

# Why the Market Should Set Credit Card Interchange Fees

By Brian W. Smith, Abbott B. Lipsky, Jr., Andrew J. Robinson and William J. Rinner

*An update and comment on legislation pending in Congress, the Credit Card Fair Fee Act.*

Credit card interchange fees have long been disdained by merchants, who now have legislative support for their scorn—in the guise of a consumer protection effort. Although years of litigation have failed to produce any court ruling that interchange fees restrain trade in violation of antitrust law, two new legislative proposals attempt to bridge the antitrust gap by directly imposing a method of setting the fees. Since the 1980s, courts have recognized the fundamentally beneficial role played by interchange fees in facilitating credit card network transactions, but the rise in credit and debit card usage has increased the total fees transferred to issuing banks, and merchants have followed the money in hopes of more favorable terms.

Credit and debit card systems operate in a distinctive competitive setting, referred to as a “two-sided market,” involving two distinct groups of customers that are interrelated by the network benefits that each provides the other. Examples of two-sided markets include newspapers, television broadcasters and Internet-based media outlets. Each serves two primary customer groups: the audience, which watches or takes in the entertainment or information, and the advertisers, who pay the media outlets to present advertising to the audience about the products and services they offer. Without the audience, advertisers would not purchase air time, and without the advertisers, the media outlets could not recover the cost of providing the entertainment or information that attracts the audience.

When such two-sided markets were less prevalent than in today’s economy, William F. Baxter—an antitrust scholar who had previously studied the

competitive dynamics of electronic funds transfer systems—recognized credit card systems as networks linking cardholders, merchants and the banks that provide credit to each. Each party in a credit-backed consumer transaction pays a fee for accessing the credit card network, compensating the issuing bank for its costs, including risk exposure. Consumers access the credit card network by paying an interest rate (and/or an annual fee to use the card) that compensates the card-issuing bank for bearing the consumer’s credit risk and other costs of issuing cards and participating in the system. Merchants pay a “merchant discount” to their “acquiring” bank, and the acquiring bank in turn pays an interchange fee to the card-issuing bank to compensate for the risk of consumer fraud, the monetized time cost of delay in processing payments and other costs of participating in the credit card business. The interchange fee plays an essential role by balancing the incentives of all parties—consumers, issuing banks, acquiring banks and merchants—to participate in network transactions. The availability of the system stimulates innovation, increasing consumer access to goods purchased on credit.

## Interchange Fee Litigation

Some merchants argue that interchange fees represent an anticompetitive price premium for processing cus-

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toomer payments, raising their cost of doing business and ultimately increasing consumer prices. As the sheer volume of credit card transactions increased, merchants began to target interchange fees, challenging them as a form of illegal price fixing. In 1984, a federal district court rejected this challenge in *National Bancard Corp. v. Visa U.S.A., Inc.* (“*NaBanco*”)<sup>1</sup> and was upheld on appeal.<sup>2</sup> The court ruled that interchange fees determined by the association of banks comprising the membership of the Visa credit card system—as opposed to individual bargains being struck between each issuing and merchant bank—did not constitute an unreasonable restraint of trade. According to the court, interchange fees were a reasonable and procompetitive cost- and risk-transfer mechanism given the absence of less restrictive alternatives—not an anti-competitive tax on consumers. In the court’s opinion, any restrictions inherent in the method of determining interchange fees were more than outweighed by the resulting gains in efficiency.

*NaBanco* did not end the challenges to interchange fees. In 2003, merchants extracted a multi-billion-dollar settlement from MasterCard and Visa after certification of a class action suit on behalf of four million retailers led by Wal-Mart and Sears. The retailers’ claim was that the card systems injured competition and harmed consumers by enforcing an honor-all-cards rule requiring merchants who accept credit cards to accept the same companies’ debit cards. No adjudication of liability was reached, and the \$2+ billion settlement paled in comparison to the damages sought by the class, estimated to be between \$40 billion and \$100 billion. Although this case did not focus primarily on the interchange fee issue, it must have encouraged creativity on the part of other class action lawyers.

Despite this apparent victory for merchants, courts remain hesitant to characterize interchange fees as a form of anticompetitive conduct. The Ninth Circuit in *Kendall v. Visa U.S.A., Inc.*<sup>3</sup> recently affirmed a lower court’s dismissal of merchant claims that credit card companies and banks violated the Sherman Act by conspiring to fix interchange fees by charging or adopting fees set by the association managing the card network. Noting gaps in the merchants’ theory of price-fixing conspiracy, the court recognized the establishment of minimum fees as little different from how “the cost of eggs set a floor for the price of an omelet on the menu” and that “[t]his behavior suggests a rational business deci-

sion, not a conspiracy.”<sup>4</sup> Another California court recently held that the rule of reason should apply to analysis of interchange fees on ATM transactions.<sup>5</sup>

Given the high stakes involved in even a small reduction of interchange fees per transaction for merchants, it is no surprise that plaintiffs’ antitrust theories have continuously adapted in search of an argument that might persuade a court to condemn the fees. Several recent suits brought against MasterCard and Visa have now been consolidated in the Eastern District of New York under the same judge who granted class certification of Wal-Mart’s antitrust claim against the honor-all-cards rule, with more than \$50 billion claimed to be at stake if the merchants prevail. The merchants again complain that Visa, MasterCard and their member banks conspired to set interchange fees at “supracompetitive levels in violation of the federal antitrust laws.”<sup>6</sup> Plaintiffs allege that interchange fees cost every American household approximately \$232 a year in 2004. Whether this new round of challenges to essentially the same business practice found to be procompetitive in *NaBanco* prevails either in the court or in forcing settlement remains to be seen.

## Interchange Fee Economics: Modern Analysis and Evidence

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Although Baxter recognized the distinctive structural characteristics of credit card networks over 20 years ago, interchange fees still provoke anxiety that consumers face higher prices due to the “tax” levied by card issuers on merchant banks for card transactions. This assumption does not square with the economic reality, however.

Three forms of competition operate in the credit card payment industry: (1) competition for consumer card subscriptions (consumers may hold multiple credit cards); (2) competition for participation in card systems (merchants may accept multiple cards); and (3) competition among networks at the system brand level itself, where networks advertise their benefits and discounts, such as cash back on transactions.<sup>7</sup> This competition already benefits consumers, impelling card companies to innovate and provide benefits and services as the lure to use one card over another.

In a two-sided market, Visa and MasterCard do not set cardholder and merchant prices but implement

interchange fees that flow from the acquiring (merchant) bank to the card-issuing bank. In equilibrium, merchants necessarily bear a larger percentage of total system costs than cardholders themselves, because demand is more elastic on the cardholder side of the market.<sup>8</sup> Recent economic analysis demonstrates that the level of interchange fees has no particular relationship to the presence of market power, which many merchants claim is what leads to excessively high fees in the absence of bilateral negotiation. Increasing competition in card issuance to consumers over the past 10 years has benefited cardholders but may harm merchants, or so the argument goes.<sup>9</sup>

A recent study published in the *ANTITRUST LAW JOURNAL* suggests that the effect of interchange fees on consumers is largely dependent on whether merchants themselves restrict payment options or price by payment method.<sup>10</sup> Even if merchants pass on the price of interchange fees to consumers, cardholders using their networks receive benefits directly stemming from the interchange fee revenues collected by issuers.<sup>11</sup> Reducing the interchange fee would likely allow merchants to reap a larger portion of the profits derived from their access to card networks, but consumers would receive fewer benefits from card issuer innovation.

## Proposed Federal Legislation

Unsatisfied with the outcome of litigation challenging interchange fees on antitrust grounds, House Judiciary Committee Chairman John Conyers (D-MI) introduced legislation that would add the United States to the list of countries that have asserted government control over the merchant/credit card provider relationship. The Government Accountability Office says that there are currently 26 countries that regulate interchange fees in some way.<sup>12</sup> The history and character of such regulation, however, differs widely from country to country. For example, Australia, which became one of the first countries to regulate interchange fees in 2003, established a formula and determined the “appropriate” benchmark interchange fee. It then required the weighted average of the interchange fees for each company’s cards to remain below this level.<sup>13</sup> Mexico, on the other hand, took a more voluntary approach. Although the Mexican congress gave the Bank of Mexico extensive authority to regulate all payment systems, the bank chose to act as a mediator between credit card companies and merchants instead

of directly regulating interchange fees.<sup>14</sup> The proposed legislation for the United States falls somewhere between these two extremes.

Chairman Conyers introduced the Credit Card Fair Fee Act<sup>15</sup> in the House of Representatives on March 6, 2008, and Senator Richard Durbin (D-IL) has introduced companion Senate legislation.<sup>16</sup> Overall, these bills originally envisioned a period of voluntary negotiation, which, if unfruitful, would conclude with presentations to a panel of judges established by the legislation. Under the original legislation, the judges would have decided appropriate rates lasting for a period of three years before the process repeated. Representative Peter Welch (D-VT) has also introduced legislation that addresses interchange fees.<sup>17</sup> His proposal would prevent credit card issuers from charging a higher interchange fee for premium credit cards and would require publishing all rules, terms and conditions—including information about interchange fees—that affect merchants and consumers.<sup>18</sup> On July 17, Representative Conyers’s bill was reported out of committee, but the version reported to the full House of Representatives was drastically altered from the original. The remainder of this article deals with the amended version of this legislation.

The Credit Card Fair Fee Act provides two paths for negotiation: voluntary and collective. While all issuing and acquiring banks could choose to voluntarily negotiate with merchants, only banks with under \$1 billion in assets and credit unions would be able to avoid the collective negotiations if the parties did not reach a voluntary agreement.<sup>19</sup> In addition, banks engaging in voluntary negotiation would be subject to strict reporting requirements. First, the rates and terms agreed to would have to be the same for all merchants, “regardless of merchant category or volume of transactions.”<sup>20</sup> In addition, parties would be required to jointly file a report for any access agreements outside of the bill’s framework that “affect any market in the United States or elsewhere.” The required report must detail the components of the interchange fee, as well as describe how access fees are split among various financial institutions and how these financial institutions spend the fees. The report would also have to disclose any variation in fees among credit card types, document any consideration given or marketing and promotional agreements and compare the interchange rates charged under the agreement to those in the 10

foreign countries with the highest volume of credit card transactions.<sup>21</sup> These reports, as well as the access agreement, would be publicly available.<sup>22</sup>

For those that are unable to reach a voluntary negotiated agreement, the bill establishes a limited antitrust immunity to allow for negotiations between the providers of a single electronic payment system (EPS) and merchants jointly.<sup>23</sup> Within one month of the legislation becoming effective, the parties would be required to file a schedule for negotiations and make initial disclosures.<sup>24</sup> These disclosures must include an itemized list of costs necessary to provide or access the EPS that were incurred over the past calendar year by the 10 largest issuers, acquirers or operators of EPSs and the 10 largest merchants, respectively. In addition, both sides must provide any access agreement between the two parties relating to any EPS.<sup>25</sup> A member of the Antitrust Division of the U.S. Department of Justice is required to be present during all negotiations.<sup>26</sup> Finally, if interchange fees are lowered as a result of these negotiations, merchants are required to pass along these gains to either its customers or employees, and if the fees are raised, the financial institutions are required to pass along these gains to its customers or employees as well.<sup>27</sup>

### Comment on the Legislative Proposals

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As an initial criticism, the perceived need to regulate credit card interchange fees appears to arise from a fundamental misunderstanding of credit card payment systems. The credit card market is two-sided, and the interchange fee therefore cannot be analyzed as though it were the “price” of a product or service exchanged between buyer and seller in markets that follow the classic model. As detailed above, the relationship between consumers, merchants and the banks that provide credit and services to each are simply different from the relationship between buyers and sellers in the markets for most other goods and services. Both Visa and MasterCard have incentives to keep the interchange fees reasonable. Neither company pays nor receives interchange fees. Rather, their interest is in having their card accepted at as many locations as possible and in the hands of as many consumers as possible. If interchange fees rise too high and merchants stop accepting their brand of credit cards, their business would dwindle. Issuing banks will cer-

tainly be hurt, but they will still have the business of banking and could increase reliance on other ways of issuing credit. Visa and MasterCard, however, have no other substantial business and could cease to exist if merchants abandoned their card systems. Moreover, new competitive payment forms are developing all the time, including a recently announced credit card that claims to have no interchange fee.<sup>28</sup> Developments such as these continually force Visa and MasterCard to maintain competitive interchange rates. The case for regulatory intervention is not apparent.

As the empirical evidence begins to accumulate in Australia, it appears that lower interchange fees harmed rather than helped consumers in that country. While the merchants won big from the changes in regulation, the benefits were not passed along to consumers. In general, merchants have not decreased prices, but in order to recoup the losses from interchange fee revenue, credit card companies have begun to increase the fees that they charge to consumers and have decreased their rewards programs.<sup>29</sup> Preliminary data from one survey showed that only five percent of merchants decreased prices to consumers, whereas more than 20 percent have seen increased profits.<sup>30</sup> Overall, 60 percent reported no change in regular operations, and merchants are saving an estimated \$500 million per year under the new system.<sup>31</sup> Although the proposed U.S. legislation purports to address this issue by requiring any gains to be passed on to the consumer, this only applies to those agreements that are reached during the mandatory negotiations and not to those that are reached voluntarily. In addition, the bill offers no way to monitor or enforce that these gains are, in fact, not just padding the merchant’s profits. It is unrealistic to imagine that the two brave sentences appended to this legislation will be self-executing.

An additional flaw of the proposed legislation is its one-size-fits-all approach to interchange fees. This is found both in the mandatory collective bargaining of §2(c), which requires that merchants negotiate as a single unit, and in the “nondiscrimination clause” of §2(d), which requires that voluntarily negotiated agreements be the same for all merchants.<sup>32</sup> Such a system does not allow these fees to serve their purpose of compensating the credit card issuers for bearing the risk of fraud and for providing what amounts to an interest-free loan to the merchant. The provision of appropriate pricing requires that credit card issuers charge higher fees to sectors or merchants that pose higher risks—for

example, those with goods that are not likely to be paid for quickly. Mandating a uniform interchange fee for all merchant-issuer relationships destroys any merchant incentive to take efficient measures to reduce fraud. Historically, credit card issuers have taken the unique attributes of various market sectors into account, setting lower interchange fees for those areas with lower profit margins (such as supermarkets) in order to allow these merchants to accept credit cards.<sup>33</sup> This legislation would prevent the issuing banks from broadening the availability of their systems by tailoring fees to the unique economic conditions of particular retailers or retail sectors. What's more, it needlessly sacrifices the enormous benefits of an existing sophisticated and efficient system of varying interchange fees designed to fit specific circumstances.<sup>34</sup>

In addition, the reporting requirements of the legislation are onerous, invasive and anticompetitive. Requiring companies that are negotiating rates voluntarily to research and compare the negotiated rates to international norms is likely to be extremely burdensome. Beyond that, the mandatory disclosure of all costs, all components of the interchange fee and how the money is divided and then spent by the financial institutions also imposes a potentially huge burden and, moreover, forces companies to disclose a wealth of competitively sensitive information. Since these reports are required to be made public, such disclosures create a manifest potential for anticompetitive harm. Further, these requirements may destroy incentives for participants to experiment or innovate through the use of new business models or otherwise. Such requirements directly interfere with the market and allow inefficient businesses to continue to prosper off of the coattails of their more successful counterparts through the mandatory disclosure requirements.

Another problematic aspect of the legislation is its continued reference to foreign interchange fees. The legislation requires both those who are parties to a voluntarily negotiated agreement and the Antitrust Division to make reports that compare the interchange fee in the United States to the rates found in foreign countries. This raises concern that the interchange levels in foreign countries will somehow be used as a benchmark for what should be achieved in the U.S. system. Such a proposal ignores the vast diversity of economic conditions, regulatory systems and consumer behavior that occurs throughout developed economies. There simply cannot be any meaningful comparison

between interchange fees in Mexico, Canada, Australia, the United Kingdom, Israel, France and any other country that might be implicated by this bill.

Finally, the timeline enforced by the bill would wreak havoc within the banking industry. The requirement that parties file within one month of enactment means that all contracts are essentially abrogated when the bill is signed by the president. An obvious concern is that some merchants will still have "bad" deals long after the passage of the law while others fix theirs quickly. To require banks to adjust to such a drastic change in bargaining at the same time as they face falling incomes from interchange fees (if this bill successfully achieves its stated goal) could throw the entire system into chaos. Even if the substantive changes made by the bill were desirable, the timeline implemented for the changes could be devastating to the banking industry. Given the current profound stresses afflicting the financial system from a variety of other sources, this is not the appropriate time for a monumental and sudden changeover in the operating rules for one of the most fundamental credit sources in the U.S. economy.

While the above criticisms are certainly not a comprehensive list, they are among the most troubling aspects of the pending legislation. The legislation is flawed on both a theoretical and practical level, and its implementation would cause significant dislocations for all parties involved. Even if legislative action is deemed appropriate to address any problems in the current system, the Credit Card Fair Fee Act most certainly is not an appropriate legislative template.

## Are Interchange Fees a Problem?

There is no coherent case that interchange fees are a problem. As the analysis of two-sided markets demonstrates, they serve an essential function of allowing the multiparty credit card payment systems to reach an efficient equilibrium. It is by no means clear on a conceptual level how the Credit Card Fair Fee Act would improve matters in any way. To the contrary, this legislation promises to impose substantial costs and promises only to distort the manner in which competitive incentives that govern the numerous interrelated components of the credit card networks are worked out.

Indeed, it has not been demonstrated that any of the numerous recent foreign government interven-

tions in the setting of interchange fees have had a net economic or consumer benefit. Although interchange fees appear to have been lowered, this may have come at the expense of consumers through increased credit card fees and reduced features and increased profits for merchants that are not being passed along to cardholders or other consumers. Interchange fee legislation presents a classic case of political opportunism leading to unnecessary economic costs, based on superficial rather than sound understanding. In simpler industries, it is often tempting to legislate low prices when prices start to rise in a politically noticeable way. History is littered with the failures of that approach—shortages exacerbated by degraded incentives to invest in new capacity, excessive administrative costs, opportunities to game the system, etc. In this more complex setting, we should expect that the failures of legislatively mandated price reductions would be recognized even more readily.

### Endnotes

- <sup>1</sup> *National Bancard Corp. v. Visa U.S.A., Inc.*, 596 FSupp 1231 (S.D. Fla. 1984).
- <sup>2</sup> *Nat'l Bancard Corp. (NaBanco) v. Visa U.S.A., Inc.*, 779 F2d 592 (11th Cir.), cert. denied, 479 US 923 (1986).
- <sup>3</sup> *Kendall v. Visa U.S.A., Inc.*, 518 F3d 1042 (9th Cir. 2008).
- <sup>4</sup> *Id.*, at 1049.
- <sup>5</sup> *In re ATM Fee Antitrust Litigation*, No. 04-02676 CRB (N.D. Cal. Mar. 24, 2008).
- <sup>6</sup> *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, 398 FSupp2d 1356, 1358 (E.D. Cal. 2005).
- <sup>7</sup> George L. Priest, *Flawed Efforts to Apply Modern Antitrust Law to Network Industries*, HIGH STAKES ANTITRUST: THE LAST HURRAH? (Ed. Robert W. Hahn), at 137 (Washington, D.C.: AEI-Brookings Joint Center for Regulatory Studies, 2003).
- <sup>8</sup> Benjamin Klein et al., *Competition in Two-Sided Markets: The Antitrust Economics of Payment Card Interchange Fees*, ANTITRUST LAW J. 73 (2006), at 571.
- <sup>9</sup> *Id.*, at 575–76.
- <sup>10</sup> Alan S. Frankel and Allan L. Shampine, *The Economic Effects of Interchange Fees*, ANTITRUST LAW J. 73 (2006), at 627, 633–34.
- <sup>11</sup> *Id.*, at 635.
- <sup>12</sup> U.S. Government Accountability Office, GAO-08-558, *Credit and Debit Cards* (2008), at 30.
- <sup>13</sup> *Id.*
- <sup>14</sup> *Id.*, at 34.
- <sup>15</sup> H.R. 5546, 110th Cong. (2008). The bill was introduced with nine Republican and four Democratic cosponsors.
- <sup>16</sup> Credit Card Fair Fee Act of 2008, S. 3086, 110th Cong. (2008).
- <sup>17</sup> Credit Card Interchange Fees Act of 2008, H.R. 4248, 110th Cong. (2008).
- <sup>18</sup> *Id.*, at §§192, 194.
- <sup>19</sup> Credit Card Fair Fee Act, at §3.
- <sup>20</sup> *Id.*, at §2(d).
- <sup>21</sup> *Id.*, at §2(f)(2)(A)–(F).
- <sup>22</sup> *Id.*, at §2(f)(3).
- <sup>23</sup> *Id.*, at §2(c)(1).
- <sup>24</sup> *Id.*, at §2(e)(1)–(2).
- <sup>25</sup> *Id.*, at §2(e)(3)–(4).
- <sup>26</sup> *Id.*, at §2(e)(6).
- <sup>27</sup> *Id.*, at §4.
- <sup>28</sup> Revolution Money's RevolutionCard claims to eliminate interchange fees for merchants while maintaining the security and incentives offered by competitors.
- <sup>29</sup> Howard Chang et al., *The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia*, REV. NETWORK ECON. 4 (2005), at 328, 338–39 (2005).
- <sup>30</sup> *Id.*, at 341.
- <sup>31</sup> *Id.*, at 340–41.
- <sup>32</sup> While the Senate companion legislation does allow for different interchange fees to be set across the type of card, it does not allow this to vary based on merchant. S. 3086, §2(d)(3)(C)(ii)(IV), (V).
- <sup>33</sup> *Hearing on H.R. 5546, the "Credit Card Fair Fee Act of 2008" before the H. Comm. on the Judiciary Antitrust Task Force*, 110th Cong. (2008) (written statement of Joshua Peirez, Chief Payment System Integrity Officer, MasterCard Worldwide), available at <http://judiciary.house.gov/media/pdfs/Peirez080515.pdf>.
- <sup>34</sup> MasterCard International's published worldwide interchange rates encompass 103 pages and literally hundreds of permutations.

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