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The Honorable Arlen Specter
Chairman, Senate Judiciary Committee
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Specter:

Per your request, attached please find responses to the questions submitted to me by several members of the Committee in connection with the hearing on July 19, 2006, "Credit Card Interchange Rates: Antitrust Concerns?". Please do not hesitate to contact me if I can be of further assistance.

Sincerely,

Joshua L. Peirez

Written Questions from Senator Specter
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. If credit cards are so valuable to merchants, why do the card associations enact rules that prevent merchants from reflecting differences in interchange fees in the prices they charge to their customers? If cards provided valuable benefits to merchants, merchants would *want* customers to use them, and the card associations wouldn't need rules to prevent merchants from discouraging card use through the pricing of their goods and services, correct?

A. MasterCard rules specifically allow for merchants to provide for a cash discount. Section 9.12.2 of our Bylaws and Rules states simply: "A merchant may provide a discount to its customers for cash payment." For example, under our rules a merchant could simply provide a 1% discount to consumers who pay for goods or services with cash. In addition, MasterCard has permitted merchants to surcharge in some markets outside the United States, and we are continuing to review that option for the U.S. market. It is our understanding and experience, however, that as a practical matter merchants have generally decided that they do not want to discount or surcharge based on payment method. Indeed, one of the merchant witnesses at the hearing testified to this fact. As indicated below, Section 9.12.2 is included in the operating rules which we provided as a follow-up to the hearing. We have enclosed an additional copy for your convenience. These rules are also publicly available on our web site, www.mastercard.com, by clicking on the link to "merchant rules".

Historically, federal and state laws have reflected the notion that imposing a surcharge on those who pay by credit card is anti-consumer. For example, for many years the federal Truth in Lending Act contained a prohibition against such surcharges. Although the prohibition expired in 1984, several states continue to prohibit such surcharges.

Q. Mr. Floum has agreed to provide the Committee with a copy of Visa's operating rules. Please do the same for MasterCard.

A. We have attached a copy of all the operating rules currently relating to merchants. As we have discussed with your staff, we will follow up to determine whether there are any other rules you may wish to review.

Written Questions from Senator DeWine
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. 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?

A. MasterCard periodically reviews and adjusts default interchange rates, generally on a semi-annual basis and this process has resulted in downward adjustments to categories of interchange fees. As you have noted, it is reported that some payment card costs have declined and that processing has become more efficient. Such cost decreases have helped contain interchange fees, and processing efficiencies combined with stiff competition have exerted downward pressure on discount fees charged to merchants by acquiring banks. These types of costs and efficiencies, however, are only some of the factors taken into account in setting interchange fees. For example, in recent years, expenditures to prevent fraud, make better credit decisions, and develop new technologies have increased. In addition, MasterCard management must consider other factors such as levels of card issuance and acceptance and our competitors' performance in the marketplace, including the level of prices they are charging.

In short, setting interchange fees is a challenging proposition that involves an extremely delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. In response to competitive forces, MasterCard management works extremely hard to maximize the value of the MasterCard system, including dollar volume spent on MasterCard cards, the number and type of MasterCard cards in circulation, and the number and type of merchants accepting MasterCard cards, by setting default interchange fees at levels that balance the benefits and costs to both cardholders and merchants. Three-party systems like American Express and Discover set their merchant discounts to establish a similar balance, demonstrating that balancing competing interests is not unique to systems that use interchange.

Q. 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 <u>higher</u> 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 <u>lower</u> 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?

A. As noted above, setting interchange rates involves a delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. Competition among payment brands and payment types provides a significant check on interchange fees. As I mentioned in my written testimony, MasterCard competes against all forms of payment, including paper-based transactions (such as cash and checks), electronic transactions such as wire transfers and ACH payments, and other electronic forms of payment, including card-based payment systems. Within the general purpose payment card industry, we compete vigorously worldwide with brands such as Visa, American Express and JCB, among others. In the United States, we also compete with other brands such as Discover/Novus. Within the debit segment, we compete with ATM and point-of-sale debit networks in various countries, such as Plus, Electron, Interlink, PULSE, Star, NYCE and Debitman in the United States, Interac in Canada, and EFTPOS in Australia. In addition, we compete against businesses that issue their own private-label payment cards such as retail stores and large petroleum companies.

In addition to our more traditional competitors, we also have competitors that have developed rapidly growing alternative payment systems, such as PayPal, and payments effected via mobile devices, such as cellular phones, transponders and other handheld electronic devices. Among other things, these competitors provide Internet currencies that can be used to buy and sell goods online, "virtual checking" programs that permit the direct debit of consumer checking accounts for online payments, and services that support payments to and from proprietary accounts for Internet, mobile commerce and other applications.

This extensive competition puts downward pressure on interchange rates. If MasterCard were to set default interchange fees that were too high, merchant acceptance of MasterCard-branded cards would suffer as merchants would shift to other payment methods, including those offered by our competitors.

Q. 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?

A. MasterCard does not coordinate with Visa or any other competitor with respect to the setting of interchange or any other fees.

As you note, many of the legal challenges MasterCard has faced with respect to setting interchange rates have been directed at the traditional ownership and governance structure of the four-party system, in which the plaintiffs claim that the customer financial institutions that receive interchange improperly owned the system and controlled the board of directors that set interchange. Although this structure was upheld in the Nabanco case discussed in my written testimony, and we believe the merchants' allegations are without merit, MasterCard has changed its structure and is now a publicly traded company with a majority of directors entirely independent of MasterCard's customers (financial institutions), and with the majority of voting power and equity in the hands of shareholders other than the financial institutions that receive interchange. Moreover, interchange fees are set by MasterCard management, not the MasterCard board.

Written Questions from Senator Grassley
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. 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?

A. MasterCard itself does not generate revenue from interchange and we generally do not keep statistics on interchange revenues. However, we will follow up with your staff to see how we can be of assistance in obtaining this information.

As for the amount of money spent on making the payment system more efficient and secure, it is difficult to estimate such an expenditure with any precision. However, based on the fact that MasterCard and its nearly 25,000 customer financial institutions devote considerable resources to fraud prevention and system security we estimate that the payment card industry spends tens of billions of dollars—if not more—a year to maintain an efficient and secure payment option for merchants and consumers.

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

A. Interchange rates are established by management at MasterCard, not the MasterCard board.

Our current board of directors can be found on the Internet at: http://investorrelations.mastercardintl.com/phoenix.zhtml?c=148835&p=irol-govboard.

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

A. Interchange rates are established by management at MasterCard. As mentioned in my written testimony, setting interchange fees is a challenging proposition that involves an extremely delicate balance. If interchange fees are too high, such that they lead to disproportionately high merchant discount fees, the merchants' desire and demand for MasterCard acceptance will drop. If interchange fees are too low, card issuers' willingness to issue and promote MasterCard cards will drop as will consumer demand for such cards. In response to competitive forces, MasterCard management works extremely hard to maximize the value of the MasterCard system, including dollar volume spent on MasterCard cards, the number and type of MasterCard cards in circulation, and the number and type of merchants accepting MasterCard cards, by setting default interchange fees at levels that balance the benefits and costs to both cardholders and merchants. Three-party systems like American Express and Discover set their merchant discounts to establish a similar balance. Interchange rates are generally reviewed and adjusted on a semi-annual basis. This process has resulted in both upward and downward adjustments to categories of interchange fees.

Q. 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?

A. MasterCard does not require merchants to sign such non-disclosure agreements in this context.

We believe that there is transparency with respect to interchange. Indeed, our interchange rates are generally available to those who wish to see them. For example, a merchant can obtain the rates from its acquiring bank. Furthermore, the rates can typically be found on the Internet. The evidence in the public record also makes it clear that merchants are well aware of what they pay for card acceptance (*i.e.*, their "merchant discount fees"). It is also clear that merchants know more about their merchant discount costs than many other types of costs. For example, the merchant discount shows up as a concise line item to the merchant. However, the costs associated with accepting cash (*e.g.*, stolen or lost cash, store management time spent counting cash drawers, time spent transporting cash, amount spent to protect cash) are not as easily quantifiable for many merchants. Apparently the hidden costs of checks are even greater, including amounts lost due to bad checks, as many merchants will not accept them at all.

It is important to note, however, that MasterCard is a business competing against other businesses and we must protect our internal decision-making processes from disclosure to our competitors. As a result, the fees we establish are available to our customers but the details of our confidential decision-making process are not. Not only is this confidentiality not unusual, it is the essence of competition that a business not disclose to its competitors its specific methodology for setting prices.

Written Questions from Senator Durbin
"Credit Card Interchange Fees: Antitrust Concerns?"
July 19, 2006

Q. On April 1, 2005, MasterCard introduced a higher fee structure for its premium World card. On the same day, Visa introduced a higher fee structure for your premium Visa Signature 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 MasterCard and Visa communicate with each other to plan the timing of the announcement?

A. MasterCard did not and does not communicate with Visa regarding the setting of fees or the timing of the announcement. MasterCard generally adjusts its interchange schedules on a semi-annual basis.

Q. Why should merchants pay higher fees for premium cards that MasterCard offers to affluent cardholders? What benefits do, say, a convenience store receive for accepting a "World" premiere card that justifies its higher cost compared to other MasterCard cards?

A. In reality, most merchants do not pay a higher merchant discount based on the type of card used by a consumer. Most merchants choose to use a uniform merchant discount rate, called a "blended" rate, regardless of the type of card presented. A smaller number of merchants may decide they would like to pay a higher or lower merchant discount depending on the card presented. However, these decisions are solely the merchants' and are agreed upon as part of contract negotiations with their respective acquiring banks.

It is also important to note that the efficiencies and cost reductions that can be derived from electronic payments (especially for many convenience stores) are greater than those that can be achieved through acceptance of paper-based payments. For example, there are costs associated with cash, such as the costs of protecting it, the costs of counting it, the costs of transporting it, and the costs of losing it or having it stolen. Checks are also not without costs, such as those that are not honored and the increased time per payment transaction.

The acceptance of cards, including premium cards, enables merchants to attract and retain the business of consumers who prefer to use those cards. Certain types of cards, such as premium cards, also benefit many merchants because of the propensity of premium cardholders to purchase more per transaction than other types of cardholders.

Having said that, one cannot simply look at the merchant discount associated with a card to determine whether one is more valuable to merchants than another. The least expensive card is not necessarily going to provide merchants with the most overall benefits. The reasons a merchant accepts payment cards will vary and price is only one factor in that decision-making process. For example, it is generally understood that today, on average, merchants pay the highest merchant discount for accepting American Express cards, the lowest for accepting Discover cards, and somewhere in between for accepting MasterCard cards. Interestingly, even though Discover is the cheapest to merchants, it is not the most widely accepted or used.

We also note that merchants can use other methods to encourage their customers to use the payment methods the merchant prefers. For example, some merchants actively encourage their customers to use certain types of debit cards that entail lower merchant discounts. Merchants can also refuse to accept brands or types of cards they believe do not provide sufficient value.