Testimony of

The Honorable Timothy J. Muris

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BEFORE THE
SENATEC OMMITTEE ON THE JUDICIARY

Chairman Specter, Ranking Member Leahy, and Members of the distinguished committee, the answer to the question posed by this hearing is, "No, interchange fees do not raise antirust concerns." My name is Timothy J. Muris, and I want to thank the committee for allowing me to discuss this important subject. I am George Mason University Foundation Professor of Law and was Chairman of the Federal Trade Commission from 200 1-2004. As you know, I personally advise Visa on antitrust law, including issues related to the setting of interchange fees, but the views that I express today are my own.

My testimony this morning addresses four points. First, I will explain why interchange fee agreements in four-party payment systems, such as Visa and MasterCard, are lawful under the Sherman Act. Second, my testimony will make clear that the Visa and MasterCard networks are not cartels of financial institutions. Third, I will discuss two-sided products and explain why increases (or decreases) in interchange levels are not evidence of market power. Finally, I describe the benefits of payment cards to consumer and merchants, and the likely harm in regulating them.

I. Interchange Fees Do Not Violate the Antitrust Laws

Today's subject is at the heart of what is now the largest private antitrust litigation in the hundred-plus year history of the Sherman Act. Various merchants have filed fifty or so cases challenging the interchange fees of the Visa and MasterCard payment systems. They claim that the practice of setting interchange fees on four-party payment networks, such as Visa and MasterCard, violates Section One of the Sherman Act.

Section One concerns itself with agreements that restrain competition to the detriment of consumers. Since the enactment of the Sherman Act in 1890, the price fixing cartel has provided the paradigmatic case for Section One enforcement. Merchants attempt to analogize interchange to a cartel fixing prices. They are wrong.

After decades of antitrust enforcement, cartel pricing has become relatively easy to spot.

A group of otherwise competing firms simply agrees to fix a price for their otherwise competing products. Basic economic theory explains why such agreements are pernicious. When firms collude to fix the price of a particular product, they deprive consumers of the benefits of competition. Assuming a sufficient number of firms participate, a price fix allows them to raise the price of the product above the level that would otherwise prevail. If a price fix sticks, it deprives some consumers of the product altogether, which results in a net loss to society as a whole, and transfers wealth from those consumers who still purchase the product to the cartel members.

The setting of interchange in a four-party payment card system has nothing in common with this cartel behavior.' To understand why, it helps to understand how different payment card systems are organized. Although many people think of American Express, Discover, Mastercard, and Visa as rough equivalents (and, in most important respects, they are), the systems operate much differently. American Express and Discover are three-party systems.2 A single corporate entity issues cards to cardholders and signs merchants to accept those cards.

Consequently, when a three-party payment card is used, the rights and responsibilities all stay within a single corporate family. The entity that issued the card pays the merchants the face value of the transaction, less whatever fee the system charges the merchants. This amount is known as the merchant discount. That same corporate entity then collects from the cardholder according to whatever agreement has been struck.

In contrast, Visa and MasterCard are four-party systems. Here, the payment system itself does not issue cards or sign merchants to accept those cards. The job of issuing cards and signing merchants falls to participating banks, credit unions, and thrifts. When a cardholder of one financial institution--called an issuer-uses a card at a merchant signed by another financial institution--called an acquirer-matters are more complicated than in the three-party systems. The issuer has the right to collect from the cardholder but has no relationship with the merchant. The acquirer has the obligation to pay the merchant but no right to collect from the cardholder.

For a four-party payment card system to work, the issuer needs to pay the acquirer for the obligation incurred by the issuer's cardholder. This is where interchange is necessary. Interchange is the word used to describe the rate at which the issuer and acquirer exchange a transaction on a four-party payment card system.

It should now be clear why setting interchange rates in a four-party payment card system does not raise the cartel issues the merchants claim. Unlike the cartel described above, economic theory tells us nothing about what the world would look like without interchange on four-party payment card systems. A four-party payment card system simply cannot exist without interchange. With thousands of issuers and acquirers, and over six million merchant outlets accepting Visa and MasterCard, the absence of a default interchange fee would require in its place millions of bilateral agreements. A set fee reduces these transaction costs of negotiating separate interchange fees between acquirers and issuers.

Moreover, for Visa to succeed as a "brand,"4 merchants need to honor cards from each of the thousands of issuers. Otherwise, consumers would not be guaranteed that their "Visa" card would be accepted widely. Knowing that all cards must be honored, individual issuers could insist on very high fees for the payment cards they issue. Merchants would then be subject to those high fees and would be less willing to accept the entire network. A default interchange avoids this problem. Without this interchange fee, issuers and acquirers would have no way to exchange transactions.

Thus, the difference between a true cartel and Visa is stark. With cartel pricing, an end to the cartel leads to lower prices, higher output, and greater innovation. The end of interchange will instead lead to chaos, and less innovation.

The merchants understand this fact. They do not want an end to interchange. They simply want interchange rates to be lowered. But this is not an antitrust remedy. If he were to follow antitrust principles, a Federal judge could not mandate a new price fix (albeit at a lower level) as a remedy to a price fixing claim. One of the fundamental maxims of antitrust is that the market, not the government, should set prices. Indeed, "reasonableness" is never a defense to a price fixing claim. To set interchange at a reduced rate, however it was ultimately justified, would run directly counter to these core principles of antitrust.

11. Visa and MasterCard Are Not Cartels of Banks

We can expect that merchants will object to this defense of interchange. They will argue that I have omitted a critical fact-that Visa and MasterCard are actually cartels of member financial institutions. This objection has always been misplaced, and it is even less true today.

The same analysis applies to MasterCard.

The company that we now think of as Visa formed in the early 1970s. Visa is a spin-off of Bank of America, which started a three-party payment card system in California in the 1950s.

Bank of America wanted to expand its card outside of California to compete with national systems sponsored by Diner's Club and, later, American Express. But banks were prohibited from operating across state lines at the time. In the 1960s, Bank of America first tried to expand by franchising the operation to banks in different states, but it found few takers. Bank of America then spun-off the system level operation in the early 1970s.

That spin-off, renamed Visa, has fbnctioned as a cooperative ever since. The individual financial institution member/owners control the cooperative according to, roughly speaking, their issuing and acquiring volume. They collectively elected a Board of Directors drawn from the executive ranks of the various members. The Board, working with management that it had the authority to hire and fire, wrote the rules and set the rates, including interchange, that made the system work.

Although MasterCard originated slightly differently, it was, until recently, organized almost precisely the same way. Both MasterCard and Visa have now made profound changes to their ownership and governance structures. MasterCard has ceased to be a cooperative. The financial institutions that until recently owned MasterCard have sold a controlling interest in the company to third-party investors, taking the company public through an IPO. Visa is still owned by its member financial institutions, but directors not affiliated with the financial institutions will soon be a majority of its Board. Visa has also announced that those independent directors will have exclusive responsibility over the setting of interchange rates, or any other action with a potential economic impact on Visa members.

111. Interchange Levels Are Not Evidence of Market Power

At this point, we can expect the merchants to change tack again. Because "price fix" and "bank cartel" are empty slogans, the merchants will undoubtedly argue that interchange represents an abuse of market power. Here, too, they are wrong.
Payment card systems are a leading example of what economists and antitrust lawyers call two-sided products. Along with other two-sided products, such as newspapers, exchanges (e.g., auction houses, eBay, NASDAQ, NYSE) and search engines, payment card systems bring together two different groups of customers. A basic understanding of the economics of twosided products illustrates why the attack on the setting of interchange is flawed, not just as a matter of antitrust law and policy, but of broader public policy as well.

The challenge for the operator of any two-sided product is bringing both sides on board.

For payment card systems, the two groups of customers are cardholders, who want access to the financial resources to make purchases anywhere in the world at any time, and merchants, who want to supply those cardholders. The trick for operating a successhl payment card system is attracting enough cardholders to make the system appealing to merchants and, simultaneously, attracting enough merchants to make the system appealing to cardholders.

Although the problem is easy to state, it can be devilishly hard to solve, at least in practice. A payment card system could, of course, attempt to attract merchants and cardholders simultaneously by calculating the precise cost of supplying each "side" of the market. Even assuming, however, that these costs could be identified, there is no guarantee that a price based on those costs would appeal to either potential cardholders or merchants.

The pricing strategy employed by most newspapers illustrates how most two-sided products actually set their respective prices. Newspapers and other advertiser-sponsored media bring together two distinct groups of customers, readers and advertisers. Readers of newspapers pay little or nothing to enjoy the benefits. Instead, publishers collect the vast bulk of their revenue from advertisers. If a newspaper charged readers a price based solely on the direct marginal costs of supplying readers with the paper, it would likely lose readers who, after all, have many other options. Without enough readers, there will not be enough advertisers.

The economics of attracting two distinct groups of consumers drives the pricing strategy for all two-sided products. As we discussed above, the value of a two-sided product to one group of customers is determined by its attractiveness to the other group of customers. This means that the group of customers with attractive low cost substitutes, as are newspaper readers, will always get the better deal. This is not a matter of fairness or cost recovery. It is simply the way that the supplier of the two-sided product maximizes the appeal and the use of the product to both sides.

For payment card systems, at least at present, the consumer is king. Although merchants decide which payment forms to accept, consumers typically decide the payment form to use on a particular transaction. Payment card systems face competition from two historically dominant forms of payment, cash and check, that the federal government subsidizes and that generally carry a low marginal cost to use. To compete, payment card systems have settled on a pricing strategy that directs substantial value to cardholders (e.g., cash-back, rewards, a grace period, and low revolving rates) at no explicit price per transaction. Merchants are charged on all purchase transactions.

The industry has followed this pricing model from its very inception, before anyone could credibly argue that any payment card system had any conceivable market power. When Frank McNamara kicked off the payment card revolution in 1948 with the introduction of the Diner's Club card, he set the merchant discount on that three-party system at 7% of each transaction. The evolution of the industry fiom a travel-and-entertainment card carried by businessmen and accepted at exclusive restaurants and hotels has pushed fees ever lower. Today, the average merchant discount on the American Express system is approximately 2.5%, while the system wide merchant discount on the Visa system is about 2.1 %. The fact that the larger system, Visa, as measured by everything from merchants to cardholders to volume, has a lower discount should also cast grave doubt on whether so-called market power explains the pricing in this industry.

IV. The Payment Card Systems Are Not Broken, and Interchange Doesn't Need Fixing

As I mentioned previously, the merchants cannot want an end to interchange. Instead, they would like the courts to fix a lower "reasonable" price for a service that they voluntarily accepted and continue to use. The agreements that are in place between card systems, merchants, and cardholders are consensual, not the product of force or fraud. It is hard to imagine how intervention in the form of price regulation could possibly improve matters. Consumers clearly enjoy the benefits of card membership. Payment cards offer consumers greater convenience, reduction of the risk of theft, better management of expenses, improved recordkeeping, float for those who do not revolve balances, and reward programs.

Merchants also derive enormous benefit from payment card systems. Merchants get ready access to bank-supplied credit. They get faster throughput at the point of sale, enabling merchants to sell more product in less time at lower cost. As a result, new merchants are added to the system almost daily, and the networks are constantly innovating to address the needs of entire merchant segments to attract them to the network. Walk into a McDonald's or Subway now and you can swipe your payment card to purchase a meal. Just a few years ago, few if any quick service restaurants accepted cards. They were not coerced into accepting them now. They began accepting them because the payment systems offered a valuable service for a price they were willing to pay.

That price controls would put all of these benefits at risk is not simply a matter of common sense. We also have empirical evidence, courtesy of the Reserve Bank of Australia. In Australia, the Reserve Bank announced an interchange rate regulation for bank-owned card systems, namely Visa, Mastercard, and Bankcard. In October 2003, the regulations became effective, capping interchange rates at 55 basis points, and allowing merchants to surcharge anyone who chooses to pay with a payment card.

The effects of the RBA's intervention in the payment card markets will play out for many years, but the regulatory regime has already had significant impact. The RBA's mandate has clearly harmed cardholders. Since the imposition of the rate caps, credit card fees have increased substantially. In a recent study of Australia's rate regulation, economists estimated that Australia cardholders had seen their annual fees and finance charges increase by AU$197 milli~n.T~h e value of reward points to cardholders on credit cards have fallen by nearly 20%.~

The role of interchange in providing benefits to consumers is crucial to understand. When interchange increases, cardholders benefit. Because of intense competition between the many banks that issue payment cards, "higher" interchange revenues to issuing banks result in increased benefits on payment cards, such as increased rewards and lower fees.

This takes me to my final point. The attack that some merchants are waging against Visa and Mastercard poses a direct threat to the American consumer. The current system of interchange fees is a necessary part of an industry that provides enormous benefits to consumers.

I have witnessed the full fury of the aroused American consumer. While Chairman of the FTC, I led the agency in riding the wave of public resentment to create the National Do Not Call Registry. I suspect that many Americans feel as strongly about their plastic as they do about their dinner hour.

If the current interchange cases are actually litigated on the merits, the plaintiffs should lose. Nevertheless, the plaintiffs' lawyers and their merchant clients probably assume that they will never have to litigate these cases on the merits. Instead, they probably assume that they will be able to extort a settlement because, by the time of trial, the plaintiffs' stated damage theory could approach $1 trillion after trebling. They will argue for a "pragmatic" solution to the problem, and they are betting that some arm of the federal government will provide the help that they need to succeed. Because the American consumer will be the primary victim of any such solution, I continue to hope that this Committee and the rest of the Federal government has the courage and conviction to turn the merchants away empty-handed.

Mr. Chairman and members of the Committee, that concludes my testimony. Thank you again for inviting me, and I will be happy to respond to questions.