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GAO

Report to Congressional Addressees

November 2009

CREDIT CARDS

Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges

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GAO-10-45

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Highlights

Highlights of GAO-10-45, a report to congressional addressees

CREDIT CARDS

Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges

Why GAO Did This Study

When a consumer uses a credit card to make a purchase, the merchant does not receive the full purchase amount because a certain portion of the sale is deducted to compensate the merchant's bank, the bank that issued the card, and the card network that processes the transaction. The level and growth of these rates have become increasingly controversial. The 2009 Credit Card Accountability, Responsibility, and Disclosure Act directed GAO to review (1) how the fees merchants pay have changed over time and the factors affecting the competitiveness of the credit card market, (2) how credit card competition has affected consumers, (3) the benefits and costs to merchants of accepting cards and their ability to negotiate those costs, and (4) the potential impact of various options intended to lower merchant costs.

To address these objectives, GAO reviewed and analyzed relevant studies, literature, and data on the card payment market and interviewed industry participants, including large and small card issuers (including community banks and credit unions), card processors, card networks, large merchants representing a significant proportion of retail sales, and small merchants from a variety of industries, and academic experts.

GAO provided a draft of this report to the Department of Justice, the Federal Trade Commission, and federal banking regulators, and we incorporated their technical comments where appropriate.

View GAO-10-45 or key components.
For more information, contact Alicia Puente Cackley at (202) 512-8678 or cackleya@gao.gov.

What GAO Found

According to Federal Reserve analysis, total costs of accepting credit cards for merchants have risen over time as consumers use cards more. Part of these increased costs also may be the result of how Visa and MasterCard competed to attract and retain issuers to offer cards by increasing the number of interchange fee categories and the level of these rates. Concerns remain over whether the level of these rates reflects market power—the ability of some card networks to raise prices without suffering competitive effects—or whether these fees reflect the costs that issuers incur to maintain credit card programs. Issuers, particularly smaller issuers such as community banks and credit unions, report relying on interchange fees as a significant source of revenue for their credit card operations, and analyses by banking regulators indicate such operations traditionally have been among the most profitable types of activities for large banks.

Some consumers have benefited from competition in the credit card market, as cards often have no annual fees, lower interest rates than they did years ago, and greater rewards. However, consumers who do not use credit cards may be paying higher prices for goods and services, as merchants pass on their increasing card acceptance costs to all of their customers.

For merchants, the benefits of accepting credit cards include increased sales and reduced labor costs. However, representatives from some of the large merchants with whom we spoke said their increased payment costs outstripped any increased sales. These merchants also reported that their inability to refuse popular cards and network rules (which prevent charging more for credit card than for cash payments or rejecting higher-cost cards) limited their ability to negotiate payment costs. Interchange fees are not federally regulated in the United States, but concerns about card costs have prompted federal investigations and private lawsuits, and authorities in more than 30 countries have taken or are considering taking actions to address such fees and other card network practices.

Proposals for reducing interchange fees in the United States or other countries have included (1) setting or limiting interchange fees, (2) requiring their disclosure to consumers, (3) prohibiting card networks from imposing rules on merchants that limit their ability to steer customers away from higher-cost cards, and (4) granting antitrust waivers to allow merchants and issuers to voluntarily negotiate rates. If these measures were adopted here, merchants would benefit from lower interchange fees. Consumers would also benefit if merchants reduced prices for goods and services, but identifying such savings would be difficult. Consumers also might face higher card use costs if issuers raised other fees or interest rates to compensate for lost interchange fee income. Each of these options also presents challenges for implementation, such as determining at which rate to set, providing more information to consumers, or addressing the interests of both large and small issuers and merchants in bargaining efforts.

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Abbreviations

DOJ	Department of Justice
FDIC	Federal Deposit Insurance Corporation
FTC	Federal Trade Commission
OCC	Office of the Comptroller of the Currency
PIN	personal identification number
RBA	Reserve Bank of Australia
TILA	Truth in Lending Act

United States Government Accountability Office
Washington, DC 20548

November 19, 2009

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Olympia J. Snowe
Ranking Member
Committee on Small Business and Entrepreneurship
United States Senate

The Honorable Benjamin L. Cardin
The Honorable Tom Harkin
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

Consumers are increasingly using credit cards to make payments for goods and services. When a consumer uses a credit card to make a purchase, the merchant does not receive the full purchase amount because a certain portion of the sale is deducted and distributed among the merchant's financial institution, the financial institution that issued the card, and the card network that processes the transaction. The majority of this amount generally is called the interchange fee and goes to the financial institution that issued the card. As card use has become more popular, the costs for merchants of accepting them have been rising, and considerable debate has been occurring over these costs, and particularly the level of interchange fee rates. In the United States, merchants have sued the card networks several times over card acceptance rules and costs. Several congressional committees have held hearings on the topic of interchange fees and Members of Congress have introduced legislation regarding interchange fees.

In May 2009, Congress passed and the President signed the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act), which directed us to conduct a study of credit card interchange fees.[1] In addition, we were asked by members of the Senate Small Business Committee to review the market for interchange fees. In response to both, we reviewed (1) how the fees merchants pay for accepting credit cards have changed over time and the factors affecting the competitiveness of the credit card market, (2) how credit card competition has affected consumers, (3) the benefits and costs to merchants of accepting cards and their ability to negotiate those costs, and (4) the potential impact of various options intended to lower merchant card fee costs.

To address our objectives, we reviewed economic and other academic literature and analyzed industry data on the structure of the credit card payment market and merchants' reported fees for payment acceptance.[2] We reviewed materials provided to us by the card networks about the structure of interchange fees, how those fees have changed over time, and the rules for payment card acceptance. We also conducted interviews with more than 80 organizations, including U.S. federal banking and other regulators, academic researchers, and industry participants. We also interviewed and obtained information from regulatory officials in Australia, which took actions regarding interchange fees in 2003. To learn how card issuers compete to attract cardholders and the role of interchange fee revenue, we interviewed representatives from national banking associations, from some of the largest credit card issuing banks, and from credit unions and community banks from across the United States. To learn more about the role of acquiring institutions and processors, we met with an acquiring bank association and several large acquiring banks and merchant data processors. To learn more about the fees merchants pay for card acceptance, we met with representatives of large merchant groups from a variety of industries, including mass market retailers, grocery store chains, and online retailers. These merchants represent some of the largest retailers in the United States, including eight that represented 42 percent of the wholesale and retail trade industries listed in the S&P 500 in 2008. In addition, we obtained and analyzed data provided by large merchants, merchant associations, and a large credit

[1]Pub. L. No. 111-24 § 501, 123 Stat. 1734, 1754 (2009).

[2]For this report, we focused on the structure of fees for accepting credit cards, not debit cards, although the fees for debit cards play a role in factors affecting the competitiveness of the overall payment card market.

card processor on the costs of accepting credit cards and interchange fee changes over time. This information was used to corroborate some of the statements they made about the benefits of card use, but we did not independently verify these data. In general, publicly available data on interchange fee revenues, card issuer costs, and other quantitative information are limited or data could not be provided because of contractual restrictions or ongoing litigation. We also selected small merchants to interview from the Washington, D.C., and Springfield, Virginia, Chambers of Commerce. These merchants represented a diverse group of businesses, including boutique shops, sports clubs, and a health care professional. Our interviews with industry participants, academics, and regulators also provided us with an understanding of the potential impact of various options to lower credit card fees. See appendix I for more detailed information on our scope and methodology.

We conducted our work from May 2009 to November 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Payment card use has grown dramatically since the introduction of cards in the beginning of the 20th century. Hotels, oil companies, and department stores issued cards associated with charge accounts before World War I. In 1950, Diners Club established the first general purpose charge card that allowed its cardholders to purchase goods and services from many different merchants. In the late 1950s, Bank of America began offering the BankAmericard, one of the first general purpose credit cards. Unlike charge cards that require the balance to be paid in full each month, credit cards allow cardholders to make purchases up to a credit limit and pay the balance off over time. To increase the number of consumers carrying the card and to reach retailers outside of Bank of America's area of operations, other banks were given the opportunity to license Bank of America's credit card. As the network of banks issuing these credit cards expanded, the network was converted into a membership-owned corporation that became the Visa network. MasterCard began in 1966 as an association of member-owned banks. American Express launched its card network in 1958, and in the 1980s, Discover, then a business unit of Sears, issued Discover card. In 2006, MasterCard became a publicly traded company with a board of directors with a majority of directors that are independent from their financial institution customers. Visa became a publicly traded company in 2008, and its financial institution members became common stockholders with a minority of shares.

Today, customers can choose among different types of payment cards. Consumers can use debit cards with a personal identification number (PIN) they enter on payment or with a signature. The payment is transferred directly from the cardholder's account to the merchant's account. With a debit card, the payment comes from the cardholder's checking account. Credit cards allow cardholders to access borrowed funds to make a purchase and generally have a grace period between the purchase of an item and the payment date. Then the cardholder can pay the charges in full or extend the loan and keep making charges to the credit limit. Cardholders who do not pay for the charges in full are assessed finance charges by their financial institution and pay interest on the remaining balance. Credit cards offer cardholders several benefits, including

- faster transactions,
- the convenience of not having to carry cash or a checkbook,
- a convenient source of unsecured credit that allows consumers to finance their purchases over time,
- an interest-free period to finance purchases if balances are paid on time,[3]
- improved theft and loss prevention as compared with cash and easier dispute resolution in the event of problems,[4] and
- an easy record-keeping mechanism that can be useful for budgeting, planning, and income tax preparation.

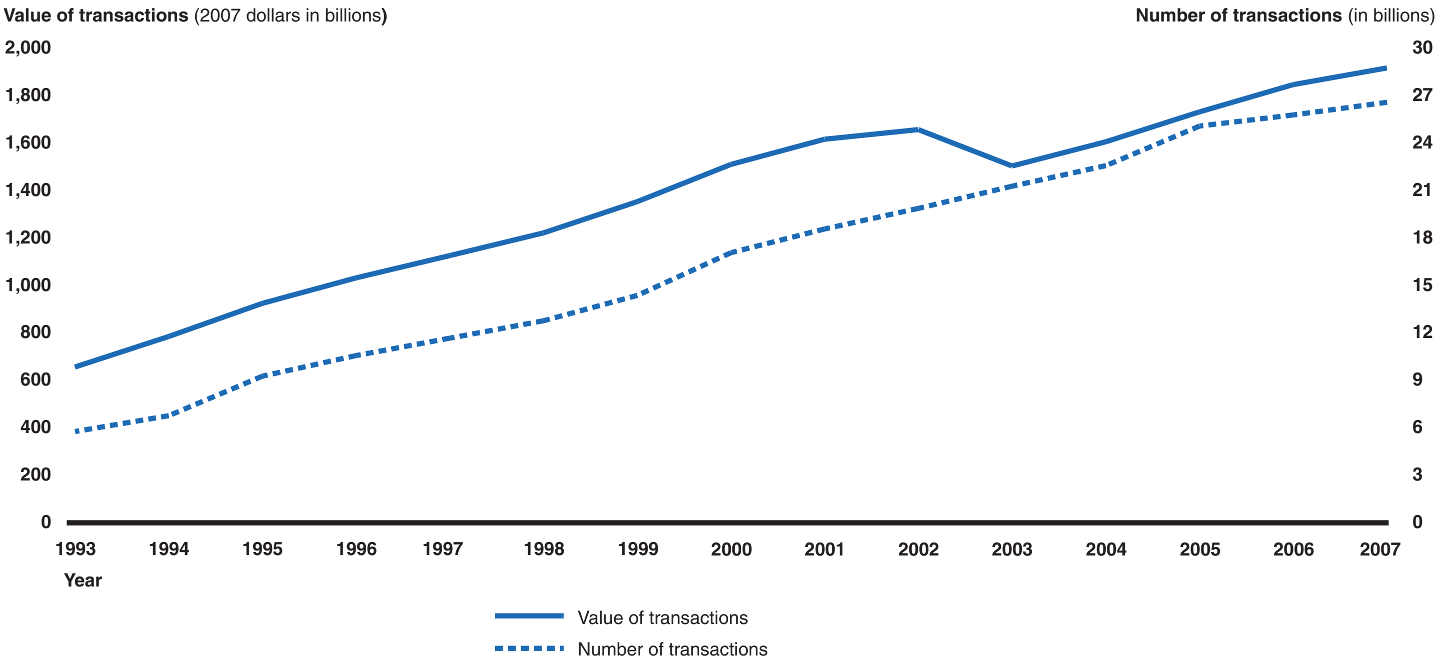
[3]Typically, cardholders with no outstanding balance on their account have at least 21days from the date of purchase to the date their credit card bill is due in which they are not charged interest.

[4]The Truth in Lending Act, generally limits consumers' liability for the unauthorized use of their cards to $50. See 12 CFR 226.12.

Consumer Use of Credit Cards Has Grown Dramatically, while a Few Large Banks Have Come to Account for Most Card Issuance

The number of credit cards in circulation and the extent to which they are used has also grown dramatically. The range of goods and services that can be purchased with credit cards has expanded, with cards now being used to pay for groceries, health care, and federal and state income taxes. In 2007, U.S. consumers held more than 694 million credit cards from Visa, MasterCard, American Express, and Discover, and as shown in figure 1, the total value of transactions for which these cards were used exceeded $1.9 trillion, according to data from the *Card Industry Directory*.[5]

Figure 1: Growth in Credit Card Usage from 1993 to 2007



Source: SourceMedia. *Card Industry Directory*, 20th edition. GAO adjusted the transaction values for inflation and the values are reported in 2007 dollars.

Note: From 2003, the transaction value data from Visa and MasterCard represent purchase volume only. Before 2003, data included cash disbursements.

[5]This includes both consumer and commercial credit card charge volume. See *Card Industry Directory: The Blue Book of the Credit and Debit Card Industry in North America*, 20th ed. (Chicago, Ill., 2008). SourceMedia, the publisher of the *Card Industry Directory*, told us that the 20th edition is the last edition that will be published and that its information has migrated into a Web-based product called PaymentsSource.

Many of the largest issuers of credit cards in the United States are commercial banks, including many of the largest banks in the country. More than 6,000 depository institutions issue credit cards, but over the past decade, the majority of accounts increasingly have become concentrated among a small number of large issuers. Table 1 shows the largest bank issuers of credit cards as of the end of 2008, and their percentage of the total United States credit card market, according to an industry newsletter.

Table 1: Ten Largest Credit Card Issuers as of Year-end 2008

Card issuer	Percentage of total U.S. credit card market by credit card balances outstanding
JPMorgan Chase	21
Bank of America	19
Citi	12
American Express	10
Capital One	7
Discover	6
Wells Fargo	4
HSBC	3
U.S. Bank	2
USAA Savings	2
Total	**88**

Source: GAO analysis of data from *The Nilson Report*, April 2009, Issue 923.

In addition, community banks, thrifts, and credit unions each issue credit and debit cards. According to information provided by banking regulators and banking associations, about 75 percent of community banks, 49 percent of credit unions, and 13 percent of thrifts issue credit cards.

Transactions through Card Networks Involve Multiple Parties and Fees

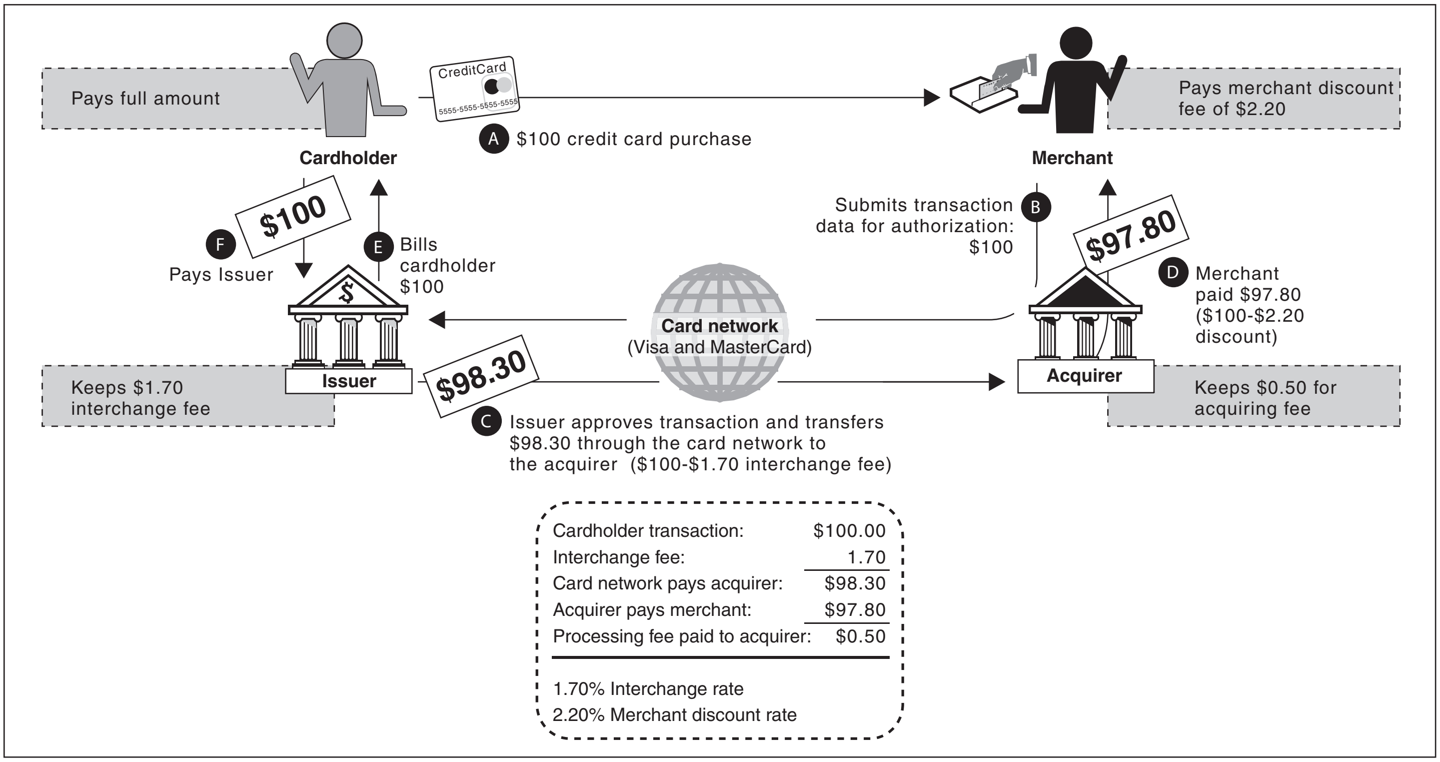
Merchants' costs of payment card acceptance involve several different fees that are divided among the parties involved in a credit card transaction. The parties involved in processing credit card transactions vary depending on the network used by the card. The United States has four primary general purpose credit card networks. For the two largest networks—Visa and MasterCard—transactions involve four parties: (1) the financial institution that issued a cardholder's card, (2) the cardholder, (3) the merchant that accepts the cardholder's card, and (4) an acquiring financial institution. A merchant that accepts Visa or MasterCard credit cards enters into a contract with an acquiring institution that has a relationship with Visa or MasterCard (or both) to provide card payment processing services. The merchant's contract with the acquiring institution or its agent specifies the level of services the merchant receives, as well as the merchant discount fee and other fees that will apply to the processing of the merchant's card transactions.[6] The acquiring institution charges the merchant a merchant discount fee that is established through negotiations.

The majority of the merchant discount fee is generally paid from the acquiring institution to the issuing institution in the form of an interchange fee. A merchant does not pay the interchange fee directly. Rather, the Visa or MasterCard network transfers the interchange fee portion of the merchant discount fee from the acquiring institution to the issuing institution. The acquiring institution retains the balance of the merchant discount fee to cover its costs for processing the transaction.[7] Figure 2 illustrates the four parties in a typical credit card transaction and how fees are transferred among the parties. In this example, when a cardholder makes a $100 purchase, the merchant pays $2.20 in merchant discount fees for the transaction. This amount is divided between the issuing institution, which received $1.70 in interchange fees, and the acquiring institution, which receives 50 cents for processing the transaction.

[6]Although Visa and MasterCard only permit acquiring institutions to authorize transactions on their networks, these institutions may partner with a third-party processor or independent sales organization to directly contract with merchants.

[7]Visa and MasterCard receive payments directly from participating issuing and acquiring institutions based on processing and payment volume.

Figure 2: Transfer of Fees in a Credit Card Transaction



Sources: GAO (analysis); Art Explosion (images).

Note: Individual credit transactions vary considerably, as do the terms of merchant acquiring contracts.

For transactions on the other two major card networks—American Express and Discover—generally only three parties are involved: the cardholder, the merchant, and one company that acts as both the issuing and acquiring entities.[8] Merchants that choose to accept these two types of cards typically negotiate directly with American Express and Discover over the merchant discount fees that will be assessed on their transactions.

Acquiring institutions provide the means for merchants to accept credit cards, by forwarding the request for authorization through the card network to the cardholder's issuing institution. The issuing institution authorizes the transaction by verifying that the account is valid and that the cardholder has a sufficient amount of credit for the sale. For merchants accepting cards in their stores, authorization generally occurs automatically through electronic point-of-sale terminals that read cards. Acquiring institutions clear and settle card purchases by providing payment from the issuing institution to the merchant's account, except for the interchange fees and their own service fees. According to industry estimates, the process takes between 24 and 72 hours for the merchant to receive payment. Acquiring institutions also assume the risks of a merchant defaulting on the promise of goods. For example, if a merchant becomes bankrupt, its acquiring institution is responsible for settling claims with the network and issuers whose cardholders are waiting for goods or services.

Interchange Fees Represent the Largest Portion of Credit Card Payment Acceptance Fees

Interchange fees generally account for the largest portion of the fees for acceptance of Visa and MasterCard credit cards. The card networks set the fees, which vary based on several factors and generally range from 1 to 3 percent of the purchase price. Card network officials told us that they have developed lower rates to encourage certain merchants to accept their

[8] In the United States, since 2004 American Express has licensed a number of banks such as Bank of America to issue cards on the American Express network; however, it continues to act as the acquiring entity for merchants. Financial arrangements between American Express and third-party bank issuers are agreed upon independently, through separate bilateral agreements, and usually constitute a percentage of the transaction amount. Discover also has had card-issuing agreements with financial institutions such as GE Money Bank since 2004, and since 2006 has had merchant acquiring agreements with third parties. For transactions that occur on Discover cards issued by these third-party issuers at merchants having acceptance agreements with third-party acquirers, Discover receives interchange revenue from the acquiring institution and pays the card issuer an interchange fee.

cards.[9] Acquiring banks and card network representatives also told us that certain merchants and transaction types are considered more risky than others and pay higher interchange fees for accepting card payments.

According to Visa and MasterCard officials, four main factors determine which interchange fee rates apply to a given transaction on their networks:

- Type of card: Different rates apply to different types of cards. Visa and MasterCard have separate interchange fee rates for general purpose consumer cards, rewards credit cards, commercial credit cards (issued to businesses), and debit cards. Debit card interchange fees generally are lower than those for credit cards. Among credit cards, premium cards such as those offering rewards and commercial cards generally have higher rates than those for standard or traditional cards.

- Merchant category: Card networks classify merchants according to their line of business. Network officials told us they develop lower interchange fee rates for industries that do not accept cards to encourage merchants in certain categories to accept cards. For example, grocery stores and utilities have lower interchange fees as a special incentive from the networks. Interchange fee rates are higher for merchants in industries such as travel and entertainment, in which network officials report customers spend more with their credit cards, providing the merchant with higher value.

- Merchant size (transaction volume): Merchants with large volumes of card transactions generally have lower interchange fee rates. Visa categorizes some merchants into three tiers based on transactions and sales volume, with top-tier merchants receiving the lowest rate. Visa and MasterCard officials told us that the lower rates also were designed to promote the use of their cards over other credit cards and forms of payment.

- Processing mode: Interchange fee rates also vary depending on how card transactions are processed. For example, transactions that occur without the card being physically present, such as on the Internet, have higher

[9] In addition, merchants may receive lower costs for card acceptance if they enter into a special relationship with a network or issuing bank. A co-branded card has the merchant's name and logo on it and can be used in the merchant's stores or in other locations. A private label card also has the merchant's name and logo on it, but can be used only to purchase goods and services from that merchant. Both types of cards offer incentives for merchants to promote the cards among their customer base. Representatives from large issuers told us that incentives could include a rebate on their interchange fees. We discuss co-branded card relationships in more detail later in this report.

interchange fee rates because of the higher risk of fraud. Similarly, swiping a card through a card terminal, rather than manually entering the account number, would lower a merchant's interchange rate. The swiped transaction provides more information to the issuer authorizing the sale, and issuers and card networks consider such transactions to be less risky because the card was present.

Merchants generally learn of changes to their rates for accepting Visa and MasterCard cards through their acquiring institution. Smaller merchants generally receive one or more flat fees (known as a blended rate) for payment acceptance that include both the interchange fee and the acquiring institution's fee. For merchants with blended rates, the costs of acceptance are uniform for each card type and interchange fee rates may not be disclosed on statements as a separate fee. In contrast, larger merchants generally receive detailed statements from their acquiring institution and card processors, which include interchange fee categories, network fees, and fees from the acquiring institution. These statements reflect "cost-plus" rates, because the acquiring institution provides the merchant with the details of the costs passed on from the network along with the acquiring institution's own fees. Visa and MasterCard develop and publish interchange rate tables (available on their Web sites) that disclose the default rates that apply to various types of transactions. Visa and MasterCard typically publish new interchange schedules twice a year.

Oversight of the Payment Card Market and Recent Legislative Initiatives

Various federal agencies oversee credit card issuers. The Federal Reserve oversees issuers that are chartered as state banks and are also members of the Federal Reserve System. The Office of the Comptroller of the Currency (OCC) supervises card issuers chartered as national banks. Other regulators are the Federal Deposit Insurance Corporation (FDIC), which oversees state-chartered banks with federally insured deposits that are not members of the Federal Reserve System; the Office of Thrift Supervision, which oversees federally chartered and state-chartered savings associations with federally insured deposits; and the National Credit Union Administration, which oversees federally chartered and state-chartered credit unions whose accounts are federally insured. As part of their oversight, these regulators review card issuers' compliance with the Truth In Lending Act (TILA)—the primary federal law pertaining to the extension of consumer credit—and ensure that an institution's credit card operations do not pose a threat to the institution's safety and soundness.[10] The Federal Trade Commission (FTC) generally has responsibility for enforcing TILA and other consumer protection laws for credit card issuers that are not subject to the enforcement authority of other federal regulators. To the extent that the imposition of interchange fees would constitute an anticompetitive or unfair business practice prohibited by the antitrust laws or the Federal Trade Commission Act, the Department of Justice (DOJ) and FTC, respectively, could take measures to ensure compliance with those laws.

Interchange fees are the subject of several federal legislative proposals. The Credit Card Fair Fee Acts of 2009, introduced in June 2009, would, among other things, establish a process by which merchant groups and providers of access to credit card networks could negotiate interchange fees and other terms of network participation under an exemption from federal antitrust laws.[11] The interchange fee would be made publicly available. Another proposal would require credit and debit card networks to remove constraints placed on merchants for card acceptance, such as requiring merchants to accept all cards from a particular network, and require issuers to disclose networks' fees to credit card users.[12]

[10]The Federal Reserve also has oversight of the debit card market under the Electronic Fund Transfer Act (EFTA), 15 U.S.C. § 1693, et. seq., implemented through Regulation E, which, among other things, contains disclosure requirements relating to the use of debit cards at merchant terminals. See 12 C.F.R. Part 205.

[11]This proposal was introduced as S. 1212 and as H.R. 2695.

[12]This proposal was introduced as H.R. 2382, captioned the "Credit Card Interchange Fees Act of 2009."

Fees Merchants Pay for Accepting Credit Cards Have Increased over Time and May Be Related to Competition for Issuers in the Credit Card Market

The amounts merchants pay to accept credit cards is increasing, as Federal Reserve data indicate that consumers increasingly use credit cards to make payments, but also because network competition in the credit card market may be contributing to rising interchange fees. As Visa and MasterCard have sought to attract new merchants to accept and issuers to offer their cards, the number of different interchange fee categories has grown. In addition, as the networks compete to attract financial institutions to issue cards on their networks, they may have increased their interchange fees to provide issuers with greater revenue from the fees. However, concerns remain over whether the level of interchange fee rates reflect the ability of some card networks to exercise market power by raising prices without suffering competitive effects, or whether these fees are the result of the costs that issuers incur to maintain their credit card programs.[13] Issuers, particularly smaller issuers such as community banks and credit unions, report relying on interchange fees as a significant source of revenue for their credit card operations, and analyses by banking regulators indicate that card activities traditionally have been among the most profitable types of activities for large banks.

[13]Businesses can possess market power when they have the ability to raise prices without suffering significant declines in business. The presence of market power is associated with factors in the marketplace such as a limited number of competitors and conditions that can create barriers for other businesses attempting to enter into the particular marketplace. DOJ and FTC examine the structure of the market to determine whether businesses exercise their market power in ways that are considered anticompetitive according to U.S. antitrust laws.

Reasons for the Increase in Merchant Card Acceptance Costs Include Consumers' Increasing Use of Credit and Debit Cards and Increases in Fee Rates

The amount of fees that merchants pay for card transactions has been increasing in recent years, in part because of the increasing use of credit cards to make payments. The Federal Reserve recently estimated that the use of both checks and cash have declined, or at least grown more slowly than credit and debit card use, since the mid-1990s as more consumers switched to electronic forms of payment.[14] According to data from the American Bankers Association, since 2005 more than half of total retail transactions have been paid for using cards (either debit or credit).[15] Although the total value of fees that merchants paid for card transactions as well as the total value of interchange fees are not publicly available, economists at the Federal Reserve estimated that the value of interchange fees paid on Visa and MasterCard credit and debit cards has increased substantially, from about $20 billion in 2002 to approximately $35 billion to 45 billion in 2007.[16] As the total amount of interchange fees increased, so did merchants' total fees for accepting cards.

Merchants' card acceptance costs also have been increasing as a result of rising average interchange fee rates. Visa and MasterCard officials told us that their average effective interchange rates applied to transactions have remained fairly constant in recent years when transactions on debit cards, which have lower interchange fee rates, are included. However, our own analysis of Visa and MasterCard interchange rate schedules shows that the interchange rates for credit cards have been increasing and their structures have become more complex, as hundreds of different interchange fee rate categoriess for accepting credit cards now exist (see table 2). According to our analysis, in 1991, Visa and MasterCard each had 4 standard domestic credit card interchange fee rate categories, but by

[14]See Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski, "Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues." (Working Paper 2009-23, Federal Reserve Board Divisions of Research & Statistics and Monetary Affairs, Washington, D.C.: May 13, 2009). Data from *The Nilson Report*, an industry newsletter, indicates that since 2006, debit card purchases represent a greater share of transaction volume than credit card purchases. See *The Nilson Report*, November 2008, Issue 915.

[15]American Bankers Association/Dove Consulting. "2005/2006 Study of Consumer Payment Preferences" (Washington, D.C.: October 2005).

[16]Federal Reserve officials told us these numbers were calculated by multiplying the average interchange fee rate times the total amount of card payments for Visa and MasterCard credit, signature debit, and PIN debit cards. They noted that because they could not determine the volume of payments associated with each of the many interchange fee categories, this is a crude estimate and should be viewed as a rough approximation of the total. See Prager et al.

2009, Visa had 60 and MasterCard had 243 different rate categories that could be charged to card transactions, although not all of these rates would apply to all merchants.[17] According to card network officials, the increase in the number of rates occurred as different types of merchants and cards were added to their interchange rate schedules. For example, the networks introduced new rates for certain industries that previously had not accepted cards (such as energy utility companies or government agencies) or for new methods of shopping (such as online purchases). In addition to the increase in the number of interchange fee rates, the maximum domestic credit card interchange fee per transaction also has increased, as shown in table 2. While some of the networks' interchange fee rates remained the same during this time and a few decreased, another reason merchant card acceptance costs are increasing may be that individual interchange fee rates also are increasing. According to our analysis, from 1991 to 2009, 43 percent of the individual Visa rates and 45 percent of the MasterCard rates that prevailed in 2009 had been increased since they were originally introduced.

Table 2: Changes in Visa and MasterCard Domestic Credit Card Interchange Fee Rates, Numbers, and Average Rates, 1991 and 2009

Changes in rates from 1991 and 2009	Visa	MasterCard
Number of interchange rate categories in 1991	4	4
Number of interchange rate categories in 2009	60	243
Range of interchange rates in 1991	1.25% to 1.91%	1.30% to 2.08%
Range of interchange rates in 2009	0.95% to 2.95%	0.90% to 3.25%
Percentage of rates that increased	43%	45%
Percentage of rates that stayed the same	45%	45%
Percentage of rates that decreased	12%	10%

Source: GAO analysis of Visa and MasterCard interchange fees schedules.

Note: Any additional transaction fees or rates that were not based on a percentage of the total sales amount were excluded from this analysis. For example, Visa has a flat fee of 75 cents for payments accepted by utility companies. Analysis of increases or decreases in rates compared each rate when initially introduced with its level as of April 2009.

Our interchange fee rate analysis showed that the interchange fee rates that increased the most during this period were for some standard card

[17]Visa officials noted that some of these interchange rate categories have the same rate. In addition, they reported that at least one category was added as a processing alternative provided to acquiring institutions.

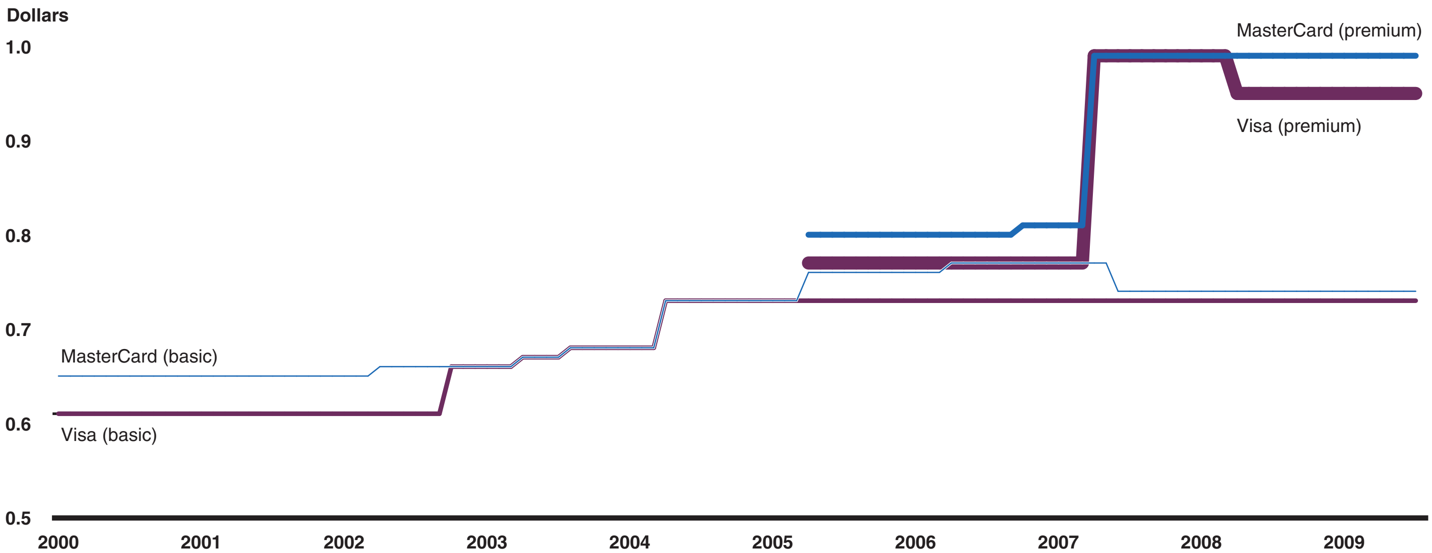
types. For example, the rate that applied to MasterCard transactions using basic nonrewards credit cards at merchants that would not otherwise qualify for a special rate—called Merit III base—was 1.30 percent in 1991 and 1.58 percent in April 2009—representing a 22 percent increase.[18] A similar rate for Visa—known as CPS/Retail Credit—increased from 1.25 percent to 1.54 percent, or 23 percent, from 1995 to April 2009. In addition, several of the networks' higher interchange fee rates also increased during this period. For example, both networks' corporate card (issued to business customers) interchange fee rates increased considerably—Visa by 36 percent and MasterCard by 82 percent. Rates on other cards that had lower-cost incentive rates for sectors that previously did not take cards also increased. For example, MasterCard's interchange rate for standard credit cards used at a supermarket increased nearly 29 percent, from an introduction at 1.15 percent in 1998 to 1.48 percent in 2009.

Analysis by Federal Reserve staff also showed that interchange fee rates have increased, particularly for premium cards that have higher rates than basic cards.[19] As shown in figure 3, the interchange fee costs for Visa's and MasterCard's premium cards have increased about 24 percent since they were introduced in 2005. Interchange fee costs for basic credit cards have stayed roughly the same since 2005, with a 3-percent decline for MasterCard and none for Visa.

[18]Merchants that qualified for special rates for MasterCard included restaurants, convenience stores, supermarkets, and warehouse stores.

[19]See Prager and others.

Figure 3: Changes in Interchange Fee Costs from 2000 to 2009



Source: GAO analysis based on publicly available data collected by the Federal Reserve.

Note: Interchange fees displayed assume a $40 purchase at a typical merchant. Fees are reported for each month in each year. Thicker lines are for premium cards.

Although limited information about cost trends for accepting cards exists for American Express and Discover, the rates these two networks charge have not generated the same level of concern as those of the other networks, in part because they are less widely used. Information on the rates that American Express and Discover charge merchants to accept their cards is limited; these networks do not publish the rates they charge merchants, but instead generally negotiate these charges with merchants on an individual basis. As discussed previously, American Express and Discover, for large merchants, generally serve as both the issuer and acquirer of their cards, so merchants' fees for accepting those cards represent their entire merchant discount fee. Representatives from American Express told us that they do not have interchange fees but instead contract directly with merchants for a fixed merchant discount rate for all types of American Express cards. Discover officials told us that Discover is moving from a single rate for each merchant that applies to all of their cards to a tiered interchange fee model, with higher interchange fees for rewards and corporate cards.[20] Although these networks do not make their merchant discount rate information publicly available, a recent survey of 750 small business owners found that merchants with fewer than 250 employees paid an average of 3.2 percent to accept American Express Cards and 2.5 percent for Discover cards, compared with the average merchant discount fee (which includes the interchange fee and acquiring costs) that these merchants reported of 2.3 percent for MasterCard and Visa.[21] According to data provided to us by American Express, the average merchant discount rate for its cards has decreased in recent years, from roughly 3.25 percent in 1990 to 2.56 percent in 2009.

The Structure of the Card Networks and Increased Competition for Issuers May Increase the Price of Card Acceptance for Merchants

The structure of the credit card market is different from that of other markets and could be one reason why merchants' costs for card acceptance are rising. Economists and other researchers note that credit card networks function differently from most markets because the card market can be considered a "two-sided" market, in which two different groups—merchants and consumers—pay prices for goods or services offered by a producer. Other two-sided markets include newspapers, which charge different prices to consumers who purchase the publications and advertisers that purchase space in the publications. Typically, newspapers offer low subscription rate or per copy price to attract readers, while funding most of their costs from revenue received from advertisers. Charging low prices to encourage larger numbers of consumers to purchase the newspaper increases the paper's attractiveness to advertisers as a place to reach a large number of consumers, and thus allows publishers to charge such advertisers more. As a newspaper attracts more readers, it can charge higher prices to advertisers.

Similarly, card networks use interchange fees as a way to balance demand from both consumers (who want to use cards to pay for goods) and merchants (who accept cards as payment for goods). As with newspapers, the costs to both sides of the card market are not borne equally. To attract a sufficient number of consumers to use their cards, card networks

[20] Discover officials told us that after 2004, they were able to offer card-issuing agreements with other financial institutions. For transactions that occur on Discover cards issued by third-party issuers at merchants having acceptance arrangements with third-party acquirers, Discover receives interchange fees from the acquiring institution and also pays the card issuer an interchange fee.

[21] NFIB Research Foundation, "Credit Cards," *National Small Business Poll* 8, no. 3 (2008). Available at http://www.nfib.com/research-foundation/national-small-business-poll/.

compete to attract financial institutions to issue them, and institutions in turn compete to find additional cardholders. Just as readers have a variety of sources from which they can receive their news, consumers also have a number of different methods (such as cash, check, or credit card) by which they can pay for a good or service. Because of the choices consumers have available, card networks and issuers want to minimize the costs for consumers to carry their cards to encourage greater acceptance and use. In contrast, merchants have less choice about card costs, particularly once a large number of consumers are using a particular network's cards.[22] Whereas a consumer may not pay any fee or charge for using a card, card networks charge merchants for accepting cards through interchange and other network fees. Consumers' payment choices, such as using rewards cards with higher interchange fees, also affect merchants' costs for card acceptance.[23] As a result, some academic researchers have argued that card networks can keep attracting cardholders by offering them increasingly attractive terms while increasing costs to merchants, whose ability to refuse to accept cards is more limited.

The concentration of participants in the credit card network market also has raised concerns over competition and pricing. Visa and MasterCard together accounted for about 71 percent of U.S. credit card purchase volume in 2008, American Express for about 24 percent, and Discover for 5 percent, according to an industry newsletter.[24] Some economists and other academic researchers have argued that the large market share of Visa and MasterCard provides these networks with market power—the ability to raise prices without suffering significant negative competitive effects such as lost sales or reduced transaction volume. As more consumers demand to use Visa and MasterCard cards, merchants feel limited in their ability to refuse these cards even as interchange fee rates rise or as consumers increasingly use rewards cards that have higher interchange rates. These researchers cite the low market share for

[22]The more consumers use the network, the more attractive the network becomes to consumers, and the easier it becomes for the network to attract new customers to its cards. The increasing attractiveness of cards to consumers limits the ability of merchants to refuse that network's card, an effect known in economic theory as a network, or adoption, externality.

[23]Economists have also questioned whether consumers' payment choices appropriately affect the social costs and benefits of various payment methods. However, they note that determining whether a payment type is over or underused is extremely difficult. See Prager and others.

[24]See *The Nilson Report*, April 2009, Issue 924.

Discover as evidence that a new product has had difficulty breaking into the mature market. With fewer cardholders, the attractiveness of this network's cards to merchants is reduced. In order for Discover or another low-cost credit card network to enter the market, it has to compete against the dominance of Visa and MasterCard, which already have successfully recruited thousands of financial institutions to issue their cards and millions of merchants to accept them.[25] Card networks face initial fixed costs, including building and maintaining the infrastructure to process transactions and promoting card usage. Many of the economists that study card market issues generally agree that card networks provide a valuable service that benefits issuers, consumers, and merchants. However, some have pointed out that once a network's initial start-up and coordination costs have been recovered, the justification for charging merchants higher prices for card acceptance is reduced.

Competition among networks for issuers also may increase merchants' card acceptance costs, as networks increase interchange fees. Although greater competition generally produces lower prices for goods and services, some economists have noted that competition among card networks instead increases costs for merchants. To maintain or increase their market share, networks compete for financial institutions to issue their cards, and the revenues that the issuers earn from interchange fees are an incentive to choose to issue one network's card over another. A recent court ruling increased the potential for competition among networks for issuers. Before 2001, Visa and MasterCard had exclusionary rules prohibiting their member institutions from issuing American Express or Discover cards. In 1998, DOJ initiated a lawsuit charging, among other things, that Visa and MasterCard had conspired to restrain trade by enacting and enforcing these exclusionary rules. The trial court held that Visa and MasterCard had violated section 1 of the Sherman Antitrust Act by enforcing their respective versions of the exclusionary rule.[26] As a result of the court's decision, an issuer of one of these network's cards now has the option to issue cards on the Visa, MasterCard, American Express, or Discover network, or a combination of them. Network officials from Visa told us that they actively compete to retain issuers on their network and interchange fees play a role in that effort. Our analysis of

[25]Similarly, merchants also face challenges in starting their own card network or card, because a large portion of their customers already have Visa and MasterCard brand cards.

[26]United States v. Visa U.S.A., Inc., 344 F.3d 229 (2d Cir. 2003), aff'g, 163 F. Supp. 2d. 322 (S.D.N.Y. 2001) and cert. denied, 543 U.S. 811 (2004).

interchange fee rate schedules showed that Visa and MasterCard introduced several of their highest interchange fee rates after this decision, which led to a significant increase in the average interchange fee rates for both networks. According to our analysis, 46 percent of the different Visa interchange rates that prevailed in 2009 had been introduced since 2003, and the average of the new interchange rates created by that network since 2003 was 18 percent higher than the average of interchange rates introduced prior to 2003. Similarly, 89 percent of the different MasterCard interchange rates that prevailed in 2009 had been introduced since 2003, and the average of the interchange rates created by that network since 2003 was 11 percent higher. According to analysis provided by the Federal Reserve, Visa and MasterCard introduced higher interchange fee categories in 2005 for premium cards. Visa and MasterCard officials told us that Visa's "signature preferred" and MasterCard's "world card" interchange categories were limited only to higher-spending cardholders.

Although Offering Cards Involves Various Costs, Issuers Traditionally Have Derived Significant Revenues from Interchange Fees

Issuers report that the revenue they receive from interchange fees is used to cover a variety of costs in their card programs. Establishing a credit card program by soliciting customers, offering them unsecured credit, and paying for any resulting credit or fraud losses involves many costs. Representatives from issuers and networks reported that interchange fees represent a value to merchants, as issuers' credit card programs provide merchants with increased sales and eliminate the need for merchants to create and maintain their own credit card operations or internal credit departments.[27] Among the costs that issuers told us they incur in running their credit card programs were costs related to preventing and addressing fraud and data breaches; write-offs for credit losses from delinquent or defaulting cardholders; funding costs associated with paying the merchant before receiving payment from the cardholder; paying for rewards and other cardholder benefits; and general operations, including the issuance of cards and credit card bill statements.

Although issuers incur costs for offering cards, concerns remain about the extent to which interchange fee levels closely relate to the level of card program expenses or whether they are set high so as to increase issuer profits. In a competitive market, the price of the product and the cost of

[27]We discuss the benefits and costs of card acceptance to merchants in more detail later in this report.

producing it would be closely aligned. However, producers with market power—such as monopolists or those offering goods not generally offered by others—have the ability to charge high, noncompetitive prices. Representatives of issuers told us that interchange fees did not directly cover specific costs of establishing and maintaining a credit card program, but were one of several revenue sources for issuers, in addition to interest charges on outstanding balances and cardholder fees (such as a late fee or an annual fee). Representatives from a banking industry consultancy group told us that the allocation of issuers' revenue varied widely, as some issuers provide more benefits through greater rewards and others by offering more credit. For example, issuers derive revenue from cardholders who pay interest charges and other fees on their outstanding balances. However, issuers may receive little to no revenue from cardholders who pay off their balances on time. Representatives from large and small issuers told us that interchange fees provide them with income that covers the costs of providing short-term credit during the grace period and rewards benefits to those cardholders who do not pay interest charges or other fees.

Representatives of credit unions and community banks reported that revenue from interchange fees allowed them to cover expenses related to offering credit cards and compete with large issuers to offer their customers credit cards. According to data provided by the Independent Community Bankers of America, the interchange fee portion of community banks' credit card revenue varies widely, with some receiving little income from interchange fees because of inactive cards and others receiving nearly all of their income from interchange fees. Staff from this organization told us that they have contracted with a vendor processor that provides card processing for many of their members. They reported that of the 689 community banks that issue credit cards through this vendor, the average amount of revenue from interchange fees represented about 43 percent of these institutions' total card revenues. Credit unions and community banks had a higher portion of cardholders who did not carry a balance or incur penalty fees, according to representatives of financial institutions, so they had to rely more on interchange fee revenues than revenues from fee income and interest payments. Representatives of the smaller issuers also reported that they felt they had to offer rewards programs to compete with the larger issuers, but for some, rewards programs did not constitute a majority of their expenses. In addition, two of the credit unions with which we met outsourced the issuance and maintenance of a card program to a third party.

Information on the amount of revenues larger financial institutions collect from interchange fees and how those revenues compare with their costs of card operations and rewards programs is limited. We were not able to obtain data from the largest card issuers about their revenues, profits, or expenses to compare interchange fee revenues with expenses. However, industry sources indicate that credit card issuers have derived a significant amount of revenue from interchange fees. According to an industry newsletter, in 2007, roughly 20 percent of Visa and MasterCard issuers' card-related revenue—roughly $24 billion—came from interchange fees, while their total costs (for costs of funds, charge-offs, operations, marketing, and fraud) were about $90 billion, and their profits after taxes $18.3 billion.[28] According to an economist working for the largest issuers, issuers pass on increased revenue from interchange fees to their cardholders in the form of greater rewards. He reported that from 2003 to 2008 one large credit card issuer provided an increasing portion of its interchange fee income as rewards to its cardholders and that Visa's traditional rewards, premium rewards, and superpremium interchange fee categories had minimum cardholder rewards programs associated with them. Beginning in March 2008, national and state-chartered banks had to submit data on revenues from credit and debit card interchange fees in quarterly reports on their condition and income (Call Reports) when such amounts exceeded certain thresholds.[29] However, officials from one banking regulator cautioned that they were still reviewing the consistency of the data provided on these forms.

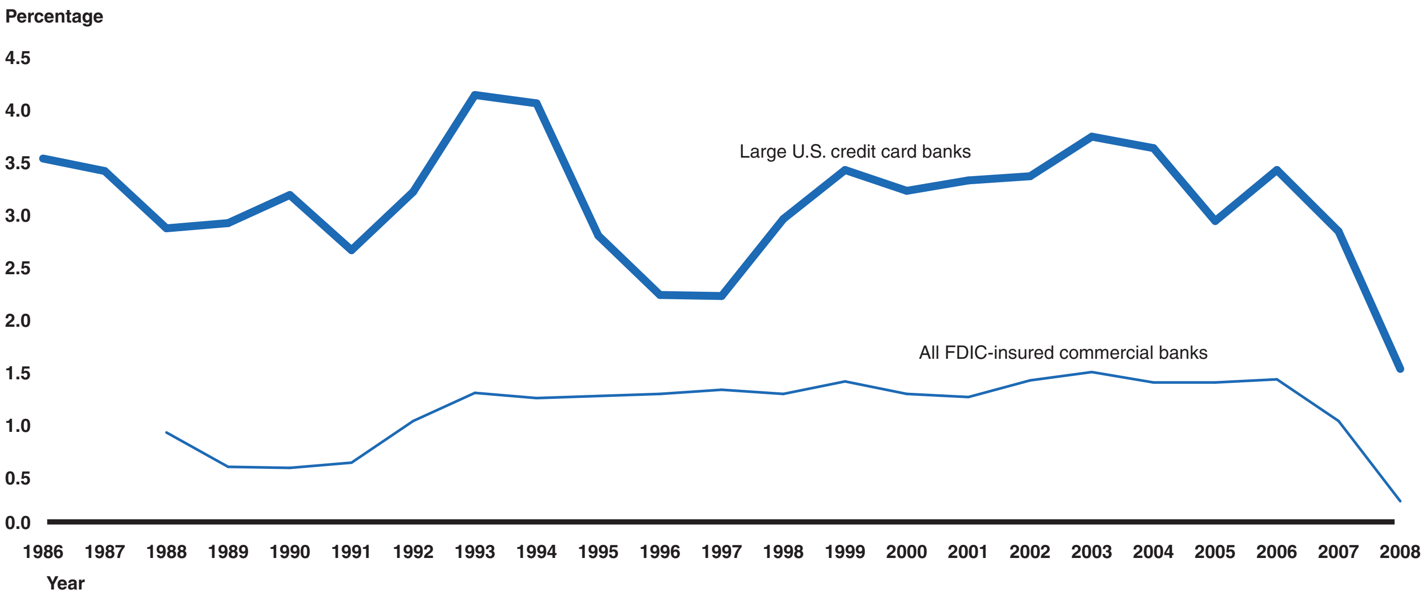
Large issuers of credit cards traditionally have been among the most profitable banking institutions. Although credit card issuers have suffered losses in the recent economic downturn, a June 2009 Federal Reserve

[28]The *Card Industry Directory*, 2007 data. These data do not break out rewards as a separate cost. In addition, we were not able to verify these data with issuers. An economist from the Federal Reserve Bank of Kansas City and representatives of merchant groups have cited work by Diamond Consulting that broke down interchange fee expenses. This report estimated that of the components of interchange revenue, 44 percent went to issuer rewards and only 13 percent went to network and issuer processing. Since these data have been published, Diamond Consulting has issued a statement cautioning that these data were based on the author's views and not on data that issuers provided.

[29]The Federal Financial Institutions Examinations Council, the interagency body that prescribes uniform principles, standards, and report forms for the federal examination of financial institutions by the federal banking regulators and the state liaison committee, governs the collection of the Call Report data, but these requirements are only for banks overseen by the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation.

report points out that for large credit card banks, credit card earnings have been consistently higher than returns for all other commercial bank activities, as shown in figure 4.[30] Recent analysis by FDIC also shows that credit card lending remains a profitable business for credit card issuers, and an FDIC official recently testified that credit card lending has been one of the most profitable business lines for some time.[31] However, FDIC data also show that federally insured institutions that focus on credit card lending have lost some of their profitability in the economic downturn as these institutions experienced some of the highest rates of charge-offs.[32]

Figure 4. Return on Assets, Large U.S. Credit Card Banks, 1986-2008 and All FDIC-Insured Commercial Banks, 1988-2008



Sources: Federal Reserve analysis from Banks' Reports of Condition and Income, 1986-2008, *Report to Congress on the Profitability of Credit Card Operations of Depository Institutions*; GAO analysis of FDIC Quarterly Banking Profile Data, 1988-2008.

Note: Federal Reserve defines credit card banks as the bulk of their assets are individual loans and 90 percent or more of their consumer lending involves credit cards or related plans.

[30]Board of Governors of the Federal Reserve System, "Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions" (Washington, D.C.: June 2009).

[31]Statement of Martin J. Gruenberg, Vice Chairman, Federal Deposit Insurance Corporation. "Credit Cardholders' Bill of Rights: Providing New Protections for Consumers" before the Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee, U.S. House of Representatives. 110th Cong., 2nd sess. 2008.

[32]FDIC Quarterly Banking Profile, second quarter 2009.

While Competition among Issuers Has Increased Benefits and Lowered Costs for Some Cardholders, Other Consumers May Be Negatively Affected by Increased Card Use

Some consumers have benefited from competition in the credit card market, as those using credit cards enjoy lower fees and interest rates and greater rewards. Benefits to cardholders vary depending on how they use their cards; those with credit card debt accrue finance charges and may pay additional fees. However, consumers who do not use credit cards may be made worse off by paying higher prices for goods and services, as merchants pass on their increasing card acceptance costs to their customers.

Cardholders Benefit from Rewards as Credit Card Issuers Compete for Their Business

Although most cards in the United States are issued by the largest issuers, consumers have a wide variety of issuers and cards to choose from. According to the Federal Reserve, over 6,000 depository institutions issue credit cards. These issuers range from some of the very largest financial institutions—such as Bank of America and Citigroup—to credit unions and community banks that range in size and can be small. While there are estimated to be thousands of credit unions and community banks that issue cards, the 10 largest issuers account for about 92 percent of all outstanding credit card debt.

Given the large number of issuers and widespread use of credit cards by consumers, issuers compete to obtain new customers and retain existing ones. According to the Survey of Consumer Finances, in 2007, 73 percent of U.S. families had a least one credit card. Issuers typically use mail solicitations to market their card products—mailing 3.8 billion solicitations in 2008—but representatives from one large issuer we spoke with told us that they can also advertise online and at their branch locations.[33] Issuers target their marketing efforts depending on cardholders' payment and use patterns. Cardholders paying their balance

[33]The number of mailings in 2008 represents a sharp decline from the 5.2 billion mailings in 2007 and likely reflects the effects of a weaker economy, rising unemployment, and increased credit risk among current and prospective card holders. The decline in activity may also reflect the effects of funding issues (as problems in the market for credit card-backed securitizations emerged in 2008 and may have reduced the ability of card issuers to fund their outstanding credit card liabilities at attractive rates.)

in full each month (convenience users) and high-volume card users may be drawn to cards that offer rewards programs, while those cardholders carrying a balance may be more likely to choose a card that offers a low interest rate.

As competition for cardholders has intensified, issuers increasingly have turned to rewards programs to attract and retain cardholders. As discussed earlier, these programs are funded in part by interchange fee revenues. According to an industry study, 71 percent of cardholders held a rewards card in 2008.[34] Representatives of all of the large issuers with whom we spoke told us rewards cards represent a significant portion of the cards they offer and are designed with incentives to increase their use by cardholders. One issuer's staff told us that all of their bank's traditional credit cards that are in active status have a rewards component and they believe that rewards programs help them to build customer loyalty and to retain existing cardholders. A representative of another large issuer stated that about 51 percent of its cardholders have rewards cards, representing about 81 percent of total volume for the issuer, and a representative of another issuer reported that approximately 50 percent of its cards earn points that can be redeemed for rewards or other benefits. Visa and MasterCard also now allow issuing institutions to upgrade cardholders with basic cards to those with rewards without reissuing the card.

Competition among issuers also can lower many cardholders' credit card costs. For example, issuers compete with one another by offering cards with low interest rates. Representatives from one of the large issuers with whom we spoke stated that they typically offer these types of benefits to appeal to cardholders. For example, many issuers offer low temporary rates to transfer existing card balances to a new account. In 2006, we reported that many issuers attempted to obtain new cardholders by offering low, even zero, introductory interest rates for limited periods.[35]

[34]Diners Club introduced a rewards program that offered airline miles to its customers in 1984. Over time, an increasing variety of rewards have been offered to cardholders, including cash-back bonuses based on purchase volume and rewards point donations to charities, alumni associations, and environmental groups. Some issuers also began offering co-branded cards—with the merchant's and the network's name on the card—that provide discounts at the merchant with whom the issuer has established the co-branded relationship. Currently, cash-back bonuses of 3 to 5 percent are common on purchases at certain types of retailers.

[35]GAO, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, GAO-06-929 (Washington, D.C.: Sept. 12, 2006), 16.

According to an issuer representative and industry analyst we interviewed at that time, low introductory interest rates were necessary to attract cardholders in a competitive environment in which most consumers who qualify for a credit card already have at least one. In addition to offering low interest rates, issuers compete by offering cards that have no annual fees and low fees for other actions associated with usage. These lower rates and fees can decrease the cost of using credit cards for some cardholders.

However, in recent months, changes in the economy and the passage of the CARD Act have led many issuers to “reprice” their credit card accounts by altering the rates, fees, and other terms that apply to cardholders’ cards. For example, increasing numbers of consumers have been falling behind on their credit card payments. In the first quarter of 2009, the 30-day credit card delinquency rate reached its highest rate—6.6 percent—in 18 years. Provisions in the CARD Act—most of which will take effect in February 2010—limit the ability of card issuers to increase the interest rates, fees, or finance charges on outstanding balances to the conditions set forth in the act.[36] According to an industry publication, in anticipation of the law taking effect, some issuers have increased the interest rates they charge on consumer purchases as well as some of the fees associated with card usage, such as balance transfer fees. According to Federal Reserve data, interest rates on consumer credit card accounts have been increasing steadily each quarter since the second quarter of 2008, when rates were 11.88 percent.[37] Since that time, rates have increased to 13.32 percent in the second quarter of 2009.[38]

Increased Use of Credit Cards May Not Benefit All Consumers

Increased merchant costs for card transactions may lead to higher prices for noncardholding consumers. As discussed earlier, merchants have faced increased costs from accepting credit cards in recent years, in part because of the increasing number of customers using credit cards and in

[36] See §101 (b) of the CARD Act, *to be codified at 15 U.S.C. § 1661i-1*.

[37] G.19 Federal Reserve Statistical Release. Consumer Credit, August 2009. (Washington, D.C.: October 7, 2009).

[38] Cardholders also can incur numerous costs associated with using their cards. Depending on how consumers use their cards, they may be assessed a variety of fees. For example, cardholders who make late payments may be charged a late payment fee. Or if a cardholder chooses to obtain a cash advance on the card, he or she may be assessed a fee for the advance. See GAO-06-929.

part because of the increase in average interchange fees, particularly from higher-fee rewards cards. Representatives of merchants we interviewed told us that they generally passed any increased costs—including the costs of accepting credit cards—on to their consumers through higher retail prices. Thus, all their customers may be paying higher prices for goods and services, whether using a credit card or not.

Economists disagree whether the increased use of rewards cards further increases costs for merchants. Some researchers state that the increased use of rewards cards, which have higher interchange fees, increase costs for merchants, as their customers switch from paying with cash, check, and basic credit cards to using rewards cards. As a result all customers, including cash and check users, may pay higher prices for goods and services. In addition, some economists have stated that because rewards cardholders do not pay for rewards cards directly, they use their rewards cards more for transactions than if their cards included explicit costs. For example, one study in which consumer survey data were used found that cardholders with rewards cards were more likely to use their cards exclusively than cardholders without rewards cards.[39]

However, the extent to which merchants increase retail prices to account for the costs associated with accepting cards is difficult to measure. Some researchers argue that consumers—even those paying cash or by check—may still be better off because of widespread card use. While merchants may pay more out of pocket to accept credit cards than they do for other forms of payment, credit cards also provide significant benefits to merchants, such as lower labor and processing costs and increased sales. For example, one of these researchers has theorized that the benefits of increased credit card use may lower merchants' costs, which in turn would allow them to sell their goods and services more cheaply.[40]

[39]Andrew Ching and Fumiko Hayashi. "Payment Card Rewards Programs and Consumer Payment Choice." (Federal Reserve Bank of Kansas City, Working Paper, May 13, 2008).

[40]Steven Semeraro. "The Reverse-Robin-Hood-Cross-Subsidy Hypothesis: Do Credit Card Systems Effectively Tax the Poor and Reward the Rich?" (Working Paper, San Diego, Calif., 2008).

Although Accepting Credit Cards Provides Benefits, Merchants Report Card Costs Are Increasing Faster and Their Ability to Negotiate or Lower These Costs Is Limited

Merchants can receive a wide range of benefits from accepting credit cards, and some merchants we interviewed reported receiving increased sales from credit cards. However, representatives of the large merchants with whom we spoke with said that their increased payment costs had not led to a corresponding increase in sales, particularly for cards with higher interchange fees such as rewards cards. In addition, these merchants reported that their ability to negotiate lower payment costs was limited by their inability to refuse popular network cards as well as network rules for card acceptance, which, among other things, preclude merchants from adding surcharges for credit card payments or rejecting higher-cost cards. Finally, although interchange fees are not regulated at the federal level in the United States, concerns regarding card costs have prompted DOJ investigations and private lawsuits, and authorities in more than 30 countries have taken or are considering taking actions to address such fees and other card network practices.

Merchants Reported Benefits from Credit Card Acceptance Include Increased Sales, Faster Payments, and Lower Labor Costs

Merchants can receive a variety of benefits—primarily, increased sales—from accepting credit card payments. Increased sales can occur for several reasons. First, a customer without sufficient cash can make a purchase immediately using a credit card, resulting in a sale that the merchant otherwise would not have made. In addition, some research has shown that, when not paying with cash, some customers may purchase more than they would have otherwise.[41] These researchers say the additional spending occurs because paying with a card can feel less like true spending to some consumers than paying with cash. Representatives of card networks and issuers also report that consumers with rewards cards spend more because they factor in the price of the rewards they receive from their issuing institution, which also results in greater sales than the merchants would otherwise have made. One researcher noted that the amount of additional sales merchants receive from accepting credit cards can be greater for certain businesses. Customers more commonly use credit cards for large purchases and for purchases that they might not be able to pay off right away. Several of the merchants we interviewed have seen some evidence that accepting credit cards has increased their sales. For example, representatives from a national discount store and a small home improvement store told us that customers paying with credit cards spent more than customers paying with cash or debit cards. A dentist told

[41]See, for example, Tom Brown and Lacey Plache. “Paying with Plastic: Maybe Not So Crazy.” *University of Chicago Law Review*, 73 (Winter 2006): 63-86

us that his patients spent more on procedures because of the credit that their cards provided.

Representatives of the card networks also told us that they also are able to increase merchant sales by providing merchants with customer information to enhance their marketing efforts. For example, representatives from one card network told us that they have specific staff tasked with organizing marketing campaigns targeted to particular merchants to increase the sales these merchants make from this network's cardholders. For example, if cardholders purchased particular items, their next billing statement would include offers for additional discounts on future purchases at specific merchants that accept their card that also sell such items. The networks reported that through their respective databases, they help merchants identify and better understand their prospective, current, and lapsed customers and employ a variety of niche marketing approaches that ultimately serve to increase sales.

Accepting credit cards also allows merchants to make sales on credit at a generally lower cost than operating their own credit program. As noted previously, individual merchants originally offered credit cards that could be used only at their stores, but many such merchant programs have been discontinued now that cards issued by third parties—banks, credit unions, and thrifts—are available. Card network and issuer staff told us that credit cards allow merchants to obtain sales from customers that want to finance their purchases over time without the merchants having to incur the costs involved with offering credit. For example, they said merchants avoid the costs of credit losses, debt collection, credit quality assessment, card production, and statement preparation.

Credit card acceptance benefits merchants in other ways. For example, merchants can receive faster and more certain payment from customers using cards than from customers using other means, such as checks. Receiving the funds from a check can take as long as 5 days, but merchants can receive the proceeds from card payments from their acquiring institution in 1 or 2 calendar days.[42] For example, the dentist we interviewed told us that his credit card payments are credited to his bank account the day they are processed, providing him almost immediate

[42]Even though the legal maximum generally is 5 days, banks make funds available from the majority of consumer check deposits within 1 business day, according to the Federal Reserve. Federal Reserve staff noted that this maximum will change in early 2010.

access to the funds. A small flower shop owner told us that she receives faster payments by credit card than from customers to whom she extends credit by sending a bill. Several of the merchant and banking organizations we interviewed also cited the certainty of credit card payments as a benefit to merchants. For example, the home improvement merchant noted that she preferred being paid by credit card to receiving bad checks. Similarly, a sports club owner reported that he prefers the guaranteed payment associated with accepting credit cards to the risks associated with accepting checks. Staff of an association that represents credit unions noted merchants that accept cards have less cash to handle and less risk of employee theft. Staff from a banking association noted that card acceptance reduces the need for merchants to make physical deposits, since card payments are settled directly with their financial institution. Economists have also documented the benefits of guaranteed payments to merchants.[43]

Card acceptance also can reduce the time merchants' customers spend at checkout and can reduce labor costs. For example, representatives of one large merchant told us that their analyses indicated that processing a check payment takes them an average of 70 seconds, processing a cash payment averages 51 seconds, and a credit card payment 32 seconds. Staff from card networks and card issuers told us that the efficiency of card payments has allowed merchants to reduce their staffing, thus saving on labor costs. For example, they noted that credit card customers at gas stations and other retail stores often can pay for purchases without necessarily interacting with an employee.

Large Merchants Report Rising Use of Rewards Cards Leads to Costs That Are Not Commensurate with Benefits

Despite the benefits of payment card acceptance, representatives of several of the large merchants we interviewed reported that their costs of card acceptance have increased disproportionately in comparison with benefits, in large part because of increasing card use. Several of the large merchants we interviewed reported that as a percentage of sales, payment cards are more expensive to process than cash and checks, a fact they explained reflects the technological advances in check processing as well as a competitive market for check-processing services. They also reported that even allowing for the operational and administrative costs associated with processing cash (such as armored cars and losses by theft), credit

[43]See, for example, Daniel D. Garcia-Swartz, Robert W. Hahn, and Anne Layne-Farrar. "The Move toward a Cashless Society: A Closer Look at Payment Instrument Economics," *Review of Network Economics*, 5 (2) June 2006.

card interchange fees result in credit card payments being more expensive for them overall. For example, staff from one large retail chain told us that for a $100 transaction, a credit card payment generally cost the company about 14 times as much to accept as cash. Other merchants reported that transaction costs for credit cards were two to four times more than their transaction costs for cash. Representatives from large national merchants also provided us with data showing that sales made with cash and checks have decreased in recent years, while sales made with credit cards—particularly those using high-interchange fee cards—have increased.

Although credit cards are supposed to generate increased sales for merchants in exchange for their acceptance costs, representatives of large merchants we interviewed told us that their card acceptance costs had increased faster than their sales. For example, a large home improvement retailer told us that although cards may have increased its sales in the past, this has not been occurring recently. According to its own analysis, the total cost the company has paid to accept MasterCard, Visa, American Express, and Discover cards combined increased by 16 percent from 2002 through 2008; however, sales for those same cards increased by only 10 percent during this period. Representatives of this merchant also told us that they had calculated that for every additional 1 percent their company has paid in card acceptance fees and costs, it has received 0.63 percent in additional sales. An official representing a large convenience store chain said that although he believes that a decade ago people may have spent more with credit cards than with cash or check because of the availability of credit, he no longer thinks that is true.

Several of the large merchants that we interviewed attributed their rising card acceptance costs to customers' increased use of rewards cards. Staff from these merchants all expressed concerns that the increasing use of rewards cards was increasing merchants' costs without providing commensurate benefits. For example, one large merchant provided us with data on its overall sales and its card acceptance costs. Our analysis of these data indicated that from 2005 to June 2009, this merchant's sales had increased 23 percent, but its card acceptance costs rose 31 percent. Rewards cards were presented as payment for less than 1 percent of its total sales volume in 2005 but accounted for almost 28 percent of its sales volume by June 2009. During this same period, sales processed on nonrewards cards fell by 43 percent. Several of the other large merchants we interviewed provided data that showed that the proportion of rewards cards presented as payment by their customers also had risen significantly in recent years. For example, representatives from one merchant said about 70 percent of payments on one network's cards transferred to rewards cards over the past 5 years, representing an increase in rewards cards use of 385 percent since rewards cards were introduced.

Further, several of the large merchants also told us that they do not always see correspondingly increased sales from rewards cards compared with other cards. For example, one large merchant provided us with data on its average purchase (ticket) size by payment means. According to our analysis of these data, in July 2005 the average ticket size for rewards cards transactions was around $203, but the average ticket size for nonrewards transactions was about $184—the average rewards card purchase exceeded a nonrewards purchase by $19, or about 10 percent, that month. However, during the 47 months from July 2005 through May 2009 for which data were available, the average ticket size for Visa rewards cards was lower than for nonrewards Visa transactions in 9 months—or about 19 percent of the time.

Although representatives from the card networks and issuers provided us with data indicating that rewards cardholders spent more than nonrewards cardholders, their analysis did not demonstrate that rewards cardholders spent more than they would have with other tender types, producing increased sales for merchants. The largest networks and issuers we interviewed provided data showing the total amount of spending by their rewards cardholders exceeded that of their nonrewards cardholders. One card network provided us with data that showed that according to its analyses, its three levels of rewards cards had higher average ticket amounts than its basic cards by over $4, almost $12, and over $26 for the highest level of rewards. However, other factors suggest that attributing increased sales to card use for merchants is difficult. For example, rewards cards generally have been offered to higher-income cardholders. Such cardholders might spend more than the average cardholder generally. Thus higher total spending on rewards cards by individual cardholders or increased ticket sizes for such cards may reflect only that those cardholders spend more in general, and not represent additional sales that a merchant otherwise would not have received. Similarly, higher total spending on rewards cards compared with spending on nonrewards cards could reflect that rewards cardholders tend to consolidate their spending on fewer cards—sometimes onto a single card—in order to maximize their ability to earn rewards. As a result, such cardholders may not be spending more overall but just limiting their payment methods. Furthermore, merchants may initiate other programs to increase sales. For example, representatives from a large national retailer told us that when the company started accepting credit cards, sales did increase, but they attributed this increase to the simultaneous introduction of promotions for their new products, and they did not feel that credit card acceptance added any proven incremental sales volume. This spending also may not represent additional sales to merchants. For example, some merchant officials and others told us that cardholders can buy only so much gas; they questioned whether cards actually increased gas station sales overall. Similarly, payments for certain other goods or services, such as taxes or business permits, are not likely to result in increased sales.

In addition, some of the large retailers and merchant trade associations told us that one of the reported benefits of credit card acceptance—guaranteed payment—was not always provided to merchants. These representatives also noted that merchants received significant amounts of chargebacks—in which the card issuer subtracted amounts previously credited to the merchant. Such chargebacks can occur either because of fraud or when the customer alleges that the goods were not as described or were never received. However, some of the merchants noted that researching such instances to have the charged amount reinstated is a labor-intensive process. As a result, some told us they had established minimum amounts under which they would not attempt to research and justify a charge. According to data provided by one large issuer, chargebacks as a percentage of sales on one network's cards ranged from 0.1 percent to 0.2 percent from December 2006 through June 2009.[44]

Merchants also reported bearing costs for fraud detection and prevention—another reported benefit of credit card acceptance. For example, the increased prevalence of computer hacking incidents in which criminals obtained unauthorized access to cardholder data prompted the card industry to develop the Payment Card Industry Data Security Standard.[45] According to merchants, the card networks have also mandated compliance with these standards, and merchants that fail to meet them are subject to higher interchange fees and fines of $25,000 or more. Although merchant officials acknowledged that such standards are necessary, they noted that they have had to incur significant expenses to comply with them. For example, representatives from one large merchant

[44]According to the issuer, these data reflect chargebacks that were accepted by the network, but not those that were rejected or adjudicated.

[45]These requirements include installing and maintaining systems to protect cardholder data; not using vendor-supplied defaults for system passwords and other security parameters; protecting stored cardholder data; and encrypting transmission of cardholder data across open, public networks.

told us their company spent around $20 million initially to become compliant with these data security standards and has had to spend about $4 million annually to maintain that certification. Officials from another large retailer said their company also has spent millions of dollars becoming compliant with these standards. However, they said that their company has advocated increased data security for years, but noted that instead of just increasing costs for merchants to secure card information, the card networks should be developing payment types that are more secure. For example, several merchants we interviewed noted that other countries are moving away from cards that store sensitive data on magnetic stripes on the cards, which can be duplicated by criminals to create counterfeit cards, and instead are implementing cards that require the user to enter a PIN, which merchant representatives told us is more secure.

The small merchants we interviewed generally had mixed views about interchange fees and the overall cost of card acceptance. Some merchants, such as the owners of a private golf course and a flower shop, respectively, chose not to spend as much time examining their payment costs because the costs had remained either relatively constant or had not risen significantly in recent years. Finally, a few merchants noted they considered these fees as simply part of the cost of doing business.

Although Able to Negotiate to Lower Some of Their Card-Processing Costs, Merchants Reported Limited Ability to Negotiate Lower Interchange Fees

Increased competition for acquiring services provides merchants with considerable choice and opportunities to negotiate and lower some of their card acceptance costs. As noted previously, the merchant discount fee that merchants pay to acquiring institutions has two components: the interchange fee—which represents the bulk of the total discount fee—and the processing costs. Hundreds of financial institutions and other firms compete as acquirers to provide card-processing services. Staff from merchants, issuers, and card networks told us that the acquiring market is competitive. According to a 2007 report published by the Federal Reserve Bank of Philadelphia, approximately 1.4 million merchants change acquiring institutions each year.[46] This report stated that this is the result of the merchants seeking lower prices for acquiring services and better services. According to acquirers and merchants we interviewed, acquirers provide customized acquiring services based on processing volume.

[46]Ann Kjos, "The Merchant-Acquiring Side of the Payment Card Industry: Structure, Operations, and Challenges," Federal Reserve Bank of Philadelphia (October 2007).

Acquirers attract new merchant clients by pricing their services competitively and offering a variety of services to meet merchants' needs.

Merchants Reported Acquirers Competed for Their Business and Ability to Decrease Acquiring Fees

The competition among acquirers gives merchants the opportunity to choose among competing acquirers and negotiate lower costs. Merchants of varying sizes that we interviewed reported that they have multiple acquiring institutions and processors competing for their business and have been able to successfully decrease the acquiring fee portion of their merchant discount fees in recent years. For example, several large merchants told us they periodically issue requests for proposal soliciting bids for acquiring services and receive several responses. However, some of the largest merchants told us their choice of firms that can provide them with adequate cost-processing services is generally limited to only some of the largest providers of acquiring services.

Small merchants may choose among numerous firms for processing services, including their own financial institutions. Eight of the nine small merchants we interviewed reported getting solicitations—some frequently—for their acquiring business or have shopped their acquiring business. Several of the small merchants with which we spoke used third-party processors for electronic payments. Merchants formed these business relationships with acquirers and processors through their own research, through agreements with their financial institutions, and through direct solicitations. Also, small merchants can find competitive providers on the Internet; for example, a warehouse store partners with a third-party processor to provide this service to small merchants.

Merchants Report Limited Ability to Negotiate with Networks to Lower Majority of Card Acceptance Costs

Although merchants have reported success in negotiating their acquiring costs, several of the merchants we interviewed told us that their ability to lower their interchange fee costs was limited. These merchants told us they generally paid the rates listed in the Visa and MasterCard networks' default interchange fee schedules. Although the ability to refuse to accept Visa and MasterCard should provide merchants with the leverage to negotiate lower interchange fees, merchants reported that they could not refuse to take such cards because of customer demand. For example, several merchants told us that if they did not accept credit cards from Visa or MasterCard, their sales would decrease and they would lose business to competitors that did accept those cards.

Merchants told us that without the ability to refuse to take the two largest networks' cards, their attempts to negotiate lower fees for these networks' cards generally have not been successful in obtaining meaningful reductions in their interchange fees. According to staff from Visa and

MasterCard, their networks are willing to negotiate with merchants. For example, officials from one network told us that their network has negotiated with merchants with sales that represent 26 percent of its overall processing volume. Only one of the large merchants we interviewed told us that the company had received a limited and temporary reduction in its interchange fee costs as a result of negotiations with Visa or MasterCard following the settlement of a lawsuit.[47] Two of the merchants we interviewed told us that they could receive reductions in interchange fee rates on one network's card if they did not accept another network's card. Other merchants told us that such negotiations were difficult for their businesses, because they had limited control over which type of credit card a customer would choose to use for a purchase.

Merchants we interviewed told us that other opportunities that Visa, MasterCard, and their issuers offered to merchants to reduce interchange fees generally have had limited success. For instance, merchants can create a co-branded card. In exchange for promoting the co-branded card, the merchant could receive compensation from the issuer or network or reduced interchange fees. However, merchants we interviewed told us that they have had limited success with co-branding because they had difficulty encouraging their own customers to switch to these cards. For example, representatives from several grocery store chains said that they have had difficulty getting customers with six to eight credit cards in their wallet to add an additional one for sales in their stores. They said that they would have to offer customers rewards to compete for purchase volume with the other cards. In addition, an owner of a convenience store chain started offering a co-branded card in 2002. He said that his stores issued a total of 2,500 cards in 7 years although the issuing financial institution anticipated that the convenience store would issue 10,000 cards annually; he told us that the rebates these cards offered—a 2-percent rebate at their stores, 1 percent on purchases elsewhere—were not competitive to his customers. Similarly, officials from a large national retailer told us that less than 1 percent of their sales were on their co-branded card. Smaller merchants we interviewed generally did not have relationships with issuers and networks. Representatives of issuers told us that the fact that merchants chose to enter into co-branded relationships was evidence that merchants receive greater sales and value from these programs.

[47]Determining the extent to which merchants are able to negotiate over interchange fees is difficult, as at least one merchant we interviewed did not provide us with details of the company's negotiations with the major card networks, citing contract provisions.

In contrast to Visa and MasterCard, American Express and Discover generally act as their own acquirers and negotiate directly with the merchants accepting their cards. For example, representatives from American Express told us they negotiate a merchant discount rate directly with merchants for 1 to 5 year terms. While technically each merchant has a separate contract and rate, American Express officials noted that for many types of merchants, a standardized rate applies depending on transaction volume, with higher-volume merchants likely to pay less. The Discover card network conducts direct negotiations with large merchants and sets the merchant discount rates based upon these negotiations rather than publishing a schedule. Both the networks also use third-party acquirers that negotiate with the smaller merchants on behalf of their networks. As discussed previously, these networks have a lower market share than Visa and MasterCard, so merchants have greater ability to refuse to take such cards and a greater ability to negotiate costs and terms. Representatives of two of the grocery store owners we interviewed said that they had greater success in negotiating with American Express and Discover because these networks had lower market share and were trying to gain wider acceptance.

Merchants View Network Rules as Further Limiting Their Ability to Negotiate Payment Costs

Another factor that limits the leverage that merchants have to negotiate lower interchange fees are the card network rules. Each of the major card networks—Visa, MasterCard, American Express, and Discover—has various card acceptance rules that limit the options that merchants have for accepting or denying cards.[48] These rules include the following:

- No surcharges: Merchants may not impose a surcharge on consumers for the use of credit cards or cards with higher interchange fees.
- Honor all cards: Merchants are required to accept all credit cards within a network's brand.
- No discrimination/differentiation: Merchants may not differentiate between cards within a network or discourage the use of cards within a network.

[48]Not all of the networks have each of these rules, but if a merchant accepts cards from each of these networks, the merchant is subject to all of them. Visa, MasterCard, and American Express have posted some of their rules on their Web sites; Discover's rules are not available online.

- No minimum or maximum charges: Merchants may not impose a price floor or price ceiling on credit card transactions.
- Preferred treatment: Merchants may not direct consumers away from or to a certain network's cards.

Merchants, some academic researchers, and merchant representatives argue that these rules constrain merchants' ability to limit the costs of credit card acceptance. For example, without the ability to surcharge for credit cards generally, for a particular network's cards, or for higher interchange fee cards, merchants are unable to steer customers toward lower-cost forms of payment or recoup some of their costs for higher-cost cards. In addition, without the ability to influence customers' payment choices, merchants are unable to use their influence with the networks to encourage them to lower interchange and other fees in general, or offer more lower-fee cards. Merchants also told us that the rule requiring them to accept all cards from a network means that they are forced to accept higher-cost cards. Some of the merchants with which we spoke told us that the inability to set minimum credit card purchase amounts meant that they sometimes incurred card-processing costs that made some sales uneconomical. For example, one merchant told us that when a customer pays for a small item, such as a newspaper or a pack of gum, with a rewards card, the costs to process the transaction could exceed profit on the item. The rules provide cardholders with the ability to use any card at any accepting merchant. However, cardholders may not realize that different cards can affect merchant costs to different degrees because merchants cannot take actions that either limit cardholders' ability to use certain cards or otherwise differentiate among cards.

Representatives of issuers and card networks told us that the network rules are designed to promote the wide acceptance of their cards and ensure that their cardholders have a positive experience with the card. For example, they told us that the "honor all cards" rule ensures that merchants will accept all cards from a particular network brand, which ensures that even the cards from smaller, lesser-known issuers such as credit unions and small banks are accepted. Issuers and card network representatives also told us that surcharges are illegal in some states and would diminish cardholders' expectations for the use of their card.[49] They

[49]The states that prohibit surcharging for credit cards include California, Colorado, Connecticut, Florida, Kansas, Maine, Massachusetts, New York, Oklahoma, and Texas.

said that such prohibitions were intended to eliminate bait-and-switch tactics, in which merchants would advertise a low price, only to increase it at the point of sale if the customer used a credit card.

Although the United States Does Not Regulate Interchange Fees, Card Cost Concerns Have Prompted Investigations, Lawsuits, and Actions in Other Countries

Interchange fees are not regulated at the federal level in the United States. The Federal Reserve, under TILA, is responsible for implementing requirements relating to the disclosure of terms and conditions of consumer credit, including those applicable to credit card fees.[50] The various depository institution regulators—Federal Reserve, OCC, FDIC, Office of Thrift Supervision, and National Credit Union Administration—conduct examinations that can address how banks, thrifts, and credit unions that issue credit cards are complying with the TILA card disclosure requirements.[51] However, Federal Reserve staff told us that because interchange fees are paid by merchants' financial institutions and not directly assessed to consumers, such fees are not required to be disclosed to consumers. Staff from some of the banking regulators told us that they do not review the level at which interchange fees are set during their examinations, but instead review interchange fees as a revenue source for the institutions or the effect they may have on the financial stability of the issuer. Additionally, through the Federal Financial Institutions Examinations Council, the regulators also conduct annual examinations of the card networks to ensure that these entities are adequately managing the operational risks involved with card processing to ensure that such operations are conducted so as to reduce the potential for them to create financial problems for their institutions. Such examinations are done as a part of a program to review the activities of vendors or processors that provide services to depository institutions. Regulator staff told us that their oversight does not involve assessing how the networks set interchange fees.

Although no U.S. entity specifically regulates credit card interchange fees, card networks' practices can be subject to regulatory action by authorities responsible for enforcing competition laws. In the United States, DOJ and FTC have jurisdiction over credit card networks and issuers as part of enforcing U.S. antitrust laws or the Federal Trade Commission Act. As a

[50]See Federal Reserve Regulation E, 12 C.F.R. Part 226. TILA is set forth in Title I of the Consumer Credit Protection Act. See 15 U.S.C. § 1601, et. seq.

[51]FTC generally has responsibility for enforcing TILA and other consumer protection laws for credit card issuers that are not depository institutions.

result, DOJ and FTC can investigate if the imposition of interchange fees or other network or issuer practice constitutes an anticompetitive or unfair business practice prohibited by these laws.

The card networks' practices, including interchange fees, have been the subject of past and current investigations under these laws. As discussed previously, in 1998, DOJ sued Visa and MasterCard for alleged antitrust violations regarding, among other things, how these networks' rules in effect prevented issuers from issuing cards on their competitors' networks.[52] The court found that Visa's and MasterCard's "exclusionary rules," which prohibited member institutions from issuing cards by Discover and American Express, were a substantial restraint on competition in violation of the Sherman Act. Although the networks' imposition of interchange fees was specifically not the subject of the DOJ action, the trial court concluded that Visa and MasterCard had market power in the market for network services, citing large market shares in a highly concentrated market.[53] DOJ officials reported that they currently have another investigation under way in which they have been reviewing whether some of the networks' rules are anticompetitive. As discussed earlier, these rules include those that prevent merchants from steering customers to other forms of payment, levying surcharges for card transactions, or discriminating against cards by type. DOJ staff told us they have requested information from American Express, Discover, MasterCard, and Visa as part of this investigation. They were not able to provide an estimate for when any formal action resulting from the investigation might occur.

Interchange fees and other card network practices also have been the subject of private lawsuits. Since the mid-1980s, various lawsuits alleging problems with interchange fees and other card network practices have been litigated, as described in table 3.[54] As of September 2009, a class action was pending in the United States District Court for the Eastern District of New York, in which merchants claim that interchange fees have an anticompetitive effect that violates the federal antitrust laws. This case

[52]See United States v. Visa U.S.A., Inc., 344 F.3d 229 (2d Cir. 2003), aff'g, 163 F . Supp. 2d. 322 (S.D.N.Y. 2001) and cert. denied, 543 U.S. 811 (2004).

[53]344 F.3d at 240.

[54]For more information on these cases, see GAO, *Credit and Debit Cards: Federal Entities Are Taking Actions to Limit Their Interchange Fees, but Additional Revenue Collection Cost Savings May Exist*, GAO-08-558 (Washington, D.C.: May 15, 2008), 56.

is a consolidation of at least 14 separate lawsuits against Visa and MasterCard and their member institutions that had been in four separate districts.[55]

Table 3: Litigation Involving Card Network Practices

Date	Issues involved in litigation	Outcome
Mid-1980s	NaBanco–a third-party credit card processor—alleged that interchange fees constituted unlawful price fixing and had an anticompetitive effect.[a]	The court ruled that NaBanco failed to prove that the interchange fee at issue was an unlawful restraint of trade.
1993	In re Visa Check/Mastermoney Antitrust Litigation (Wal-Mart case)–Visa and MasterCard rules requiring merchants to accept debit cards as a condition of accepting credit cards were challenged by merchants as unlawful tying and devices to impose anticompetitive interchange fees.[b]	The case was settled in December 2003.
1998	DOJ case–Action included claim that Visa and MasterCard violated the Sherman Antitrust Act by enforcing their respective versions of a rule barring their member institutions from issuing American Express or Discover cards.[c]	The court found Visa's and MasterCard's exclusivity rules were a restraint on competition in violation of the Sherman Act.
2008	Kendall Decision—Merchants alleged that the defendants (Visa, MasterCard, Bank of America, Wells Fargo Bank, and U.S. Bank) conspired to set merchant discount fees and interchange fees in violation of Section 1 of the Sherman Act and Section 16 of the Clayton Act.[d]	The claim was dismissed because it failed to allege facts sufficient to establish a conspiracy.

Sources:

[a]National Bancard Corp. v. Visa U.S.A., Inc. 596 F. Supp. 1231 (S.D. Fla. 1984), aff'd, 779 F.2d 592 (11th Cir. 1986).

[b]In re Visa Check/Mastermoney Antitrust Litig., 396 F.3d 96 (2d Cir. 2005), aff'g 297 F. Supp. 2d 503 (E.D.N.Y., 2003).

[c]United States v. Visa U.S.A., Inc., 344 F.3d 229 (2d Cir. 2003), aff'g, 163 F . Supp. 2d . 322 (S.D.N.Y. 2001), Cert. Denied, 543 U.S. 811 (2004).

[d]Kendall v. Visa U.S.A., Inc., 518 F.3d 1042 (9th Cir. 2008), aff'g 2005 U.S. Dist. LEXIS 21450 (N.D. Cal., July 25, 2005).

[55]In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, 2006 U.S.Dist. LEXIS 45727; 2006-1 Trade Cas. (CCH) P75,278 (E.D.N.Y.).

While interchange fees are not regulated in the United States, as of September 2009, more than 30 countries have acted or are considering acting to address competition or card cost concerns involving payment cards.[56] Some actions taken by these countries include the following:

- regulating relationships between merchants and issuers and card networks, such as prohibiting card networks from imposing certain rules on merchants;
- establishing maximum interchange fees or capping average interchange fees;
- allowing more institutions to enter the credit card market by changing the requirements to allow more institutions to qualify to act as issuers or acquirers; and
- conducting investigations into the functioning of the payment card market, including legal antitrust proceedings.

History of Credit Interchange Fee Reform in Australia

After a government study reported that interchange fees were above levels that could be justified, the Reserve Bank of Australia (RBA) took various actions, beginning with capping the average interchange fees Visa and MasterCard charged. In 2003, Visa and MasterCard were required to reduce their interchange fees from a weighted average of about 0.95 percent to about 0.5 percent and to eliminate rules restricting merchants' ability to impose surcharges for credit cards, In addition, beginning in 2007, these networks had to allow merchants to accept only credit or debit cards from a network, and allow merchants to steer their customers toward lower-cost forms of payment. Credit card payments have continued to grow, but at a slower rate than before these changes, as more consumers switched to debit cards. RBA studied the impact of these reforms and issued a report in September 2008 in which regulators concluded that the reform program had achieved its main objectives of improving competition in the payment card market and providing consumers with more information about the costs of various types of payment. In August 2009, RBA issued a statement that it would continue to regulate interchange fee rates at 0.5 percent.

For example, authorities in Australia have taken various actions regarding credit card interchange fees and other card network practices since 2003 (see sidebar). In recent years, the European Commission has undertaken proceedings against card networks and set caps on cross-border interchange fees—those applying to card transactions in which a card issued in one country is used to make a purchase in another country—that affect transactions occurring in 31 European countries.[57] In 2007, the New Zealand Commerce Commission initiated proceedings against Visa and MasterCard and issuers of their cards that alleged price-fixing in the setting of fees. This resulted in an August 2009 settlement that included various actions affecting Visa cards, including directing acquirers and issuers to bilaterally negotiate interchange fees instead of having the

[56]Federal Reserve economists and others report that these countries include Argentina, Australia, Austria, Brazil, Canada, Chile, Colombia, Denmark, Finland, France, Germany, Hungary, Israel, Italy, Mexico, New Zealand, Norway, Panama, the People's Republic of China, Poland, Portugal, Romania, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom, as well as others in the European Commission. See Terri Bradford and Fumiko Hayashi, "Developments in Interchange Fees in the U.S. and Abroad" (Payments System Research Briefing, Federal Reserve Bank of Kansas City, April 2008) and GAO-08-558.

[57]These countries are part of the European Economic Area, which includes the 27 members of the European Union as well as the members of the European Free Trade Association (Iceland, Liechtenstein, Norway, and Switzerland).

network set them, removing that network's "no surcharge" rule and "no steering" rules, and allowing nonbank organizations to participate in the market as issuers or acquirers. Other countries are considering taking actions. For example, in June 2009, Canada's Standing Committee on Banking, Trade and Commerce reported the results of an investigation into this market, and recommended a number of actions, including permitting merchants to surcharge and steer customers toward low-cost payment methods, requiring merchants to disclose interchange fees to consumers, and prohibiting card networks' "honor all cards" rules.

Although Various Options to Lower Interchange Fees Exist, Impacts on Cardholders Could Be Mixed and Each Option Has Implementation Challenges

Concerns about the rising costs of card acceptance for merchants have led to regulatory measures in some foreign jurisdictions and legislative initiatives in the current U.S. Congress. These options generally have involved one or more of the following approaches: (1) setting or limiting interchange fees; (2) requiring their disclosure to consumers; (3) prohibiting card networks from imposing rules on merchants, such as those that limit merchants' ability to discriminate among different types of cards or levy a surcharge for credit cards; and (4) granting antitrust waivers to allow merchants and issuers to voluntarily negotiate rates. Industry participants and others cited a variety of advantages and disadvantages associated with each option and suggested that the categories of stakeholders—such as merchants or issuers or large merchants versus small merchants—would be affected differently. They also noted that, in some cases, the ultimate impact of the option was not clear. A more detailed discussion of industry participants and others' views on the merits of each of the options can be found in appendix II.

Each of these options is designed to lower merchants' costs for card acceptance. For example, setting or capping interchange fees would limit the amount of interchange fees charged to merchants. Both RBA and the European Commission have used this approach, and regulators in other countries have worked with Visa and MasterCard to voluntarily reduce their interchange rates. Requiring the disclosure of interchange fees could lower merchants' fees if consumers changed their behavior after seeing the different costs associated with different forms of payment, and shifted from higher-cost forms of payment such as rewards and other credit cards toward less expensive forms of payment, such as debit cards. The option to eliminate certain network rules, such as the no-discrimination or no-surcharge rule, could allow merchants to either refuse to accept higher-cost cards or receive additional revenue from the consumer to help cover the costs of the interchange fees.[58] For example, a study of surcharging in the Netherlands reported that when merchants placed a surcharge on payment cards, customers there used that form of payment less often.[59] The ability to take these actions could provide merchants with bargaining power to more effectively negotiate with the card networks and issuers over interchange fee rates, even in merchants did not exercise this ability. Refusing to take certain cards issued by a network, such as those with higher interchange fees, could prompt networks and issuers to reduce the prevalence of such cards. Direct negotiation between merchants and issuers under an antitrust waiver also could grant merchants increased bargaining leverage in negotiating interchange fee rates and terms, with a goal of lower costs to merchants.

If interchange fees for merchants were lowered, consumers could benefit from lower prices for goods and services, but proving such an effect is difficult, and consumers may face higher costs for using their cards. With lower card acceptance costs, merchants may pass on their interchange fee savings through lower prices to consumers; however, the extent to which they would do so is unclear.[60] As discussed previously, consumers—even those paying with cash and by check—may be paying higher prices because of merchants' increased costs of interchange fees. By capping interchange fees, RBA estimates that fees to merchants were lower by about 1.1 billion Australian dollars for the period of March 2007 through February 2008, but officials acknowledged that it would be very difficult to provide conclusive evidence of the extent to which these savings have resulted in lower retail prices because so many factors affect such prices at any one time. Moreover, the degree of savings depends on whether or not merchants are increasing their prices because of higher interchange fee costs. Some merchant representatives we interviewed told us that merchants would take different steps to improve customer service if interchange fees were lowered, such as hire more employees. Customers

[58]Use of this option would have to be reconciled with state laws that, as previously noted, prohibit surcharges on credit card use.

[59]See Wilko Bolt, Nicole Jonker, and Corry van Renselaar, "Incentives at the Counter: An Empirical Analysis of Surcharging Card payments and Payment Behaviour in the Netherlands," (Working paper, De Nederlandsche Bank, December 2008).

[60]Federal Reserve economists noted that the extent to which merchants would pass on their interchange fee savings likely would depend on the competitiveness of the markets in which the merchants operate.

also may not experience lower prices if merchants' overall costs do not decrease. Several industry participants speculated that if merchants were allowed to refuse higher-cost cards, merchants would lose sales from customers using premium credit cards, who, network and issuer officials told us, spend more than customers using basic credit cards. A study of the Australian reforms by several economists reported that because the actual decrease in merchant costs was very small, merchants may have hesitated to lower prices, especially when their other costs might have been changing.[61]

Lowering interchange fee revenues for issuers could prompt issuers to increase cardholder costs or curtail cardholder credit availability. In Australia, issuers reduced rewards and raised annual fees following that country's interchange fee cap. In addition, with less interchange fee income, representatives of smaller issuers such as community banks and credit unions told us that they likely would not offer rewards cards and therefore would be unable to compete with the larger issuers in the market. One credit union official told us that the credit union could not offer credit cards because of the expense involved with running such a program. In addition, representatives of credit unions and community banks we interviewed said that they benefited from a network system that developed interchange rates to attract both merchants and issuers. Allowing merchants to refuse certain cards or negotiate rates directly with the issuers would eliminate smaller institutions from the process. Representatives of larger issuers told us that with less revenue from interchange fees, they would consider reducing the amount of credit they make available to their cardholders. Australian officials reported that since their reforms were instituted, the number of credit card accounts in Australia has continued to increase and smaller credit unions have remained in the credit card business, albeit with some of their operations outsourced.

Each of these options for lowering card fee costs presents challenges for implementation that would need to be overcome. For example, if interchange fees were capped or limited, an oversight agency or organization would have to be designated to determine how and to what level such fees should be set. In addition, economists and other

[61]See Howard Chang, David S. Evans, and Daniel D. Garcia-Swartz, "The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia," *Review of Network Economics*, 4(4). December 2005, 328-358.

researchers noted that determining an optimal level that effectively balances the costs and benefits among the networks, issuers, merchants, and consumers would be very difficult to do. When Australian officials set their interchange fee cap, they did so based on their assessment of the benefits and costs of different payment methods, but they also told us that many years of data would be needed to determine the effectiveness of the rate cap. If interchange fees were disclosed to consumers, issuers and merchants said that consumers might find the additional information confusing, and some merchants said that their cashiers might not be able to clearly communicate the correct interchange fee for the specific transaction. For the option that would allow merchants to discriminate among cards and add a surcharge for more expensive credit card transactions, merchants said that it would be difficult for them to determine which cards carry higher interchange rates.[62] Finally, the proposal to allow merchants to directly negotiate with issuers raised several issues from the industry participants we interviewed. They said that such negotiations could harm small merchants and small issuers, which do not have as much leverage as larger participants and, in some cases, lack the resources to participate in bargaining sessions. In addition, prudent exercise of this option would require an exemption from federal antitrust laws, which include provisions designed to protect consumers from the consequences of agreements in restraint of trade. DOJ officials have expressed their historical opposition to efforts to create exemptions to antitrust laws, stating that these exemptions should be used only in the rare instances in which a public policy objective compellingly outweighed free market values.

Although each option had advantages and disadvantages and difficulties in implementation, removing the networks' antisteering rules and restricting interchange fees with a cap or other limit were the two options that appeared to receive the most support from the large and small merchants and merchant trade associations with which we spoke. Removing the antisteering rules appears to have various advantages, including providing merchants with the ability to send signals to cardholders about which cards increase merchant acceptance costs, a change that could improve merchants' leverage in negotiating their payment costs. Merchants' ability to surcharge or refuse certain cards also could cause cardholders using rewards cards to be more aware of and to bear more of the cost of the

[62]As discussed earlier, Visa and MasterCard allow issuers to upgrade a card to a rewards status with higher interchange fee without issuing the cardholder a new card.

rewards from which they currently benefit. This option also may require the least intervention, as merchants could decide whether to add surcharges or refuse certain cards based on their own customer mix. In addition, the potentially anticompetitive effects of these rules are also the subject of the current DOJ investigation and some of the private lawsuits. A significant advantage of capping or limiting interchange fees would be that it would reduce interchange fee costs most directly. The experience in Australia indicates that this option does lower merchant costs and Australian regulators and merchant representatives insist that consumers have also benefited, arguing that merchants in competitive markets generally lower prices. The main challenges to implementing this option are determining the right level of reduction, such as capping interchange rates at a level below that of rewards cards, and tailoring the change to avoid unintended effects on other networks or on smaller issuers.

Agency Comments and Our Evaluation

We provided a draft of this report to the Department of Justice, the Board of Governors of the Federal Reserve, the Federal Trade Commission, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision for their review and comments. Through informal discussions, staff from DOJ, the Federal Reserve, Federal Deposit Insurance Corporation, and the National Credit Union Administration noted the quality of the report. Each of these agencies, as well as the Office of the Comptroller of the Currency and the Office of Thrift Supervision, also provided technical comments that were incorporated where appropriate. Federal Trade Commission staff noted they had no comments on the report.

We are sending copies of this report to interested congressional committees and members, the Department of Justice, Federal Trade Commission, Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and other interested parties. In addition, this report will be available on our Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact me at 202-512-8678 or cackleya@gao.gov. Contact points for our Office of Congressional Relations and Office of Public Affairs can be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix III.

Alicia Puente Cackley

Alicia Puente Cackley
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

Our objectives were to describe (1) how the fees merchants pay for accepting credit cards have changed over time and the factors affecting the competitiveness of the credit card market, (2) how credit card competition has affected consumers, (3) the benefits and costs to merchants of accepting cards and their ability to negotiate those costs, and (4) the potential impact of various options intended to lower merchant card fee costs.

To assess how the fees merchants pay for accepting credit cards have changed over time, we reviewed relevant literature and analyzed available data on interchange fee rates provided by Federal Reserve staff, a large merchant, and a large credit card processor. To describe the factors affecting the competitiveness of the credit card market, including how credit card competition has affected consumers and merchants, we summarized economic and other academic literature. Our literature review built upon key studies to which experts we interviewed referred and which we found by reviewing research databases such as Econlit and through general Internet searches. In our literature review, we sought to summarize a diverse body of literature that described various views on the economics and policy implications of interchange fees. We also interviewed representatives and analyzed data from the four major credit card networks (American Express, Discover, MasterCard, and Visa) and several banking and acquiring trade associations, the members of which include large and small institutions that participate in the credit card system: the American Bankers Association, the Electronic Transfer Association, the Independent Community Bankers of America, the Credit Union National Association, and the National Association of Federal Credit Unions. In addition, we conducted interviews and analyzed data from three of the largest credit card issuers as measured by total outstanding credit card loans, as of December 31, 2007, in the *Card Industry Directory* and three of the largest credit card acquirers in the United States.[1] We also met with representatives of several small credit unions and community banks that issue credit cards. However, public information on interchange fee revenue, card issuers' costs, and other quantitative data from card networks and issuers is limited and ongoing litigation limited these entities' ability to share such information with us.

[1] *Card Industry Directory: The Blue Book of the Credit and Debit Card Industry in North America*, 20th ed. (Chicago, Ill., 2008)

To learn more about merchants' costs for accepting credit cards, we consulted relevant literature and interviewed and reviewed payment cost data provided by several merchant trade associations, large national retail merchants, and small merchants from two local Chambers of Commerce. We met with officials from the National Retail Federation, the National Grocers Association, the Food Marketing Institute, the National Association of Convenience Stores, the Retail Industry Leaders Association, and the Small Business and Entrepreneurship Council. We met with representatives of 10 of the largest retail merchants in the United States; 8 of these represented 42 percent of the wholesale and retail trade industries listed in the S&P 500 in 2008, as well as one privately owned large company and one publicly traded large company that were not listed on the S&P 500. We selected the wholesale and retail categories because merchants in these industries accept and receive payments from consumers. We also selected small merchants to interview from the Washington, D.C., and Springfield, Virginia, Chambers of Commerce. These merchants represented a diverse group of businesses, including boutique shops, sports clubs, and a health care professional. In addition, we interviewed representatives of other organizations from across the country that accept payments from consumers, including hospital owners, utility companies, and a city government official. Although we selected merchant representatives to provide broad representation of merchant experiences with accepting credit cards, their responses may not be necessarily representative of the universe of small and large merchants. As a result, we could not generalize the results of our analysis to the entire market for merchant experiences with accepting credit cards and paying interchange fees. Where possible, we obtained information from card networks about benefits to merchants.

To describe the regulation of interchange fees both in the United States and in other countries, we met with officials from the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. We also reviewed studies of the impact of interchange fee reforms in other countries, and interviewed officials from the Reserve Bank of Australia on their actions related to interchange fees because Australia was one of the first countries to act, and sufficient time has passed to allow information on the impact of their actions to be available. To discuss federal antitrust activities, we interviewed officials from the Department of Justice and the Federal Trade Commission and updated our summary of major federal antitrust actions surrounding interchange rates from our 2008 report. Our interviews with industry participants, academics, and regulators also provided us with an understanding of the potential impact of various proposals to lower interchange fees.

Quantitative information used in this report was attributed to its source and supported by other corroborative evidence, such as industry sources, federal regulatory data, or interviews. In some instances we were able to do some testing of the data. We believe that these data are sufficiently reliable for the purposes of showing general trends in the credit card industry and merchant experiences with accepting credit card payments.

We conducted this audit in Washington, D.C., from May 2009 to November 2009, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Review of Options to Regulate Interchange Fee Rates and Terms of Credit Card Acceptance

Option 1: Limiting or Capping Interchange Fees

Options to address increasing costs of interchange fees include setting or limiting interchange fees, with the intent of lowering costs for merchants and, potentially, consumers. For example, a regulatory agency could cap interchange fees at a single rate or an average rate or work with industry participants—such as networks, issuers, and merchants—to decrease the fees. Some countries have limited interchange fees using such methods. The Reserve Bank of Australia (RBA) has set a limit under which the weighted average of MasterCard and Visa interchange fees must fall. The European Commission recently reached an agreement with MasterCard that limits the average interchange fees that it can charge for cross-border transactions (purchases made in one country using a credit card issued in another) in the European Union. In addition, governments in other countries, such as Mexico, have worked with industry participants to voluntarily decrease interchange fee rates.[1]

Merchants could realize lower costs if interchange fees were limited.[2] As discussed previously, many merchants are concerned that their interchange fee-related expenses have increased significantly in recent years. Some merchants in very competitive industries, such as retail and gas stations, told us that because they were unable to increase prices to cover increases in their interchange fees, their slim profit margins had further decreased in recent years. A representative of one franchise told us that even if interchange fees were capped at their current rates, this cap would help ensure long-term profitability.

Furthermore, consumers might benefit if merchants passed on their savings through lower prices. However, many industry participants acknowledged that it would be difficult to prove a direct link between lower interchange fees and lower consumer prices. Merchants and representatives of merchants in the retail industry have argued that because retail is one of the most competitive industries, retailers would have to lower prices if their interchange fee-related costs decreased. However, other industries may face pricing constraints. For example, representatives of two utility companies told us that they could not change

[1]For a discussion of changes in Australia, Israel, and Mexico, see GAO-08-558.

[2]Overall merchant discount fees may not decrease if card networks, issuers, or acquirers respond to decreased interchange fees by increasing other fees that make up total merchant discount fees. In addition, American Express and Discover do not have interchange fees. However, representatives of both card networks told us that that fee limits likely would affect them indirectly because they would have to decrease their merchant discount fees to compete with the other card networks.

their prices without first getting approval from their respective regulatory bodies. Several economists have argued that the ability of merchants to pass on their savings from lower interchange fees would depend heavily on the respective merchants' size and market share, as well as other factors. While the amount of the price reduction might depend on these factors, some studies have demonstrated that a reduction in retailer costs in the competitive gasoline industry can lead to savings for consumers.[3] The Reserve Bank of Australia has estimated that savings to Australian consumers from decreased interchange fees and other interchange reforms likely exceeded 1.1 billion Australian dollars for the period of March 2007 to February 2008, but officials acknowledged that it would be very difficult to provide conclusive evidence of these savings. Others have argued that Australian merchants have not passed savings on to consumers, some of them citing economic literature that argues that such a reduction in merchant costs would not affect retail prices very quickly, even in the context of extensive competition.[4]

In contrast, limiting interchange fees could decrease the interchange revenues of issuers, but the impact on issuers would depend largely on the way in which the option is implemented. For instance, if an interchange fee cap were set at a level significantly below the current rates and applied to all interchange fees charged, then all issuers could be affected. But a cap also could be set at a relatively high rate, such as at the maximum rate for standard credit cards, or certain issuers could be excluded from the regulation. Card issuers, especially small issuers, oppose any option that would decrease their interchange fee revenues significantly. According to some industry participants, smaller issuers such as credit unions and community banks rely more heavily on such revenue than large banks, which receive more income from interest and other cardholder fees. Representatives of a credit union association told us that revenue from interchange fees made up over 20 percent of most credit unions' total card revenues. Several representatives of community banks and credit unions told us that they likely would not be able to offer rewards cards without

[3]For example, see Severin Borenstein, A. Colin Cameron, and Richard Gilbert. “Do Gasoline Prices Respond Asymmetrically to Crude Oil Price Changes?” *The Quarterly Journal of Economics*, 112, no. 1 (February 1997): 305-339.

[4]See Robert Stillman and others. “Regulatory Intervention in the Payment Card Industry by the Reserve Bank of Australia: Analysis of the Evidence,” CRA International (London, United Kingdom: Apr. 28, 2008).

the revenues they received from interchange fees, and not offering such cards would decrease their overall ability to compete with larger banks.

In addition, many industry participants and others agreed that the costs of card acceptance might shift from merchants to cardholders if interchange fees were limited, card surcharges permitted, and interchange revenues decreased. However, they did not agree on whether the shift would be positive or negative. Some researchers have argued that such a shift would lead to more efficient outcomes, because cardholders would pay for the benefits—such as rewards—that they enjoyed. Or, as some economists have noted, cardholders faced with higher costs for using their credit cards might change their behavior by using rewards cards less frequently and opt for alternative payment methods such as debit cards, which could result in lower costs for merchants. Other economists have argued that any consumer savings from lower prices would not be sufficient to offset the negative impacts on cardholders. Representatives of issuers and card networks we interviewed told us that this option would affect cardholders negatively, because issuers likely would respond to their reduced interchange fee income by increasing cardholders' annual fees and other user fees, decreasing the value of rewards points, and possibly increasing interest rates and decreasing available credit. In Australia, cardholders' benefits as a portion of spending dropped an average of 23 percent from 2003 to 2007 following the interchange fee reforms.[5]

Moreover, a limit on interchange fees could affect merchants negatively if this option led to decreased overall retail sales or available credit. Some industry participants and others pointed to studies that illustrate that consumers tend to spend more when paying with credit cards than when using other payment methods, and that rewards cardholders spend even more than nonrewards cardholders. If consumers shifted from using rewards cards in response to decreased rewards and increased annual and user fees, merchants might realize lower sales revenues overall. Issuers, if faced with lower interchange fee revenues, could decide that some credit card programs were too expensive to maintain and might cut credit to cardholders, including merchants that depend on credit to finance business expenses. For example, the results of the National Small Business Poll indicate that about 74 percent of small businesses use

[5]Source: GAO analysis based on data presented in RBA, "Reform of Australia's Payment System: Issues for the 2007/2008 Review." (Sydney, Australia: May 2007).

business credit cards and about 39 percent use personal credit cards for business purposes.[6]

If the fee limit option were chosen, a challenge for implementation would be setting and maintaining interchange fees at a level that effectively balanced the costs among networks, issuers, merchants, and consumers, which economists and others agree would be very difficult to do. Australian officials set their interchange fee limit using a cost-based approach, which they characterized as practical and meeting legislative requirements. They chose a cap based on the costs that issuers would incur for authorization and processing, fraud and fraud prevention, and funding the interest-free period; the costs of credit losses were not included. Using such an approach would require specialized knowledge of the benefits and costs of different payment methods, some of which may be difficult to measure accurately. In addition, industry participants and others do not agree on which costs should be covered by interchange fees; some issuers and card networks have argued that the fees should cover credit losses, but others have argued that issuers should cover credit losses with their interest revenues. Considerable cost also could be involved for an agency to collect and analyze extensive data from industry participants on interchange-related costs and benefits.

Option 2: Requiring the Disclosure of Interchange Fees

A second option to address concerns about interchange fees would require the disclosure of interchange fees to consumers and is intended to increase their awareness of the fees and change their payment behavior. The fees could be disclosed to consumers on sales receipts, on consumers' card statements, or through generic notices that merchants would post advising their customers about interchange fee costs. Although Visa and MasterCard officials told us that their rules currently do not prohibit merchants from posting their interchange fee costs, other merchants and representatives from a large acquiring bank told us that this option is difficult to implement because merchants are unable to ascertain interchange fee costs until they submit payments for processing. As discussed previously, interchange fees vary depending on the type of card used and the method of processing used.

Disclosing interchange fees to consumers could result in lower costs to merchants, which then could pass the savings to consumers, but only if

[6]NFIB Research Foundation, "Credit Cards," National Small Business Poll 8, no. 3 (2008).

consumers responded to such disclosures by decreasing their use of relatively expensive cards. Proponents contend that consumers deserve to understand interchange expenses facing merchants because consumers could be paying for at least a portion of these fees. If consumers shifted from using relatively costly credit cards to less expensive forms of payment, this would decrease interchange costs for merchants, which in turn could lower prices for consumers. However, many of the industry participants and others with whom we spoke predicted that most consumers would disregard information about interchange fees.

Such disclosures could be confusing for consumers. Merchants, issuers, and card networks expressed concern that their customers might not understand the information and might misinterpret the fees listed on the receipt or bank statement as an additional charge, rather than as a component of the total price. Merchants told us that it is very difficult for cashiers to distinguish between the numerous types of debit and credit cards, which have varying interchange rates. Thus, it could be very complicated for a cashier to clearly communicate to the consumer the correct interchange fee for the specific transaction.

Additionally, whichever party is responsible for disclosing information about interchange fees to consumers would incur the costs of updating its technology to allow for such disclosures. For disclosure in merchant receipts, merchants would incur the cost of changing their receipts. Issuers have reported that changes to card statements, such as the inclusion of additional disclosures, would generate costs for them.

Option 3: Loosening Restrictions on Merchants for Card Acceptance

A third option would prohibit card networks (and other entities) from imposing rules on merchants that limit their ability to discriminate among different types of cards, or levy a surcharge for accepting credit cards.[7] The broad intent of this option is to decrease the costs to merchants of accepting cards by allowing them to steer their customers toward less expensive forms of payment. As discussed earlier, card networks generally impose rules on merchants that accept their cards, such as not allowing merchants to add a surcharge or discriminate among cards issued by the same network and prohibiting minimum purchase amounts.

[7] Some entities other than card networks have rules regulating merchant acceptance of cards for payment. For example, as discussed earlier, some states have laws that prohibit merchants from adding a surcharge for accepting credit cards.

For merchants, the primary benefit of removing one or more of the restrictions for card acceptance could be lower costs. If the rule that merchants must honor all cards from a network were relaxed, merchants could refuse to accept cards with high interchange fees. For example, many of the merchants we interviewed with small average purchase amounts, such as convenience store owners, told us that they would receive significantly more benefits from accepting cards if they could steer consumers away from using cards with high interchange fees, especially in cases in which the purchase amount was lower than the total merchant discount fee. Several merchants told us that they would apply a minimum purchase amount for credit cards if they were allowed to, while one small merchant told us that its store already did so. If merchants could levy a surcharge, they also could receive additional revenue to cover their interchange fee-related costs. Although card networks allow merchants to discount for cash purchases, as required by law, some merchants and others have argued that the network rules and state requirements surrounding cash discounting make the practice too complicated. Merchants explained that currently they have to post a cash price and a card price for each item to offer cash discounts, which could confuse or irritate their customers, so an option that allowed merchants to add a surcharge and refuse certain cards would be a more feasible way for merchants to decrease their interchange fee-related costs.

This option also could improve merchants' bargaining power with card networks and issuers. According to some industry participants and researchers, the only leverage that merchants currently have to control their interchange-related expenses is to refuse to accept all of the cards of a given network.[8] As discussed previously, given the large market share of Visa and MasterCard, customers expect to be able to use those cards at a wide variety of merchants, and several of the merchants we interviewed told us they would lose sales if they refused to accept all cards from either of these networks. Some merchants told us that they would have a greater ability to manage their costs with the option to surcharge for credit cards or not accept cards with higher interchange fees.

This option also may reduce merchant costs as consumers shift away from higher-cost forms of payment (such as rewards cards) to less expensive forms of payment (such as debit cards). Some industry participants and

[8] As discussed previously, the Department of Justice (DOJ) is currently reviewing whether the current rules are anticompetitive.

academic researchers have argued that such a shift would lead to more efficient outcomes such as lower prices for consumers (merchants might lower prices if interchange costs decreased). As mentioned previously, all consumers, even those paying with cash or check, bear the cost of merchants' costs for card acceptance. Proponents of this option reason that without signals about the costs of different payment mechanisms, such as limited card acceptance, surcharges, or cash discounts, consumers likely have overused cards with relatively high interchange fees. There is some empirical evidence that illustrates that surcharges can change consumers' choice of payment method. For example, a recent study conducted in the Netherlands, which allows surcharges, showed that consumers there altered their behavior in response to surcharges for debit cards. While 25 percent of consumers surveyed said that they would use their debit cards regardless of an applied surcharge, the majority stated that surcharges affected their choice of payment, with most using cash for sales tickets of less than 15 euros.[9] A survey conducted in Norway also illustrated that consumers there were quite sensitive to consumer prices that reflected payment costs.[10]

However, removing merchant rules for card acceptance also could affect cardholders, issuers, acquirers, and card networks. More specifically, cardholders might not be able to use their cards in as many locations and could face higher direct costs for card usage. Credit networks, issuers, and acquirers also argued that consumer protection issues would arise because card users would be treated differently than consumers using other payment methods such as cash. Some industry participants and others were concerned about the ability of merchants operating in less competitive markets to set surcharges at a higher level than would be needed to cover their merchant discount fees, thus resulting in a new stream of revenue for merchants.[11] Also, some noted that consumers would have less choice if small issuers were forced out of the market by reduced interchange revenues.

[9]See Wilko Bolt, Nicole Jonker, and Corry van Renselaar, "Incentives at the Counter: An Empirical Analysis of Surcharging Card Payments and Payment Behaviour in the Netherlands," (Working paper, De Nederlandsche Bank, December 2008).

[10]See David Humphrey, Moshe Kim, and Bent Vale, "Realizing the Gains from Electronic Payments: Costs, Pricing, and Payment Choice," *Journal of Money, Credit and Banking* 33, No. 2 (2001): 216-234.

[11]This effect could be countered by capping the amounts merchants surcharged so that merchants did not charge consumers for more than their cost of accepting the card.

Additionally, if fewer consumers used cards and fewer merchants accepted cards, the overall benefits of the credit card network could decrease. As discussed previously, card networks can bring benefits to both consumers and merchants, and economists have argued that the benefits of a credit card network increase as more consumers use its cards and more merchants accept its cards. However, some economists have reported that the change of rules for card acceptance in Australia has not decreased the use of credit cards significantly and that credit card use has grown by at least 5 percent per year since 1995.[12]

If consumers shifted from using cards with higher interchange fees, issuers could see decreased revenues. As mentioned previously, interchange revenues make up a larger percentage of total revenue for small issuers than for large issuers. Representatives of some credit unions and community banks told us that they were concerned that under this option, merchants might discriminate against their cards. These representatives also told us that without sufficient interchange revenues, many credit unions and small banks likely would not be able to issue credit cards. However, representatives of RBA have reported that removing this network rule did not appear to have significantly decreased the number of smaller issuers offering credit cards. They said that some smaller institutions have found it commercially beneficial to outsource some or all of their issuing activities to larger financial institutions or specialist issuers. In such outsourcing arrangements, the cards still carry the small issuer's name but other providers provide the credit processing, and the credit. To preserve the ability of small issuers to successfully issue cards, some industry participants, including a large merchant, suggested that merchants could be allowed to refuse cards on the basis of costs, but could be prohibited from discriminating against cards on the basis of issuer.

The extent to which merchants would take advantage of changes to network rules on card acceptance was unclear. Many merchants of various sizes told us that they would not apply surcharges or refuse certain cards because they feared losing business, or because they thought that this could slow their checkout times. In addition, some merchants told us that they found it nearly impossible to distinguish among different types of credit and debit cards, making it difficult for them to determine which cards they should refuse or to which they should apply a surcharge

[12]See Robert Stillman and others. "Regulatory Intervention."

because of higher interchange rates. In the Netherlands and Australia, where merchants are allowed to levy a surcharge, many merchants have opted not to do so. In Australia, the number of merchants that apply a surcharge for credit cards has been increasing since the practice was allowed in 2003. However, according to a banking research firm that collected data on behalf of the Reserve Bank of Australia, as of June 2009, only about 18 percent of very small merchants, 20 percent of small merchants, 26 percent of large merchants, and 34 percent of very large merchants levied surcharges for credit cards.[13] A study of surcharges on debit cards in the Netherlands found that about 22 percent of merchants added a charge for paying with a debit card (for sales below a certain amount).[14] The results of a national poll by the National Federation of Independent Business indicate that 29 percent of U.S. small businesses who accept credit card payments would apply a surcharge for card payments if their contracts with card networks allowed, and about 13 percent currently have a minimum purchase amount for credit card sales.[15]

Option 4: Allowing Merchants and Issuers to Directly Negotiate Interchange Fees

A fourth option would allow merchants to directly negotiate with card issuers to reach an agreement on interchange fees and terms, which likely would result in lower costs for merchants. Because collective bargaining by commercial groups, such as groups of merchants or businesses, can violate U.S. antitrust laws, an exemption from those laws would be necessary to facilitate such a process.[16] According to DOJ, the granting of antitrust waivers in the United States can be justified only in very rare cases, but participants in specific industries have been granted antitrust

[13]East & Partners, the firm that collects the data, defines very small merchants as those with annual turnover between A$1 million and A$5 million, small merchants as those with turnover between A$5 million and A$20 million, large merchants as those with turnover between A$20 million and A$340 million, and very large merchants as those with turnover greater than A$340 million. See East & Partners, "Australian Merchant Acquiring & Cards Markets: Special Question Placement Report," (Sydney, Australia: June 2009).

[14]The average minimum purchase is 10 euros, and the average surcharge is about 2.3 percent of the sales ticket for purchases under this minimum amount. See Wilko Bolt, Nicole Jonker, and Corry van Renselaar, "Incentives at the Counter: An Empirical Analysis of Surcharging Card Payments and Payment Behavior in the Netherlands."

[15] NFIB Research Foundation, "Credit Cards," National Small Business Poll 8, no. 3 (2008).

[16]Both S. 1212 and H.R. 2695, described previously, contain exemptions from federal antitrust laws in connection with the negotiation process set up in those bills. The bills would exempt such negotiations from the antitrust laws defined in section 1 of the Clayton Act, 15 U.S.C. § 12, and the provisions of section 5 of the Federal Trade Commission Act that apply to unfair competition. 15 U.S.C. § 45.

waivers, including those in the insurance industry and agricultural cooperatives.

According to its proponents, this option would allow merchants more leverage with card networks and issuers in negotiating interchange rates and terms and potentially lead to lower merchant costs. As discussed previously, some have argued that merchants, especially small merchants, are not able to negotiate interchange fees or terms with card networks or issuers, partly because of the large market shares of Visa, MasterCard, and the largest issuers. The large merchants we interviewed told us that their negotiations with card networks have been unsuccessful because they need to accept Visa and MasterCard cards to retain their customers and thus have to pay whatever prices Visa and MasterCard charge. Two of the small merchants we interviewed told us that they were unaware that such negotiations were possible. Some merchants and others have argued that allowing collective bargaining could result in a fairer interchange fee system because card networks would have less ability to set different rates for merchants based on industry type, volume of sales, and other factors; collective bargaining could result in one rate for all merchants.

However, as mentioned previously, any option that decreases interchange fees may have opposing effects on different stakeholders (for example, decreased costs but decreased credit availability for merchants or lower prices but higher fees for cardholders). If negotiations resulted in lower interchange fees for merchants, then merchants could pass these savings to consumers through lower prices. However, given that representatives of issuers and card networks told us that issuers would likely respond to decreased interchange revenues by increasing annual fees, decreasing the value of rewards points, and possibly increasing interest rates and decreasing available credit, cardholders could be harmed.

In addition, it could be difficult to ensure that small issuers and small merchants benefited from collective negotiations. Representatives of small issuers said that small issuers would not have sufficient market power to negotiate favorable interchange fees with a group of merchants. Furthermore, several of these representatives said they were concerned that merchants could come to agreements with large issuers under which the merchants would accept only the large issuers' cards. Some merchants with whom we spoke were skeptical about the potential for small merchants to benefit from the collective negotiations with networks and issuers. One small merchant told us that her store would not be able to participate in such negotiations because of limited staff resources.

A significant legal barrier to implementing such negotiations is the need to obtain antitrust waivers, which DOJ has argued have been justified only in very rare instances in the United States. Credit card issuers and card network officials expressed concerns about removing antitrust exemptions that are designed to protect consumers from anticompetitive practices. In addition, DOJ officials have expressed their historical opposition to efforts to create exemptions to antitrust laws, stating that these exemptions should be used only in the rare instances in which a public policy objective compellingly outweighed free-market values. Furthermore, in response to a prior proposal that would have allowed for collective negotiations of interchange fees, DOJ officials expressed concern about the role that their agency would play in such negotiations.

Appendix III: GAO Contact and Staff Acknowledgments

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Staff Acknowledgments

Cody Goebel, Assistant Director; Michael Aksman; Jessica Bryant-Bertail; Rudy Chatlos; Katherine Bittinger Eikel; Christine Houle; Nathan Gottfried; Yesook Merrill; Marc Molino; Rachel Munn; Barbara Roesmann; Paul Thompson; and C. Patrick Washington made key contributions to this report.

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