Congressional Research Service

Payment Card Interchange Fees: An Economic Assessment

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June 9, 2010

Congressional Research Service
7-....
www.crs.gov
RL34647

CRS Report for Congress
Prepared for Members and Committees of Congress

Summary

Interchange fees in the processing of credit and debit cards have become controversial. An interchange fee is paid by the merchant's bank to a cardholder's bank (that issued the card) after the cardholder purchases goods or services with a payment (credit or debit) card. Merchants and cardholders assert that they must accept excessive and increasing interchange fees set by the card associations such as Visa and MasterCard and member card-issuing banks. Interchange fees have been rising since the 1990s, despite diminishing fraud losses and technological advances in communications that lower the costs of accessing the electronic payment system. Merchants argue that the card associations have not negotiated these fees with them but instead present the fees as "take it or leave it" offers.

Economists who have studied the payment card markets attribute the higher interchange fees to the nature and structure of the market. This is not the traditional market, they point out, but a two-sided market where suppliers compete for two types of customers with different demand responses, like a newspaper that must attract both readers and advertisers. In the payment card market, banks must attract cardholders and merchants, and a transfer of revenues is usually necessary to provide card-issuing banks an incentive to issue more cards, which provide more payment card users to merchants. This is similar to newspapers, where the lower the subscription rates, the higher the readership and the higher the advertiser revenues. For a payment card system that needs more cardholders to achieve the optimal benefits to cardholders and merchants, more revenue transfers may be needed to offset the cost of issuing more cards to cardholders. There could be cases, however, where the revenue transfers are excessive, which would mean that the interchange fees are providing excess profits to issuer banks.

Even though interchange fees were not considered a contributing cause of the 2007-2009 financial crisis, S. 3217 as amended by the full Senate and incorporated into the Senate-passed version of H.R. 4173, which addresses the regulatory causes of the crisis, also contains provisions on interchange fees. The Durbin Amendment (S.Amdt. 3989) on interchange fees was adopted. The amendment mandated specific regulations to applied debit cards to ensure that small businesses and other entities that accept debit cards pay a reasonable and proportional price for the use of the payment card network, and limit the payment card network from imposing anti-competitive restrictions on small businesses and other entities that accept payment cards. The amendment does not address what some believe to be a critical part of the interchange fee issue that relates to legal or regulatory caps on the fees. Specifically, presently there is not a mechanism that could be used to ensure that merchants lower their prices to pass the excess revenues back to the cardholders. In countries where interchange fees are capped, the governments have been relying on merchants to voluntarily lower prices. Yet, there is no evidence that merchants have done so.

This report examines the Visa and MasterCard card associations' systems. The report begins with a discussion of the nontraditional structure of the payment card market. The next section is an analysis of the problem of the optimum level of payment cards to achieve the highest social welfare benefit for cardholders and merchants. The third section discusses the provisions in Senator Durbin's amendment and other legislation in the House that was not acted upon by the full House of Representatives that would grant the payment card stakeholders limited antitrust immunity for negotiating access fees and terms for using electronic payment card system. The last section is a discussion of some implications of the analysis. This report will be updated as financial and legislative developments warrant.

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Introduction

Payment card interchange fees, which were paid without contention for almost seven decades, are now the source of controversy. An interchange fee is paid by the merchant's bank to the cardholder's bank (that issued the card) after the cardholder purchases goods or services with a payment (credit or debit) card.

The Durbin Amendment to S. 3217 as amended and incorporated into the Senate-passed version of H.R. 4173 proposes to ensure that small businesses and other entities that accept debit cards pay a reasonable and proportional price for using the payment card networks and prohibit the payment card network from imposing anti-competitive restrictions on small businesses and other entities that accept payment cards, such as providing discount to customers who pay with cash.

Earlier in the 111th Congress, the House Judiciary Committee had introduced interchange fee legislation. On June 4, 2009, House Judiciary Chairman John Conyers Jr. introduced the Credit Card Fair Fee Act of 2009 (H.R. 2695), which would require voluntary interchange fee negotiations among merchants, the Visa and MasterCard associations, and card-issuing banks. It would also require that the negotiating parties file the negotiation schedule with the U.S. Attorney General within one month of the enactment of the bill. If the negotiating parties do not file such a schedule within one month, the Attorney General would issue the schedule. The act would grant the negotiating parties limited antitrust immunity for negotiation of access fees and terms for using the electronic payment system to make electronic transactions. Some opponents of H.R. 2695 argue that the bill would force interchange negotiations whether or not the stake holders are interested in such negotiations.[1] The Credit Card Accountability, Responsibility and Disclosure Act of 2009 (P.L. 111-24) was enacted on May 22, 2009, two weeks before H.R. 2695 was introduced. P.L. 111-24 did not mandate any change in interchange fees. However, it directed the Government Accountability Office (GAO) to complete a study of the interchange issues within six months of its enactment.

In the 110th Congress, Chairman Conyers established a congressional task force to look into interchange fees because some merchant and consumer groups had complained that these fees are cutting into merchants' profits and are costing the cardholders and non-cardholders, who ultimately pay the fee in the price of the goods or services.[2] According to Chairman Conyers, "in 2005, U.S. families paid an average of more than $300 for hidden interchange fees including households that do not even use credit cards."[3] Another source estimated that, "in 2007, retail merchants in the United States will pay banks issuing Visa and MasterCard payment cards more than $30 billion in *collectively set* per transaction interchange fees."[4] At issue are increases in interchange fees set by the credit card associations like Visa and MasterCard and card-issuing banks or companies like Discover Card and American Express to enable merchants to gain access to the associations' and issuers' electronic payment network.

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[1] The Credit Union National Association, "Conyers bill would force interchange negotiation," *News Now*, June 5, 2009, p. 1.

[2] Non-users of payment cards pay interchange fees because merchants usually raise their prices to compensate them for the costs of accepting payment cards. These higher prices are paid by all their customers.

[3] Michael Posner, "Credit Card Interchange Fee Negotiation Bill Advances," *Congress Daily*, July 16, 2008, p. 1.

[4] James M. Lyon, "The Interchange Fee Debate: Issues and Economics," Federal Reserves of Minneapolis, January 19, 2006, at http://www.Minneapolisfed.org/pubs/regional/0606/interchange.cfm.

Interchange fees have been rising since the 1990s, despite diminishing fraud losses and technological advances in communications that lowered the costs of accessing the electronic payment system.[5] Merchants argue that the card associations have not negotiated these fees with them but instead present them as take it or leave it offers. Economists who have studied the payment card market attribute the higher interchange fees to the nature and structure of the market, which is not the traditional market but a two-sided market.[6] Within this structure, they have identified two conditions that, combined, could lead to high interchange fees. The conditions are where the payment card issuers have market power and merchants have an inelastic demand for accepting payment cards.[7] Some commentators note that if it is determined that interchange fees are excessive as a result of issuing banks' marketing power, those circumstances could lead to the government imposing legal or regulatory caps on interchange fees, as was the case in Australia and the United Kingdom. Related questions have been raised concerning the mechanism the government might use to induce merchants to lower their prices and pass the excess revenues back to the cardholders.[8] In these two countries, the pass back of the fees through price reduction has been voluntary, and there is no formal evidence that merchants lowered their prices.[9]

This report focuses on the Visa and MasterCard card associations that account for more than three-fourths of the payment card market, with Visa accounting for 44% and MasterCard accounting for 31% of the market in the United States in 2008.[10] The report does not discuss unitary payment card systems, such as American Express and Discover cards, that issue virtually all their own cards and sign up their own merchants. This report does not analyze the application of antitrust statutes to interchange fees. The report begins with a discussion of the nontraditional structure of the payment card market. The second section is an analysis of the problem of the optimum level of payment cards to achieve the highest social welfare benefit for cardholders and

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[5] Steve Semeraro, "Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty," *Thomas Jefferson School of Law, San Diego, California, Legal Studies Research Paper Series,* March 6, 2007, p. 70, and Adam J. Levitin, *Payment Wars: The Merchant-Bank Struggle for Control of Payment System*, working paper, September 5, 2006, p. 3.

[6] Two-sided markets compete for two types of customers with different elasticities of demand. A good example is a newspaper that must attract both readers and advertisers. To optimize output in both markets, the equilibrium price depends on the price elasticities of demand of customers on both sides, the network effect, and the marginal costs resulting from changing output on each side. In this example, newspapers usually provide newspapers to readers below their marginal production and distribution costs in order to build sufficient readerships to attract advertisers. Raising the subscription rates for the newspaper will not only lead to fewer readers, but also less advertising revenues because revenues are a function of the number of readers. The two-sided market limits a firm's ability to retain excess profit. A monopoly newspaper might be able to increase subscription rates to readers, but in doing so it might have to compete away its profits to attract advertising revenues. Two-sided markets differ from ordinary markets. In most markets, price collusion generally leads to harm to consumers by enabling competitors to restrict output and raise prices. Two-sided markets cannot be presumed to behave anti-competitively based on the assumptions applied to standard markets, but they can be anti-competitive nonetheless. See Steve Semeraro, "Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty," *Thomas Jefferson School of Law, San Diego, California, Legal Studies Research Paper Series,* March 6, 2007, p. 43.

[7] Ibid., Steve Semeraro, p. 45.

[8] Fumiko Hayashi and Stuart E. Weiner, "Interchange Fees in Australia, the UK , and the United States: Matching Theory and Practice," Economic Review of *Federal Reserve Bank of Kansas City*, Third Quarter 2007, pp. 75-112.

[9] Congressional Quarterly, "House Judiciary Subcommittee on Antitrust and Competition Policy Holds Hearing on Merchant Credit Card Payment Fees," May 12, 2008, p. 81. http://www.cq.com/display.do?dockey=/cqonline/prod/data/docs/html/transcripts/congressional/110/congressionaltranscripts110-000002878244.html@committees&metapub=CQ-CONGTRANSCRIPTS&searchIndex=0&seqNum=34.

[10] William Bishop, Kyla Malcolm, and Nicole Hildebrandt, *Regulatory Intervention in the Payment Card Industry by the Reserve Bank of Australia: Analysis of the Evidence*, CRA International, April 21, 2008, p. 2.

merchants. The third section discusses the Durbin Amendment to the Restoring American Financial Stability Act of 2010 (S. 3217) and provisions of the Credit Card Fair Fee Act of 2009 (H.R. 2695) and 2008 (H.R. 5546), respectively. The last section discusses the implications of the analysis.

The Cost Structure in a Payment Card Transaction

The Components

There are several components of cost in a payment card transaction. When a consumer makes a purchase with a payment card, the merchant's account at the merchant's bank, the acquirer bank, is credited with the purchase amount, less an amount called the *merchant discount fee*. The merchant discount fee consists of a flat rate in the amount ranging from a few cents to a dollar or a percentage amount of the purchase. The total fees usually range from 1% to 3% but could be as high as 15% for merchants who are of high risk because of low transaction volume, limited credit history, or the nature of their business.[11] The acquirer bank retains part of the merchant discount fee, and the remainder is remitted to the network association. The *interchange fee* is this remittance to the network association. The remittance to the card issuer is also called the *interchange fee*. The network association that receives the remittance from the acquiring bank keeps a small portion of it for the costs of authorization, clearing, and settling the transaction. The association remits the rest to the issuer bank to cover the costs of funding the purchase, chargebacks (returns), and fraud risks.

The network association sets the interchange rates annually. The level of the fees charged by the network is partially based on the interchange rate, which is set by the issuing and acquirer banks. Thus, the merchant discount fee is the interchange rate plus an additional percentage taken by the acquirer bank. However, the interchange rate does not vary much on the basis of the cost of the transaction. It varies mainly on the merchant's type and the level of bundled reward points attached to a particular payment card. As mentioned above, the merchant's discount fee varies by the merchant's risk profile and the acquirer bank profit component of the fee. Overall, the interchange rates are lower in stable, low-margin industries like groceries and higher in small volume, high-risk businesses like adult Internet websites.

Merchant Restraints

Explicit costs in the Visa or MasterCard association network reflect the associations' rules. These rules include merchant restraints that are designed to increase card usage at the expense of all other types of payments and to maintain higher interchange rates: (1) Merchants are forbidden to impose a surcharge for the use of payment (credit or debit) cards [no surcharge rule], even though card transactions cost merchants more than some other payment methods. The effect is to prevent merchants from passing on the cost of the payment card directly to their customers, who use the card, which would give their customers a disincentive to use the card. Thus, the merchants absorb the payment card transaction costs. (2) Merchants are required to take all credit cards bearing the card association brand [honor-all-cards rule], and they are required to accept these cards at all

[11] PSW, Inc., Merchant Services Agreement, available at http://www.pwsbilling.com/contractno-ccas-all.pdf at 4.

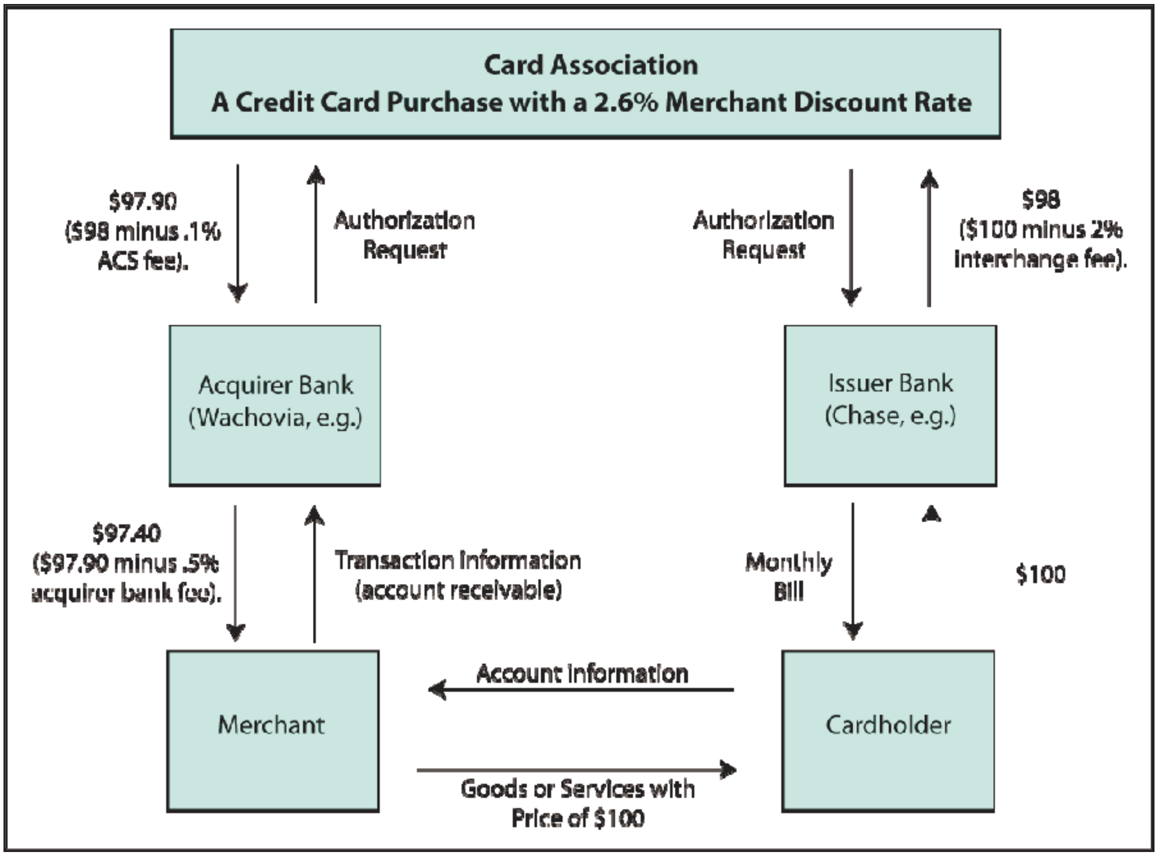
outlets [all-outlets rule]. In addition, (3) merchants are prohibited from offering discounts to particular types of cards [non-differentiation rule]. These rules prevent merchants from operating at overall minimum cost because the rules force them to accept all [all or none rule] the association's cards, even though different cards have different costs attached to them.

To summarize the description of the mechanism, **Figure 1** shows an example in which the merchant discount fee is 2.6% as set by the banks and the card association. For this discount, the merchant may attract cardholder customers and potentially higher sale volume, guaranteed payments, and reduced administration and accounting costs, as well as increased checkout efficiency. On the cardholder side, the card issuer bank issues payment cards to cardholders at its own costs, including card production and advertisements. In the beginning of card issuance, cardholders paid an annual fee for most cards. Today, issuer banks are profitable enough from the lines of credit attached to their cards as well as related fees (such as late and overdraft fees) that they generally no longer demand annual fees. More important, issuer banks are in highly competitive markets where the elasticity of demand for payment cards is high enough to force the fees to practically zero.

In a card association network, the association serves as an active umbrella organization for four parties: (1) the acquiring bank and (2) the merchant, on one side, and (3) the issuing bank and (4) the cardholder, on the other. Starting at the bottom of **Figure 1**, the cardholder purchases goods or services for $100.00 with a payment card. The accounting information goes to the merchant's acquirer bank as an account receivable. The acquirer bank credits the merchant's account $97.40, which is the merchant discount that was agreed to by accepting the card. The acquirer bank takes a 0.5% fee for its services and asks the card association for authorization for the $100.00 payment. The association sends the acquirer bank a payment of $97.90 as the association deducts its 0.1% for authorization, clearing and settling fees from the amount it receives from the issuer bank. The card association then requests authorization from the payment card's issuer banks, which sends the card association $98.00, after deducting its 2% interchange fee from the $100.00.

The issuer bank usually extends the $100.00 credit to the cardholder if the payment card is a credit card, and there is no balance on the credit card, in which case, the cardholder enjoys the $100.00 float. The float is the use of the funds in transition of payment until the payment is actually collected by the issuer bank. The value of the float to the cardholder depends on the market rate of interest and when the purchase is made in the cardholder's payment cycle. On the other hand, if the payment card is a debit card, the issuer bank may deduct the $100.00 from the cardholder's deposit account immediately. In either case, processing is done electronically in seconds where all five parties are credited and debited the appropriate amounts.

Figure 1. Visa or MasterCard Payment Card Network



Source: Adam J. Levitin, *Payment Wars: The Merchant-Bank Struggle for Control of Payment System*, working paper, September 5, 2006, p. 7.

The Optimal Payment Card System

Students of the process of setting interchange fees, which include regulatory authorities, economists, and lawyers, have offered two proposed solutions to rising interchange fees. The first would regulate the cost that a card system may use to calculate its interchange fees. The second would permit merchants to put a surcharge on payment card transactions so that interchange fees could be passed on directly to the cardholder using the credit card. Each of these solutions has its own problems in terms of maximizing the overall social benefits of a payment card system.

The Problem with Cost Regulation

It is argued that interchange fees based on card issuers' cost (which is now implemented in several countries, such as Australia) could solve the problem of rising interchange fees. Others argue that interchange fees should be abolished, set to zero. Issuers can cover their costs by raising interest rates and annual fees for the card. However, economists have pointed out that price regulations based on costs have historically been plagued with practical problems even in industries in which theory would predict that the optimal price can be based on cost. The practical reason for these theories' failure to determine the optimal price based on costs is that a firm has little incentive to cut cost if its revenues are tied to those costs. However, in the case of interchange fees, economic theory also suggests that cost-based regulation would not be expected to produce the optimal interchange fee.

Economists have shown that, because of the nature of the credit card market, it would be very unlikely that the optimal interchange fee could be reached by setting it at zero or determining it strictly on a cost-based measure. As we can see from **Figure 1**, the credit card market is two-sided: services are being sold to cardholders and merchants, and each side affects the other.[12] Costs play a significantly reduced role in determining the optimal interchange fee or price. There are effectively two demand and supply curves to determine the optimal price. Maximizing output requires issuers and acquirers to set prices in a way that will provide proper incentives for cardholders to use and merchants to accept the payment card. Balancing costs in some fashion would achieve this result only if the elasticity of demand on both sides were equal. Furthermore, setting the fee to zero would maximize output only if on both sides of the two-sided market costs and demand were equal. Because neither is likely to be true, one should not expect either a cost-based or zero interchange fee to be optimal.[13] This conclusion is supported by the newspaper subscription and advertising revenues described in an earlier footnote. In both the newspaper and the payment card cases, revenue transfers are necessary to maximize overall social welfare.

Allowing Merchants to Pass Through the Interchange Fees

Some analysts would lift the prohibition that keeps merchants from surcharging card transactions. They believe that this would be fair because it would place the costs of the interchange fee on the party generating the costs. If the merchant was free to charge extra for using a particular card, cardholders would be paying the interchange fees that card issuers charge to the merchants. The card issuer would lose transaction volume, if the cardholders shift to another card with lower interchange fees or pay by cash as a result of the surcharge. This would give issuers an incentive not to raise the interchange fee above the optimal levels. However, a surcharge solution has practical as well as theoretical concerns. There is empirical evidence that suggests that high-volume merchants are reluctant to impose surcharges because of the administrative costs associated with alternative methods of payment such as the cost of handling cash.[14] Most important, merchants will not impose surcharges because of fear of losing customers to competitors who do not surcharge.

Theoretically, to maximize welfare in a two-sided market, a seller needs a way to discriminate between the two sides. When the rule prohibiting surcharge is eliminated, the division of benefits between merchants and cardholders becomes irrelevant. Only when the surcharge is constrained [with the no surcharge rule] does the payment card system concentrate on its charges on merchants and provide rebates to cardholders to induce card use.[15] In a case where greater volume

[12] There are partial demand curves and that unless the partial demand curves are identical, using cost-based regulation to determine the per transaction fee to maximize the payment card system's output would only occur by chance.

[13] David Evans & Richard Schmalensee, "The Economics of Interchange Fees and Their Regulation: An Overview," MIT Sloan School of Management, MIT Sloan Working Paper 4548-05, May 2005, n. 10, p. 114, and Steve Semeraro, "Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty," *Thomas Jefferson School of Law, San Diego, California, Legal Studies Research Paper Series*, March 6, 2007. p. 17.

[14] Steve Semeraro, "Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty," *Thomas Jefferson School of Law, San Diego, California, Legal Studies Research Paper Series*, March 6, 2007, p. 70.

[15] Marius Schwartz &Daniel R. Vincent, *Same Price, Cash or Card: Vertical Control by payment networks*, Working Paper 0201, February 2002, p. 47 at 3. Once the surcharge is unrestricted, only the payment system's aggregate share would matter, because the market would no longer be a two-sided market.

is needed to optimize the efficiency of the payment card system, the surcharge would raise costs to the cardholder equal to at least the benefits that the issuer can provide to the cardholder from the interchange fee income. Consequently, merchant surcharging of card transactions would prevent issuers from stimulating card use in the circumstances where greater volume is needed to optimize the efficiency of the payment system.[16]

A third solution to the interchange fee issue is the antitrust aspect of the payment card association, which is currently tied up in the courts. This solution is beyond the scope of this report. However, below, the report presents a summary of H.R. 2695 and H.R. 5546 that is related to the antitrust solution. In that regard, the economic assessment of the issue may contribute to the judicial and legislative determination of whether the Visa and MasterCard associations are monopolies and whether the domination of these associations warrants granting limited antitrust immunity to providers and merchants to negotiate interchange fees. Even though Visa and MasterCard have dominated the payment card volume since the 1970s, some analysts argue that it is difficult to see how banks are able to control the system and collectively harm the over all welfare of the society. The reason given is that within the association individual banks set virtually all their own fees and compete with each other. And, although interchange fees are set collectively, the associations are open to any bank or federally insured financial institution.[17] Others argue, however, that larger banks dominate the association, because larger issuing banks have lower costs than the thousands of smaller issuers in the system. The more favorable cost structure enables larger banks to charge higher fees because of their market power. These higher fees are high enough to be beneficial to smaller banks, even though smaller banks face higher cost structures. In short, the card associations allow some smaller banks to piggyback on the marketing power of the larger ones.

The Durbin Interchange Fee Amendment to S. 3217, and the Credit Card Fair Fee Act of 2009 (H.R. 2695)

The Durbin Amendment

Even though interchange fees were not considered a contributing cause of the 2007-2009 financial crisis, the Restoring American Financial Stability Act of 2010 (S. 3217), which addresses the regulatory failures that caused of the crisis, also contains provisions concerning interchange fees. Senator Durbin's Amendment on interchange fees that was adopted as part of S. 3217 as amended by the full Senate and incorporated into the Senate-passed version of H.R. 4173 mandates specific regulatory actions. The amendment applies to debit cards and contains no explanation of why it could not apply to other cards. Its purpose is to ensure that small businesses and other entities that accept debit cards pay a reasonable and proportional price for the use of the payment card networks and prohibits the payment card network from imposing anti-competitive restrictions, such as prohibiting discounts to customers who pay with cash, on small businesses and other entities that accept payment cards.

[16] Steve Semeraro, p. 20.

[17] MasterCard and Visa have converted from associations to publically held companies, but merchants challenging the interchange fee have alleged that the banks have retained the same level of control as before the associations went public.

Specifically, the amendment mandates that the Federal Reserve Board establish rules regarding any interchange transaction fee that an issuer or payment card network may charge with respect to an electronic debit transaction. The rules must establish the amount of the fee for a debit transaction that shall be reasonable and proportional to the actual cost incurred by the issuer or payment card network with respect to the transaction. The board shall issue the final rules not later than nine months after the date of enactment of the Consumer Financial Protection Act of 2010. The amendment exempts small issuers that together with affiliates have assets less than $10 billion. It also limits anti-competitive payment card network restrictions by allowing businesses to offer discounts for using a competing payment card network, the network through contract can not prevent businesses from providing discounts or in-kind incentive for payment by use of cash, check, debit or credit card. A payment card network cannot restrict the setting minimum or maximum dollar value for acceptance of a debit transaction.

The effect of the Durbin Amendment would be to lower the cost to merchants for using the payment card network to process debit card transactions, but does not guarantee the cost to consumers will be lowered. In testimony before the House Judiciary Committee, Mr. Jushua R. Floum, general counsel and corporate secretary of Visa Inc argued the following:

> “We've seen it now twice in other jurisdictions. The retailers don't lower their retail prices; they simply keep the revenue at the expense of the local community banks. So that’s threat number one to consumers. Threat number two to consumers is they pay more for cards, and they get fewer rewards. The Reserve Bank of Australia, there’s a quote—they're the regulators, they found out themselves. And in today’s GAO report, just released, on Page 36, the GAO concluded that lowering interchange in Australia meant that—this is a quote—”Cardholders have experienced a decline in the value of credit cards, reward points for most cards and an increase in annual and other consumer credit card fees.” So consumers pay more; that’s the second problem.”[18]

Credit Card Fair Fee Act of 2009 (H.R. 2695)[19]

On June 4, 2009, House Judiciary Chairman John Conyers Jr. introduced the Credit Card Fair Fee Act of 2009 (H.R. 2695) that would require voluntary interchange fee negotiations. It would also require that the negotiating parties file their negotiation schedule with the U.S. Attorney General within one month of the bill’s enactment. If the negotiating parties do not file such a schedule within one month, the Attorney General would issue the schedule. The act would grant the negotiating parties limited antitrust immunity for negotiating access fees and terms to use the electronic payment system for making electronic payment transactions.

In the 110th Congress, Chairman Conyers introduced a bill by the identical title, and the committee’s task force on competition policy and antitrust laws held a hearing on this bill on May 15, 2008. The House Judiciary Committee held a markup session on July 16, 2008, after which the bill was reported as amended to the full House. On October 3, 2008, H.R. 5546 was reported

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[18] U.S. Congress, House of Representatives, Judiciary Committee Antitrust Task Force, “ *The Credit Card Fair Fee Act of 2008*, hearings on H.R. 5546, 110th Cong., 2nd sess. May 15, 2008, p. 8. The GAO report that Mr. Floum referred to is *Credit and Debit Cards: Federal Entities Are Taking Actions to Limit Their Interchange Fees, but Additional Revenue Collection Cost Savings May Exist*, GAO-08-558, May 15, 2008, http://www.GAO.gov.

[19] See Independent Community Bankers of America, ICBA Statement on Senate Passage of Wall Street Reform Bill, *ICBA News Release*, May 20, 2010, p. 1. and Credit Union National Association, Senate Cleared Reg Reform, CUNA Opposed with Interchange In, *CUNA News Now*, May 2, 2010, p. 1.

as amended by the Committee on Judiciary (H.Rept. 110-913). No further action was taken on the bill by the House, and no similar bill on interchange fees was introduced in the Senate in the 110th Congress.

Both bills authorize providers and merchants to enter in voluntarily negotiated access agreements and declare that such voluntarily negotiated access agreements shall be given effect between the signatories in lieu of any other determination. The major difference between the 2008 and the 2009 bills is who would be responsible to make sure that negotiation take place. In the 2009 bill, the U.S. Attorney General would have the responsibility. In one version of the 2008 bill, it would have been a panel of three full-time electronic payment system judges, appointed by the Antitrust Division of the Department of Justice and the Federal Trade Commission Bureau of Competition, to determine the schedule of rates and terms for three-year periods. In the final version of H.R. 5546 that was reported to the House, the Antitrust Division of the Department of Justice would have been required to see that the negotiations take place as well as filing a report to the House and Senate Judiciary Committees detailing the negotiations and, if an agreement is reached, whether such access rates and terms will have an adverse effect on competition and how such rates compare with access rates and terms in current use in other countries.[20]

Reaction to the Durbin Amendment, H.R. 2695 and H.R. 5546

Even though the Durbin Amendment exempt financial firms, including affiliates with assets less than $10 billion that would include most credit unions and community banks, the associations of both these groups of financial have not supported the amendment.[21] The main reason for their opposition to changes in the existing interchange fee structure is that smaller issuers get practically the same interchange payment per transaction as larger institutions at a fraction of the cost. As a result, the interchange fee is a large profit center for credit unions and community banks. The proponents and opponents have not changed regarding interchange fee regulation since 2008.[22]

The amendments and bills have gotten support from merchant and consumer groups and opposition from payment card companies and the banking community, including credit unions. In general, the reaction to the 2009 bill was not expected to be much different from those of the 2008 bill because the changes in the new bill did not address the provisions that resulted in support or opposition to the bill. The National Credit Union Association (NCUA) came out with an announcement of its opposition to H.R. 2695 that states that the bill would only benefit merchants, who are expected to support H.R. 2695 as they did H.R. 5546. This is reflected in a statement by John J. Motley of the Food Marketing Institute about H.R. 5546, "a major milestone in our long-standing campaign for a fair, competitive and transparent credit card interchange fee system. The credit card company cartels fix the fees at levels that far exceed actual transaction

[20] See H.Rept. 110-913, Credit Card Fair Fee Act of 2009.

[21] See Independent Community Bankers of America, ICBA Statement on Senate Passage of Wall Street Reform Bill, *ICBA News Release*, May 20, 2010, p. 1, and Credit Union National Association, Senate Cleared Reg Reform, CUNA Opposed with Interchange In, *CUNA News Now*, May 2, 2010, p. 1.

[22] Thecla Fabian, "Banking, Credit Union, Retail Groups Prepare for Long, Intense Interchange Battle," *BNA Banking Daily*, May 17, 2010, p. 1, and Thecla Fabian, "High-Pitched Interchange Fee Battle Moves to Regulatory Reform Conference Committee," *BNA Banking Daily*, May 26, 2010, p. 2. See letter sent to the Senate at credit Union and community bank opposition to Durbin amendment #3932 at http://www.cuna.org/download/congress_letter_051210a.pdf.

costs. This legislation gives retailers the right to negotiate reasonable fees with the Visa and MasterCard networks." Consumer groups also supported the bill at the Task Force hearing on the bill. U.S. Pubic Interest Research Group consumer program director, Ed Mierzwinski, argued,

> An oligopoly of issuers dominates the marketplace. They can do whatever they want. I am completely unconvinced that there is any competition in this marketplace. We are fortunate [the Antitrust Task Force] is shining light on the issue. This act would create a non-price control mechanism. It is a commonsense approach to the problem that will force the two sides to the bargaining table.[23]

In contrast, the general council of Visa argued that the bill would suppress competition and innovation and result in unintended and harmful consequences for consumers. The American Bankers Association points out that the bill contains provisions that violate fundamental antitrust principles and will ultimately result in less competition and increased costs and reduced benefits for consumers. Despite receiving an exemption for most credit unions, the Credit Union National Association (CUNA) opposes government intervention in setting interchange fees.[24] The Federal Trade Commission (FTC) opposed the bill because the commission has long discouraged exemptions from the antitrust laws, and the Justice Department's Office of Legislative Affairs opposes the bill on similar grounds as the FTC.[25]

One important issue raised at the hearing on H.R. 5546 and is expected to be raised again in considering H.R. 2695 is whether merchants would pass on to their customers the savings they obtain from lower interchange fees. The representative from Visa suggested that there is no evidence that merchants have lowered their profits by passing on the lower cost of interchange fees to their customers.[26] According to the testimony, there is little evidence that customers benefitted from the lower interchange fees, including the lower interchange fee case that was settled with Wal-Mart. [27] In the case in Australia where the interchange fees were capped by regulation, the Royal Bank of Australia has not offered empirical estimates that savings from lower interchange fees have been passed on to consumers in terms of lower prices.[28]

Implications

The economic assessment of the two-sided market is a critical part of analyzing the interchange fee issue. Merchant complaints are focused on the rise of the merchant discount rate, indicating that the acquirer banks' costs do not justify the merchant's discount fee that they collect from

[23] Shane M. Walter, "House Judiciary Reports Bill to Allow Merchants to Negotiate Transaction Fees," *BNA Daily Report for Executives*, July 17, 2008, p. A14.

[24] Credit Union National Association, "Interchange Bill May Be Dead for '08," *CUNA News Now*, July 17, 2008, p. 1.

[25] Shane Walter, "Credit Card Companies Respond to Interchange Fee Criticism, Oppose Bill," *BNA's Banking Report*, May 19, 2008, p. 935, http://ippubs.bna.com/NWSSTND/IP/BNA/BAR.NSF/SearchAllView/27B1829A452582998525744C0000D2B4?Open&highlight=INTERCHANGE,FEES.

[26] Congressional Quarterly, "House Judiciary Subcommittee on Antitrust and Competition Policy Holds Hearing on Merchant Credit Card Payment Fees," May 12, 2008, p. 85, at http://www.cq.com/display.do?dockey=/cqonline/prod/data/docs/html/transcripts/congressional/110/congressionaltranscripts110-000002878244.html@committees&metapub=CQ-CONGTRANSCRIPTS&searchIndex=0&seqNum=34.

[27] Ibid.

[28] William Bishop, Kyla Malcolm, and Nicole Hildebrandt, "Regulatory Intervention in the payment Card Industry by the Reserve Bank of Australia: Analysis of the Evidence," CRA International, April 28, 2008.

them. However, it is not clear that the merchants fully account for the costs of the issuing banks that are included in the discount fee. Some evidence shows that the amount of the merchant discount fee that the acquirer bank keeps is competitively determined; it is estimated to be about 0.5% of the transaction amount for most payment cards, including Discover and American Express. However, empirical evidence suggests that merchant's acceptance of payment cards has little to do with the acquirer bank's fees, because raising the acquirer fee did not show a reduction in card acceptance.[29] Consequently, the focus turns to the cardholder and the issuing bank's side of the market. On this side, there is evidence that payment card pricing has a dramatic effect on card usage because of the ease of switching to another card or method of payment. Cardholders avoid using a card rather than paying more, which may justify the card association making larger payments to the issuer banks, which lowers the costs to the cardholder but provides little perceived benefit to the merchants.

Another implication concerns the market mechanism that would reverse any anti-competitive behavior existing in the payment card industry. For example, if it is determined that the interchange fee is currently the result of anti-competitive behavior on the part of the card associations and issuing banks, interchange fees should arguably be lowered. What mechanism might be used to ensure that the price of the goods and services is lowered to reflect the lower interchange fees? Although experience has shown that interchange fees can be lowered by regulatory caps and other government restrictions, there has been little discussion of how to pass the excess fees back to the cardholders. If the government just lowers the fee with the expectation that merchants will pass the savings back to cardholders, it might not occur. The government's regulatory caps would be redistributing revenues from the issuing banks to merchants. The result could be that the social benefit of the electronic payment card system is lowered, because the government's action would lower revenues to the card-issuing banks, causing them to issue fewer than the optimal number of cards to cardholders. With fewer cardholders using the payment system, merchants may not see the growth in customers they had in the past.

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[29] Steve Semeraro, p. 70.