Issue Analysis

Payment Card Networks under Assault

How Capping Interchange Fees Will Hurt Consumers, Charities, Community Banks, and Credit Unions

By John Berlau and Ryan Radia

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Executive Summary

In recent years, the use of credit and debit cards to purchase goods and services has surged in the United States, and American consumers pay with "plastic" now more than ever before. The growth in popularity of payment cards has benefited greatly both consumers and retailers. Innovations in electronic payment networks have improved the efficiency of business transactions, enabled seamless and secure digital commerce, and provided consumers with valuable tools for saving money and managing personal finances.

The modern payment card system requires significant private investment. Payment card networks and credit and debit card-issuing banks collectively spend tens of billions of dollars annually to combat fraud, ensure the smooth operation of payment systems, and develop new tools for merchants and cardholders to track and monitor transactions. Card networks and card-issuing banks fund these investments by charging interest on credit card balances, assessing various cardholder and processing fees, and retaining a small percentage of payment card transactions.

Despite this success story, both houses of Congress are now considering legislation that would inject government into a central role in the setting of fees and rules for payment cards. Several major retailers are waging a lobbying campaign aimed at persuading lawmakers to support government controls on interchange fees—the fees that card-issuing banks retain for the services they provide in payment card transactions. Retailers blame interchange fees, which typically amount to around 1.75 percent of payment card transactions, for allegedly resulting in higher prices for consumers while making it harder for struggling merchants to stay afloat.

Contrary to retailers' claims, a body of economic and empirical evidence indicates that government intervention in the setting of interchange fees would hurt consumers, undermine efficiency in commercial transactions, and stunt innovation in electronic payment networks. Retailers also overlook the role of interchange fees in sustaining cardholder rewards programs, which have become quite popular among consumers in recent years, because they increase consumers' buying power.

Government intervention in interchange fee setting is not unprecedented. Australia imposed stringent fee controls in 2003 for many of the same reasons which retailers say justify regulation in the United States. The results have not been pretty. Australian consumers now face higher annual cardholder fees, while they have not benefited from the price reductions promised by retailers. Consumers in Australia now shoulder a greater portion of the burden of card processing, while retailers have largely pocketed the savings. Additionally, Australian banks have limited the scope of rewards programs. If the Unites States follows Australia's path, American consumers stand to face higher costs and reduced benefits.

To the extent that the current market for payment cards is insufficiently competitive, government regulation of card-issuing institutions, not interchange fees and payment card industry practices, is to blame. If Congress wants to advance consumer interests, it should reject proposals to regulate interchange fees and instead focus on reforming laws that distort natural market arrangements in the payment card market.

The payment card system is a complex one that involves not only merchants and consumers but also payment card networks and financial institutions from banks to credit unions. The marketplace for credit and debit cards is vibrant and competitive, and its innovations have been a boon for consumers and merchants alike. At a time when the U.S. economy is recovering from one of the worst recessions in decades, for government to intervene in this well-functioning market would have serious unintended negative consequences for consumer welfare.

Introduction

The United States officially climbed out of the "Great Recession" in the third quarter of 2009, with Gross Domestic Product climbing by more than 3 percent.[1] While the speed and magnitude of the recovery are still uncertain, the nation's economic outlook is likely to continue improving as the economy grows and job creation picks up.

The recent recession will have lasting effects on U.S. consumers, whose financial management habits may have been permanently altered. A Hart Research survey conducted in September 2009 found 63 percent of Americans stating that, "the way they spend and save has been forever changed as a result of the economic downturn."[2] Consumers are saving more money, clipping coupons, and increasingly hunting for bargains. Television and radio personalities who promote frugal habits, like Dave Ramsey, are gaining larger audiences, while online traffic on personal finance websites like Mint.com has soared.[3,4] As *PR Week* recently noted, the "blogosphere touts thriftiness."[5]

Yet this widespread adoption of thriftiness is not a threat to economic growth. As empirical evidence has demonstrated, the Keynesian "paradox of thrift"—the idea that increasing personal savings translates into reduced production and employment—is false.[6] In fact, saving is an indirect form spending. When consumers save money, banks can lend that money to businesses which subsequently invest in capital and labor inputs to create the goods and services consumers will buy. With sound policy incentives, the recent increase in consumer savings should boost long-term economic growth.

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More and more, savvy consumers are discovering that credit and debit cards—long associated with spending and indebtedness, respectively—are actually valuable as tools for saving money. As *Consumer Reports* recently noted, some "consumers, specifically people who never carry a balance and always pay their bills on time, can actually make their cards work for them rather than against them."[7] Thanks to programs like "rewards points," responsible credit and debit card owners can accumulate perks ranging from cash to merchandise to airplane tickets. According to Bankrate.com, "For the first time in history, more U.S. consumers belong to credit card rewards programs than to airlines' frequent-flier programs."[8] And a *Consumer Reports* study finds that, "about 85 percent of U.S. households participate in at least one [payment card] rewards program."[9]

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Payment cards also allow consumers greater flexibility. Consumers who wish to obtain a credit or debit card can select from a vast array of card-issuing financial institutions, from big national banks to local community banks to credit unions. Visa and MasterCard are accepted around the world—and around the Web—regardless of whether the cards were issued by a credit union or a major bank.

Credit and debit card networks also give individuals protection against having their bank accounts wiped out by a single fraudulent transaction. Electronic payment networks are designed to detect fraudulent activity, and retailers are subject to suspension of their card network privileges if they are involved in repeat unauthorized use. Banks and payment card companies have implemented advanced security features, including holograms, and have developed technology to detect potentially fraudulent transactions by searching for unusual spending activity.[10]

The payment card network system also greatly benefits retailers, saving them costs stemming from the risks of storing paper money, combating counterfeiting and theft, and verifying personal checks. This is true for both online retailers as well as brick-and-mortar merchants. And the growth of instant electronic payment has been crucial to the massive growth of commerce over the telephone and on the Internet.

Furthermore, many charitable organizations, facing tough financial times because of the recent economic downturn, have found credit cards to be a useful means of maximizing public support. For instance, charities such as the Make-A-Wish Foundation, Susan G. Komen Breast Cancer Foundation, and university alumni associations now partner with credit card-issuing financial institutions to issue cards in which a portion of each transaction is retained by the nonprofit. The mechanism for these charitable contributions resembles that of personal rewards credit cards. "Charity credit cards make it easy for cardholders to donate cash back to good causes," writes personal finance blogger Fleur Hupston of Suite101.com. "They work like credit cards with rewards except the reward goes to a chosen charity."[11] By the end of 2006, about 60 million consumers carried more than 320 million "affinity" credit cards associated with charities and other organizations, which they used for $849 billion worth of transactions.[12] Consumer use of charity cards has held up well throughout the recession, helping bolster many charities' bottom lines.[13] Moreover, some credit card reward programs allow consumers to give away some of their rewards. As *Consumer Reports* notes, "A growing

number of affinity cards now give users the option to earn reward points redeemable for cash or merchandise for themselves and still donate something to a charity they support."[14]

Unfortunately, some of the mechanisms that have made the growth of payment cards possible are now under threat by some ill-considered policies currently being proposed in Washington. To understand why these would be so harmful, it is necessary to understand what exactly it is they threaten.

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Interchange and the Four-Party Model

Today, the predominant payment card transactions system is the four-party network of Visa and MasterCard. Every time a consumer pays for a good or service by swiping a credit, debit, or other payment card supported by a card network like Visa and MasterCard, a transaction takes place that typically involves four parties: the consumer, the merchant, the card-issuing bank, and the acquiring bank. The card-issuing bank is the financial institution that issued the payment card to the consumer, and the acquiring bank is the financial institution used by the merchant to accept payment card transactions. When a consumer swipes a payment card, the card-issuing bank verifies the account and then electronically transfers funds to the acquiring bank, which then deposits the funds in the merchant's account.

Each of the four parties to payment card transactions benefits from their participation. Consumers get goods or services they want, and in exchange merchants receive monetary compensation. The other two parties—the card-issuing bank and the acquiring bank—each earn a portion of each transaction. The portion deducted by the banks from the merchant's earnings is termed the *merchant discount rate*.[15] The discount rate is comprised of several fees, including card association dues, merchant service fees, and processing fees. Most of these fees are retained by the card-issuing bank, while a portion is retained by the acquiring bank.[16]

By far the largest component of the merchant discount rate is the *interchange fee*. This fee is determined by the payment card networks, but retained by the card-issuing banks. Interchange fees can vary from transaction to transaction based on many factors, such as the type of payment card used—for example, whether the card is Visa Gold or standard Visa—and the category of merchant—supermarket, filling station, utility, etc. Details of how interchange fees are determined can be found

Not a Unique Business Model

In their 2001 book chronicling the evolution of the payment card market, *Paying with Plastic: The Digital Revolution in Buying and Borrowing*, finance scholars David S. Evans and Richard Schmalensee describe modern payment cards as a "two-sided platform market," observing that many other major industries fit into a similar economic model. Newspapers and magazines, for instance, charge both subscribers and advertisers for the product, as do many cable television networks. Computer and gaming systems frequently collect fees from both software developers and end users. And supermarkets—including, ironically, some whose management have complained about the two-sided payment card fee structure—sometimes charge "slotting fees" to grocery manufacturers for prominently displaying particular products. Evans and Schmalensee argue that, "multisided markets engage in price discrimination because it is possible to increase revenue by doing so, and because in the case of businesses with extensive scale economies, it may be the only way to cover fixed costs."[1]

1 David S. Evans and Richard Schmalensee, *Paying with Plastic: The Digital Revolution in Buying and Borrowing* (Second Edition), The MIT Press, Cambridge, Massachusetts, 2005, pp. 133-56.

in detailed rate schedules that are available online.[17] In some instances, merchants can choose to pay a "blended rate," which is a flat fee that stays the same regardless of the type of card used.[18]

According to economists at the Federal Reserve, interchange fees for Visa and MasterCard payment cards totaled approximately $40 billion in 2007. Interchange fees range from roughly 1 to 3 percent of each transaction, with higher rates typically associated with "premium" payment cards (such as Visa Signature or World MasterCard).[19] In recent years, the increasing use of rewards cards has resulted in merchants paying more in interchange fees—though still nowhere near the 7 percent they paid in the early days of credit cards when the benefits of payment cards were far more limited than they are today.

The War over Interchange Fees

As American consumers have tightened their belts and increasingly turned toward debit and credit cards, several large retailers and merchant trade associations have seen a political opportunity to win favorable government regulation. Some retailers are now pushing for new rules governing credit and debit card fees in the name of consumer welfare. This push comes on the heels of the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (sometimes known as the Credit CARD Act of 2009 or the Credit Card Holders' Bill or Rights), which was enacted by Congress in May 2009. The legislation placed several restrictions on the interest rates and fees that card issuing institutions could levy on its consumers.[20]

Big retailers like convenient store giant 7-Eleven[21] and online closeout seller Overstock.com[22] launched a campaign in 2008 aimed at spurring public backlash against interchange fees and garnering support for various forms of government actions to control them. As one major retailer trade association put it, "The credit card interchange fee is the biggest credit card fee you've never heard of. Nearly $2 of every $100 American consumers spend using credit cards goes directly to the credit card industry through the interchange fee."[23]

Cards' Benefits to Customers

These claims are disingenuous and misleading on several levels. Interchange fee revenue goes to card-issuing institutions such as credit unions and community banks, while only around $0.10 of every $100

spent on plastic goes to payment card networks like Visa or MasterCard. Especially misleading are merchants' claims that imposing price controls on interchange fees will be a boon for consumers. In fact, such controls would actually shift the costs of processing cards onto the backs of consumers, and undermine the significant, yet often hidden, efficiencies that payment cards deliver to consumers, merchants, and ultimately the American economy.

A November 2009 Government Accountability Office (GAO) report on the economic effects of interchange fees refutes a number of common criticisms of interchange fees. The study concludes that if Congress were to restrict interchange fees, consumers "may not experience lower prices" and retailers could pocket the entire windfall resulting from any reduction in interchange fees.[24] It also found that limiting interchange fees would cause the costs associated with payment card use to increase, hurting consumers, as payment card issuers would likely curtail or eliminate rewards programs and perhaps even hike annual fees to make up the lost revenue.[25]

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The GAO report also highlights the many benefits payment cards bring to consumers and retailers. The benefits to consumers include:

- Faster transactions;
- The convenience of not having to carry cash or a checkbook;
- A convenient source of unsecured credit that allows consumers to finance their purchases over time;
- An interest-free period to finance purchases if balances are paid on time;
- Improved theft and loss prevention as compared with cash and easier dispute resolution in the event of problems; and
- A simple record-keeping mechanism that can be useful for budgeting, planning, and income tax preparation.

Cards' Benefits to Merchants

According to the GAO, payment cards are also a boon for merchants. They allow a potential customer who is not carrying enough cash to make a purchase immediately using a credit card, "resulting in a sale that the merchant otherwise would not have made."[26] This does not necessarily result from consumers spending beyond their means (although some do), but from the simple fact that even consumers who have the savings to cover purchases prefer not to carry large wads of cash when making a

large purchase. Overall, customers spend markedly higher amounts when retailers accept payment cards than when retailers accept cash only.[27]

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Merchants also benefit from the certainty of payment that credit and debit cards offer. Processing and receiving funds from personal checks can take five days, but retailers typically retrieve card payments within one to two days.[28] Moreover, credit cards, as well as debit cards with overdraft features, eliminate the risk to merchants of being shortchanged by a bad check. "Merchants that accept cards have less cash to handle and less risk of employee theft" than they would otherwise, notes the GAO report.[29] "Payment cards also save merchants the costs of transporting cash to a bank, which sometimes requires the expensive use of secure vehicles such as armored trucks."

Swiping a payment card at the register is typically far faster and easier for cashiers than handling cash, saving time and labor. As GAO notes, "Card acceptance also can reduce the time merchants' customers spend at checkout and can reduce labor costs," as processing a card can take less time than cash or check and "credit card customers at gas stations and other retail stores often can pay for purchases without necessarily interacting with an employee."[30] Finally, the GAO notes, credit card networks greatly assist merchants with marketing to their customers. Credit card databases that retailer can access "help merchants identify and better understand their prospective, current, and lapsed customers and employ a variety of niche marketing approaches that ultimately serve to increase sales."[31]

Ignoring the Economics

Raymond J. Keating, chief economist for the Small Business & Entrepreneurship Council, has observed that people often "take for granted the businesses the benefit from most." He argues that attacks on the payment card industry, like those on energy companies, are "another case of the work, costs, investments and risks faced by businesses in an industry being largely taken for granted, and the economics of the industry simply being ignored."[32] Keating is right.

While credit and debit cards have benefited merchants and consumers alike, maintaining a payment card network remains expensive, and someone has to pay the costs. Since the advent of the modern credit card, these costs have been split between the merchant and the consumer. When Diners Club established the first general purpose credit card in

1950, participating restaurants, hotels, and nightclubs paid the company an average of 7 percent of the cardholders' bills. When American Express began offering credit cards in the late 1950s, it charged participating merchants about 5 percent of their proceeds from the cards.[33] This share was much higher than the 1.75 percent rate that merchants rail against today, but retailers were willing to pay nevertheless because they calculated that accepting credit cards reduced their costs and brought in enough new sales to offset the fees. Today, more merchants than ever—including those griping to Congress—still find accepting payment cards worthwhile, or they would simply stop accepting plastic.

If a merchant were to find the fees charged by a credit card issuer to be excessive, it could simply resort to alternate payment systems. Contrary to the claims of some retailers that they are held "captive" by interchange fees,[34] there are many competing payment systems in widespread use. In addition to Visa and MasterCard, merchants can accept Discover and American Express. New online payment services like PayPal allow Web-based startups to do business without the hassles of credit card acceptance. In some cases, large retailers have negotiated exclusive agreements with certain card networks. Costco, for instance, accepts credit cards only from American Express, and Sam's Club accepts MasterCard but not Visa credit cards.[35] Some major retailers—including Macy's, Sears, and Home Depot—have agreements with major card networks, such as Visa and MasterCard, to issue their own cards through those networks. In fact, the first credit cards were introduced by large retailers as perks for their best customers. Discover, for instance, began as a unit of Sears, Roebuck & Co.[36] Over the years, some retailer payment cards went by the wayside as general purpose credit cards offered greater efficiency.

In addition, retailers always have the option of only taking cash if they believe the costs of accepting credit cards outweigh the benefits. Ironically, the advent of electronic payment cards has made it easier than ever for businesses to choose this option, as automated teller machines are now on practically every street corner in major cities. In New York City, for example, a number of renowned restaurants, including the Carnegie Deli in Manhattan[37] and Peter Luger Steakhouse in Brooklyn,[38] still accept only cash. And until a few years ago, major nationwide fast food chains typically did not accept credit or debit cards.[39]

Finally, acquiring banks compete aggressively over processing fees to win over merchants. According to the GAO, merchants have

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many choices among acquiring banks. This allows them to bargain for lower processing and authorization fees, which, like interchange fees, are included within the merchant discount rate.[40]

Regulatory Barriers in the Payment Card Market

While the payment card market is "competitive and dynamic," as Raymond Keating described it,[41] existing regulatory barriers prevent the market from realizing its full potential. One such barrier is the Bank Holding Company Act of 1956, which prohibits non-financial institutions such as retailers from forming their own banking divisions.[42] In 2006, when Wal-Mart and Home Depot applied to form limited-purpose banks called industrial loan corporations (ILCs) to reduce their credit card processing costs, a major controversy ensued and the FDIC soon placed a moratorium on ILCs. If restrictions on the formation of these new banks were lifted, more choices would exist in the payment card marketplace, benefiting both retailers and consumers.[43]

Congress Ponders Interchange Fee Limits

Proposals to limit interchange fees currently under consideration in Congress would institute hidden price controls and abrogate private voluntary contracts between card issuers and merchants. In the Senate, the Credit Card Fair Fee Act of 2009 (S. 1212), sponsored by Sen. Richard Durbin (D-Ill.), would force credit card issuers, including community banks and credit unions, to enter into a form of collective bargaining agreement with all retailers. If these government-mandated "negotiations" do not produce results to merchants' satisfaction, then a panel of three "Electronic Payment System Judges," appointed by the U.S. Attorney General and the Chairman of the Federal Trade Commission, would set interchange fees for three years. Potentially thousands of merchants, banks and credit unions could end up in front of these panels. Such a scenario would provide work for lawyers, while spurring a slowdown in overall retail sales.

In the House of Representatives, Reps. Peter Welch (D-Vt.) and Bill Shuster (R-Pa.) have co-sponsored the Credit Card Interchange Fees Act of 2009 (H.R. 2382), which would prohibit card networks from enforcing the current "Honor All Cards" rule that requires participating merchants to accept all cards from a certain network, from all issuing financial institutions. Retailers may also not impose surcharges on particular types of cards within a payment network. The Welch-Shuster

legislation would take away card networks' ability to prevent merchants from discriminating against specific types of card issuers—for example, by preferring banks issued by major banks over those issued by credit unions—and would allow retailers to slap new hidden fees on credit and debit card holders.

Moreover, without the "Honor All Cards" policy, a consumer waiting in line at a store would no longer be able to know for sure whether his or her particular credit or debit card would be accepted. The current payment card system that now hums along in the background seamlessly could start coming apart at the proverbial seams.

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Perhaps the most telling evidence of how restrictions on interchange fees would harm consumers comes from the experience of Australia. In 2003, the Reserve Bank of Australia (RBA) instituted sweeping interchange fee caps that required card issuers to reduce interchange fees to an average of 0.5 percent per transaction. As the GAO and numerous economists have noted, Australian consumers bore the economic brunt of these de facto price controls. To make up for lost interchange revenue, Australian card issuers "reduced rewards and raised annual fees," states the GAO in its report on interchange fees.[44]

Worse, it appears that Australian consumers did not recoup any of the retailer savings from the lower fees. Summing up the findings of the RBA, the GAO points out that Australian merchants saved A$1.1 billion (US$1 billion) from reduced fees, but notes that, "officials acknowledged that it would be very difficult to provide conclusive evidence of the extent to which these savings have resulted in lower retail prices because so many factors affect such prices at any one time."[45] At a May 2009 U.S. Federal Reserve conference, John Simon, chief manager for the Payments Policy Department of the RBA, acknowledged there was no evidence of savings for Australian consumers arising from the interchange controls.[46]

Interchange fee controls would also make it harder for community banks and credit unions to compete in offering credit and debit cards, because making payment cards less profitable per transaction would give a clear advantage to large issuers that can issue cards and process payments in greater volume. As the GAO report notes, "With less interchange fee income, representatives of smaller issuers such as community banks and credit unions told us that they likely would not offer rewards cards and therefore would be unable to compete with the larger issuers in the market."[47]

A Broad Range of Consumers

Interchange fees have enabled card networks to significantly reduce annual fees on cardholders.

Prudent consumers would likely be the hardest hit by interchange fee controls due to the resulting new fees and clawing back of rewards. Currently, consumers who pay off their credit card balance in full every month (known as "convenience users" in industry jargon) pay no additional fees, while they enjoy perks like cash-back programs, airline miles, or other rewards. Interchange fee controls would cause responsible cardholders to lose these incentives.

Many critics of interchange fees make the mistake of conflating the thrifty with the affluent and claim that rewards points made possible by interchange fees benefit wealthy cardholders at the expense of poor ones.[48] For example, *New York Times* business columnist Floyd Norris argues, "You know there is something wrong when a middle-class person can get a part of his purchases refunded by the bank, or can collect miles good for free airline tickets, while paying the same price as a poor person who can get none of those benefits."[49] Thus, these critics argue that, even if interchange fees benefit some consumers, government should nevertheless restrict the fees in order to protect low-income individuals.

But cardholder statistics paint a vastly different picture of who benefits from interchange fees. In 2008, 78 percent of U.S. households—almost 100 million households—held at least one credit card, and 85 percent of cardholders held a card offering rewards.[50] A broad range of U.S. consumers, from the working-class to the wealthy, enjoy the benefits that payment cards make possible. As interchange fees have grown over the past two decades, the U.S. credit card market has evolved considerably, and the accessibility of credit cards has improved markedly.[51,52] In 2007, credit card usage reached an all-time high, with over $1.9 trillion changing hands in over 25 billion credit card transactions.[53]

Interchange fees have enabled card networks to significantly reduce annual fees on cardholders.[54] From 1990 to 2006, cardholder annual fees declined by 50 percent. In fact, the vast majority of credit cards offered in the United States today have no annual fees (although some credit card issuers have introduced modest annual fees on certain cards following the passage of the CARD Act of 2009).[55,56] Additionally, Visa and MasterCard have recently changed their policies to allow card issuers to upgrade basic credit cards to rewards cards without the need to reissue the card.[57]

Conclusion

Policy makers should heed the lesson of Australia and stay out of interchange rate setting. Government intervention in the payment card market would harm consumers and, ultimately retailers. Someone has to "pay the piper," and limiting interchange revenue will only cause other fees and interest rates to increase while forcing consumers to shoulder a greater burden. Capping interchange fees would endanger rewards programs, charities, and community banks. Worse, it would stifle innovation in electronic payments, delaying the evolution of tomorrow's payment networks and financial transaction instruments.

Ill-conceived government involvement in the credit and debit card market has already dampened the industry's vibrancy, and piling on another layer of government regulation would only worsen the problems. As Congress ponders payment card legislation, it should consider the unintended consequences of strict limits on ownership of banking institutions and of past price controls governing personal credit cards.

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