**Answers to Written Questions**
**"Credit Card Interchange Fees: Antitrust Concerns?"**
A Hearing before the Senate Judiciary Committee
July 19, 2006

**Questions from Senator Specter:**

**1. It seems clear to me that MasterCard and Visa have market power, and the courts seem to agree with me on that. Your member banks overlap almost completely, and together you have roughly a 75 percent market share. Can you explain to me why—other than that it has resulted in over $30 billion dollars in revenues—interchange fees are a percentage of every purchase? As Mrs. Miller has testified, it seems to me that the cost of processing the payment is the same, regardless of the amount.**

Answer to Question 1:

Visa believes that the guiding analysis here is to be found in *National Bancard Corp. v. Visa U.S.A., Inc.*, 779 F.2d 592 (11th Cir. 1986), a case where the trial and appeals courts expressly considered whether interchange is unlawful price-fixing. Those courts found that interchange, far from being unlawful, in fact promotes competition. The courts held that interchange is both fair and necessary to the operation of a payment card system. Further, the courts recognized that Visa competes with a broad variety of payment methods – including cash and checks – for the loyalty of merchants and consumers. Visa continues to compete vigorously with cash and checks, and in fact an array of new market entrants such as PayPal, Debitman, Google Checkout and others create more fierce competition for every payment transaction every day.

Although one court recently found that MasterCard and Visa have market power, it is important to emphasize that the market at issue in that case was not consumer or merchant use of payments. Instead, the court's finding in *United States v. Visa U.S.A. Inc.*, 344 F.3d 229 (2d Cir. 2003), was that Visa and MasterCard together had market power in an alleged market for "general purpose network services" to banks and processors. Although Visa disagrees, the finding should be understood within the context of that litigation – litigation in which banks were the customers at issue. Here, this Committee is considering the effect of interchange fees on merchants and cardholders, and that calls for a different analysis.

If a company unlawfully exercises market power, one would expect output to be restricted and prices to be set at unreasonably high levels. This is far from the case with Visa, as more and more cardholders and merchants use the services provided by Visa's member banks and Visa's interchange and its member banks' merchant discount rates are lower than its smaller competitor American Express.

It is important to emphasize as well that interchange fees are not charged to merchants or cardholders and are not revenues received by Visa. Rather, they are fees which are paid by the merchant's bank (the "acquirer") to the cardholder's bank (the "issuer"). Just as for any other service provider or manufacturer, these rates reflect not only the costs of communicating transaction information, but also the value to stakeholders of providing a constantly improving and efficient system. Visa uses interchange to encourage members to grow and invest in the system, to the benefit of both merchants and cardholders. Increased cardholder use means increased volume and profit for merchants, and increased acceptance means increased value for cardholders. Interchange must strike the balance that accomplishes both of these goals. If acquirers charge too much to merchants, acceptance would be discouraged and the system as a whole would suffer. And, if issuers charge cardholders too much, use would be discouraged and, again, the system as a whole would suffer. Visa uses the interchange fee to incent innovation, product development and use, data security, cardholder convenience and the increased use of more efficient payment devices in lieu of cash and checks.

**2. Retailers have said that they do not get a copy of the full schedule of interchange fee rates charged on different transactions. How can you justify not letting your customers see the prices they are paying for the service you provide?**

Answer to Question 2:

Retailers do know, and always have known, the price they pay to accept Visa cards. Retailers are not customers of Visa nor do they pay fees to Visa. Instead, they negotiate their cost of acceptance directly with their bank; this price is known as the "merchant discount." Retailers are fully aware of the merchant discount they pay.

Interchange, on the other hand, is a fee paid from acquirers, the merchant's bank, to issuers, the cardholder's bank, within the Visa system. It is, in essence, the "wholesale cost" of a payment card transaction. As I testified, neither the Macy's at Pentagon City nor for that matter any gas station or other retailer posts their wholesale costs, only their retail prices—because this is what the consumer pays. Unlike interest rates or late fees charged by banks to consumers, interchange fees are not paid by merchants or cardholders. They are inter-bank wholesale rates, which the merchant's bank can either mark up or down, and to require disclosure to merchants or cardholders would be analogous to requiring gas stations to post what they pay wholesale for fuel from their suppliers.

**3. Could you describe in detail the process Visa uses to establish interchange fees for its various card products? What costs are included? What costs are excluded?**

Answer to Question 3:

Interchange is a transfer of value between the merchant's bank and the cardholder's bank involved in a particular transaction. Like any other value-based model, interchange reflects not only the costs of communicating transaction information, but also the value to stakeholders of providing a constantly improving and efficient system. All participants benefit as the system expands and becomes more efficient. Visa uses interchange to reflect this value between bank participants, and to encourage members to grow and invest in the system, to the benefit of merchants and cardholders.

Visa manages its interchange rates to reflect unique product attributes, the modes of processing a payment, and the different dynamics of various merchant segments. On the product side, Visa has a separate set of interchange rates for Visa's debit product from the interchange rates that apply to its consumer credit products, and both are different from the interchange rates applied to Visa's commercial products. In all cases, interchange reflects the costs of providing these various product types, the value each product type generates for acquirers and merchants, and the level of pricing on competing products and services.

In each case, product-level distinctions in the cost-of-funds, the risk of cardholder default on payment, and other costs of acquiring and servicing consumers are taken into account.

Examples of how Visa has used interchange to achieve its goals of expanding participation in the Visa payment system and strengthen system performance include the following:

- To provide greater cardholder and merchant security on internet transactions, in December 2001 Visa developed its Verified-by-Visa Program. To provide incentives for merchant adoption, Visa provides lower interchange rates on transactions authenticated through the service.
- In October 2003, Visa created the Small Ticket Payment Service to drive further penetration of low dollar transactions in cash-heavy segments. As part of the program, Visa eliminated signature requirements, provided incentive interchange rates, and provided additional merchant protections. These pricing strategies led to the development of wide payments acceptance in, for example, quick-service restaurants.
- Visa also created a utilities program in April 2005, designed to grow the use of Visa for consumer bill payments in that segment. A custom-tailored interchange schedule for this program has led to

the enrollment of more than 4,000 utilities in the program, leading to greater efficiency, security, and payment certainty for these regulated providers.

Visa U.S.A.'s Independent Directors are responsible for managing Visa's interchange rates that apply to the U.S. marketplace. When evaluating interchange rates to determine if Visa is competing effectively and meeting its goals to grow system participation and payment volume, Visa looks at data from the marketplace, including rates of transaction and sales volume growth in key merchant segments, and the product, merchant, and risk attributes described above.

**4. Visa introduced a higher fee structure for its premium Visa Signature card on April 1, 2005, the same day that MasterCard introduced a higher fee structure for its premium World card. What process was used to ensure that the higher fees for the premium cards offered by MasterCard and Visa were made effective the same day?**

Answer to Question 4:

Visa did not communicate with MasterCard about this pricing decision, and, to the best of my knowledge, it has never communicated with MasterCard about any other pricing decision. To the contrary, Visa competes vigorously with MasterCard and considers its interchange strategies among its most confidential and competitively sensitive information.

Visa's system processes billions of transactions a year virtually flawlessly. In 2005, the system experienced only 72 seconds of "down time." To accomplish this feat, Visa makes sure that all updates to its system are carefully planned and coordinated. Visa, therefore, announces system changes in advance and implements them on a predictable schedule, timed to avoid critical peak transaction seasons. Upgrades are made in April and October of each year. Visa announced its changes to Visa Signature to acquirers on November 19, 2004 and implemented them the following April. Visa did not learn of the MasterCard changes to its World card product until after MasterCard announced its changes in February 2005.

**5. Please make a full copy of Visa’s operating rules available to the Committee.**

Answer to Question 5:

Visa will make a fully copy of its Operating Regulations available to the Committee.

Visa Operating Regulations contain confidential and sensitive information about the Visa system. Securing the Visa system and cardholder information with which we are entrusted is crucial to all stakeholders in our system; therefore, we request that the Committee review our Operating Regulations in confidence.

We also note for the Committee that Visa has recently announced that Visa will make its Operating Regulations available to its merchants. As Visa continues to grow and expand in today’s dynamic and competitive marketplace, we are committed to making the organization as transparent as reasonably possible. While Visa’s merchant rules guide has been available for over a decade, and it is among the most viewed documents on our web site, some merchants have asked us to provide even more detail. We are responding to this request by sharing Visa’s operating regulations with those qualifying merchants and third-party agents who participate in the Visa system. The operating regulations will be available beginning in September 2006 and will be provided under a nondisclosure agreement to protect confidentiality.

**Answers to Written Questions**
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July 19, 2006

**Questions from Senator Durbin:**

**1. On April 1, 2005, Visa introduced a higher fee structure for your premium Visa Signature card. On the same day, MasterCard introduced a higher fee structure for its premium World card. Was this a mere coincidence that your two competing companies introduced higher fees for the two competing products on the same day, or did Visa and MasterCard communicate with each other to plan the timing of the announcement?**

Answer to Question 1:

Visa did not communicate with MasterCard about this pricing decision or its timing, and, to the best of my knowledge, it has never communicated with MasterCard about any other pricing decision. To the contrary, Visa competes vigorously with MasterCard and considers its interchange strategies among its most confidential and competitively sensitive information.

The Visa system processes billions of transactions a year virtually flawlessly. Even with this volume and nearly instantaneous transaction time, in 2005 the Visa network experienced only 72 seconds of "down time." Visa makes sure that all updates to its system are carefully planned and coordinated. Visa therefore announces system changes in advance and implements them on a predictable schedule, timed to avoid critical peak transaction seasons. Upgrades are made in April and October of each year. Visa announced its changes to Visa Signature to acquirers on November 19, 2004 and implemented them the following April. Visa did not learn of the MasterCard changes to its World card product until after MasterCard announced its changes in February 2005.

**2. At the hearing, one of the merchant witnesses mentioned the problem of “reason code 96,” which your company uses to deny gasoline retailers payment on the entire amount of a transaction when the gasoline purchase by a consumer at that station is more than a set amount. Yet, I understand that the retailer is not allowed to set a maximum transaction amount for credit card sales of gasoline under your rules. What is the rationale for this rule? How does Visa alert merchants about this rule and the consequences for violating it? How much in dollars were these chargebacks made to retailers during the past year?**

Answer to Question 2:

“Reason code 96” is one of the several examples of Visa’s efforts to balance the many interests within a payment system – facilitating the development of new and innovative payment methods on the one hand, while managing the risks of these new opportunities on the other. To support gas stations’ efforts to reduce costs and improve customer service, as well as to provide cardholders with a new and easy way to pay for their gas, Visa introduced special procedures that make it possible to use a Visa card at a gasoline pump without ever seeing an attendant (these pumps are known as "Automated Fuel Dispensers” (AFDs)). But, as would be expected, these pumps do create additional risk to the system, and that risk increases with the transaction amount. To manage this risk, Visa limits these transaction amounts to $50 and, in turn, permits the issuer, the cardholder’s bank, to “charge back” (refuse payment to) the acquirer, the merchant’s bank, where an AFD transaction exceeds $50 and the issuer is unable to honor the transaction. In the Visa system, the acquirer or merchant’s bank is responsible for communicating to the merchants rules related to card acceptance, including chargebacks.

Gasoline retailers can set maximum sale amounts at unattended pumps, and Visa understands that many do so. In this way, gasoline retailers, too, can manage their risk. For sales more than $50, retailers can always process them in person at the counter, in which case no limit applies, reflecting the reduced risk of an in-person sale.

Visa can provide the number of chargebacks sent through its system from the cardholder’s bank to the merchant’s bank, but we do not know what the financial arrangements are between the retailer and its bank. For the last 12 months ending July 2006, only 0.01% of Visa AFD purchase transactions were charged back from the cardholder’s bank to the merchant’s bank.

**3. What would be the effects of Federal Reserve regulation of credit card interchange fees? Would fees increase or decrease if the Fed regulated these fees?**

Answer to Question 3:

The effect of Federal Reserve price controls that force interchange rates down would be to shift the cost of supporting card payment systems from merchants to consumers. Visa recognizes that a reduction in interchange could lead to a reduction in retailers' costs – the question, however, is who will bear the cost of their increased profits? Visa suggests to this Committee that ultimately it is consumers that will bear the cost, as the Australian experience tells us. While the Visa system must consider the needs of both merchants and cardholders to survive, merchants have no similar incentive to engage in that balancing. And that it is why cardholders have the most to lose if the balance becomes skewed towards the interests of merchants alone.

Ultimately, Visa believes that allowing free markets to work, rather than government intervention, is the best way to foster competition, drive innovation, and serve consumers. Visa believes that free market competition is working in our industry, and that you can see that every day in our performance. Indeed, unlike firms with market power that restrict output to obtain high prices, Visa has continuously worked to expand the Visa system, increasing the value it creates for both merchants and cardholders so that the Visa card is today accepted and used more than at any time in the past.

**Answers to Written Questions**
**"Credit Card Interchange Fees: Antitrust Concerns?"**
A Hearing before the Senate Judiciary Committee
July 19, 2006

**Questions from Senator Grassley:**

**1. How much revenue, per year, is raised because of interchange fees? How much is spent, per year, on making the payment system more efficient and secure?**

Answer to Question 1:

Revenue from interchange flows to banks, not Visa. On purchase transactions, interchange fees are paid by financial institutions that sign merchants up for card acceptance to financial institutions that issue cards to cardholders. Visa has more than 10,000 card-issuing banks in the United States, including credit unions, community banks, and thrifts, among others. Together, those financial institutions in 2005 collected some $19 billion in interchange fee revenues on Visa purchase transactions in the United States. These revenues helped fund a wide range of issuer investments, operations, and activities that benefit the Visa system, merchants, and cardholders. Indeed, each and every of Visa's thousands of card-issuing financial institutions must invest in its own security and efficiency controls to manage its own card programs.

Visa realizes its revenue not through interchange, but predominately from fees paid by banks, specifically, separate transaction processing and service fees that it charges its participating member banks. In fiscal year 2005, Visa USA collected some $1.9 billion in net transaction processing and service fees. In this same year, Visa spending on risk management and security, systems development and enhancements, and product and service development was in excess of $500 million. This investment results in a payment system that processes payment transactions virtually instantaneously, and without fault, and fraud detection systems that can spot fraud even before it happens.

**2. Who sits on the board that sets the policy and rates for interchange fees?**

Answer to Question 2:

Visa U.S.A.'s Independent Directors are responsible for U.S. interchange policy and rates. These directors are not affiliated with any of the banks which pay or receive interchange. They instead come from an array of backgrounds and bring to our company a wealth of diverse experiences and perspectives, including merchant perspectives. Our four Independent Directors are:

- Philip D. DeFeo, who is a managing partner of Lithos Capital Partners LLC. Prior to joining Lithos Capital Partners, Mr. DeFeo served as Chairman and CEO of the Pacific Exchange, Inc., from 1999 to 2005. Mr. DeFeo currently serves as Deputy Chairman of the board of directors of Computershare Investor Services.
- Linda Baker Keene, who has held management positions with a number of consumer-driven companies, including The Gillette Company, The Pillsbury Company, and American Express Financial Advisors. Ms. Keene has served on the board of directors of two public companies, Scholastic, Inc. and Huffy Corporation.
- Jon C. Madonna, who has held prominent positions with Carlson Wagonlit Travel, Travelers Insurance Group, Inc., and KPMG. Mr. Madonna's career with KPMG spanned 28 years, where he held the position of Chairman and CEO. Mr. Madonna has been a member of the boards of directors of Albertson's, Inc., Phelps Dodge Corporation, Tidewater, Inc., and AT&T.
- John A. Swainson, who is the President, CEO, and a member of the board of directors of CA Inc. Prior to joining CA Inc. in 2004, Mr. Swainson spent 26 years with IBM Corporation. Mr. Swainson is a member of the board of directors of the U.S. Chamber of Commerce and Cadence Design Systems, Inc.

Other Visa U.S.A. Board members are:

- William I. Campbell, Senior Advisor to the CEO, J.P. Morgan Chase
- Richard K. Davis, President and CEO, U.S. Bancorp
- Charles T. Doyle, Chairman of the Board, Texas First Bank
- Robert R. Hackney III, Cardservices for Credit Unions
- Benjamin P. Jenkins III, Vice Chairman and President General Bank, Wachovia Corporation
- Bruce R. Lauritzen, Chairman, First National Bank of Omaha
- Peter E. Raskind, Vice Chairman, National City Corporation
- Joseph W. Saunders, President, Card Services, Washington Mutual

- Charles W. Scharf, CEO, Retail Financial Services, J.P. Morgan Chase
- John G. Stumpf, President and COO, Wells Fargo & Company
- James M. Wells III, President and COO, SunTrust Banks, Inc.
- John Philip Coghlan, President and CEO, Visa U.S.A.
- Christopher Rodrigues, President and CEO, Visa International

**3. Who makes the decision to increase interchange fees? Have these fees ever been lowered rather than increased?**

Answer to Question 3:

As explained above, Visa U.S.A.'s independent directors are responsible for managing U.S. interchange rates.

Interchange rates today are significantly lower than they were when the Visa system was formed, and Visa has reduced interchange fees many times in recent years. For example:

- In April 2005, Visa reduced several of its offline debit rates for transactions at supermarkets and retail stores, effectively reducing the interchange rates on 40% of the sales volume on the Visa check card.
- In October 2003, Visa launched its small ticket payment service, which reduced the interchange rate applied to consumer credit and debit transactions below $15 in seven merchant segments including fast food and other restaurants, movie theaters, and video rental stores.
- In April 2006, Visa expanded its small ticket payment service to an additional seven merchant segments and lowered the rate applied to small ticket consumer debit transactions.
- In April 2005, Visa introduced a new reduced incentive interchange rate applied to transactions in the utility segment.

**4. Why do merchants have to sign non-disclosure agreements regarding the interchange fee rules? Why is there not more transparency with respect to interchange operations?**

Answer to Question 4:

The interchange fee rules govern only the relationship between acquiring banks and issuing banks; they do not directly impose any obligation on merchants. Merchant obligations toward the Visa system are reflected in the contracts that each individual merchant has with its bank. That said, Visa has long made public those aspects of its operations that most directly affect merchants and cardholders. I am told that, for more than a decade, Visa has made a merchant rules guide available to merchants, and it is among the most viewed documents on the Visa website.

In addition, recognizing the important role merchants play in the Visa system, Visa has recently taken the step of making almost its entire Operating Regulations available to merchants. Unlike MasterCard, which provides an excerpt of its Operating Regulations to merchants, Visa intends to make all of its rules available, subject only to the omission of information that would raise simply too great of a competitive or security risk to the system. Visa is merely seeking from merchants a commitment – similar to those it has always sought from its members – to respect the confidentiality of the regulations so that the safeness and soundness of the system is protected. It is important to recognize that our rules include information related to issues such as the processing of transactions and card design that must be protected to avoid security risks – risks that have the potential to harm merchants and cardholders as well as Visa.

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July 19, 2006

**<u>Questions from Senator DeWine:</u>**

**1. We heard testimony that interchange fees continue to go up, yet credit card costs, including card processing, borrowing, fraud, and other costs, are reported to have declined. If the credit card industry really is competitive, with decreasing costs and more claimed efficiencies in the credit card payment system, why don't we see interchange fees coming down? Have any interchange fees decreased?**

Answer to Question 1:

Interchange is a transfer of value between the acquirer and the issuer involved in a particular transaction. Like any other value-based model, interchange reflects not only the costs of communicating transaction information, but also the value to stakeholders of providing a constantly improving and efficient system. All participants benefit as the system expands and becomes more efficient. Visa uses interchange to reflect this value between bank participants and to encourage members to grow and invest in the system, to the benefit of merchants and cardholders.

Visa manages its interchange rates to reflect unique product attributes, the modes of processing a payment, and the different dynamics of various merchant segments. In all cases, interchange reflects the value each product type generates for acquirers and merchants.

In each case, product-level distinctions in the cost-of-funds, the risk of cardholder default on payment, and other costs of acquiring and servicing consumers are taken into account.

Today, interchange rates are significantly lower than they were when the Visa system was formed – even as the US system has grown to allow more than 6.3 million merchant outlets to conduct business and make sales to more than 500 million cardholders.

Visa has a long history of using lower interchange rates as a tool to expand merchant acceptance and usage, encourage strong system performance, and incent adoption of new Visa products and services. Examples of times Visa has reduced interchange fees in recent years include:

- To provide greater cardholder and merchant security on internet transactions, in December 2001 Visa developed its Verified-by-Visa Program. To provide incentives for merchant adoption, Visa provides lower interchange rates on transactions authenticated through the service.

- In October 2003, Visa launched its small ticket payment service, which reduced the interchange rate applied to consumer credit and debit transactions below $15 in seven merchant segments including fast food and other restaurants, movie theaters, and video rental stores. In April 2006, Visa expanded this service to an additional seven merchant segments and further lowered the rate applied to small ticket consumer debit transactions.
- In April 2005, Visa reduced several of its offline debit rates for transactions at supermarkets and retail stores, effectively reducing the interchange rates on 40% of the sales volume on the Visa check card.
- Also in April 2005, Visa introduced an incentive interchange rate applied to transactions in the utility segment, to help grow Visa's acceptance and usage in this importance bill pay segment.

**2. Issuing banks choose which card to issue in part based on which card will give them more revenues from interchange fees. In other words, credit cards compete over issuing banks by offering higher interchange fees. Because of this, competition seems to push prices up rather than down. On the other hand, to attract cardholders, a credit card company needs to be widely accepted, so it needs to attract merchants to accept the cards. This encourages the card companies to lower interchange fees. How do you balance these two pressures, and how does competition between Visa, MasterCard, American Express, and other cards provide a check on fees?**

Answer to Question 2:

Your question strikes at the heart of how the Visa system works, the way competition drives interchange, and how the current payments marketplace leads to efficient use of electronic payments, rapid payments innovation, and the maximization of cardholder and merchant participation in the system.

You are correct that Visa competes with other payment networks for the business of issuing banks, which ensures the cardholder participation that is essential to the value proposition that we offer to merchants. And, at the same time, you are also correct that Visa must compete for merchant acceptance to ensure the merchant participation that is essential to the value proposition that we offer to cardholders.

Interchange is indeed the way we manage these two goals. If Visa set interchange too high, merchant acceptance could drop. If Visa set interchange too low, cardholder use could drop and banks may leave Visa to issue cards on competing networks with higher interchange. When setting interchange, Visa has to conduct a careful analysis that looks at a variety of factors that have been discussed, but, as you note, one of these factors is always the level of pricing on competing goods and services (which includes an array of payment alternatives, not just competitors like MasterCard and American Express). In this way, competition always acts as a check on interchange. Visa's ability to appeal – through acquirers – to a much broader set of merchants is a key factor in competing against American Express (which is generally priced higher). Similarly, Visa's ability to appeal – through issuers – to the largest number of cardholders is a key factor in competing against Discover (which is generally priced lower). Overall, it is Visa's objective to have the highest level of merchant acceptance and cardholder usage, and striking an appropriate balance in the setting of interchange is central to achieving this objective.

**3. Merchants have claimed that when Visa and MasterCard coordinate on setting interchange fees, or set fees collectively, this violates the antitrust laws. In fact, some merchants have brought antitrust suits challenging the way Visa and MasterCard have set their fees. On the other hand, Mr. Muris has testified that their coordination has been reasonable and pro-competitive. Nonetheless, Visa and MasterCard have made changes in the way interchange fees are set. What changes have you made, and do Visa and MasterCard currently coordinate in any way on setting of any fees?**

Answer to Question 3:

I am not aware of anything suggesting that Visa has ever coordinated with MasterCard on pricing decisions. Mr. Muris said that coordination within Visa has been reasonable and pro-competitive. He did not speak to coordination between Visa and MasterCard.

Visa has made changes to the setting of interchange, and, as previously described, has also implemented certain decreases in interchange. Nevertheless, some retailers and plaintiffs' attorneys have been driving antitrust challenges against Visa in the courts. Visa disagrees with all of their claims. As discussed at the hearing, every court to rule on the issue to date has held that the setting of interchange is fair and pro-competitive.

In May 2006, Visa U.S.A. added four independent directors to its Board of Directors. These independent directors are solely responsible for reviewing decisions with a direct economic impact on Visa member banks, including the interchange rates that apply to the U.S. marketplace. Interchange has always been set lawfully. Visa believes these directors add value to our Board for a number of additional reasons, including the increased level of diversity and breadth of experience they bring as we move forward in an increasingly competitive marketplace.