Testimony of

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CREDIT CARD INTERCHANGE RATES: ANTITRUST CONCERNS?
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Good morning Chairman Specter, Ranking Member Leahy, and members of the Committee. My name is Joshua Peirez and I am the Group Executive, Global Public Policy and Associate General Counsel of MasterCard Worldwide. It is my pleasure to appear before you this morning to discuss the highly innovative and efficient MasterCard system and the role of interchange. Specifically, both have been essential to the transformation of global commerce, which has produced enormous benefits to consumers, merchants, and the economy as a whole, while fostering a high degree of competition among payment systems.

MasterCard is a driving force at the heart of commerce, enabling global transactions and striving to make commerce faster, more secure, and more valuable to everyone involved. MasterCard seamlessly processes close to 14 billion transactions each year. With more than 1 billion cards issued through its family of brands, including MasterCard®, Maestro® and Cirrus®, MasterCard serves consumers and businesses in more than 210 countries and territories, and is a partner to more than 25,000 of the world's leading financial institutions. With more than 24 million acceptance locations worldwide, no payment card is more widely accepted than MasterCard. MasterCard maintains a competitive infrastructure that drives business growth for merchants and banking customers alike.

It is important to note that MasterCard itself does not issue payment cards, nor does it contract with merchants to accept those cards. Those functions are performed by our customer financial institutions. The financial institutions that issue payment cards bearing the MasterCard brands are referred to as "card issuers." The financial institutions that enter into contracts with merchants to accept MasterCard cards are referred to as "acquirers." MasterCard provides the networks through which these financial institutions interact to complete payment transactions and sets certain rules regarding those interactions. Often, MasterCard's rules are "default" rules, meaning that they apply only if the financial institutions do not otherwise reach alternative arrangements among themselves. This is true with respect to interchange.

Healthy Competition

For many decades cash and check have been the primary forms of payment in the United States. In the last few years, however, the payments business has evolved more rapidly than at any other time in history. We fully expect this evolution in payments preferences to continue as merchants and consumers are increasingly seeking and using new forms of payment from payment cards, to electronic checks, to virtual currency.

MasterCard competes against all of these forms of payment, including paper-based transactions (such as cash and checks), electronic transactions such as wire transfers and ACH payments, and other electronic forms of payment, including card-based payment systems. Within the general purpose payment card industry, we compete vigorously worldwide with brands such as Visa, American Express and JCB, among others. In the United States, we also compete with other brands such as Discover/Novus. Within the debit segment, we compete with ATM and point-of-sale debit networks in various countries, such as Plus, Electron, Interlink, PULSE, Star, NYCE and Debitman in the United States, Interac in Canada, and EFTPOS in Australia. In addition, we compete against businesses that issue their own private-label payment cards such as retail stores and large petroleum companies.

In addition to our more traditional competitors, we also have competitors that have developed rapidly growing alternative payment systems such as PayPal and payments effected via mobile devices, such as cellular phones, transponders and other handheld electronic devices. Among other things, these competitors provide Internet currencies that can be used to buy and sell goods online, "virtual checking" programs that permit the direct debit of consumer checking accounts for online payments, and services that support payments to and from proprietary accounts for Internet, mobile commerce and other applications. Finally, we compete intensely for the loyalty of our financial institution customers and for their merchant and cardholder customers.

Tremendous Benefits to Consumers

Consumers have a wide variety of choices of payment methods at the point of sale--in a store, on the phone or online. Consumers can pay with cash, check, debit card, charge card, credit card, prepaid card, merchant-issued cards of many types, PayPal and many other alternative payment systems. Even among the types of payment cards, consumers have thousands of options for the provider of those cards and the benefits associated with their use. Regardless of the form of payment, consumers obviously find value in the form they choose to use.

MasterCard Payment Cards Offer Convenience and Consumer Protections

MasterCard payment cards offer consumers significant benefits and convenience. Individuals carrying a MasterCard payment card know they can walk into an establishment almost anywhere in the world and make a purchase using their MasterCard card. In fact, MasterCard cardholders can transact in more than 150 currencies without the need to exchange cash. A MasterCard cardholder can travel the world with only a single piece of plastic and make payments without the need to carry large amounts of cash or travelers checks. A MasterCard cardholder can buy everything from groceries to medical services on a MasterCard card.

MasterCard cardholders can use MasterCard cards at millions of merchants. That means fewer trips to the bank or ATM and the security that comes with not having to worry about carrying the right amount of cash, losing it, or having it stolen. Our popular advertising campaign says it best:

"There are some things money can't buy...for everything else, there's MasterCard." In essence, MasterCard's role at the heart of commerce is an integral part of the globalization that has fueled our economy over the last forty years.
In addition to the protections that MasterCard provides, consumers receive a wide variety of protections under the Truth in Lending Act (TILA) and Electronic Fund Transfer Act with respect to their payment cards. These protections include unauthorized use liability limitations, rights requiring banks to investigate and correct billing errors, and expansive disclosures to ensure that consumers fully understand these and other rights. MasterCard cardholders also receive a convenient, detailed accounting of their spending through periodic statements provided by their card issuers, which helps them to keep track of their purchases and manage their expenses. Furthermore, under TILA, credit cardholders receive protections from liability when they use their cards to pay for goods that are defective or that the merchant fails to deliver. Credit cardholders also can obtain what is essentially an interest-free loan for the period between their purchase and when their payment for that purchase is due to their card issuing bank.

Payment Cards Fuel the Internet

MasterCard cardholders need not even leave the comfort of their own home to shop around the globe. For years, cardholders have made purchases through catalogs delivered right to their home. Now, the Internet has become a powerful tool for consumers to find the lowest prices on a myriad of products. The rapid development of e-commerce is due largely to a cardholder's ability to pay for a product online by using a payment card. Furthermore, MasterCard is developing, and intends to continue developing, new and innovative payment options and features related to Internet purchases.

Consumers Benefit from Competition in the Marketplace

Aside from convenience and security, MasterCard cards also offer consumers significant, tangible benefits. These include airline miles, reward points, cash back offers, and a variety of other benefits. The proliferation of these key benefits is the direct result of intense competition in the payment card industry and the payments market generally. Not only does MasterCard compete with other forms of payment, but MasterCard issuers compete vigorously against each other and other payment card issuers. Because consumers can literally pick from thousands of different payment cards, issuers strive to make their payment cards more innovative and appealing to consumers. This intense competition has resulted in the elimination of annual fees for many types of payment cards and a reduction in cost to consumers seeking the value and convenience they provide. The increase in rewards and loyalty cards is also a direct result of healthy competition in the marketplace.

Substantial Benefits to Merchants

Merchants Have Choices in a Competitive Marketplace

Merchants derive enormous benefits from this competition, including the ability to provide an unprecedented number of payment options to their customers. For example, a single merchant can now offer its customers the choice to pay by cash, check, credit card, charge card, off-line or on-line debit card, proprietary card, installment loan, ACH, PayPal or a growing number of other means. Even with all these options, merchants prefer to accept certain types of payment, or only certain brands, and are free to restrict payment options in their stores (as many merchants do). They can also offer a variety of payment options but steer their customers to the preferred methods, which many merchants routinely do, for example when they prompt a consumer to enter a PIN on a debit card transaction. Merchants who prefer to receive payment by cash have many options as well, such as requiring payment in cash or providing incentives, such as cash discounts, to encourage their customers to use cash in lieu of other payment forms. This ability to offer cash discounts is unambiguous and easily implemented via signs at the cash register stating, for example, "discount of XX afforded to customers paying with cash."

Merchants Choose Payment Cards Because of Superior Benefits

Amidst this wide array of payment choices, merchants have been offering a growing number of payment card options to their customers. This is not surprising when one examines the profitability and other benefits payment cards create for merchants who accept them. For example, the convenience and flexibility payment cards offer consumers means that consumers are likely to spend more than they would if they had to pay with cash or checks. They can make purchases when they are far away from home where they do not have cash, or where the merchant does not accept checks (which most merchants believe to be a risky form of payment). Payment card transactions generally take less time at the point of sale than other forms of payment, so merchants can serve their customers more quickly and efficiently. Payment cards also lack many of the difficult to measure costs associated with the acceptance of cash, such as the risk of employee theft or fraud, or the need to count and transport cash (the costs to society of cash are even more significant). Unlike checks, payment cards offer merchants the benefit of guaranteed payment (subject only to the federally mandated and other consumer rights that could result in chargebacks). Perhaps most importantly, merchants accept payment cards because they, and consumers, prefer to use them. In sum, payment cards offer merchants an extraordinary value. It is therefore no surprise that the number of merchant outlets accepting payment cards continues to increase.

Merchants Invented Payment Cards But Others Provide Payment Cards More Cost Effectively

Merchants were the first to recognize the benefits of payment cards when, in the 1920s, individual merchants began to issue credit cards to their customers. These card programs, known now as two-party systems, grew because they were attractive to consumers given the convenience and ready access to credit they provided while bringing merchants increased revenues and some of the other benefits described above. These programs were not very efficient, however. Each merchant had to conduct its own underwriting to determine which customers qualified for credit. Merchants also learned the difficult lesson that while the availability of credit can increase sales, collecting on that credit can be challenging and expensive. This problem was compounded for merchants in that the borrowers from whom they sought to collect were the very customers from whom they derived their sales--and collection activities generally run counter to retail efforts to create customer loyalty.

Merchants' powerful desire to benefit from payment cards combined with the relative inefficiency of the two-party systems, and the merchants' lack of expertise and operational infrastructure for lending created opportunity for entry by other providers, and in 1950, a company known as Diners Club introduced the first so-called "universal" payment card that could be used at any store or business that chose to accept it. In 1958, American Express followed suit and offered its own widely-accepted card. Diners Club and American Express both used the three-party system in which a single company issues the cards, signs up merchants to accept the cards, and performs the functions necessary to complete the transactions. These three-party systems have generally been less expensive to operate and more efficient than merchant provided payment cards.

In the 1960s, banks began to use a "four-party" system to offer their own card programs. One group of banks joined forces to create Interbank and MasterCharge (which became MasterCard in 1979). Around the same time, Bank of America licensed a group of banks in the U.S. to issue its BankAmericard (which eventually became known as Visa). These four-party systems created even greater efficiencies and benefits by bringing together the cardholders and merchants of hundreds and eventually thousands of banks to complete transactions. Indeed, the four-party systems are more efficient and often less expensive than the two-party or three-party systems--a result which our antitrust laws are intended to encourage. Small banks and credit unions can also participate and compete in four-party systems so long as those systems have default interchange rates.

Value of Payment Cards Exceeds Costs to Merchants

More and more merchants, especially small businesses, were drawn to these various card offerings as the benefits became more widely known, notwithstanding the costs of acceptance. Indeed, it is worth mentioning here that the costs of acceptance in the early days of the payment card industry were as much as 5 to 7% of the purchase amount, far more than they are today. Merchants of all sizes, especially small- and medium-sized businesses, see great value from the three- and four-party system cards because it is far less expensive and less burdensome than running their own proprietary card programs. It also provides small merchants the opportunity to provide their consumers payment card options and thereby compete with large retailers and gas companies that can afford to offer their own cards. One can imagine the reaction of a merchant who had struggled with the underwriting, administrative, legal, credit risk, and other problems associated with its own credit card when Diners Club offered to perform all of those functions for the merchant's customers. The prospect of guaranteed and timely payment alone (i.e., getting paid for a transaction even if the customer does not pay the bill) was a huge benefit. Thus, merchants quickly recognized that all of these benefits far outweighed the costs of card acceptance and the industry grew.

Interchange Allocates Costs and Value

Since the inception of these three- and four-party payment systems, merchants have paid a fee, called a "merchant discount fee," in exchange for the benefits of card acceptance. In a three-party system, the merchant discount is paid directly to the network that provided all of the services to the merchant. For example, in the American Express system, the merchant discount is paid to American Express, which issues the payment card, licenses the merchant to accept the card, and operates the system that enables the completion of the transactions.

In a four-party system, the merchant pays the merchant discount to the acquirer (i.e., the bank that licensed the merchant to accept the card). A substantial portion of the benefit provided to the merchant by the acquirer, however, is derived from the activities of the card issuers. For example, it is the card issuers that assume the credit losses when the cardholders make purchases from merchants but do not pay their bills. In recognition of these services provided by an issuer in connection with a particular transaction, the acquirer pays the issuer a fee, called an "interchange fee."

MasterCard management is responsible for establishing interchange fees in the United States. Although MasterCard establishes interchange fees and collects and remits them on behalf of our financial institution customers, we do not keep any portion of them. Nonetheless, interchange fees are an important part of the system because they balance the demands of the cardholders and merchants and have been arrived at through intense competition among payment networks and other forms of payment. This is true whether two banks agree to an interchange fee between themselves or rely on the MasterCard system's default rates. Functionally it is the equivalent of what three-party systems do on a balance sheet and what two-party systems do in reality--funding some portion of the issuing activity through revenues earned in connection with selling merchandise.

Setting interchange fees is a challenging proposition that involves an extremely delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. In response to competitive forces, MasterCard management works extremely hard to maximize the value of the MasterCard system, including dollar volume spent on MasterCard cards, the number and type of MasterCard cards in circulation, and the number and type of merchants accepting MasterCard cards, by setting default interchange fees at levels that balance the benefits and costs to both cardholders and merchants. Three-party systems like American Express and Discover set their merchant discounts to establish a similar balance.

Today, on average, merchants pay the highest merchant discount for accepting American Express cards, the lowest for accepting Discover cards, and somewhere in between for accepting MasterCard cards. Interestingly, even though Discover is the cheapest to merchants it is not the most widely accepted or used. Two-party systems or proprietary card programs are much more expensive and less efficient to operate for merchants such that most of these programs are now operated by banks. In fact, two-party systems are so inefficient that even a representative of the National Association of Convenience Stores recently stated in Congressional testimony that any payment system the convenience store merchants could create themselves would be too expensive compared to those of MasterCard and Visa.

Legal Challenges Groups of retailers and plaintiffs' attorneys have sought to use the courts to attempt to reduce the merchant discount fees by challenging on antitrust grounds the methods by which MasterCard, and its competitor Visa, set their respective interchange fees. To date, these cases have all failed. Generally, these cases allege that because the four-party systems traditionally involved joint ventures owned by competing financial institutions, the setting of interchange fees by those joint ventures involved a conspiracy to fix prices in restraint of trade. This line of attack was first attempted in the 1980s, in a case called Nabanco, which claimed that Visa's setting of interchange fees constituted unlawful horizontal price-fixing.

The court rejected the challenge to interchange on both per se and rule of reason analyses grounds. When the plaintiffs appealed, the appellate court also rejected the challenge to interchange and made it clear that interchange fees are a necessary part of the four-party system without which the system would not function. Plaintiffs appealed the appellate court's decision to the Supreme Court, which declined to hear the case.

More recently, in a case called Kendall, various merchants sued Visa, MasterCard and several banks, alleging that defendants had violated the antitrust laws by: (1) fixing merchant discounts directly; and (2) fixing default interchange fees, and thereby setting a "floor" for merchant discounts. The court dismissed the case on the pleadings, holding, as to MasterCard and Visa, that: (1) plaintiffs had not alleged facts showing a conspiracy to fix merchant discount fees directly; and (2) with respect to interchange, the acquiring banks, not the merchants, are the direct purchasers, and therefore the merchants lacked standing to sue. The court also held that "merely charging, adopting or following" the default interchange fees allegedly set by Visa and/or MasterCard did not constitute an antitrust violation by the bank defendants.

In addition, beginning in June 2005, numerous merchants have filed suit in federal courts across the country against MasterCard, Visa, and, in some cases, a number of banks. In total, approximately 50 such cases have been filed. The Judicial Panel on Multidistrict Litigation has transferred these cases to the Eastern District of New York for coordinated pretrial proceedings in Multidistrict Litigation No. 1720. Plaintiffs filed a consolidated complaint in this matter. Defendants moved to dismiss or to strike certain claims and answered others. Two weeks ago, on July 5, 2006, plaintiffs filed a supplemental complaint challenging MasterCard's new ownership and governance structure under the antitrust laws. The trial lawyers have told the court that the supplemental complaint seeks to reverse and unwind MasterCard's IPO, which is an unprecedented form of relief in a private class action. In addition to the consolidated complaint, there are several individual merchant complaints. MasterCard moved to dismiss some claims brought in those individual complaints and answered others.

We also note an interesting inconsistency in these cases. The suits that the merchants have brought are based on a false premise that prices merchants pay for MasterCard and Visa are too high (as this is the alleged harm resulting from their claims). It is widely known, however, that American Express imposes merchant discounts that are on average the highest in the industry. Yet, the merchants have not brought suit challenging American Express' ability to set discount fees. The fact that merchants are willing to pay higher American Express fees without challenge suggests that merchants recognize they should pay for participating in the payment systems. Merchant statements before Congress and in other public forums show that the issues they are raising about merchant discount really are a business dispute about price and not an antitrust or policy issue.

The Kendall decision is currently on appeal. A similar case, called Reyn's Pasta Bella, was brought by a group of small merchants in San Francisco. The case, which also attacked interchange as an unlawful price-fixing arrangement, was determined to be released by the settlement in the merchant class action brought by Wal-Mart and others.

Fortunately, for merchants, consumers and all others who benefit from payment systems, it is a fundamental principle of antitrust law that the free market, not the government, should set prices. Any attempt to price regulate interchange fees at a reduced rate, which is their true objective, would be directly counter to this cornerstone element of our economic structure. Indeed, experience in Australia demonstrates that such an approach would only have one certain effect-- consumers and competition would be harmed. The Reserve Bank of Australia (RBA) has effectuated price controls by regulating the interchange fee formula for the four-party systems in Australia. The net effect of the RBA's arbitrary price caps has been that consumers have seen annual fees and finance charges increase while consumer benefits have decreased. There is also no evidence that merchants have lowered prices to consumers as a result of their paying lower fees for card acceptance. (Importantly, the RBA actions were not based on any theory of antitrust law.)

Finally, many of the legal challenges MasterCard has faced in this area were directed at the traditional ownership and governance structure of the four-party system, in which the plaintiffs claim that the customer financial institutions that receive interchange improperly own the system and control the board of directors that set interchange. Although this structure was upheld in the Nabanco case and the merchants' allegations are without merit, MasterCard is now a publicly traded company with a majority of independent directors, and with the majority of voting power and equity in the hands of shareholders other than MasterCard's participating financial institutions. Showing their true intention of price regulations, rather than applauding this development that they had in essence been requesting for years (i.e., an end to the alleged improper control of MasterCard by banks), the trial lawyers and special interest groups have instead expressed a desire for the unprecedented unwinding of the IPO. Such an action would, of course, restore the wholly-owned bank structure that these same trial lawyers and merchants have spoken against and sued over for years. Regardless, such a remedy is not only unprecedented, we believe it to be unwarranted.

It seems clear that the true objective of these efforts is government-mandated price caps on interchange fees that would be lower than the default rates established by MasterCard today. We cannot emphasize enough that there is no precedent for such a remedy under U.S. antitrust law, as such laws are in place to promote competition and to prevent price-fixing, not to arbitrarily set lower prices. Consumers would be harmed as a result of such action.

We are pleased to have the opportunity to brief this committee on the tremendous value of the MasterCard system with interchange. It is my pleasure to discuss this topic with you, and I would be pleased to answer any questions you may have.