greatest hardship on the most vulnerable consumers – the millions of American consumers without credit cards or banking relationships. These consumers basically subsidize credit card usage by paying inflated prices – prices inflated by the billions of dollars of anticompetitive interchange fees. And unfortunately, those credit card interchange fees continue to accelerate, because there is nothing to restrain Visa and MasterCard from charging consumers and merchants more."[20] In addition, consumer groups including the Consumer Federation of America, Consumer's Union, and Consumer Action have all submitted Congressional testimony criticizing the current system of swipe fees because it is not fair to consumers.

Economists with the Kansas City Federal Reserve Bank appear to agree with consumer groups on some of the problems with the current system for consumers. In a 2006 working paper titled "Payment Card Rewards Programs and Consumer Payment Choice," they wrote that "rewards programs and the accompanied merchant fee structure may work as tools that distribute income from low-income earners to high-income earners." That is, of course, just what the Hispanic Institute found in its study.

In addition, the European Commission has found that swipe fees harm consumers. In December 2007, the Commission found MasterCard's multilateral interchange fee illegal and Competition Commissioner Neelie Kroes said that swipe fees "inflated the cost of card acceptance by retailers without leading to any advantage for consumers or retailers. On the contrary, 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 . . ." Kroes concluded that MasterCard's interchange "acts like a 'tax on consumption' paid not only on card users but also by consumers using cash and cheques."

[20] Testimony of Ed Mierzwinski before the House Judiciary Committee Antitrust Task Force, May 15, 2008.

Myth: *Swipe fees are needed to balance the two sides of the card market – consumers and merchants – so that the system is used by more people and better benefits everyone.*

Reality: This rationale has been firmly rejected. European regulators have investigated this claim in-depth and concluded that it is inconsistent with the facts and does not create an economic efficiency that makes up for the problems created by the lack of price competition between member banks in the setting of interchange fees.[21] Interchange is a charge imposed by Visa, MasterCard and their member banks – not a mystical balancing mechanism. When Australia moved to regulate rates (after Visa and MasterCard rejected attempts to address the antitrust problems with the system), the card associations argued that regulation would kill the card system. It hasn't happened. Card use has continued to climb in Australia in spite of Visa and MasterCard's protestations and the banks are competing to offer consumers lower interest rates. Once reformed, the credit card system in the United States will continue to flourish.

Myth: *When Australia took regulatory action in this area it resulted in consumers paying more for credit cards and hurt the credit system.*

Reality: When Australia acted, MasterCard said it would mean the end of the credit card system in that nation. They were wrong. More consumers use more cards for less than ever before in Australia. In fact, rather than Visa and MasterCard competing to raise swipe fees so that banks will issue more of their cards, they have had to give consumers what they really wanted – lower interest rates on their cards. This interest rate competition has benefitted consumers immensely. The only ones who don't like it are Visa and MasterCard (and their member banks) because they don't make as much on swipe fees and must now compete more thoroughly on the value they deliver to consumers. The Reserve Bank of Australia reviewed the reforms instituted there and concluded, "Overall, consumers are benefiting from this greater competition and lower merchant costs . . . one group of consumers clearly better off are those who regularly borrow on their credit cards. <u>They are now able to obtain a card with an interest rate of 10 to 13 per cent, rather than the 16 to 18 per cent payable on traditional cards</u>. For many consumers the resulting savings can run into hundreds of dollars per year . . . <u>Consumers who do not use credit cards at all are also benefiting from the reforms as they are paying lower prices for goods and services than would otherwise have been the case.</u> For many years, these consumers have helped subsidise the generous reward points of the credit card issuers through paying higher prices for goods and services. The reforms have helped unwind some of this subsidy."[22] It should be noted that the credit card companies have funded studies that have a different view of the reforms in Australia. Merchants have funded their own studies, but we think the

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[21] See December 19, 2007 Antitrust Ruling of the European Commission.

[22] Payments System Board Annual Report, *Reserve Bank of Australia*, 2005 at 14.

Reserve Bank's findings are the most authoritative source and urge everyone on the Committee to read them when making their judgments – and not listen to how they are characterized (and often mischaracterized) by others.

Myth: *Credit and debit cards provide a valuable service for merchants and consumers, but merchants do not want to pay a fair price for that service.*

Reality: Credit and debit cards do provide a service. Just as was the case with the old AT&T, the problem is that the swipe fee system now violates the antitrust laws and is so riddled with unfair rules that keep any competition from entering the system that it must be reformed. Any reform would still allow swipe fees – getting rid of price-fixing would just bring competition and transparency to those fees. Once reformed, not only will there be swipe fees, but there will still be processing fees and merchants will have to pay any fees associated with maintaining their accounts at their local banks. And, of course, credit card companies will still charge consumers an array of interest charges and fees. While credit card companies will not like reform, they will continue to have many avenues to recover costs, compete, and make profits, but they will have to do so in a transparent system so that consumers and merchants have real choices about the payment services they use and the costs they incur.

Myth: *Banks need high swipe fees in order to recover the costs of fraud and guarantee payment to merchants.*

Reality: Economists with the Federal Reserve Bank of Kansas City have found that fraud costs are not a justification for over-inflated swipe fees. They wrote, "Card organizations have often argued that the reason why they impose proportional fees stems from the cost they bear from their "payment guarantee" service which insures merchants against customers who pay with cards without having sufficient funds. We argue that the cost of fraud and insufficient funding is negligible compared with fees at the range of 1% to 3% commonly imposed by brand name cards. For example, industry studies show that the average net fraud losses are around 0.05% for signature debit cards, which do not extend credit to card users."[23]

Even if banks issuing cards paid out more in fraud, however, that would not justify them charging the merchants for this. While the card companies claim that they guarantee payment to merchants, in reality this "guarantee" is nothing more than a promise to pay when they want to pay. Both Visa and MasterCard have pages and pages of rules for situations in which they can "chargeback" the amount of a transaction to the merchant. These chargebacks are so common that in actuality U.S. merchants absorb more of the cost of fraud each year than the banks that issue the cards. A 2009 study from LexisNexis in conjunction with

[23] "Why Do Card Issuers Charge Proportional Fees?" Oz Shy and Zhu Wang, December 2008 at 3.

Javelin Strategy & Research found that merchants absorb nearly ten times the cost of fraud that the banks absorb each year.[24]

One example demonstrates in microcosm why this is the case. The owner of the The Catch Seafood Tavern in Port Jefferson, New York wrote about it to his representatives in Congress a few years ago. His account details his experience with the card companies. He had five chargebacks in a month that meant the bank took $78 in sales from him. He argued successfully that each chargeback was in fact a valid transaction and that he should get his money. Finally, the bank agreed with him, but charged him a fee of $15.50 for processing his dispute. So, he received his $78 but then was charged a total of $77.50 in fees. Obviously, this didn't amount to any kind of guarantee at all. This type of behavior is blatantly unfair, amounts to a license for the banks to take merchants' money, and happens frequently. It demonstrates another reason why large swipe fees cannot be justified and must be reformed.

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Comprehensive testimony regarding the ways in which the credit card industry abuses merchants and consumers through charging swipe fees could go on for many, many more pages. I hope, however, that this provides a brief overview of the severity of the problems currently on display. The American economy has shown that there is nothing like competition and transparency to spur growth and benefit all Americans. That is just what we need here. If we put an end to the price-fixing of swipe fees, the benefits can and will be dramatic for all of us.

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[24] 2009 LexisNexis True Cost of Fraud Study at 23.