

# Interchange Fees: Network, Issuer, Acquirer, and Merchant Perspectives:

## Panel Remarks

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*Chair: Avivah Litan*

**Ms. Litan:** We are finally here. We are able to hear the perspectives of the issuers and the acquirers, and we do have merchant representation in the form of a couple associations, and of course the issuers and associations. So we will hear all sides of the issue today.

As an analyst who follows different areas of payments, I see this as the one market in the United States where volume will go up, risk will go down, but prices will go up. On the other hand, as an analyst who follows fraud and identity theft, I also see the cards as the best mechanism for consumers to use, especially credit cards.

As an analyst who follows the retail payment community, I know the average retailer really does find credit cards as a very preferable payment mechanism because of the guaranteed payment the next day, etc. It is a complex issue and hopefully we will hear today from the different sides of the equation on their perspectives.

We are going to start with an introduction from each of the panelists and a discussion on their companies and perspectives, and then we will get into the general discussion.

Let's start with Xavier Durieu.

**Mr. Durieu:** During the last 40 years, Europe has focused its efforts on building an internal market between its now-25 member states. This single market has been achieved in many areas, notably for our single currency. But for decades, all European retailers, whatever their size, have been facing the same issues as their American, Australia, Mexican, and other counterparts in the payments systems field: dominant position of two card schemes (networks), collective price fixing, lack of transparency, and absurd consequences of the four-party systems. In addition, even if banks claim it is possible, cross-border acquiring is still not possible in practice in Europe, preventing retailers from fully benefiting from the internal market.

The current situation in the credit card market is highly anticompetitive, not transparent, inefficient, and unfair. The schemes, in dominant position, impose unilaterally their condition to the whole market; 80 percent of the discount fee paid by the retailer is not negotiable; and once they have signed a contract for one type of card, retailers are forced to accept all other products—even the most expensive—delivered by the scheme, the so-called honor-all-cards rule (HACR). We are convinced that it is in the interest of society as a whole to prevent these behaviors.

The fact that the interchange fee represents 80 percent of the merchant discount leaves little room for competition on the acquiring side, whatever the number of acquirers in a specific state. This absence of competition and transparency keeps the retailers from purchasing services they would like to offer to consumers at the best prices.

It is even sadder to realize, though, that even an increase of competition in the acquiring market would not solve the issue, as the system is built as such that more competition on the issuing side implies more free gifts and loyalty benefits being offered by issuers to cardholders, leading to fee increases for the merchants. The case of Spain, which has several acquirers but higher merchant interchange fees (MIF) than Luxembourg with only one acquirer, illustrates this.

Today, there is a total distortion in the price signals sent to the consumers. Consumers see credit cards as free—or even as a way to get some air miles—while this instrument is much more expensive for the retailers than other means of payments. This nonrespect of the “user pays” principle leads to cross-subsidization between payment means, which is inefficient and costly for the society as a whole.

The situation in the debit card market is not much brighter. Some card schemes, influenced by industry associations like the European Payment Council, are replacing efficient, well-functioning, PIN-based national debit card schemes with their own, more-expensive network debit cards. In the United Kingdom, the replacement of the national Switch system by Maestro led to a 60 percent increase of the prices.

The situation in the payments system in Europe has somewhat evolved in the previous years, in particular thanks to the efforts of the European Commission and several national competition bodies. However, it still has to go great lengths to be a fair deal for the society as a whole and for consumers and retailers in particular.

The commerce sector welcomes the initiative from the European Commission to introduce more competition and more transparency in the payments services market with its directive for a New Legal Framework.<sup>1</sup> The Single European Payment Area, a project of the banking industry, is a good initiative, but its commitments are still vague and its scope seems not to include cards.

The literature and the recent cases at the national level confirm that the current situation is absurd and not tenable. The Australians gave a shock to the system and demolished some of the banks' arguments when they discovered that decreasing the MIF by half did not change the banks' income. Even some Visa consultants have come to the conclusion that the MIF is not necessary to the system.<sup>2</sup>

Retailers are not asking for a free lunch, but rather for a fair price. Society calls for more competition, more transparency, and, above all, a fairer distribution of costs between the stakeholders. Regulators have to intervene in the four-party payment systems in order to obtain transparency and ensure an optimal outcome in terms of public benefit. The ultimate beneficiary will be the consumer, as in any democratic system.

**Mr. Gabeiras:** I will start by telling you that Spain is *not* a mature market as far as payments systems are concerned. The point of sales (POS) volume represents only 15 percent of private consumer expenditures, while in more mature markets, such as France or the United Kingdom, this figure covers approximately 24 and 30 percent, respectively. There is always still a span to reach these levels. We have about 50,000 ATMs for a population of 43 million people, 900,000 POS terminals deployed in the field, and roughly 45 million bank cards issued.

I am, of course, totally in favor of interchange rates. We have read, at least within my organization, everything that has been written concerning interchange rates, both from the academic side as well as from the industry realm, and, as a result of that, I personally share the models of Jean-Charles Rochet, Tirole, and Schmalensee. In fact, the procedure we have devised in the past is a mixing of both, trying to estimate demand with a log linear function as well as to calculate the interchange rate in a two-step model, postulating that the aggregate demand is a function of the average price applied to the customer and the average price applied to the cardholder. This interchange rate drives us to a formula that can be easily

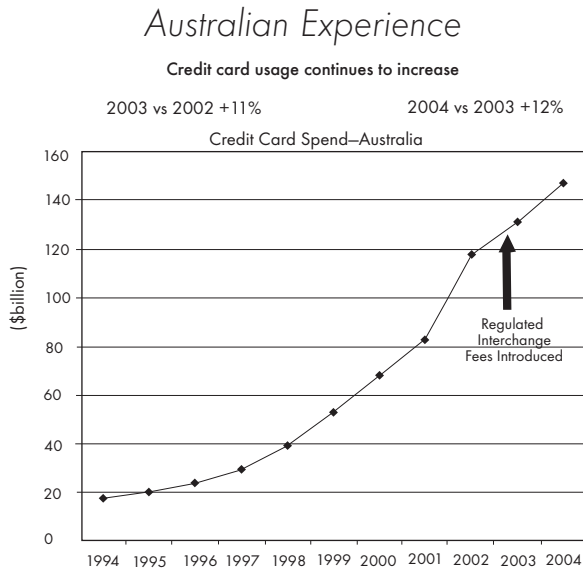
calculated, as a linear function of acquiring and issuing prices and costs, mainly the average price to the customer, cardholder, and retailer; the average cost of the issuing side; and the average cost of the acquiring side, in a such a way that, for us, the interchange rate has to grow if the price to the merchant and the cost of the issuer grows. It has to decrease if the cost of the acquirer grows and the price applied by the issuer grows. But this model, which had been defended before the Spanish competition authorities, was recently rejected and, as a result of that, we are obliged to apply a totally new procedure starting on July 5, 2005, and take into account the following principles.

First, the debit interchange rate has to be a flat value. This flat value has to be calculated exclusively taking into account the processing of authorization and clearing costs—no other cost component allowed, including the fraud-based cost. For the Spanish authority, there is no counterfeit fraud on the debit side. Second, on the credit side, our authority allows two components. The first is the same one as in the debit card interchange rate, a flat value reflecting processing costs. The second is a variable component per transaction, a percentage of the value of the transaction reflecting the fraud but not the float.

We are in the middle of the process of deciding what to do. Possibly, we will appeal the resolution before the normal justice system. But in any case, in the short run, we are obliged to apply a new procedure, taking into account these components of cost that have been defined by the competition authorities. Alternatively, we are also studying the possibility of applying the international interchange rates authorized by the European Commission for intra-European Visa transactions.

**Mr. Gove:** TransAction Resources works for merchants around the world. So what I am going to provide is a merchant perspective that is going to be very light on economic theory and is going to be focusing much more on the practicalities and the pragmatic issues that we approach. I would also like to say that while the focus of this whole session and my remarks is on interchange, we must remember those other issues that are associated—the other scheme rules, the honor-all-cards rule, access to card schemes, and others—when considering things in the wider environment beyond here.

I will talk a little bit about the Australian experience, talk a little bit about cost-based interchange, and then wrap it up by talking about regulatory oversight and where that stands. In 2001, the Reserve Bank of Australia (RBA) designated the credit card payments system, which allows it to mandate standards for the payments system. It implemented those reforms in 2003.

**Chart 1:**

There were three key parts of that. The first was that a cost-based interchange was introduced. The second was that they allowed merchant surcharging for credit cards. The third was it opened up access to card association membership, so that nonfinancial institutions and, indeed, merchants themselves could become acquirers subject to prudential regulation.

As a result of that, the credit card interchange rate reduced from an average of around 0.95 percent to around 0.5 percent currently, excluding tax. The card-present electronic rate (the lowest rate) is about 0.44 percent, excluding tax, for Visa and about 0.46 percent for MasterCard.

Despite the doom and gloom predictions by the card associations and by the banks, the Australian system hasn't fallen. MasterCard's famous death spiral, resulting in a collapse of the system, just hasn't happened. We are going to have a look at that in a moment.

From a merchant perspective, we believe it demonstrates that interchange is not a delicate balancing act. It hasn't all fallen apart. Chart 1 shows what has happened prior to and since the introduction of interchange.

Credit card spending has continued to increase. It hasn't dramatically stopped that. What it really has done is realigned the issuing banks' income. Their income overall hasn't particularly changed, just the source of it. So they are now getting more income from the cardholders and less

from the merchants. That was part of the RBA's objective. They didn't want incentives for cardholders to use a more expensive, less efficient payment system, so they have taken out the loyalty component from the cost-based interchange formula.

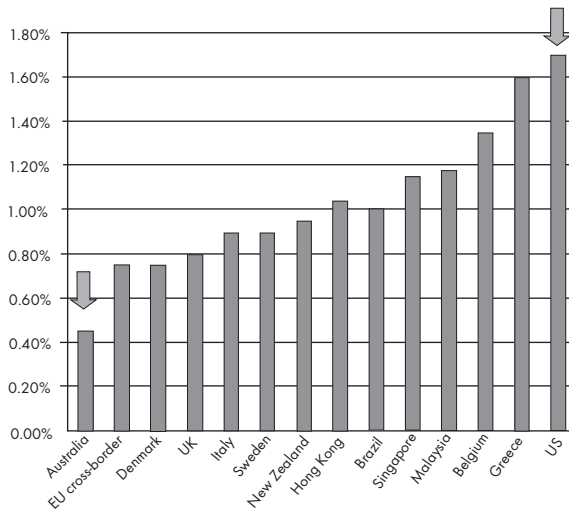
We have seen an increase in annual cardholder fees. We have seen fees introduced for belonging to the loyalty programs and/or a reduction in the benefits in those loyalty programs. In fact, some of the card divisions of the banks are making better-than-ever profits. The ANZ Bank had a profit growth of 58 percent in its card-issuing and merchant services division. Westpac indicated the regulations have had no negative impact on their results. Commonwealth Bank also has said similar things. These are the three largest card issuers in Australia.

So that brings us to the issue of cost-based interchange. From a merchant perspective, what to look for is an equitable distribution of the costs and the benefits. Acquirers and processors provide a service to issuers. And that shouldn't be overlooked. Without acquirers, and in some cases the larger merchants, making considerable investment in infrastructure, then issuers don't actually have a product to offer. Unless there is a network out there so that the card can be used at any merchant, then there is no point in the issuer issuing that card.

So these acquirers and merchants that make this investment need a return on their investment for providing that infrastructure and that service. I think it is interesting that regulators in Australia, in the European Union, in the United Kingdom (certainly the preliminary decision), and now, we've heard, in Spain have all considered the economic arguments we've heard about two-sided markets, about network externalities, and about the delicate balancing acts. In all cases, they have mandated a cost-based structure.

If that were applied in the U.S. market, a move to cost-based interchange here could reduce the value of interchange effectively paid by merchants by more than \$10 billion per annum. So it is a significant amount of money.

Just looking at the U.S. environment, there are international precedents which should be persuasive in this market. In fact, the costs in the U.S. market should be less than those in other markets because of the economies of scale. We have seen a lot of the costs coming down here. The cost of fraud has come down; the cost of charge-backs, borrowings, processing are all reducing. But interchange rates are increasing. At the end of the day, cost-based interchange here could be lower than in other countries because of those economies of scale and because of those reductions.

**Chart 2:***International Credit Card Interchange Fees*

In Chart 2, I've tried to take some countries at random and show where the United States fits with Australia in terms of interchange fees for credit cards.

You'll see at the left-hand end you have the Australian and European cross-border. The United Kingdom winds up that end as well, and the bar representing its interchange fees is likely to become a bit lower when the decision is finalized there. At the other extreme, we have the United States, with its lower costs and economies of scale. It doesn't seem to make sense that a country where you have significant card usage and significant economies of scale would have the highest interchange fee.

Finally, why is regulatory oversight increasing around the world in recent years? In the United States and in other countries, we are seeing control of currency moving from public authorities to private organizations. As we move from cash and check payment to card payment, we are seeing private organizations taking control. These organizations have market power. They also determine who plays (who are members), what the costs are (interchange fees, association fees, etc.), and what the rules are, such as the honor-all-cards rule and the nondiscriminate rule.

We are moving from currencies with no interchange fees, such as cash and check, to one with interchange. Cash payers, who are often from lower-income groups, are subsidizing card payers, who are often from higher-income groups.

In summary, I would like to quote the Office of Fair Trading in the United Kingdom, which said, “In effect, these fees act like a tax on retail transactions that is paid by all consumers in shops that accept credit cards.”

**Mr. Haasdijk:** When Interpay started, back in the early 1990s, it was cumbersome. Large investments were involved. We had a number of loss-making years, until such point in time when a very big retail chain in Holland committed itself to a certain number of transactions. Then it really started hitting off and has been growing ever since. That is also maybe illustrated by the fact that since we began, in nominal terms, we have reduced the charge to the merchants by 50 percent, which in real terms makes for a much higher reduction in price over the years. And it has been established—not by ourselves, but by the Dutch central bank, as well as KPMG and CapGemini—that our fees are the lowest in Europe if not in the world.

In Holland, there is no interchange fee. It was set at zero by Interpay. That is true and, at the same time, not entirely true. Let me explain what I mean by that.

The issuing banks in Holland are also our shareholders. If we pay an authorization fee or an interchange fee for authorization to our banks, we would have sustained a period in which we would have losses for that much longer. So we agreed to pay dividends as long as we had profits, and we would pay dividends comparable with Dankort, the domestic debit card profit. After many, many years, that came into being and those profits were distributed, not on the basis of the shareholding percentages in Interpay, but on the basis of the debit transactions. So the issuers, in a roundabout way, as long as our results allowed it, were reimbursed for the authorization costs they incurred.

In looking at the developments in Europe and looking at the developments in Holland as well, a commission was launched by the governor of the Dutch central bank at the request of the Minister of Finance. They came up with a number of suggestions to improve the transparency in the Netherlands. As a consequence of this, we stepped back as an acquirer; we are no longer the acquirer in the Netherlands for the debit card transactions. The acquiring was taken over by the banks, and we render the processing.

We also separated. You have to bear in mind we just started launching an activity like that. You bring everything together. You consider yourselves about rules and regulations. You consider yourselves about technical standards that need to be adhered to in terms of POS and what-have-you. At



the beginning of last year, we separated the rules and regulation part of the Dutch domestic debit card system out of Interpay. It is now a separately operating company.

Having said all that, we were scrutinized by the Dutch anticompetition authority, NMa for short. They came to the conclusion that we have charged excessive prices during the periods under scrutiny—1998 through 2001—and we were subsequently fined.

At the same time, the banks—our shareholders—were fined because they are accused of having used Interpay as what we call a “central sales office,” which makes for a bit of a bigger thing. Either we have made decisions to use excessive pricing and therefore Interpay should be fined, or the shareholders have used Interpay as a sales office and they should be fined. But the two don’t seem to go together that well.

Apart from that, we are totally convinced that the way the NMa went about arriving at the conclusion with regard to our excessive pricing is not valid for that reason and for the reason that retail organizations in Holland have said, “You have charged excessive pricing. You have been fined for that. We have suffered damages (*despite the lowest rates in the world*), so we’ll sue you for those damages.”

We recently have received about 12,000 letters from retailers through the main retail organization, and those letters are obviously of the same wording and go along the lines of, “You have been fined. We have suffered damages. We are not in a position to compute our own damages, so please would you be so kind as to calculate the damages we have suffered, and will you then subsequently transfer the amount over to us?”

That is the situation we are in. I can tell you it is a very challenging one.

**Mr. Sheedy:** We will spend some time here in a few minutes talking about balance and the successes we’ve had in the U.S. market. It is a different market. I agree with a number of the economic perspectives this morning. We need to appreciate the unique dynamics of each domestic market before you can weigh in and discuss interchange.

Lloyd Constantine talked about Visa debit roughly being analogous to an electronic check. I think first and foremost, it is not. The value that is being provided by electronic payments systems in the United States, and check card in particular, far exceeds that of checks. This includes the efficiency on the back end, certainly, but also the value that is being provided consumers. This morning, a number of the economists mentioned that absolutely has to be appreciated in the discussion.

Lloyd would suggest that the consumer's judgment should be substituted with his own. We ought to go to zero interchange. We have a debit market in the United States that, again countering his perspective, evolved, quite frankly, not from the government setting up a PIN debit scheme, as has happened in some markets internationally, but with the check card market kick-started by Visa in the early 1990s. The merchants responded by deploying PIN pads, and the free market raged on. And consumers and merchants have ultimately benefited.

The 20 percent of check card customers that use their check card in a signature-based environment 25 times a month would take exception with the perception that it is equal to a check. It is not.

Lastly, Lloyd had suggested that Dick Schmalensee was an employee of Visa U.S.A. Dick, I've been a Visa employee for 12 years. I am a member of the senior management team. I have never met you, so, "Welcome aboard!"

Again, interchange in the United States is a challenging matter. We believe it is central, as we will discuss, to trying to position the electronic payments market in the United States to drive value to consumers and merchants, ultimately to the economic benefit of all participants. We have heard quite a number of different perspectives today. I am going to use the time certainly to lay out the way we look at the matter and continue to, hopefully, foster a healthy debate, but also to set the facts straight on some inaccuracies that have been heard and will continue to be heard in the press.

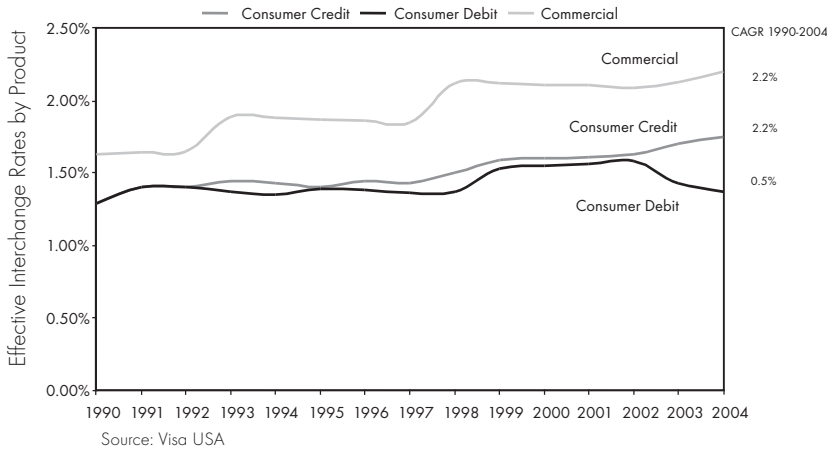
The number one challenge from my perspective is the merchant one. Merchants perceive interchange as a cost. Last night Tom Hoenig referred to, as Lloyd also pointed out, interchange as a pricing mechanism. Perception being reality, I can acknowledge that. But interchange is more than a pricing mechanism. To us, it is a basic tenet of our business, right along with product, brand, systems, and the relationships we have with our member financial institutions and merchants. It is how we drive value. And ultimately the continued growth of this industry, we believe, is best served if pricing continues to be a function of the competitive market.

That being said, we are all for greater transparency and greater dialogue. Stu and I have talked, and we are very open to providing any and all information at data points. Ultimately we think that is healthy.

As my responsibilities are on the U.S. market for Visa U.S.A. and interchange strategy, I am going to focus my comments on three areas in particular. First, for those of you paying attention to the press in the United States, there have been very political, very well-organized merchant interest groups that have been, in our opinion, misleading the market and providing misinformation on interchange. We are going to be more vocal in

**Chart 3:***Interchange Fees: Rate versus Usage*

Systemwide, interchange rates have increased 1.86% annually since 1990



trying to set the facts straight, not with conjecture but with data.

Second, interchange has been absolutely key to Visa driving value to merchants and consumers. We are going to talk about how we've done that and how we plan to continue doing that going forward.

The third point is the Visa payment system is by no means static, and we will continue to drive innovation. We will continue to drive data security. Ultimately, interchange is a very important part of enabling Visa and the member financial institutions to be able to do that.

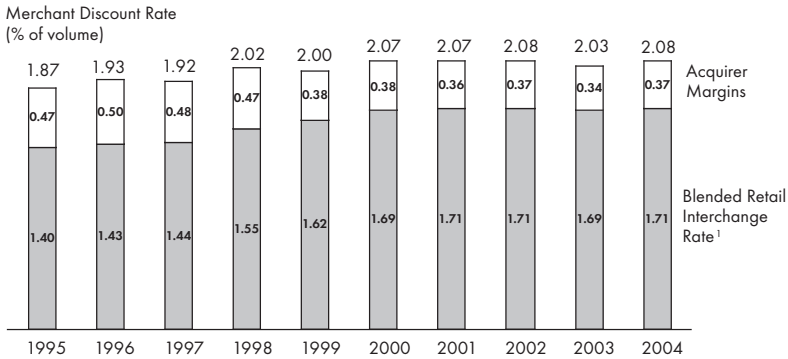
In my interchange strategy responsibilities with Visa U.S.A., I spent a considerable amount of my time and company resources trying to understand the merchant point of view, the member point of view, and the consumer. I have personal relationships with most, if not all, of the merchants represented in the audience today. It is a very challenging balance, looking at interchange and trying to represent all constituencies in order to optimize the growth of the venture. I think we have done it pretty well. I think there are absolutely opportunities to improve. And the free market ultimately will determine how best that is accomplished.

Merchants want to lower their costs. I get that. Every vendor and in every relationship that merchants have that drives their costs, they want to manage those costs down. The data on Chart 3 shows that some of the rhetoric you are hearing from the merchant constituencies in the United States misleads the picture.

## Chart 4:

## Rate Increase Effect is Overstated

Over the past six years, merchants' Visa discount rate has been relatively flat (<0.5% CAAGR)



<sup>1</sup> Blended credit and offline debit interchange rates

Source: Visa Profit Analysis Reports and internal analysis

They talk about escalating rates. They talk about rates going up, as being out of control. And it is just not borne by the facts.

Systemwide in the United States since 1990, rates have increased by 1.86 percent per year. That data point is a bit challenging to understand, because it is a rate on a rate. The fact remains: We continue to be a much cheaper alternative versus American Express.

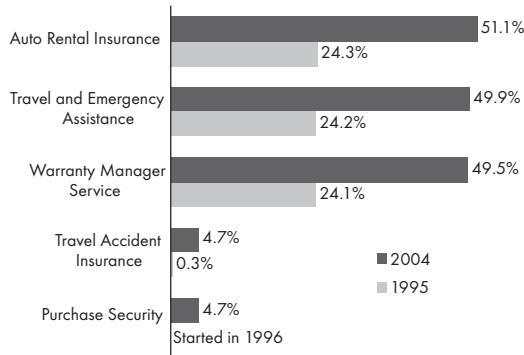
By and large, when you look at total costs from a merchant point of view, costs as characterized by the expenses that they get from their acquirer, these costs have been relatively flat over the last six years, as you can see on Chart 4.

Merchants in the United States benefit tremendously from the thousands of Visa acquirers that are competing every day for their business. Merchants of all types and sizes have significant negotiating leverage, and they benefit from that competition. That competition is fostered within the Visa association. Furthermore, and a bit unique to the U.S. market, Visa U.S.A. has partnered with many merchants directly in structuring customized interchange agreements designed to shift share away from their more expensive cost payments. We have customized marketing arrangements with each individual merchant. We have co-branding agreements with a number of various successful merchant partners. Ultimately, we believe it is these business levers that are going to be a much more successful mechanism by which merchants manage their costs, as opposed to hiring lobbyists and partnering with class-action attorneys.

**Chart 5:***Delivering Consumers More Value*

*Significantly more cards enjoy enhancements in 2004 than in 1995, as annual account fees have declined*

Visa Credit Card Enhancements, 1995 and 2004; % of Cards in Force



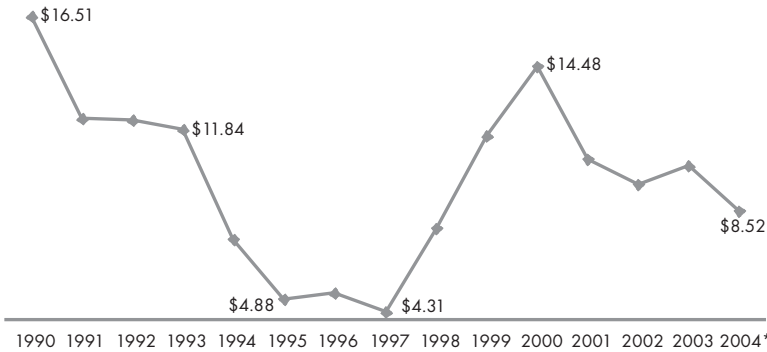
Purchase Security with Extended Protection replaced by Warranty Manager Service by most Issuers. Warranty Manager Service started in 1999.  
Source: Visa Enhancement Management

Total dollar interchange has absolutely increased in the U.S. system. This is where the pressure is coming from. But, as we have just observed from the data that I have shared, the total dollar of interchange in the U.S. system has grown, not because rates are out of control, but because there has been usage. And the usage has been driven by consumer-merchant participation in the payments system.

Why? Chart 5 touches on the considerable benefits to one side of this equation, which is the consumer.

Over time, the consumer experience in the payments system hasn't been static. They continue to drive and realize considerable benefits from the payments system. I am very concerned, as are a number of the folks who spoke earlier, that the consumers' perspective often gets lost in this debate. In fact, in the title of this panel discussion, "Interchange Fees: Network, Issuer, Acquirer, and Merchant Perspectives," where is the consumer? We want to make sure that the consumer doesn't get lost in this debate. Ultimately, they are the point of reference that everyone can share—merchants, regulators, and Visa and our banks included.

But merchants have benefited tremendously as well. There are fantastic examples of ticket lift, faster throughput at the point of sale, more payment guarantees, and the ability for merchants to deploy more effective product delivery channels—such as automated fuel dispensers, electronic com-

**Chart 6:***Falling Cardholder Annual Fees**The average annual fee accross all cards<sup>1</sup> has fallen by 50% since 1990*Average Bankcard Annual Fees  
(Based on Offers)<sup>1</sup>Includes cards without annual fees—defined as Total Fees on all offers/# of Total Offers

\*YTD 2004

Source: Mail Monitor®

merce, self-checkout, and the like. Some of these benefits can be quantified; some of them show up in the form of a more convenient experience for the consumer.

Reinforcing the need to focus on competition and benefits to the consumer, Chart 6 shows that over the last 14 years, annual fees in the U.S. market have been cut in half.

If the merchant lobby had its way with reduced interchange or even zero interchange, those costs don't go away. They get shifted, as we've seen in Australia in the higher annual fees to consumers. Even our critics on this case would have a difficult time characterizing the Australia experience as being pro-consumer. I refer you to the Julian Wright-Stuart Weiner paper on this point.

As for annual fees, Chart 7 shows how the association model, where there are thousands of Visa member financial institutions that compete vigorously for consumer business, has driven down cost of borrowing to revolvers.

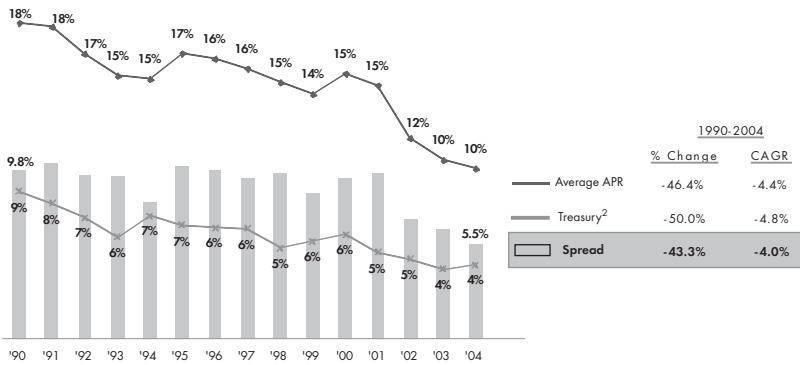
This chart shows stated APRs and cost-of-funds trending over the last 14 years. And you can see that net borrowing cost, adjusted for cost-of-funds changes, has been nearly cut in half over this period. This is an example of how competition and innovation have benefited the consumer.

**Chart 7:**

*Driving Consumer Prices Down*

*The spread between average APRs and prevailing Treasury rates has fallen by 4% per year since 1990*

Consumer Credit—Average APR<sup>1</sup>, Treasury Rate, and Spread



<sup>1</sup> GoTo Rates

<sup>2</sup> 10 year Constant Maturity Treasury Rate

Sources: Synovate Mail Monitor; Federal Reserve

Ultimately, revolvers will bear the brunt, in our opinion, of any regulatory action on interchange—price caps, rate controls, etc. These costs would ultimately shift back and find their way to higher APRs and hit those consumers that are least likely to be able to foot the bill and benefit the merchants.

Alternatively, our member financial institutions, our issuers, could decide they don't want to participate in the Visa association with lower interchange rates. They could issue American Express; higher costs to merchants; and, ultimately, lower levels of utilities to consumers.

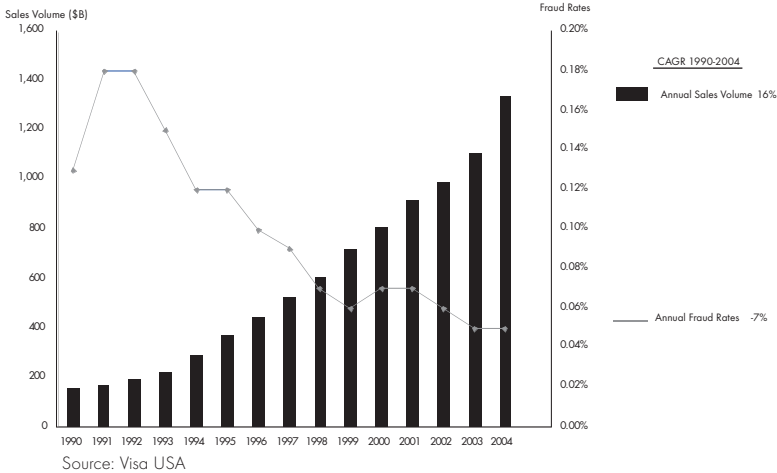
One of the questions observed earlier, and a question I often hear from merchant partners, is, Where are the scale benefits? There has been extraordinary growth in the payments system. Shouldn't there be cost benefits, and how come those haven't found their way into the interchange structure? The cost benefits are absolutely there. There have been enormous scale efficiencies, but what you see—and to my earlier point—is the product hasn't been static. The product has innovated. The product provides greater levels of security, greater functionality, and greater utility to consumers and merchants than ever before. We have been successful, we believe, versus our card competition, debit competition, and the Automated Clearing House (all due respect to the Federal Reserve). And

Chart 8:

Increasing System Security

Fraud rates have decreased by 7% per year from 1990 to 2004, even as Visa volume has increased 16% annually

Visa Annual Sales Volume and Fraud Rates



we have been successful versus cash and check because of this innovation. We are not a utility. We are an innovative, competitive payments system, and interchange makes sure we stay that way.

I would like to shift my focus to a place where consumers and merchants can absolutely agree. It is the security of the payments system. Chart 8 shows trends in fraud over the last 14 years.

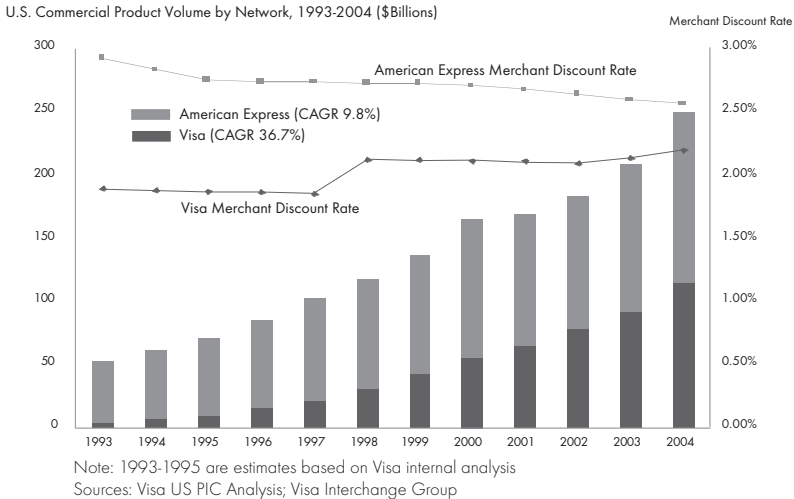
You can see that as the payments system has grown 16 percent annually in the United States, fraud rates have dropped 7 percent annually. Fraud rates in the United States are the lowest in the industrialized world. Interchange has been absolutely key to facilitating the investments, incentives for merchants to submit clean transactions in the system, and investments on the part of Visa and our member banks to manage and maintain that risk dynamic.

One of the more challenging aspects, and Avivah Litan hit this up front, of the industry is that in recent years competition has manifested itself in the form of raising rates. How could that be? For the economists who studied two-sided markets, I think they understand it conceptually. I am going to show you a real-life example of where this has happened and how it has been good for all constituencies.



**Chart 9:***Driving Product Innovation*

*Visa commercial interchange fees increased competition and product innovation for commercial customers*



Higher interchange has absolutely been a source of product innovation and competition in the commercial card market. As shown on Chart 9, back to the mid-1990s, American Express dominated this market.

They owned the vast majority of the small-business purchasing and corporate travel and entertainment (T&E) business. We already had higher interchange rates in the Visa system for commercial products, but we could not get the banks attracted to invest in this market. There wasn't a return on investment.

With an increase that we took to market in 1997, we then crossed that threshold, created a positive business case for the banks to enter that market, and now in 2005, Visa issuers are the largest provider of business purchasing and corporate T&E products in the United States, supplanting American Express.

We have brought down rates for consumers. We have increased the level of competition and innovation in the marketplace. And we did it with rising rates.

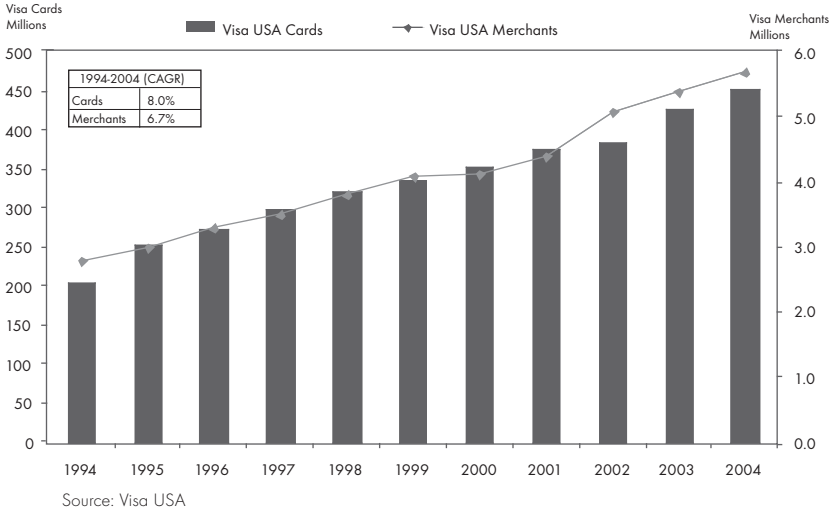
In conclusion, in our opinion, it is hard to see what is broken here. Our success is based on maximizing the value proposition to consumers and merchants. In absence of a balanced value proposition, it just doesn't work.

The question being posed at this conference is, What role is there for

Chart 10:

### Visa Payment System

Success is primarily based on balanced merchant and cardholder participation



public authorities? From a Visa perspective, we welcome free and open dialogue. We look forward to helping anyone understand our business and sharing whatever data are possible. But with consideration to U.S. rate controls, we don't see a role. Chart 10 shows that beginning in 1994, merchant participation in the payments system has grown from 2.8 million merchants to north of 5.5 million today. Cardholder participation in the payments system has grown almost lockstep with that merchant participation—extraordinary growth, and evidence of value being provided on both the merchant and the consumer side. The assertions being made by the trial bar and some of the merchant advocacy groups would suggest that the electronic payments system, as it has been managed, hasn't been good for them. However, I think if you look at the data points and the successes we have had in the U.S. market, you would conclude to the contrary.

**Ms. Webb:** I suspect you know, but in case you don't, JPMorgan Chase is a quite large issuer of credit cards, debit cards, and stored-value cards, and we are also a substantial player in the merchant acquiring space in this country.

Today, I have four points that I'd like to make with you. One is that we believe interchange is actually a great value. Two, we believe that interchange pricing (I just learned today that I am supposed to call it "equilib-

rium”) is quite competitive. Three, merchants do have choice. And four, regulation would be quite detrimental to consumers.

Let me start with point one, which is that interchange represents a terrific value. And unfortunately, like everyone else here today, I will not discuss the consumer, which is a shame. But you are all consumers, and my guess is that every one of you has a couple cards in your wallet and appreciates the value they bring to you. So I will not spend time on that and will move on to the merchant, who is paying the freight here. Let’s talk about that.

We think the number one area where merchants get tremendous value out of interchange is in increasing sales. Let me give you a couple of examples. Over the past year, both associations have spent considerable amounts of money investing in radio frequency identification (RFID) terminals at quick-service restaurants in this country, enabling consumers to go into those restaurants and pay for their transactions without having to swipe their cards, requiring issuers, by the way, to have to re-card those consumers as well. This is a considerable investment. But the early results are showing that the average spend of those consumers is \$7 versus \$5 when they go in with cash.

I’ll give you another example: our partnership with Starbucks. In 2003, we issued with them the Duetto card, which is a combination of a stored-value card and a credit card. Since inception until now, when you look at the Starbucks stores that accept the card, their sales lift has been 13 percent versus 5 percent without the card. Unequivocally, cards drive increased revenues for merchants.

What we also see is that cards are making new markets available to merchants. Ninety-two percent of the transactions that are completed on the Internet are paid for with plastic. The stored-value market today is \$70 billion. These are enormous markets enabled by this payments system. We bring these benefits to merchants, and we do it by attracting consumers, acquiring consumers, and then incenting consumers to use those cards. Interchange is the means by which we are compensated for doing that.

The economic system, or the monetary system, as a whole realizes a benefit from the card-based payment system. We have replaced 26 percent of consumer checks with cards. That has not only resulted in the Fed being able to close a number of check processing centers, but it has also provided a wealth of data that didn’t exist previously for anything from macroeconomic trends to increasingly focusing on money laundering.

My second point is that interchange pricing is actually quite competitive. Look at the cost of a cash transaction—we saw it this morning with a back-of-the-envelope, and we also have a McKinsey study that looks at the aver-

age cash transaction, factoring in fraud, float, and theft. When you factor it all in, you are looking at 165 basis points. A debit transaction, which is the competitor, on average on a blended rate is 42 basis points for a PIN and 112 basis points for a signature.

We've seen lots of charts look at only interchange in the credit market and credit cards globally, and those charts are missing a big part of the equation. The acquiring business is incredibly competitive in this country. However, in many other developed countries, the acquiring business is quite different and adds a substantial amount of cost to the merchant. So when you look at all-in merchant acceptance costs across 16 developed countries that were surveyed by the EDA Group, what you find is that the United States actually is among the lowest, with only three being lower—France, Denmark, and the United Kingdom.

We think this is a very competitive market that is actually becoming more competitive. DebitMan is attempting to enter the market with great merchant support, although they are finding that it is quite difficult to get these cards into consumers' wallets and have them use the cards.

Also, let's look at what GE is doing, quite interestingly, to leverage its private-label network and partner in a different way with the likes of Discover and Wal-Mart.

That brings me to my third point, which is merchants not only have choice, they have more choice now than ever before. They have more choice from these new competitors. They have more choice because of some laws that have been passed recently or some judicial proceedings. Also, they have more choice about which network they will work with and why. They can leverage that and, frankly, should be leveraging that.

They can also look at with whom they want to co-brand. We have 900 different credit cards, many of which are co-brand cards, where the merchant enjoys tremendous benefit from the cards being used. It is not just the big merchants, such as Walgreens and the like, that we've heard about that have in fact negotiated better interchange rates, demonstrating their market power. It is also smaller merchants. Gas stations, for example, do have the choice to accept cash at a discounted rate. They don't choose to do so and, in fact, have spent money to equip their pumps with terminals to enhance consumer convenience and presumably to get greater throughput and probably greater ticket sizes. And then there is the dry cleaner, who has a clear sign posted saying that only cash or PIN debit are accepted. That is it. Merchants have choices and more choices as time goes on.

My fourth point: When we look at regulation—to Bill's point earlier—

we see no evidence that when interchange goes down due to regulation, due to negotiated bilateral deals, or due to anything, that benefit is passed on to the consumer. We haven't seen any evidence of that. The consumers continue to pay the same prices and actually do receive less value on their cards. So in summary, consumers pay. We don't think that is a good thing.

We also think this is an incredibly innovative market. I wouldn't call it just a dynamic market; I'd say it is a frothy market. That is why we are all here, right? This is really a frothy market. That is a terrific thing. There are new competitors. There are new products. There are new markets for us to attack. There are new customers for us to acquire. Regulation is static, and regulation would make this a stagnant market.

In closing, what I'd like to say to you is that *we believe* that the best way to optimize the efficiency and safety and soundness of the payments system in this country is to minimize the use of paper with all of its attendant cost, risks, and leakage in the monetary system. We believe this would enable merchants to get rid of not only their variable but also their fixed costs of processing paper payments and continue to realize the spend lift from accepting plastic. We very much look forward to collaborating with any and all toward that objective.

**ENDNOTES**

<sup>1</sup>The complete name is New Legal Framework for Payments in the Internal Market.

<sup>2</sup>“If the courts had mandated a zero interchange fee and forced issuers to take receivables at par, Visa probably would have survived,” David S. Evans and Richard Schmalensee, “Paying with Plastic” (MIT, 1999).