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On behalf of U.S. PIRG and
The Consumer Federation of America

Hearing on The Law and Economics of Interchange Fees

Before the Subcommittee on Commerce, Trade and Consumer Protection
Of the Committee on Energy and Commerce,

U.S. House of Representatives
Honorable Cliff Stearns, Chairman

15 February 2006

Chairman Stearns, Representative Schakowsky and members of the committee:

My name is Edmund Mierzwinski. I am Consumer Program Director of the U.S. Public Interest Research Group, which serves as the federal advocacy office of the National Association of State PIRGs, which are non-profit, non-partisan public interest advocacy organizations active around the country. My testimony today is also on behalf of the Consumer Federation of America. Founded in 1968, CFA is an association of some 300 nonprofit consumer and cooperative organizations from throughout the nation with a combined membership exceeding 50 million people.

Summary

Skyrocketing bank fee income reported last summer was not due to any new or greater sophistication or marketing innovations on the part of bank executives. Rather, it was simply due to the spike in gasoline prices, which provided banks with massive returns on their long-term strategy to use legally questionable market power and anti-competitive practices to collect billions of dollars in excessive "interchange" fees from merchants accepting credit or debit cards.[1] Because many consumers, and perhaps even more consumers as gas prices skyrocketed, used credit or debit cards at the pump, bank income from fees imposed on merchants simply spiked.

Some time ago I saw an industry newspaper ad for a bank conference. The event's title was "Fee Income: The Holy Grail." They weren't kidding. As Margaret Pressler detailed in the Washington Post[2] in September:

> "So a year ago, when gas prices averaged $1.87, banks involved in credit card processing made about $12.5 million a day on fees. Now, with prices averaging $2.75 nationally, the credit card companies are raking in $18.4 million a day. That is $183 million more a month, or nearly $2.2 billion dollars on an annual basis in extra money paid to the nation's banking giants just because of rising gasoline prices."

Many merchants, particularly small businesses, assert that these bank fees – known as interchange fees and averaging as much as 1.6% or more of each transaction on a credit or debit card -- are among their highest costs of doing business (more than rent, salaries or utilities), are unfair and non-negotiable and raise the costs of goods for all consumers, not just those who use credit cards. Many of the estimated 10-12 million consumers who do not have credit or debit cards are unbanked due to the high costs of maintaining a bank account, yet these lower-income Americans are also paying more at the store and more at the pump due to high interchange fees.

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[1] Your debit and credit card purchases are processed through the retailer's bank and the bank that issued you the card. The issuing bank charges the retailer's bank a fee to process the transaction. The retailer's bank then adds its own fee for processing the transaction and passes on both of these fees to the merchant as the "interchange fee."

[2] See "Card Companies Are Filling Up At the Station," By Margaret Webb Pressler, Washington Post 25 September 2005; Page F01 http://www.washingtonpost.com/wp-dyn/content/article/2005/09/24/AR2005092400255.html, last visited 14 February 2005.

We cannot stress three points enough. **First, all consumers, even those who pay with cash, pay more at the store because the interchange fees that merchants pay banks are passed on to all customers.**[3]

Second, the success of the banks' legally suspect practices has given them tremendous market power. In anti-trust terms this allows them to dictate the terms of trade: Merchants have no choice but to accept Visa and Mastercard products on the sellers' terms. Otherwise, they will lose customers and sales.

Third, the banks engage in a variety of deceptive practices to drive consumers to higher cost forms of payment. For example, many banks surcharge PIN-debit transactions even though those are safer, less costly, and have a far lower opportunity for fraud than signature-debit transactions. They engage in these tactics to maximize their interchange fee revenue.

Further, numerous studies have shown that interchange fees, averaging between 1.5-2% of purchase prices in the United States market, are much higher than interchange fees in other countries. Yet as the head of one retail association has pointed out:

> We pay the highest fees in spite of the fact that our costs are the lowest. We have the greatest economies of scale, we have the lowest interest rates, and our fraud and bankruptcy liability has just been sharply limited. Yet the fees are being driven relentlessly higher.[4]

Hypothetically, if a U.S. merchant paid 2% in interchange fees and 50% of its customers paid with plastic, then, its costs, which must be recovered across all customers, have increased an average of 1%.[5] In retail, 1% is a big number. In effect, interchange is a hidden sales tax on all consumers.

So, we agree with merchants' concerns and commend the committee for its inquiry. We hope that the committee and the Congress will continue the investigations you have begun today of the impact on the economy of potentially anti-competitive bank practices

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[3] And of course, while these interchange fees are hidden fees that consumers pay, consumers directly pay many other unfair credit card and bank fees and high interest charges imposed by credit card companies and banks. See testimonies of Edmund Mierzwinski, U.S. PIRG, Travis Plunkett, Consumer Federation of America and Linda Sherry, Consumer Action, at hearing of the U.S. Senate Banking Committee on unfair credit card practices, 17 May 2005 available at http://banking.senate.gov Also see the PIRG websites http://www.truthaboutcredit.org and http://www.stopatmfees.com

[4] Tim Hammonds, President, Food Marketing Institute, "Interchange Fees," speech of 24 January 2006 available from author.

[5] While this is intended merely as an example, we have no seen no study that suggests any of these costs of business are merely absorbed by the business. Of course, some of the costs of accepting plastic offset other costs of accepting cash or checks. See November 2004, Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees, pages 9-11 for a discussion of costs for various payment types. See http://www.federalreserve.gov/boarddocs/rptcongress/posdebit2004.pdf (last visited 14 February 2006).

that make prices higher for all Americans and may limit competition and entry in payment system networks.

It is encouraging that the Congress is today joining the courts, which are considering a variety of merchant class actions[6] and even the U.S. Department of Justice,[7] which has been involved since 1998 in litigation into whether bank payment card and network governance, membership and ownership practices are fair and in compliance with the antitrust and other consumer laws.[8] One major merchant class action involving signature debit cards has already settled[9] for an estimated $3.3 billion in compensatory relief.[10]

The important questions being raised in these cases concern whether the practices of the banks and their associations, VISA and Mastercard, have been purposely designed and implemented to assert market power, limit entry by potential competitors and fix prices for users, both consumers and merchants, at unfair or illegal levels. Interchange practices are only one element, but an important one, of the various investigations, lawsuits and inquiries.

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[6] "Four major merchant associations have filed an antitrust, class-action lawsuit against most of the major credit card issuers in the United States over allegations of collusive behavior regarding interchange fees." See Retail group sues MasterCard, Visa, 4 October 2005, ATM Marketplace, http://www.atmmarketplace.com/news_story.htm?i=24148 last visited 14 Feb 2006. Those Associations include the National Association of Convenience Stores, the National Community Pharmacists Association, the National Grocers Association, The American Booksellers Association, the National Association of Chain Drug Stores, the Minnesota Grocers Association, and the National Cooperative Grocers Association.

[7] In a 1998 complaint, the U.S. challenged the interrelationships, governance structure and exclusionary rules between and among the VISA and Mastercard associations and the banks that own them as violations of the Sherman Antitrust Act. In 2003, the Second Circuit upheld a 2001 district court ruling in favor of the government's position that the exclusionary practices of the associations (essentially designed to prohibited entry by American Express or Discover into their payment networks) were illegal. See the DOJ's page containing documents relating to the United States vs. VISA U.S.A. Inc., VISA International Corp., MasterCard International Inc. litigation. http://www.usdoj.gov/atr/cases/indx57.htm(last visited 12 Feb 2006).

[8] It is also important to understand that while the banks may attempt to confuse the issue by claiming that 6,000 supposedly vigorously competing banks offer card choices, that particular comparison is irrelevant. The market under discussion is the market for network payment systems. Visa and Mastercard are the dominant national payment systems and there are only two others (American Express and Discover). Visa and Mastercard are alleged to have conspired together to keep prices high. Merchants generally have no choice in the marketplace that has developed; they must accept the two cards at the card associations' dictated terms.

[9] "In the Action, Plaintiffs claimed, among other things, that Visa and MasterCard, individually, and in conspiracy with each other and with their member banks, have violated the federal antitrust laws by forcing merchants who accept Visa and/or MasterCard-branded credit cards for payment also to accept Visa and/or MasterCard-branded debit cards for payment, and by conspiring and attempting to monopolize a market for general purpose point of sale debit cards. Plaintiffs claimed that Defendants' actions have caused merchants to pay excessive fees on Visa and MasterCard signature debit and credit transactions and on on-line PIN debit transactions, and have injured competition, merchants and consumers." See Wal-Mart et al vs. Visa and Mastercard.

[10] The case has also resulted in elimination of the so-called "honor-all-cards" rules of the associations. See Merchant Advisory on Final Approval and Payout of Settlement of Visa Check/MasterMoney Antitrust Litigation, Law Firm of Constantine Cannon, 29 June 2005, available at http://www.inrevisacheckmastermoneyantitrustlitigation.com/6_29_05.pdf (last visited 14 February 2005).

How Interchange Fees Work

Banks collect interchange fees when merchants accept credit and debit cards. Credit card transactions are signature-based (off-line) and switched only through the national VISA or Mastercard payment network systems. Debit cards are enhanced ATM cards with VISA or Mastercard brands on them and can be used not only in ATM machines, but also can used in either on-line (PIN-based) or off-line (signature-based) transactions in-person at a store or over the phone or on the Internet, just like a credit card. Because debit cards withdraw money from the consumer's own deposit (savings or checking) account, merchants have argued, successfully, that the transactions do not involve a loan, and therefore that fees should be lower due to the lack of credit risk. Nevertheless, fees for signature debit – as much as 1.6% or more of the purchase -- are higher than for PIN-debit, and reflect a large part of the dispute before you today.

According to the Federal Reserve, "the interchange fees set by Visa and MasterCard for signature debit have been substantially higher than those set by the regional POS networks for PIN debit." The Board goes on to explain:

> Whereas the prices of PIN debit are capped at fixed levels, those of signature debit and credit increase with the purchase amount. For the average debit purchase amount (about $40), a signature debit transaction generates an interchange fee of about $0.57; for PIN-based networks, the fee is $0.34. The difference between the fees is even more substantial for purchases of $80, the amount of a typical credit transaction. For a purchase of this amount, the signature debit rate is about $0.99, more than twice the PIN debit rate of $0.44. The fees for signature debit and PIN debit are less than those for credit ($0.72 and $1.33 for the two purchase amounts).[11]

For every $100 purchased on either signature debit or credit, the merchant only receives approximately $98.40.

Bank strategies to increase interchange fee income have involved several tactics:

> 1) Switch consumer behavior from PIN to signature: Banks seek to grow the market for signature debit by offering incentives (rewards) to consumers for off-line transactions but punishments (surcharges) for PIN-based transactions.[12] Banks frequently create the impression that the merchants are assessing these surcharges through deceptive billing practices.

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[11] November 2004, Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees, page 11 See http://www.federalreserve.gov/boarddocs/rptcongress/posdebit2004.pdf (last visited 14 February 2006).

[12] As an example of the fee punishments, see "Pricey Plastic: A NYPIRG Survey of Plastic Card Fees," at http://www.nypirg.org/Consumer/cards/ (last visited 12 Feb 2006). The 2004 survey reported that 89% of the banks surveyed assess a debit card POS fee for PIN-based transactions. The average fee assessed is 70¢. The fees ranged from 10¢ to $1.50. Also see Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees (citation above).

2) Switch consumer behavior from cash to plastic: Similarly, banks use Rewards Cards with cash-back, miles or other incentives to convince consumers to switch from cash transactions to plastic transactions, further increasing fee income.
3) Switch merchant behavior with unfair practices: Banks force merchants to accept signature debit (e.g., not merely lower-cost PIN-debit) through anti-competitive contractual terms such as the so-called "Honor All Cards" rule successfully challenged in the Wal-Mart case.
4) Make offers the merchants can't refuse: Like the Godfather, the banks make offers "you can't refuse." They use contractual terms and market power to keep merchant interchange fees high. Further, they force merchants to pay even higher fees when customers offer to pay with Rewards cards (of course, the merchant doesn't even know it is a Rewards card) so that the merchant, and the rest of us who shop at that store, actually pay for the cost of the consumer's miles offered by the bank.

One of the most important elements of the rapid growth in fees is the growing use of plastic as a substitute for cash. According to the Federal Reserve[13]:

> In 2003, consumers in the United States conducted more transactions with debit cards than with credit cards for the first time in history. In 2004, consumers in the United States will conduct an estimated 18.6 billion debit card transactions at the point of sale, an amount that accounts for roughly 53 percent of all card-based purchase transactions. Consumers will secure roughly 11.8 billion debit transactions with a signature and the remaining 6.8 billion with a PIN.

A separate Federal Reserve study[14] analyzes the rapid growth in electronic payments and the decline in the use of checks and cash:

> Electronic payments grew rapidly between 2000 and 2003. There were 13.8 billion more electronic payments in 2003 than in 2000.7 During the same time period, checks paid declined 5.2 billion, suggesting that some check payments were replaced by electronic payments. Electronic payments are also likely replacing some cash payments or reflecting general increases in payment activity.

Further, perversely and paradoxically, the incentives, such as higher fees, that the two associations offer their member banks to market their particular card result in reverse competition, where prices go up, not true competition where prices decline.

[13] November 2004, Federal Reserve Board, Report to the Congress on Disclosure of Point-of-Sale Debit Card Fees, page 4, See http://www.federalreserve.gov/boarddocs/rptcongress/posdebit2004.pdf (last visited 14 February 2006).

[14] The 2004 Federal Reserve Payments Study, 15 December 2004, available at http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf (last visited 14 February 2006).

Interchange Fees Are Hidden, But Consumers Pay Other Fees Directly

Banks, especially bigger banks, have long had a policy of raising fees, inventing new fees and making it harder to avoid fees. A series of PIRG studies has further documented that big banks charge higher fees than smaller institutions.[15] Analysts estimate that banks impose as many as two hundred different fees on consumers and small business customers. Many of these are nuisance fees, such as the fee for unknowingly depositing someone else's check that bounces, or even for seeking to withdraw more than your daily ATM limit, even if you have the money in your account. Who knew?

A few of these consumer fees drive vast amounts of bank income, among them the ATM surcharge of $1.50-$2.00 (imposed on non-customers even though that ATM owner also receives a share of the $1.50-$2.00 "foreign" fee the customer pays his or her own bank), the $30-$35 so-called bounce-protection fee imposed as a "service" in lieu of actually "bouncing" your check and, finally, the $29-$39 credit card over-the-limit and late payment fees. Most studies estimate that **each** of these few fees drives billions, or tens of billions, of dollars of fee income annually.

While consumers, policymakers and the press are well-aware of how banks have nickel-and-dimed consumers with this wide and growing variety of fees for virtually every service that they provide except, so far, for breathing the air in the bank, many policymakers have been unaware of the stream of income derived from fees imposed on merchants for accepting credit and debit cards. Nor is the public generally aware that some of this growing stream of income may be obtained through anti-competitive practices.

Conclusion

As consumer advocates, we are gravely concerned about the fairness and legality of bank schemes to increase credit and debit card fee income, especially because an underlying bank goal is also to encourage greater consumer use of plastic payments. As more consumers pay with plastic instead of cash, due to bank incentives such as rewards cards, but merchant fee income is buoyed by potentially anti-competitive practices, all consumers will pay more than we should at the pump, and more than we should at the department store, even those of us who still pay with cash. This is especially troubling as a matter of public policy due to the estimated 10-12 million unbanked American families forced to absorb these higher costs even though they pay with cash.

> **Here's a complaint I received via email:** I own a small gas/convenience store in WA state. Recently a customer "told" me to process her debit as a credit since she got a small fee back from her U S Bank debit card. Now, I know how high the fees are for me to process her card as a debit and how much higher as a credit. And yet, I am not allowed to charge a processing fee. In other words, the dollar fountain drink costs me money instead of making the few cents I would normally make, since the consumer is making an offer to pay. Yes, I can refuse service, but

[15] See the PIRG website http://www.stopatmfees.com

> I don't understand what is going on here-when is the merchant allowed to make any kind of profit at all with the use of credit/debit cards?

Is this small retailer a dinosaur whose store should die or is he a victim of predatory practices of his credit card payments systems suppliers? We believe the latter – and further that all consumers pay too much due to excessive interchange fees. We offer the following recommendations.

Recommendations

1) Congress should require separate Federal Reserve and Government Account Office (GAO) studies of the impact of interchange on the U.S. economy, including a review of interchange practices in other countries, a review of the need for greater disclosure and the need for further regulation of or prohibition of certain practices of bank payment networks.

2) Based on the results of the studies, Congress should consider regulating interchange fees, especially debit card interchange fees. Regulation of the monetary supply is a traditional role of government and as plastic becomes the dominant form of tender, Congress should assure that the market is unencumbered by anticompetitive or deceptive practices.

3) A concomitant problem we also encourage the Congress to examine is the difference in legal protections for consumers, depending on which sort of plastic they use. Consumers are largely unaware that while their legal rights against fraud are strong when they use a credit card, these rights by law are substantially less so when they use a debit card and non-existent when they use certain other stored value cards, including gift cards.[16] Since some of these cards are not issued by financial institutions they likely come under committee jurisdiction. Further, as we know from the committee's inquiry into data breaches, many of the serious breach notifications being made under California's and now other states' security breach notification laws involve risks to debit card account numbers.

Thank you for the opportunity to provide our views.

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[16] We and other consumer organizations including Consumers Union discuss many of these disparities and related issues in comments to the Federal Reserve Board here http://www.naca.net/FDICLetterNov05.pdf and http://www.federalreserve.gov/SECRS/2005/September/20050929/R-1210/R-1210_122_1.pdf and