STATEMENT OF W. STEPHEN CANNON
ON BEHALF OF
THE MERCHANTS PAYMENTS COALITION, INC.

BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON THE JUDICIARY
ANTITRUST TASK FORCE

HEARING ON
H.R. 5546, THE "CREDIT CARD FAIR FEE ACT OF 2008"
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I. INTRODUCTION

Chairman Conyers, Ranking Member Chabot, and Members of the Antitrust Task Force, thank you for inviting me to participate as a witness today. I am honored to appear before you on behalf of the Merchants Payments Coalition to discuss H.R. 5546, the "Credit Card Fair Fee Act." The Merchants Payments Coalition fully supports and endorses H.R. 5546 as a remedy to the interchange problem.

Currently, competing banks collude to fix the price of interchange that they charge Americans on millions of transactions every day. These colluding banks may have formed Visa and MasterCard to manage their cartel activities, but make no mistake about it: the $42 billion of interchange fees that Americans paid last year went directly to these banks, not to Visa and MasterCard. This price fixing conduct by otherwise competing banks is anticompetitive under the antitrust laws, as antitrust authorities in other countries have concluded and more than 50 currently pending individual and class action lawsuits allege.

Using their collective market power, the banks affiliated with Visa and MasterCard force merchants to accept these anticompetitive interchange fees as well as rules that, among other things, prevent merchants from offering customers any financial incentives to use other brands of payment cards. In essence, the banks have colluded to design and perpetuate a dysfunctional marketplace. The banks' use of Visa and MasterCard to manage these two price fixing cartels does not change the fact that their collusive behavior is anticompetitive. Highlighting the current absence of competition, none of these individual banks affiliated with Visa or MasterCard will negotiate interchange rates and terms with any merchant that are different than those established by their cartel.

H.R. 5546 is a market-based remedy that fixes this current anticompetitive behavior. It facilitates voluntary agreements between the parties every three years using both a carrot and a stick. The carrot is limited antitrust immunity so that both sides can negotiate collectively on a level playing field. The stick is that if the parties cannot reach agreement then judges will pick one of the two sides' final offers using a competitive market standard after a short proceeding. The banks and their cartel managers (Visa and MasterCard) argue without any factual support that such proceedings would constitute "price controls." They would not. What the banks and their allies refuse to acknowledge is that H.R. 5546 limits the discretion of the judges – they can only choose one of the two "final offers" submitted by the parties themselves. No modifications and no other options are allowed.

In short, H.R. 5546 addresses the current anticompetitive and dysfunctional interchange scheme that the banks have designed and perpetuated. Specifically, H.R. 5546 offers a market-based remedy to fix this existing antitrust problem based upon statutory precedent reported out of this committee and enacted into law in 2004.

A. Background on the Merchants Payments Coalition

The Merchants Payments Coalition ("MPC") is a group of 23 trade associations[1] representing retailers, restaurants, supermarkets, drug stores, convenience stores, gasoline stations, theater owners, on-line merchants, and other businesses that accept debit and credit cards. MPC's goal is to create a more competitive and transparent card system that works better for consumers and merchants alike. The coalition's member associations collectively represent about 2.7 million locations and 50 million employees.

By way of background, I am currently Chairman of the law firm Constantine Cannon LLP, and was privileged to serve as Chief Antitrust Counsel to the Senate Judiciary Committee during the 97th and 98th Congresses (1981-1984). In addition, I served as a trial attorney and subsequently as Deputy Assistant Attorney General for Policy and Legislation in the Antitrust Division of the Department of Justice. More recently, I was a Commissioner on the Antitrust Modernization Commission, which concluded its work in 2007. Further, as General Counsel of Circuit City Stores, Inc. from 1994 to 2005, I had numerous opportunities to see the impact of interchange issues, and I can understand the plight of merchants and consumers throughout this country.

B. Leadership of this Task Force on the interchange issue

The MPC congratulates you and your colleagues, Mr. Chairman, for holding this hearing as the next step in your consideration of H.R. 5546, the Credit Card Fair Fee Act. You and Representative Cannon have provided bipartisan leadership on this issue. Twenty-

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[1] MPC's members include the Food Marketing Institute, National Association of Convenience Stores, National Grocers Association, National Retail Federation, National Association of Chain Drug Stores, American Petroleum Institute, Retail Industry Leaders Association, National Restaurant Association Petroleum Marketers Association of America, National Council of Chain Restaurants, National Association of College Stores, National Association of Truck Stop Operators, International Association of Airport Duty Free Stores, International Franchise Association, National Association of Theatre Owners, American Beverage Licensees, Bowling Proprietors Association of America, National Association of Shell Marketers, Interactive Travel Services Association, Society of American Florists, Society of Independent Gasoline Marketers of America, National Franchise Association, and Coalition of Franchisee Associations.

eight additional members (15 Democrats and 13 Republicans) already have expressed their support for your bill. Building upon your successful oversight hearing last year, this legislation provides a market-based solution to the problem of unlawful cartel pricing by payment card systems with market power.

Price fixing of interchange fees by the two dominant electronic payment systems—Visa and MasterCard—cost Americans $42 billion in 2007 alone. These fees, hidden from consumers, are in addition to other fees and practices of individual banks, like universal default. Consumers are only too familiar with those. While other legislative proposals before Congress and even our financial regulators may address those practices, H.R. 5546 is currently the only vehicle that addresses the cartel practices of competing banks that collectively set interchange rates and terms.

C. Visa and MasterCard have a history of antitrust trouble

Visa and MasterCard have become well-known in recent years for anticompetitive behavior. For example, the government successfully challenged Visa's and MasterCard's so-called "exclusionary" rules, which prohibited literally thousands of their affiliated banks from issuing cards of other electronic payment systems. Additionally, Visa and MasterCard paid billions of dollars to settle another antitrust case regarding their longstanding practice of forcing merchants to accept their debit cards as a condition of accepting their credit cards.

Despite this antitrust trouble during the past few years, Visa and MasterCard continue to engage in anticompetitive conduct regarding interchange rates and terms. As described in more detail below, each of these electronic payment systems (and their affiliated banks) has established a cartel to fix the price of interchange and related terms. Each then uses its market power to force merchants to accept these anticompetitive rates and terms. In light of this behavior, Australia decided to have its central bank comprehensively regulate these interchange practices. Moreover, just this past December, the EC found that these interchange practices violated Europe's antitrust laws.

D. The Credit Card Fair Fee Act is a market-based remedy to the interchange problem

Because of the intractable nature of this interchange problem – addressed in detail at the Task Force's hearing last summer – action is necessary. Having analyzed a variety of possible legislative remedies, the Merchants Payments Coalition agrees that the best approach is to have a market-based remedy analogous to an existing statutory framework that this committee approved with respect to music licensing. The Credit Card Fair Fee Act is such a remedy. Under H.R. 5546, parties are encouraged to reach a voluntary agreement on rates and terms that merchants must comply with to access an electronic payment system such as Visa or MasterCard. If they cannot, these parties must participate in a binding proceeding before a judicial panel. The panel would decide which of the parties' "final offers" best approximates the outcome in a competitive marketplace.

My testimony today will focus on three general topics. First, I will provide an overview of the interchange problem and how it harms American merchants and consumers. Second, I will review what MPC believes to be the key aspects of the Credit Card Fair Fee Act. Finally, I will address why H.R. 5546 is a strong pro-consumer, market-based remedy to the interchange problem.

II. OVERVIEW OF THE INTERCHANGE PROBLEM

Visa, MasterCard, and their affiliated banks suggest that the problem raised by merchants regarding interchange is too complex to understand. It is not.

A. Merchants must accept Visa and MasterCard brands of credit and debit cards

In 2006, the dollar value of all U.S. general-purpose payment card transactions exceeded $2.7 trillion. This represents more than 38 billion credit and debit card transactions in the United States alone, which account for more than 40% of all transactions between merchants and consumers. Such widespread use of general-purpose credit and debit cards dictates that most merchants cannot conduct business without accepting at least certain card brands.

More specifically, Visa and MasterCard collectively control approximately 75% of electronic card payments. Given this market power, the competitive nature of the retail market, and consumer demand for electronic card payments, merchants effectively are compelled to accept Visa and MasterCard as a matter of economic necessity.

B. To accept these cards, merchants must accept interchange fees and related rules without negotiation

A merchant that wants to accept a specific brand of general-purpose credit or debit cards must have access to that brand's electronic payment system. This access, however, is conditioned upon the merchant paying interchange fees and following certain rules (*e.g.*, merchants accepting any Visa credit cards must accept all Visa credit cards from every bank that issues them).

Thousands of banks issue branded cards for specific electronic payment systems (*e.g.*, Visa and MasterCard). Each of these competing banks charges a fee, called an interchange fee, whenever a consumer uses a card issued by that bank to purchase products or services from a merchant. The banks simply deduct this fee from the purchase price otherwise owed to the merchant before remitting the funds to the merchant.

C. Competing banks collude to fix the interchange rates and related terms

Simply put, interchange rates and terms are not determined by competition in the marketplace between these thousands of competing banks. Instead, the rival banks that use Visa and MasterCard as cartel managers collectively set uniform interchange rates (that apply to every Visa or MasterCard transaction regardless of the bank that issued the card or signed the merchant). They similarly agree to impose the same terms (*i.e.*, operating rules) on the merchants. In short, these rival banks collude rather than compete.

In the Visa and MasterCard electronic payment systems, therefore, the interchange rates and terms imposed upon the merchant are the same regardless of which bank issued the consumer's card.[2] In short, the banks have established cartels within different electronic payment systems (*e.g.*, one for Visa, a different one for MasterCard). The result is that merchants cannot negotiate with individual banks regarding interchange rates and terms. Because rival banks don't compete, merchants don't get rates and terms that would have been negotiated in a competitive marketplace.

D. Interchange fees cost Americans $42 billion in 2007 alone

These colluding banks imposed $42 billion of interchange fees on Americans in 2007 alone. Research indicates that these fees are more than <u>seven times</u> the banks' costs to process the transactions. Given the magnitude of these fees, merchants must factor this cost into the price of the goods or services they sell. As a result, consumers using payment cards and even consumers who pay by cash, check, or food stamps are harmed by these fees. Unfortunately, consumers are not aware that their choice of payment card will affect the amount of hidden fees imposed upon merchants, and that this choice can affect the prices all consumers pay.

In sum, the problem is that (i) competing banks collude to fix anticompetitive rates and terms and (ii) because of market power, merchants are forced to accept them. The result is that Americans currently pay $42 billion a year in interchange fees that are set by collusion, not market forces.

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[2] It should be noted that there is not a single interchange rate for each specific brand (*e.g.*, Visa). Rather, there is an entire schedule of interchange rates that differ depending upon the type of card the consumer uses. For example, a "premium" Visa card marketed to affluent individuals is likely to have an even higher interchange rate than a "classic" Visa card marketed to college students. The key point is that while a couple of hundred different interchange rates may exist within a specific brand like MasterCard, every issuing bank for that electronic payment system imposes the same schedule of interchange rates on merchants.

III. THE CREDIT CARD FAIR FEE ACT IS A MARKET-BASED REMEDY TO THE INTERCHANGE PROBLEM

A. Overview of the remedy

H.R. 5546 addresses the interchange problem by creating two paths to market-based rates and terms. First, and primarily, the bill facilitates voluntary negotiation and agreement between the parties. Second, if the parties cannot reach agreement, each side submits a final offer. Then a judicial panel chooses the one final offer that it decides (based upon evidence and witnesses presented by the parties in an expedited proceeding) is closest to the rates and terms that would have been negotiated in a competitive marketplace.

Either way, the parties themselves propose the interchange rates and terms under this bill. Even if the judges have to choose one of the two "final offers," both offers contain rates and terms proposed by a party. The judges have no discretion to make any modification. Thus, the bill's practical, market-based approach – driven by the parties, not government regulators – levels the playing field without dictating the outcome.

B. Key elements of the Credit Card Fair Fee Act

Mr. Chairman, based on the MPC's analysis of H.R. 5546, we believe its provisions provide an effective, market-based remedy to the underlying problems created by Visa and MasterCard's anticompetitive behavior. In particular, the MPC believes the following are key elements of the Act:

1. <u>Precedent exists for using this type of market-based legislative remedy</u>. This remedy follows an approach Congress has used for years to determine market-based royalty rates and terms for the licensing of copyrighted sound recordings. It was most recently revised by the Copyright Royalty and Distribution Reform Act of 2004, legislation supported by the bipartisan leadership of the House and Senate Judiciary Committees. This approach is codified in Title 17 of the U.S. Code.
2. <u>The remedy would apply only to electronic payment systems with substantial market power</u>. Regardless of their corporate form, Visa and MasterCard are both electronic payment systems controlled by rival banks. For each of these electronic payment systems, otherwise competing banks that control them currently eliminate competition by collectively setting the rates and terms that they then impose upon merchants. Because both Visa and MasterCard have substantial market power, merchants must accept these anticompetitively-set rates and terms which ultimately harm consumers. Accordingly, the remedy covers only electronic payment systems that have substantial market power (and these may change over time).
3. <u>The remedy would facilitate reaching a voluntary agreement on rates and terms</u>. Voluntary agreement would be facilitated by granting both merchants and a covered electronic payment system (including its affiliated banks) limited antitrust immunity to negotiate collectively. Additionally, these

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parties will negotiate in the face of a binding judicial proceeding if they fail to reach a voluntary agreement – a proceeding whose outcome neither side would be able to control.

4. Absent voluntary agreement among all parties, each side would submit a set of rates and terms for judges to choose between in an expedited, market-based proceeding. If the parties fail to reach a voluntary agreement, a panel of judges appointed by DOJ and the FTC would hold a binding proceeding. This panel would choose one of the two sets of rates and terms offered by the parties. Each proceeding would be expedited with a limited 60-day discovery period and other statutory deadlines. Critically important, the judges would be required to apply a market standard in making their choice – they would select the set of rates and terms that most closely represents what would have been negotiated in a competitive marketplace.

5. Market-based rates and terms would be available to any merchant regardless of size, industry, or location. A covered electronic payment system would have to offer the rates and terms chosen in such a market-based proceeding to any merchant who wants them. A covered electronic payment system could not force any individual merchant to negotiate separately.

6. Non-universal voluntary agreements would be possible and could be used as evidence in proceedings before the judicial panel. One or more merchants and a covered electronic payment system (including its affiliated banks) would have the option to negotiate a voluntary agreement at any time. While such an individual agreement would not formally apply to all merchants and parties, the judges and parties could look to it in a subsequent proceeding as evidence of the appropriate rates and terms.

7. Rates and terms would be set for only three years. The rates and terms chosen by the panel of judges would be in effect for three years, and then the process would repeat itself. This would allow the parties and judges periodically to take into account any changed circumstances that may impact the rates and terms. Experience with Title 17 suggests that any voluntary agreements negotiated likely would have the same duration.

8. Both sides would have limited antitrust immunity for negotiating voluntary agreements and, if necessary, participating in the market-based proceedings. Pursuant to a limited grant of immunity, all of the parties on each side would be able to negotiate and participate in any binding proceedings collectively without any risk of antitrust liability. In fact, each side could create and use a single common agent to engage in these negotiations and proceedings, as has occurred under Title 17's existing, analogous statutory approach.

C. Differences from Title 17 music licensing

Although the Credit Card Fair Fee Act is modeled after a similar process for licensing copyrighted sound recordings that is codified in Title 17 of the U.S. Code, there are significant differences and, we think, improvements. These include:

1. Statutory approach even better suited for the electronic payment system industry. The Credit Card Fair Fee Act addresses the electronic payment systems industry rather than the sound recording industry. This type of statutory approach is better suited for the electronic payment systems industry because that industry has well-defined revenue and cost attributes. In contrast, applying this statutory approach to the music industry can implicate intangible measures of artistic value.
2. Competitive market standard governing judges clarified to close loopholes. If a judicial proceeding is necessary under the Credit Card Fair Fee Act, the Act would require judges to select one of the final offers submitted by the two sides based upon a competitive market standard. This competitive market standard is more specific than the general willing buyer/willing seller standard in Title 17 whose meaning parties have litigated. Accordingly, this more precise standard should result in less need for interpretation.
3. Determination by judges limited to choosing one of the two final offers submitted by the parties. Under the Credit Card Fair Fee Act, the judges do not have the authority to select any rates and terms they wish if there is a proceeding. Instead, they are constrained simply to choose the one final offer of rates and terms (of the two presented by the parties) that they determine more closely reflects what would have been negotiated in a competitive market. Title 17 places no such constraint on its judges.
4. Required filing of voluntarily negotiated access agreements. Unlike Title 17, the Credit Card Fair Fee Act requires that the parties publicly file any voluntarily negotiated access agreements. This facilitates a transparent process as well as the use of these arms-length agreements as evidence of marketplace behavior in all subsequent negotiations and proceedings.
5. Oversight bodies with antitrust expertise and limited role. The Credit Card Fair Fee Act delegates a limited oversight role to the Antitrust Division of the Department of Justice and the Federal Trade Commission because they have extensive experience addressing the very type of antitrust concerns that create the need for the Act. This differs from Title 17, where the Librarian of Congress and Register of Copyrights provide oversight and copyright expertise. Further, while both approaches permit appeal to the D.C. Circuit, the Credit Card Fair Fee Act relieves the oversight bodies of having to address "novel questions of law." This results in a more limited and less burdensome role for the oversight bodies than under Title 17.
6. Reexamination of rates and terms every three years. The Credit Card Fair Fee Act requires a reexamination of the rates and terms every three years to take into account any relevant changes in the marketplace. Under Title 17 cycles typically last five years.
7. Streamlined initiation of judicial proceedings if no voluntary agreement among all. Under the Credit Card Fair Fee Act, all merchants participate in a single consolidated proceeding for each covered electronic payment system. In contrast, Title 17 calls for multiple proceedings for various users of

copyrighted sound recordings. By avoiding the need to determine which merchants are supposed to participate in which of several proceedings, the procedure for initiating a judicial proceeding under the Credit Card Fair Fee Act is more streamlined than the procedure under Title 17.

8. Initial disclosures to further expedite discovery. To further expedite the 60-day discovery process, the Credit Card Fair Fee Act requires a limited number of affected companies to provide initial disclosures to the other side. Although analogous to the approach of the Federal Rules of Civil Procedure, there is no provision for initial disclosures in Title 17.
9. Penalties for failure to comply with discovery requests. The Credit Card Fair Fee Act also provides for sanctions against parties that fail to comply with discovery requests. Again, this approach is analogous to procedures in other judicial proceedings, but Title 17 does not include any such penalties.

IV. H.R. 5546 PROVIDES A STRONG PRO-CONSUMER, MARKET-BASED REMEDY TO THE INTERCHANGE PROBLEM

Mr. Chairman, based upon the MPC's analysis, the pro-consumer, market-based rationale for H.R. 5546 is strong.

A. The collective setting of interchange fees by a cartel of competing banks is classic price fixing that violates the antitrust laws. Merely changing corporate form through an IPO does not immunize this anticompetitive conduct.

Traditionally, Visa and MasterCard were associations of competing banks. The collective setting of interchange fees (by or on behalf of member banks) by each of these card associations constitutes classic price fixing by a cartel of competitors that violates the antitrust laws.

Recent changes in ownership structure due to the Visa and MasterCard IPOs reflect changes merely in form, not substance. The card systems now simply act as the agents of these competing banks in managing the interchange fee cartel. The card systems (regardless of the nominal "independence" of board members) have every incentive to fulfill their expected cartel manager function, since these affiliated banks are the card systems' only customers. These cartel manager arrangements continue to violate the antitrust laws.

Specifically, the antitrust laws forbid a "hub-and-spoke" form of conspiracy in which a central agent manages a cartel even if the conspirators do not expressly agree with each other to go along with the hub's plan.[3] The antitrust violation is even clearer where there is an agreement among members along the "rim" to utilize the hub.[4]

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[3] *See, e.g., Toys "R" Us v. FTC,* 221 F.3d 928, 932 (7th Cir. 2000).
[4] *See, e.g., Spectators' Communication Network v. Colonial Country Club,* 253 F. 3d 215 (5th Cir. 2001).

This is precisely the case with the Visa and MasterCard reorganizations. By agreeing to these reorganizations based on the understanding that existing agreements such as the interchange fee mechanism would continue, the member banks have agreed to use the services of Visa and MasterCard as managers of their existing interchange fee cartels. Moreover, when the member banks agreed to designate Visa or MasterCard as the ongoing manager of the interchange fee-setting process, they had every reason to believe that their boards would operate in their collective best interest as cartel agent: the member banks would remain significant shareholders, and they would remain the payment systems' dominant, if not only, customers.

According to Visa, "[a] significant portion of our operating revenues are concentrated among our largest customers . . . Loss of business from any of our largest customers could have a material adverse effect on our business."[5] Similarly, MasterCard says "[w]e are, and will continue to be, significantly dependent on our relationships with our [member banks]."[6] As the saying goes the proof of the pudding is in the eating: since the IPO, MasterCard has not made any changes to reduce interchange rates or make its rules more reasonable for merchants, and none of its affiliated banks has offered to accept interchange rates different from those set by MasterCard. The price fixing continues unabated.

The existence of a post-IPO antitrust violation was recently confirmed in the European Commission's decision holding that MasterCard's setting of interchange fees in Europe violates European competition law, notwithstanding the IPO. The Commission has ordered MasterCard to terminate those interchange fees within six months, rejecting the argument that a change in corporate form somehow immunizes an electronic payment system from antitrust liability:

> MasterCard's viewpoint that the IPO . . . had changed the organization's governance so fundamentally that any decision of MasterCard Incorporated's Global Board no longer qualifies as a decision of an association [of its member banks] but rather as [a] "unilateral" act which each member bank bilaterally agrees to abide by, cannot be accepted . . . MasterCard's member banks shaped and eventually approved the IPO in order to perpetuate the MIF [multilateral interchange fee] as part of the business model in a form they perceived to be less exposed to antitrust scrutiny. Contrary to MasterCard's argument, the aim of avoiding exposure to antitrust risks due to the MasterCard MIF was a clear driving force behind the IPO. Rather than modifying the business model to bring it in line with EU competition law, the banks chose to change the governance of their co-ordination specifically for antitrust sensitive decision making. The member banks effectively "outsourced" this decision making to a new management body and made sure that their direct influence ... would be limited to minority rights. However, the banks also agreed to the IPO ... after MasterCard's management assured them that the banks' interests will continue to

[5] Visa SEC Form S-1, at 23 (November 2007).
[6] MasterCard SEC Form S-1, Amendment No. 8, at 21 (May 23, 2006).

be preserved under a new "enhanced customer approach" and via the local input of the banks in the decision making. It cannot be doubted that in approving the IPO and thereby delegating the decision making powers for the MIF to the new independent Global Board, the member banks legitimately expected and therefore agreed that the Board would henceforth set the MIF in a manner that is in their common interest.[7]

B. Courts have ruled recently that Visa and MasterCard possess market power

Whatever the merits of the use of an interchange fee when Visa was an "infant" electronic payment system, those justifications have become irrelevant more than three decades later. The electronic payment system marketplace is now mature. Courts last reviewed the legality of interchange more than two decades ago when the "VISA business arrangement [wa]s relatively young."[8] At that time, "the court determined that the relevant product market was all payment devices (including cash, checks, and all forms of credit cards) and that VISA did not possess power in that market."[9]

Much has changed over the last several decades. More than twenty years of evolution in payment systems has substantially changed the boundaries of the relevant market. In the current century, "neither consumers nor [Visa and MasterCard] view debit, cash, and checks as reasonably interchangeable with credit cards."[10] Another court pointed out that Visa itself had "adopted this market definition, excluding all forms of payment except credit and charge cards" in a previous case.[11] Accordingly, the findings in *NaBANCO* are irrelevant to any antitrust analysis of today's mature credit card market.

Not surprisingly, therefore, multiple courts have held recently that Visa and MasterCard have market power:

- Following a thirty-four day trial, a district court in the Southern District of New York held that "whether considered jointly or separately, [Visa and MasterCard] have market power." [12] Specific evidence supporting this holding was that "Visa members accounted for approximately 47% of the dollar volume of credit and

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[7] European Commission Decision, COMP/34.579, at ¶¶ 357, 378-379 (December 19, 2007) (footnotes omitted).
[8] *National Bancard Corp. (NaBANCO) v. Visa USA,* 596 F. Supp. 1231, 1263 (S. D. Fla. 1984).
[9] *National Bankcard Corporation v. Visa U.S.A., Inc.*, 779 F.2d 592, 603 (11th Cir. 1986) (concluding also that the fees were "reasonably cost related").
[10] *United States v. Visa U.S.A., Inc.*, 163 F.Supp.2d 322, 338 (S.D.N.Y. 2001) (holding that "general purpose cards constitute a product market").
[11] *In re Visa Check/Mastermoney Antitrust Litigation*, 2003 WL 1712568 at *3 (E.D.N.Y. April 1, 2003) (citing *SCFC ILC, Inc. v. Visa U.S.A., Inc.*, 36 F.3d 958, 966 (10th Cir. 1994) ("Visa USA stipulated 'the relevant market is the general purpose card market in the United States'").
[12] *Visa U.S.A., Inc.*, 163 F.Supp.2d at 341. The court defined this market as the one in which networks like Visa and MasterCard "provide the infrastructure and mechanisms through which general purpose card transactions are conducted, including the authorization, settlement, and clearance of transactions." *Id.* at 338. The court also noted that "[m]erchant acceptance of a card brand is also defined and controlled at the system level and the merchant discount rate is established, directly or indirectly, by the networks." *Id.*

charge card transactions and MasterCard members for approximately 26%."[13] Combined, Visa and MasterCard together control over 73% of the volume of transactions on general purpose cards in the United States and approximately 85% of the cards issued.[14] In addition to these high market shares, Visa and MasterCard "have demonstrated their power in the network services market by effectively precluding their largest competitor from successfully soliciting any bank as a customer for its network services and brand."[15] Based upon these and other facts in the record – *e.g.,* that the market is highly concentrated and has high barriers to entry – the Second Circuit affirmed the trial court, ruling that Visa and MasterCard "jointly and separately, have power within the market for network services."[16]

- In addition to this government case against the Visa and MasterCard joint ventures, there was a private case brought by merchants who also claimed that Visa and MasterCard engaged in anticompetitive conduct in violation of the antitrust laws. In this private action, another court held that "Visa possesses appreciable economic power" in the credit card services market, finding that Visa's share of the credit card market alone was nearly 60 percent.[17]

Given this market power, merchants cannot refuse to accept Visa and MasterCard cards as a practical matter. As the court in *Visa Check/Mastermoney Antitrust Litigation* observed, "evidence establishes conclusively that merchants have not switched to other payment devices despite significant increases in the interchange fees on the defendants' credit cards."[18] These findings are consistent with a recent staff report by the Kansas City Federal Reserve that concluded merchants cannot realistically refuse to accept Visa and MasterCard.[19] The bottom line is that the market power of Visa and MasterCard means that the vast majority of merchants have no realistic ability to refuse to accept their cards.

C. No individual bank will negotiate interchange fees with merchants

Visa and MasterCard each claim that on certain occasions they will negotiate with a merchant or set of merchants regarding interchange fees (typically as part of a settlement of a lawsuit or as an initial offer to entice new categories of merchants to start accepting their cards). Such claims actually prove the merchants' point because the anticompetitive harm at issue here is that rival banks collude to fix prices rather than compete. The banks' use of Visa and MasterCard to manage the two cartels is part of the problem. The

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[13] *Id.* at 341.
[14] *Id.*
[15] *United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 240 (2d Cir. 2003).
[16] *Id.* at 239.
[17] *In re Visa Check/Mastermoney Antitrust Litigation*, 2003 WL 1712568 at *3-*4 (E.D.N.Y. April 1, 2003).
[18] *Id.* at *3 ("there is no cross-elasticity of demand at the merchant level between the defendants' products and all other forms of payment").
[19] F. Hayashi, "A Puzzle of Payment Card Pricing: Why Are Merchants Still Accepting Card Payments?" *Review of Network Economics* 144, at 172 (March 2006).

fact that Visa or MasterCard, in their role as cartel manager, may negotiate with merchants on behalf of the cartel of colluding banks underscores the anticompetitive nature of this interchange scheme. In a competitive market, *individual* banks would compete with each other by negotiating interchange rates and terms on their own with the merchants. Under the current Visa and MasterCard interchange systems, this never happens – no individual bank will negotiate interchange fees with merchants.

D. *The Act directly addresses the inability of individual merchants effectively to bargain with a cartel with market power*

As just noted, Visa and MasterCard each has the ability to act as a collective cartel agent on behalf of all of its banks. In contrast, competing merchants (given the constraints of the antitrust laws) must attempt to bargain individually with each cartel. Not surprisingly given this disparity of bargaining power, meaningful bargaining over interchange rates and terms does not occur under the circumstances. The Australian central bank highlighted this reality just last month, following an extensive review of the first four years' operation of interchange fee regulation:[20]

> Following a careful consideration of this issue, the [Bank's Payment Systems] Board remains of the view that, in the absence of regulatory oversight, there is a significant risk that interchange fees in some systems will be set at levels that are too high . . . The main reason for this is that *merchants find it difficult to exert sufficient downward pressure on interchange fees, largely as a result of the structure of incentives that they face* . . . In a sense, merchants are in a game akin to the 'prisoner's dilemma': *they would be better off if they could collectively agree on the terms of credit card acceptance, paying no more than their collective benefit, but instead they act individually and, as a result, can in aggregate potentially pay more for credit card acceptance than the benefit they receive.*

Rather than adopting Australia's regulatory solution, however, H.R. 5546 solves these problems of negotiating structure by facilitating merchants' ability voluntarily to negotiate with a card system as part of a group in a market-based process that promotes transparency. If there is no agreement, a judicial panel will choose one of the two parties' final offers that most closely reflects a competitive solution, a further incentive to the parties reaching an agreement.

E. *Interchange fees account for approximately 2% of every Visa and MasterCard transaction in the United States*

As explained in a recent GAO study, merchants pay interchange fees of approximately 2% on Visa and MasterCard transactions ($2 on a $100 transaction).[21] While there are other fees that go to the merchant's bank and the electronic payment system (Visa or

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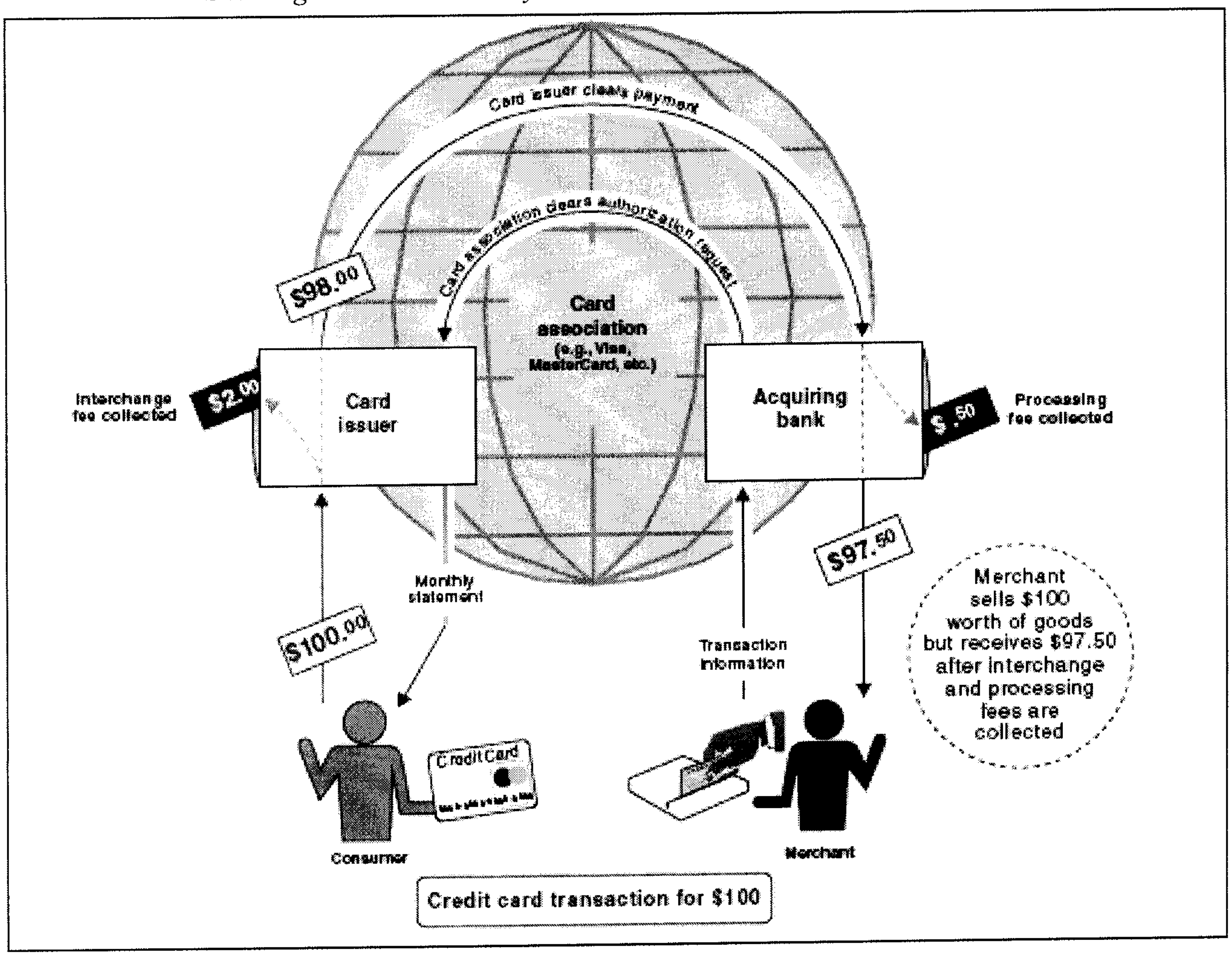
[20] Payment Systems Board, Reserve Bank of Australia, *Preliminary Conclusions of the 2007/08 Review*, at 15 (April 2008) (emphasis added).
[21] GAO, *Credit Cards- Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosure to Consumers*, GAO-06-929, at 74 (September 2006).

MasterCard), the interchange fees account for approximately 80% of the total fees charged. Here is a graphic from that GAO study explaining how the Visa and MasterCard interchange scheme works:

Illustration of a Typical Credit Card Purchase Transaction Showing How Fees Paid by Merchants Are Allocated



Sources: GAO (analysis); Art Explosion (images).

It is also notable that interchange fees are largely imposed on a percentage basis rather than as a flat per-transaction fee, so merchants pay an interchange fee of $0.20 on a $10 transaction but $2 on a $100 transaction. This means that the banks realize a surge in interchange fees simply when prices rise for items like gasoline or food, even though there is no increase in the cost to process these transactions. Visa and MasterCard also charge interchange fees on the gross amount of the transaction, which typically includes some amount of state and local taxes. In other words, the banks charge interchange fees even on amounts that merchants collect for the government but do not retain.

Additionally, interchange rates in the United States are significantly higher than in those countries in which policymakers have challenged the anticompetitive conduct of Visa, MasterCard, and their affiliated banks. As noted above, the average interchange rate that Americans pay is approximately 2%. In contrast, the average interchange rate in Australia is only 0.5 percent.[22] Similarly, under a recently-expired consent decree with the European Commission, Visa's cross-border interchange rate had decreased to 0.7 percent.[23]

F. There is no procompetitive justification for the electronic payment systems' price fixing and exploitation of market power

H.R. 5546 appropriately affects only payment systems that process at least 20% of U.S. electronic card payments. According to a recent working paper by the staff at the Federal Reserve Bank of Kansas City, it appears "market power of credit card networks" is a factor that "plays a critical role in determining the card pricing."[24] The reality is that Visa and MasterCard interchange fees do not appear to be based upon costs – a further indication that market forces do not determine interchange rates. A 2006 consultant's report concludes that transaction processing comprises only 13% of interchange costs.[25]

Visa and MasterCard argue there are justifications for their anticompetitive interchange rates and terms, but the governments that have addressed these justifications have rejected them. For example, a 2006 study jointly undertaken by the EC's Competition and Financial Services Directorates:[26]

> [S]eem[s] to cast substantial doubt on the justifications for the existence of interchange fees put forward by the payment card systems. For instance, one international network believes that in the absence of . . . interchange fees paid by acquirers to issuers, issuers would have to recoup all of their costs from cardholders and this would lead to a level of card issuing that is "not optimal" for the system as a whole. This statement seems to be largely refuted by our results. The justification put forward by another international network, which considers that the interchange fee provides for a transfer of revenue between issuers and acquirers to achieve the optimal delivery of services by both acquirers and issuers to merchants and cardholders, is also not supported by our results . . . In such a context, the role of interchange fees as a "mechanism to redress the imbalance

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[22] Reserve Bank of Australia, "Interchange Fees for the Visa and MasterCard Schemes" (Press Release, September 29, 2006).

[23] European Commission, "Antitrust: Commission prohibits MasterCard's intra-EEA Multilateral Interchange Fee, at 2 (Press Release, December 19, 2007) The Commission noted that the MasterCard's credit card interchange fee, which the Commission found to be unlawful, varied between 0.8 and 1.2 percent. *Id.* at 1.

[24] Z. Wang, *Market Structure and Credit Card Pricing: What Drives Interchange?* at 38 (December 2006).

[25] Diamond Management and Technology Consultants, *A New Business Model for Card Payments,* at 10 (2006).

[26] European Commission, *Financial Services Sector Inquiry, Interim Report I: Payment Cards,* at 71 (April 12, 2006).

between issuers' and acquirers' costs and revenues in delivering a payment card service" is not readily understandable.

More specifically, in its recent investigation of MasterCard's interchange fee system, the European Commission's Competition Directorate gave MasterCard the opportunity to demonstrate that the theoretical justifications given for interchange fees could be demonstrated factually. The EC concluded that MasterCard simply could not show that the theoretical benefits of interchange fees actually exist.

In particular, the EC attempted to verify "whether the model underlying MasterCard's MIF [multilateral interchange fee] was founded on realistic assumptions, whether the methodology used to implement that model could be considered objective and reasonable and whether the MIF had indeed led to the positive effects that MasterCard claims." The EC concluded that MasterCard could not meet that burden.[27] Accordingly, the EC gave MasterCard six months (from December 2007) to end its interchange fee for transactions across European national boundaries or institute a new compensation mechanism that did not violate EC competition law.

G. Congress is best-suited to remedy the interchange problem prospectively

Visa, MasterCard, and some members of the MPC currently are participating in litigation regarding interchange. Specifically, *In re Payment Card Interchange Fee & Merchant Discount Antitrust Litigation* (MDL Docket No. 05-1720) is comprised of approximately 50 class actions and individual lawsuits that have been designated multidistrict litigation and transferred for pretrial proceedings to U.S. District Court Judge Gleeson in the Eastern District of New York. Visa and MasterCard have argued that it is inappropriate for Congress to act while this litigation is pending, noting specifically that the parties have been participating in mediation sessions. This argument is misguided.[28]

First, resolution of these antitrust class action lawsuits can take literally years. For example, a similar antitrust class action against Visa and MasterCard was pending for over seven years before they agreed to settle. It is also typical for courts to require the parties in complex commercial litigation to participate in non-binding mediation sessions.

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[27] European Commission, *Antitrust: Commission prohibits MasterCard's intra-EEA Multilateral Interchange Fee – frequently asked questions*, MEMO/07/590, at 2-3 (December 19, 2007). MasterCard is appealing this decision.

[28] Visa and MasterCard also like to cite an individual case – *Kendall* – from California that addressed interchange practices but was dismissed prior to full discovery because the complaint was not well-pleaded. In contrast, substantial discovery already has taken place in *In re Payment Card Interchange Fee & Merchant Discount Antitrust Litigation* that would make a dismissal like in *Kendall* virtually impossible. With the benefit of this discovery the amended complaint in *In re Payment Card Interchange Fee & Merchant Discount Antitrust Litigation* is not susceptible to dismissal on the points raised in *Kendall* given its additional allegations and specificity supporting its claims. Tellingly, while Visa and MasterCard like to highlight the *Kendall* dismissal here in Congress, their lawyers have not even attempted to make the same arguments to the court in the pending litigation.

Unfortunately, however, participation by the parties in these mandatory sessions does not indicate that the case is about to end. Any resolution of the pending interchange litigation may take years, including possible appeals and remands, while Visa and MasterCard's ongoing price fixing and exploitation of their market power continues unabated.

Second, while courts are effective at remedying past unlawful conduct, Congress better-suited to prevent *future* anticompetitive conduct in a complex industry such as electronic payment systems. In large part, this is because there are only a limited number of injunctive relief options available to courts to affect on-going conduct. The experience of the AT&T divestiture decree is surely a cautionary one for Congress. In that case a federal district judge ruled on the fundamental details of the telephone industry for over a decade based primarily upon an historical court record.

For these reasons, the MPC believes Congress should enact the Credit Card Fair Fee Act as a market-based, non-regulatory remedy and not wait for resolution by the courts.

H. Consumers will benefit from lower interchange fees under H.R. 5546

All consumers shoulder the burden of interchange fees as they are a factor in merchants' pricing of goods and services. In fact, U.S. households paid an average of more than $300 for hidden interchange fees in 2006, including households that did not even use payment cards. The Credit Card Fair Fee Act is a market-based approach to relieving consumers of this burden.

This market-based approach stands in contrast to the solutions undertaken in other countries, such as direct regulation of interchange fees by the central bank (Australia), negotiated rate reductions between card systems and central banks (Mexico), or direct intervention by competition authorities (in the European Union). While their approaches differed, however, all of these countries addressed the same problem we are facing in the United States – anticompetitive interchange rates and terms imposed by cartels of rival banks that possess market power. Accordingly, despite these differences in approach, experiences in countries like Australia are instructive in anticipating the potential impact of H.R. 5546 here in the United States:

1. <u>Billions of dollars of relief to merchants and consumers</u>

Australia's regulators have found that lower interchange rates for Australian credit and debit card holders have benefited consumers in several ways. For example, the central bank concluded that the overall consumer price index was lower than it otherwise would have been had interchange fees not been subject to central bank limitations, with the bulk of interchange fee savings passed on to merchants' customers.[29] More specifically, the Reserve Bank found that as a result of the reforms, "the net savings to merchants was around $920 million in 2006/07. Since the reforms came into effect in 2003, merchants

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[29] Payment Systems Board, Reserve Bank of Australia, *Preliminary Conclusions of the 2007/08 Review,* at 23 (April 2008).

have saved a net total of at least $2.5 billion which, in the normal course, would be passed through into lower prices for goods and services."[30]

2. Increased competition among banks for consumers

Additionally, even the credit card companies themselves have recognized that competition among credit card issuers has flourished in Australia since the reforms. Notably, however, the new competition has focused on price rather than on mileage points and other features apart from price. This reconfirms that high interchange fees are a subsidy from merchants and their customers to cards with high marketing costs and expensive features. In an August 2005 letter to the Reserve Bank of Australia, MasterCard stated:[31]

> 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.

Subsequent events have confirmed the benefits to cardholders from this interest rate competition. According to the central bank, "Interest rates on 'no frills' cards range from 9-13 per cent compared with interest rates of 17 percent or higher on most standard rewards-based cards."[32] The head of one major Australian bank (ANZ Bank) was pleased with the results of competing on interest rates, rather than rewards: the shift away from the bank's loyalty point system resulted in a loss of credit-card transactors which has been offset by growth in customers wanting the lower-rate cards. "We lost a lot of ground (in transactors) but gained a lot of ground in people actually borrowing against their credit cards because of the lower rates . . . Over the long run that will be more beneficial to us in terms that the earnings have shifted away from transactions to much more interest bearing accounts."[33]

3. Lower net bank fees

Opponents of the Credit Card Fair Fee Act reportedly have argued that if cartel-set interchange fees are lowered, banks will merely raise other fees to their customers. This

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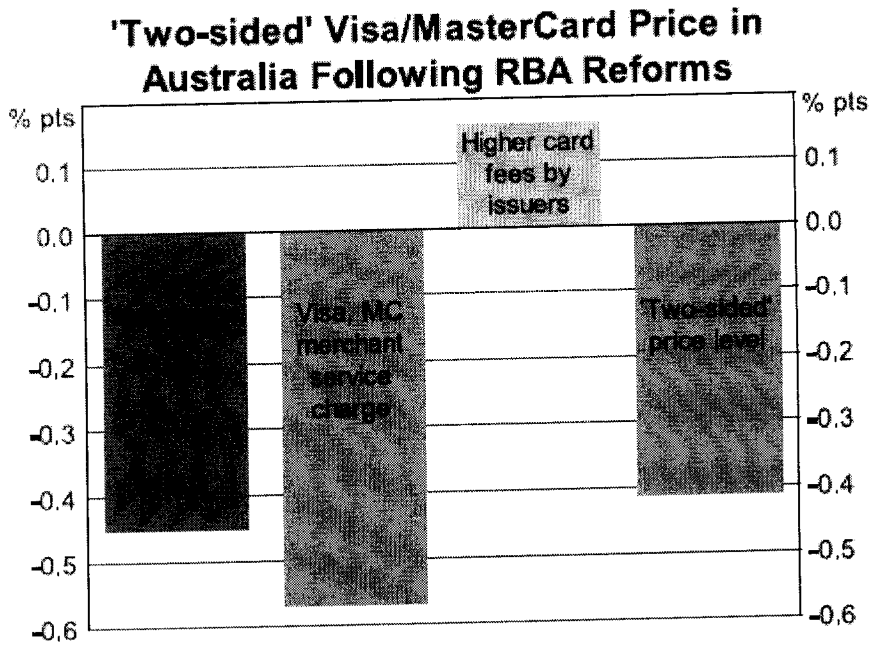
[30] Payments System Board, Reserve Bank of Australia, *Annual Report 2007*, at 26 (October 2007).
[31] Letter from Senior Vice President—Australia, MasterCard International to Head of Payments Policy, Reserve Bank of Australia, August 25, 2005, at 3 (emphasis in original).
[32] Reserve Bank of Australia, *Statement on Monetary Policy*, at 50 (Feb. 13, 2006).
[33] "Credit Cards Trend to Lower Rates," *The Australian*, (Feb. 22, 2006).

line of argument is truly remarkable. No bank is entitled to the illegal revenues from high cartel prices. Visa and MasterCard banks around the world continue to issue cards even though interchange fees in many countries are significantly lower than they are in the United States. In fact, it is far more likely that banks will respond to lower payments from merchants (if that is the result of the agreement process) by reducing their extraordinary card marketing expenditures, such as the billions of unsolicited junk mail credit card solicitations they send out each year.[34]

One study of the impact of interchange fee regulation by the Australian central bank concluded that the merchant discount charged by acquirers fell more than the decline in interchange fees, and the decline in costs to merchants more than offset any increased fees charged to cardholders. Consequently, looking at payment cards as a "two-sided" market of cardholders and merchants, the controls on interchange fees had led to a net 41 basis point per transaction reduction in the cost of cards:[35]



Source: RBA Bulletin Table C.3 and Chang *et al* (2005)
Note: Uses midpoint of Chang *et al* estimates of increase in cardholder fees

[34] There were over 5 billion such solicitations in 2007, with a response rates of 0.5 percent (one out of 200). Thus, banks with loan losses and/or sub-prime card holders apparently reduced mailings, while banks with relatively fewer problems, such as Chase, *increased* their junk mail solicitations. Synovate, "US credit card mail volume declined in 4th quarter 2007 as troubled issuers pulled back" (Press release, February 6, 2008).
[35] A. Frankel, "Towards a Competitive Card Payments Marketplace," in Reserve Bank of Australia, *Proceedings, Payments System Review Conference* 27, at 63 (April 2008).

4. Competitive pressures on all merchants to compete away cost reductions in the form of lower consumer prices

Some opponents of the legislation also argue that even if there are significant reductions in the interchange fees charged merchants, consumers as a whole will not benefit because merchants will not reduce prices for consumers. I find such claims divorced from reality.

Australia's central bank has concluded that the bulk of cost savings to merchants resulting from the lower interchange fees "ha[s] been, or will eventually be, passed through into savings to consumers."[36] At the same time, these interchange reforms have provided credit card users with a *choice* they previously did not have: no-frills cards with lower fees and interest rates or rewards cards with higher rates – just the outcome one would expect in a competitive card marketplace. Not surprisingly, the Reserve Bank's current review of its regulation of credit and debit card interchange fees and related rules found significant benefits to society from improving the pricing signals to consumers regarding the true relative costs and benefits of various forms of payment: [37]

> The Board's overall assessment is that the welfare gains from the reforms are likely to have been substantial. Not only has the change in payment patterns *relative to what would have occurred in the absence of the reforms* resulted in lower costs, but there has also likely been an increase in welfare from consumers using a payment instrument from which they derive higher benefits.

Further, retailing is one of the most competitive segments of the American economy, and there is competitive pressure on all merchants to compete away cost reductions in the form of lower consumer prices. My ten years' experience as a Circuit City executive taught me that retailers factor cost reductions in pricing decisions to remain competitive, particularly when, as here, any lower interchange fees achieved through H.R. 5546 would be broadly available to all merchants.

V. CONCLUSION

Mr. Chairman, for the reasons discussed above, the Merchants Payments Coalition supports H.R. 5546 as a market-based remedy to address the current anticompetitive and dysfunctional interchange scheme that the banks have designed and perpetuated. The MPC urges the full committee to report H.R. 5546 favorably to the House as soon as possible.

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[36] Payment Systems Board, Reserve Bank of Australia, *Preliminary Conclusions of the 2007/08 Review,* at 23 (April 2008).

[37] *Id.* at 20 (emphasis in original).