

The Need for Federal Reserve and Antitrust Intervention in the Failed U.S. Debit and Credit Card Markets

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Before I begin my formal remarks, I want to tell you about two encounters that I had with people who work for the Fed within two hours of my arrival at this conference. I was driven from the airport in Albuquerque by a staffer for the Kansas City Fed, and I asked her whether she used a debit card, and if so, whether she signed or used her PIN. She said she always used her PIN except when she shopped at a “mom and pop” store, where she signed. I asked her why she did that. She said that she knew how much more they paid for PIN debit and felt sorry for them. I explained to her that she had it backward, and it behooved the Fed, which was finally beginning to study these issues, to understand the basic facts.

An hour later, I was talking with another official from another branch of the Fed. His jurisdiction was payment cards. He said that although we had never met, he often spoke about me, telling people that there were two big winners in the *Visa Check/MasterMoney* case: Wal-Mart and Lloyd Constantine. So I asked him whether he knew that just one part of the settlement required all of the more than 200 million debit cards issued with Visa or MasterCard logos to be reissued with conspicuous “DEBIT” identifiers and with electronic identities which distinguished them from credit cards. And I also asked this Fed official, whose responsibility was payment cards, whether he knew that millions of consumers had first used their signature debit cards thinking it was a credit card and only found out the truth when they bounced a check. He hadn’t known either of these things. So I told him that next time he spoke to people about the case, he might want to have some basic facts at his disposal.

I realize as I address this conference, many people in attendance have already made up their minds on the important issues that will be discussed. I hope that I am not one of them. I now speak directly to the people at the Fed: please open your minds and begin to confront the market failures in

debit cards and credit cards with some very basic facts that have not been widely known or appreciated at your agencies.

Having said that, I want to thank the Federal Reserve Bank of Kansas City and, in particular, Stuart Weiner, the Kansas City Fed's Director of Payments System Research, for his foresight and vision in holding this Conference.

My point of personal privilege and disclosure is that I have an ongoing love/hate relationship with this conference. I was pleased last year when the Kansas City Fed sent out a "Save the Date"—announcing that the featured speakers were Australian Fed Governor Ian Macfarlane and myself. I also was amused that this announcement spawned several analyses and articles saying that the Fed's choice of lead speakers—the two *bête noire* of the U.S. credit/debit industry—bode ill for U.S. banks. However, the Fed's apparent response to this banking industry reaction was distressing. The final roster of speakers includes at least six Visa/MasterCard representatives, while there is not a single U.S. merchant speaker and not a single speaker from any of the PIN debit networks, such as Star, Pulse, Shazam, NYCE, or AFFN. In a conference, whose topic is interchange fees and whose introductory materials concisely state, "Paid by merchants to card issuers on a per-transaction basis, interchange fees in most countries are set by credit and debit card networks." There is no satisfactory explanation for this imbalance, and the only one that I got was, "You, Lloyd, will represent the merchants' and the PIN debit networks' perspective."

I am flattered—but I can't fill those shoes, and I won't even try. I will submit a paper calling upon the Fed to fulfill its mandate and correct the massive failures of the U.S. debit card market.

Today, I will bring to bear relevant facts and law on the topic of whether the U.S. debit card and credit card markets are failing, as I believe they are, and the responsibility of the Federal Reserve and government antitrust authorities to intervene.

The debit card market presents the clearest case of market failure. The reasons for this failure are known. And the responsibility of the Federal Reserve to address this market failure is also clear.

Prior to the establishment of the Federal Reserve in 1913, varying interchange fees, called "exchange charges," were applied when checks were deposited in banks different from the banks where the people who wrote those checks maintained their accounts. To avoid these interchange fees, a Byzantine system of correspondent banks arose, with checks traveling around the country by rail, sometimes for weeks.

This chaos contributed to the instability of banks and was clearly an

obstacle to the free-flow of interstate commerce. Within a decade of its establishment, the Fed corrected this situation by aggressive tactics, which resulted in the at-par clearance of virtually all checks drawn on U.S. banks. Free of this burden, the use of checks rapidly expanded, and with it, commerce among the states.

Although it is true, it is not my purpose today to detail or attempt to explain why the Fed, during the 1970s and 1980s, did not act when it was clear that paper checks were beginning to be replaced by debit card transactions, that this process would eventually result in debit volume overwhelming check volume, and that the same rationale for the Fed creating at-par clearance of paper checks fully applied to the debit transactions which were replacing them and were nothing other than electronic checks. Indeed the Federal Reserve Act and Electronic Funds Transfer Act gave the Fed the authority to assure at-par clearance of debit. (These obvious trends and these vital issues were the primary motivation for the *Entree* case which I filed in 1989 on behalf of 14 state attorneys general, charging that the merger of Visa and MasterCard PIN debit operations was an attempt to monopolize the debit card market. Visa/MasterCard capitulated and abandoned *Entree* within months of our lawsuit.) Moreover, it could not have escaped the Fed's notice that in 1991, in the absence of Federal Reserve action, the State of Iowa attempted to require that all debit transactions linked to Iowa bank accounts clear at-par. The testimony of Dale Dooley, then head of the Shazam ATM/debit network, was that the Iowa at-par legislation was killed by a "planeload of lawyers" sent in by Visa and MasterCard. That same still-born law also prohibited the tying of debit card acceptance to credit card acceptance and required the conspicuous labeling of debit cards, as such, so that merchants could distinguish them from credit cards. Those two reforms ultimately were achieved by merchants and consumers 12 years later in the *Visa Check/MasterMoney* settlement.

There is only one possible explanation, which is both plausible and satisfactory, for the Fed's inaction. It is that free market forces were creating the precise result—at-par clearance for debit transactions—that the Fed would and should have required through regulation and/or aggressive tactics, as with its early-twentieth-century assault on exchange charges for clearing paper checks.

The Federal Reserve properly favors free market outcomes and should only intervene when a market has failed. By the early 1990s, some 15 years after on-line PIN debit and off-line Visa/MasterCard signature debit were created by U.S. ingenuity, PIN debit was dominant. PIN debit transactions

cleared at-par, except in the few regional networks that were paying merchants a per-transaction fee to accept debit transactions (as is still the case in Australia). Virtually everyone in the industry, including Visa and MasterCard themselves, predicted that at-par PIN debit would not merely continue to dominate, but would eliminate the slower, fraud-prone, and much costlier signature debit system. MasterCard's CEO, Pete Hart, frequently and publicly stated this.

Visa's analyses, unsealed in the *Visa Check* litigation, predicted not only that unless Visa intervened, mature at-par PIN debit networks would eliminate signature debit with its credit card interchange fees, but also that the competition posed by mature at-par debit networks would reduce credit card revenues for Visa and MasterCard by an amount in 1991 dollars variously estimated by Visa to be in the range of \$701 million to \$3.5 billion, annually.

At-par regional PIN debit networks were thriving, their transactional volume was building rapidly, and they were beginning to consolidate into super-regional and eventually competing national payment networks. They had over 100 million cardholders. They had bank members and a happy and rapidly expanding roster of merchant customers. Among these were most supermarkets and wholesale clubs, who had not yet started to accept Visa/MasterCard credit cards, and therefore, had not yet been forced to accept Visa/MasterCard signature debit. They had state-of-the-art network infrastructure. With all this, these debit networks were likely entrants into the credit card market, but with safer/faster PIN technology and an at-par structure which allowed issuers and acquirers to individually set charges to their respective customers.

Visa went into action and eventually forced MasterCard to go along in a successful assault on the PIN debit networks and their at-par model. The detailed factual chronicle of this assault is set out in the merchants' summary judgment submission to the *In re Visa Check* district court and can be reviewed at the case Web site: <http://www.inrevisacheckmastermoneyantitrustlitigation.com>. This submission led the court to award summary judgment to the merchants on most of their claims prior to the trial.

Visa and MasterCard's predatory assault included the suppression of PIN pad installation; the acquisition of the largest PIN debit network, Interlink, and its conversion from a thriving at-par network to a lever for forcing other PIN debit networks to abandon their at-par structures; and the disintermediation by MasterCard of a nascent national network being formed by the regional networks, through Maestro, which MasterCard virtually abandoned in the United States (although it thrives in other

MasterCard regions of the world). Banks were paid to abandon the regional debit networks, and the six largest debit-issuing banks were initially targeted so that their exit from the regional debit networks would create a “domino” or “snowball” effect with 100 additional key debit-issuing banks exiting the networks as well.

Visa/MasterCard signature debit was tied to their credit cards at credit card interchange rates. The debit cards were both physically and electronically designed to look like credit cards, making it difficult, if not impossible, for merchants to detect. Those few merchants who could recognize the debit cards were inhibited by so-called antidiscrimination, no-surcharge, and no-discount rules from even attempting to steer their customers toward other forms of payment. Millions of cardholders made their first signature debit card transaction thinking it was a credit card transaction.

There is more, and I will provide anyone—and especially anyone at the Fed—unsealed documents to illustrate each of the statements of fact which I have made.

By the time the *Visa Check* settlement was signed in June 2003, the debit market had been so distorted that the untying of debit, the physical and electronic redesigning of more than 200 million debit cards (currently underway), the elimination of most antisteering rules, and other related injunctive relief could not restore the debit market to where it was in the early 1990s. At-par clearance was a distant memory. U.S. banks, which initially created PIN debit as a mechanism to avoid the heavy costs of processing paper checks, to retain accounts, and to deepen their banking relationships, were, by now, drunk on credit-card-styled interchange fees grafted onto PIN debit. The banks frequently penalized their depositors for using PIN debit. Typical of this practice, John Fennell, an executive of New York Community Bank, explained the \$1.50 charge assessed by his bank for each PIN debit transaction: “We are trying to encourage people to use debit cards the way they are supposed to be used, not with a PIN We want everybody to use them as credit cards.”

Of course, this widespread tactic deters banks from reaping the massive benefits of cost avoidance being realized by Canadian banks. In Canada, at-par debit transactions have long since dominated paper checks. Canada, whose debit systems developed roughly a decade after those in the United States, has more than double the U.S. per-capita use of point-of-sale debit, including all U.S. debit, both signature and PIN. Similar comparisons obtain in other parts of the world.

The untying of debit, the redesign of debit cards with conspicuous debit

identifiers, and the elimination of many no-steering rules have all had salutary results. Signature debit interchange fees have declined substantially (the Weiner/Wright paper failed to note that Visa's published rates dropped another 13 percent on April 1 of this year).

Beyond these lower published rates, many large merchants have used the threat of dropping untied signature debit as a lever for negotiating much lower interchange rates with Visa and MasterCard for not only signature debit, but also for credit and PIN debit as well. Although I am not privy to the specifics of these bilateral deals, public reports put just one of these merchant deals in the range of \$2 billion to \$4 billion in reduced interchange fees for the next decade. All these lower interchange rates, both published and private (bilateral), reduce prices for consumers and, most importantly, for consumers who don't use these forms of payment.

In reading the Evans/Schmalensee paper, I was struck by their anecdotal claim that after the Australian Federal Reserve lowered credit card interchange by half, there was little increase in cardholder charges and no reduction in card usage. This gleeful anecdote fails to acknowledge a basic premise of the Aussie Fed's action, which is to lower consumer prices and reduce the subsidization of card users by non-card payers. Evans and Schmalensee also fail to admit that this alleged lack of correlation between lower interchange and higher card fees demonstrates the tenuous nature of their primary claim—in other words, that interchange equilibrates merchant and cardholder demand.

The settlement has also quickened the pace of PIN terminalization and the ability of merchants to steer customers toward PIN debit. However, bank penalties for PIN debit use and Visa/MasterCard-driven escalation of PIN debit interchange rates work in the opposite direction.

While the settlements have achieved much, the once ubiquitous, successful, and rapidly expanding at-par model for PIN debit has been destroyed. In the reasonably foreseeable future, the market, still dominated at the network level by Visa and at the issuing level by Visa/MasterCard's dual owner/member banks, does not perform competitively. The merchant side of the market is substantially ignored. The documented case for Federal Reserve intervention could not be more clear. In this market, the Fed's intervention would not create through regulation a world which the Fed conceived; it would recreate a world which existed for 15 years in the United States, in a free market environment. It would recreate a world that was destroyed through predation and in a vacuum partially created by the Federal Reserve's curious quiescence.

Shifting now to the credit card market, the evidence of market failure is

equally clear and compelling. The utility and appropriateness of the Federal Reserve's intervention, while present, is less compelling than in the debit market. However, that is primarily because the market's imperfection was exacerbated, if not created, by federal antitrust agency failure. As an antitrust lawyer, I favor an antitrust remedy for this market failure. The Federal Reserve's expertise and involvement are also welcome.

The evidence of market failure abounds. Visa/MasterCard have dominant market power. This market power has been stable and increasing for more than a decade. The barriers to new entrants are almost insuperable. The last new entrant was Discover in 1985. Visa and MasterCard have regularly and substantially raised their interchange rates without losing any merchants. I am impressed and amused by the team effort mounted by the Visa/MasterCard economists, at this conference and elsewhere, to dismiss the significance of Visa and MasterCard's demonstrated power over price and not merely their own prices. And all of the arguments devolve into the explanation that the interchange fee, which all merchants and all U.S. consumers pay, is not really a price—it's a balancing or equilibrating device.

Last night when Kansas City Federal Reserve President Tom Hoenig made his welcoming remarks, he said that interchange fees were a "price" and a price that had to be better understood. I could see the jaws drop all over the room on the economists and lawyers from Visa/MasterCard who came here to teach us that interchange is not a price. The President of the KC Fed is probably going to need plenty of extra after-school remedial tutoring.

Let's look at Visa and MasterCard equilibrating the two sides of the market, merchant and cardholder demand, in a scene from the 1998-1999 round of price increases. This one was from the debit side. On May 29, 1998, Visa announced that it would raise signature debit interchange rates by roughly 20 percent effective April 1, 1999. On November 18, 1998, MasterCard, with one quarter of Visa's debit volume, announced that it would continue to have higher fees than Visa, raising its April 1999 rates by roughly 9 percent. So two months later, Visa raised its April 1999 rates by another 6 percent, and MasterCard countered with yet another increase five days later. At the end of this cycle, Visa's rates were up 26 percent, MasterCard's up by 17 percent—and MasterCard, with one-fourth Visa's volume, still charged more. Perhaps Bill Sheedy, Visa's interchange guru, will explain how this game of leapfrog on the backs of U.S. merchants and consumers was actually just a careful equilibration of merchant and cardholder demand.

On the subject of interchange as a device to balance demand on the two

sides of these markets, there is an assertion belied by the public spectacle of the way Visa and MasterCard actually set and use interchange, and further belied by the Evans/Schmalensee observations about Australia. Consider this question—I pose it to the economists among you, and in particular the two living Frenchmen, Rochet and Tirole (we antitrust lawyers usually have to contend with two dead Frenchmen, Bertrand and Cournot, so I am glad that today we have Frenchmen who can talk back): *Mes amis, expliquez moi*, how can 8,000 banks, collectively fixing prices on the merchant side, balance demand on the cardholder side, when on that side each bank acts independently? *Je ne comprends pas?* That's different from American Express or Discover balancing demand on the two sides of the market with the prices that they and they alone set for each side, *n'est-ce pas?*

Would anyone seriously contend that a cartel of 8,000 newspapers should be free to collectively fix prices to advertisers so long as they continued to individually set the prices they charged to readers?

For more than a decade, Visa and MasterCard blocked their only two competitors, American Express and Discover, from doing business with virtually all of the bank issuers of general-purpose credit and charge cards, and along the way, they completely blocked American Express and Discover from entering the debit market with either a PIN or signature offering.

Discover entered the debit network market within moments of the Supreme Court's denial of Visa/MasterCard's petition for certiorari in *U.S. v. Visa and MasterCard*.

The basic flaw in that case was the government's failure to bring a real challenge to Visa/MasterCard's duality—a system in which virtually every U.S. bank is an owner and member of both associations, and simultaneously issues both brands of credit cards. The United States didn't challenge this competition abomination. Perhaps it didn't because the Federal Antitrust Division helped create duality in the late 1970s. So instead of challenging duality, the 1998 Antitrust Division challenged so-called governance duality, a construct of the division and its expert, Mr. Katz. They claimed that the tepid competition between Visa and MasterCard resulted not from dual ownership/membership/card issuance, but from the presence on Visa and MasterCard boards of banks who issue a substantial percentage of their credit cards on the other network. Federal District Judge Jones accurately pointed out that blunted intersystem competition was the result of dual ownership and issuance, not this cramped view of dual governance. The judge also pointed to some signs of increased competition between the associations.

The clearest example of that competition was the nonduality of debit card issuance, which resulted from the 1990 *Entree* decree. Inexplicably, the state attorneys general who brought that case allowed the decree to sunset in 1997 without lifting a finger. There have been bad antitrust enforcement decisions at both the state and federal agencies.

A recent sign of competition between the associations occurred in the wake of the *Visa Check* settlement, when MasterCard sued Visa for violating the antitrust laws by enacting a so-called Settlement Service Fee to help pay for Visa's part of the more than \$3 billion cash portion of the settlement.

If the government's failure to challenge Visa/MasterCard duality was the low point of the U.S. case, the high point was a simple factual statement in the decision by the U.S. Court of Appeals for the Second Circuit. The court said, "Visa U.S.A. and MasterCard . . . are not single entities; they are consortiums of competitors. They are owned and effectively operated by some 20,000 banks . . ." (344 F. 3d 242).

Those consortiums of competitors or cartels fix the prices of the interchange fees paid by merchants and, ultimately, paid by all U.S. consumers. Three things stand in the way of ending this cartel mechanism, which extorts billions of dollars annually from U.S. merchants and consumers through supracompetitive credit card interchange fees. These three things are the now thoroughly discredited *NaBanco* decision, the two-sided market argument being prepared for imminent litigation, and the still-unknown resolve of a public or private enforcer of the antitrust laws to forcefully and skillfully litigate this price-fixing case.

NaBanco was a 1986 decision which condoned Visa's collective fixing of interchange prices. *NaBanco* was built upon three pillars, all widely recognized to have crumbled. One pillar of *NaBanco* was that most of the profit in a four-party credit card network, such as Visa, was on the acquiring side. Therefore, fixed interchange was necessary to keep issuers from fleeing the network. Since most of the profit is on the issuing side and most acquirers have already fled, that pillar crumbled.

The second pillar was that credit cards were part of an "all forms of payment" market, including cash, checks, credit, debit, charge, travelers checks, wampum, etc. In that market, Visa did not and could not have market power. That market definition has been roundly rejected, most recently by the *Visa Check* and *U.S. v. Visa and MasterCard* courts. Both courts also found a credit card market, and both also easily found that Visa had substantial power in that market.

(Mr. Schmalensee abandoned the *NaBanco* market definition 14 years

ago in his expert report for Visa in the *Mountain West* litigation.)

The third pillar of *NaBanco* was the court's finding that Visa credit card interchange was "cost-based." The coordinated attack on the Aussie Fed's cost-based interchange regulations, mounted by Visa/MasterCard at this conference, leaves no doubt that they concede that this final pillar of *NaBanco* also has crumbled. The attack on cost-based regulation also is more than a tacit recognition of how much above cost Visa/MasterCard fixed interchange fees are. Please do not misunderstand my recitation of these facts as my endorsement of cost-based interchange. If there is to be any interchange in a four-party credit card network, and none is necessary, then it must be the product of competition, not collusion. Nor should it be the product of the market imperfection of substantial and entrenched market power.

The *NaBanco* court based its decision on these three pillars, now gone, and muttered something about how Visa, a powerless entity in a vast market, used interchange to reconcile the interests of issuers and acquirers in a "mutually dependent relationship." I have already said enough (perhaps too much) about the equilibration argument and both the doctrinal and empirical problems with the associations' effort to apply that learning to their price fixing.

So who will step up to the plate and bring a real challenge to the fixing of interchange fees by Visa and MasterCard? The potential heroes are out there. They probably don't include the opt-out merchants from *In re Visa Check*, who took a free ride on our effort and then added, and quickly settled, price-fixing claims to get more cents on the dollar than the Class, upon whom they piggybacked. The hero is not likely to be from any currently pending case. A federal or state antitrust agency would do, if one finally could mount a comprehensive and coherent effort. This hypothetical, but inevitable, case would not merely challenge interchange price fixing, but also challenge related conduct. Visa and MasterCard employ numerous rules which continue to inhibit merchants from informing their customers about the costs of various payment forms, from providing economic incentives for consumers to use efficient payment forms, and from assuring that those consumers who choose less efficient payment forms bear all or most of the cost of their choices and of their miles and other rewards.

The merchant community has not done enough to communicate with its customers about these important issues. By and large, they have allowed the communication about these issues to be a dialogue between the associations and the merchants' customers. The merchant/consumer dialogue about

these issues must commence promptly. Here, the role of the Federal Reserve is crucial. It must help the consuming public understand the differences among payment forms and the consequences of using each.

One day during one of the many court appearances in the *Visa Check* case, I was shocked by a statement made by my esteemed adversary, Larry Popofsky, who represented Visa. Illustrating one of Visa's arguments in defense of the tying arrangement, Popofsky told the court that Visa now functions like the Federal Reserve. Congress gave that job to the real Federal Reserve. The time has come for the Fed to reassert its stewardship over the U.S. payments system.