Testimony of

Mr. Joshua R. Floum

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Before the Senate Judiciary Committee
Interchange Fees: Antitrust Concerns?
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Chairman Specter, Ranking Member Leahy, and Members of the distinguished committee, my name is Josh Floum and I am the General Counsel and Executive President of Visa U.S.A. Inc. I want to thank the committee for giving me the opportunity to answer the question posed by this important hearing.

I. There Isn't a Problem Here

The setting of interchange on four-party payment systems, like Visa, MasterCard and, more recently, American Express and Discover, does not raise an antitrust issue. I recognize that my unqualified "no" to the question posed by this Committee is something of a statement, coming in the midst of approximately 50 lawsuits claiming the contrary. I want to assure this Committee that we take the concerns that retailers have expressed in the litigation and express here today seriously, but I believe that the particular legal claims alleged by the merchants involved in these suits have no merit. As I will touch on in a moment, the fact that interchange and antitrust claims are in the Courts is an additional reason why this Committee should not entertain the idea of artificial price controls.

You will hear the former chair of the Federal Trade Commission Timothy J. Muris lay out the legal and economic case for interchange fees today in his testimony. I agree with the things that Tim has to say, but I want to approach the issue from a slightly different perspective. I am not here today as a law professor or a legal theorist. I am Visa's General Counsel, and in that position, my interest in Visa's legal problems is fundamentally pragmatic. Whenever Visa finds itself the defendant in litigation, I have two questions: (1) why have we been sued and (2) what, consistent with our legitimate business interest, can we do to resolve this dispute. Having applied this approach to interchange, I have come to the conclusion that the fight about interchange fees is not a legal issue, antitrust or otherwise. It is a business dispute, and it should be and, I believe, will be resolved at the negotiating table.

II. Merchants Derive Enormous Value from the Visa
Payment System

Cash and check are, relatively speaking, inefficient ways of exchanging value. Cash is costly to move from place to place and can be stolen or counterfeited. Checks combine many of the inefficiencies of cash with time-consuming authentication procedures at the point of sale. Over the past thirty years, Visa has worked with merchants to build a safer, more efficient and more reliable alternative. Visa's value to merchants is reflected in the structure of its interchange rate system.

Electronic payments offer all sorts of benefits. Many leading economists as well as the Courts have described the Visa payment system and other electronic payment methods as among the great innovations of the 20th Century. Before the cell phone, the personal computer and the Internet, Visa and other payment networks helped transform how people live their lives and how commerce is conducted. With a Visa card, a cardholder can get access to her finances just about anywhere, anytime. Visa cards speed people through the check-out line and give merchants access to the credit that banks supply to their customers. They have also created new channels of commerce that enable merchants to transact business more efficiently on new technologies, with e-commerce and automated fuel dispensers the two most visible examples.

Merchants have played an important role in the development and extension of the Visa payment system. When Visa was trying to build a national payment system to rival American Express in the 1970s, merchants were important partners. Visa offered smaller merchants, which had not traditionally offered lines of credit to their customers, the opportunity to compete with the likes of Macy's, Bloomingdale's, Nordstrom and other large department stores that used credit as a way of attracting customers into their stores. With Visa members offering cardholders the convenience of a single card accepted at many locations and at lower rates than those offered by the big department stores or American Express, Visa quickly attracted cardholders. And with lower discount rates than those featured by American Express and Diner's Club, Visa quickly attracted merchants as well. This expansion of the payment system fostered competition in another important way, too. Thousands of community banks and credit unions gained the ability to offer a payment card product that could compete directly with the offerings of large national financial institutions.

Visa is continuing to work with merchants to improve the efficiency of the payment system. In the late 70s and early 80s, Visa created a special interchange rate for electronic transactions that gave financial institutions an incentive to move their merchant customers from inefficient paper-based authorization to electronic authorization. That work continues today, even with the overhang of the interchange litigation. Visa and Wawa, for example, recently teamed-up to introduce contactless payments throughout the Wawa chain. As Howard Stoeckel of Wawa observed when this program was announced, Visa's contactless payment platform gives Wawa "customers a faster and easier way to pay, which helps simplify their daily lives."

Visa's close work with merchants is reflected in its interchange rate structure. As Visa's network has expanded from boutique retailers, restaurants and other travel-and-entertainment type merchants to near ubiquity, Visa has recognized that different types of merchants derive different levels of value from their participation in the Visa payment system. Supermarkets, for example, have long been bastions of cash and check. In order to make Visa an attractive option for such merchants, Visa has set low interchange rates for the supermarket category. E-commerce merchants, by contrast, derive enormous value from payment cards, and Visa's rates for that segment are higher than the rates for the supermarket category. Visa's pricing, like all companies in a market economy, is value-based, based on the costs of supply and the value of demand.

III. This Isn't a Fight About Principle; It's a Fight About Price

Against this backdrop, the debate about interchange seems misplaced. Merchants, even the relatively small group that is sponsoring the current litigation, do not dispute the benefits of electronic payment. Instead, they want the Federal government to cap the price that they pay for these valuable services. Plain and simple, the retailers and merchants behind these lawsuits want to use the current antitrust litigation to reduce their cost of electronic payments and to shift those costs to consumers.

It is important to understand that within the Visa system, financial institution members provide value to two different stakeholders: merchants and cardholders. This Committee must be mindful not only of the interests of merchants in your States, but also the interests of consumers who use Visa payment cards, as well as the many banks, thrifts and credit unions that issue those cards.

Over the years, Visa has provided enormous benefits to cardholders, and these benefits are just as important to us as those we provide to merchants. Visa services allow cardholders to access credit and deposit accounts, and give them zero liability protection. Although Visa itself does not set fees or interest rates, annual fees and interest rates on revolving credit balances have declined across the industry because of the competition that Visa has fostered. In addition, card issuers frequently offer rebates, airline miles and other benefits to encourage cardholders to use their cards. Visa has also responded in a meaningful way to consumer concerns about overextension or misuse of credit products. Visa pioneered the debit card category in the United States, introducing the first debit card in the 1970s, Debit cards, of course, directly access cardholders' deposit accounts and do not carry interest charges. Today, more than half of Visa's transactions are debit, rather than credit.

Consumers will lose the most if the prices merchants pay for electronic payment services are artificially depressed. As we all know, price controls in any industry have many unintended consequences. You are hearing today from merchant representatives, and we take their interests very seriously, but we also must balance the exchange of value between the merchant's and the cardholder's bank so we continue to promote the interests of the cardholder. Interchange fees play a key role in balancing the exchange of value between cardholders and merchants. If price controls push prices to merchants down, prices to consumers will very likely go up.

Price controls are a severe tool which should be used, if at all, only in the case of real market dysfunction. When a market is not functioning properly, and there is monopoly-type behavior, one would expect output to be restricted and prices to be pushed up. Neither is the case within the Visa system. Merchants in the United States today pay a lower rate to accept general purpose payment cards than they did a half-century ago when those cards were first introduced. The rate on the country's first generally accepted payment card system, Diner's Club, was 7%. Today, the average merchant discount on the Visa system hovers at around 2.2%. Value in the form of access to consumers, efficiency at the point of sale and reliability of the system, however, has sky-rocketed over this period. This means, quite literally, that merchants are paying less and getting more. And the vast majority of merchants are not unhappy with the status quo.

And of course there is no evidence of output restriction. Quite the contrary. There are more cardholders who use the cards and merchants which accept them than ever before. In the past three years, more than 100 million additional Visa cards have been put in the hands of U.S.

cardholders, and the number of merchant outlets accepting Visa has grown by more than 900 thousand. Over this same time period, the number of Visa transactions and purchase volume on the Visa network have each seen annual growth rates in excess of 15%, and cumulative growth of more than 50%, as more cardholders and merchants move away from cash and check. The system continues to add new cardholders and new merchants every day, and more and more volumes are moving to Visa's enhanced credit, debit, and commercial products. Hardly the symptoms of restricted output or an unhealthy marketplace.

Nevertheless, we recognize that a small minority, claiming to represent the entirety of the merchant community, is upset. From our perspective, this unhappiness is misdirected. Consumers are driving the increase in payment expense that merchants see on their expense reports by migrating away from cash and check to electronic payments. However, this expense is more than made up to merchants by the increased value to them of electronic payments in place of cash and check transactions. Further, merchants have a real opportunity to control their costs. They can, for example, make different choices about which payment systems they accept. With Visa, MasterCard, American Express, Discover, First Data, Pay Pal, Debitman, Google Checkout and many others--not to mention cash and check--all vying for business, this is not an industry dominated by one or even a few firms. More merchants could also take a greater interest in the payment choices that their customers make and use their influence over the customers at the point of sale to steer them to the payment system that merchants prefer.

This Committee should not be misled. Visa's interchange mechanism is fundamentally indistinguishable from the cross-subsidies that run between the card issuing and merchant signing sides of proprietary card systems like American Express and Discover, and the many other competitors I have just mentioned. It is also no different than the countless other companies that have to attract two groups of constituents to offer value to either. Payment systems, financial markets, auction companies, real estate brokers, and media companies all use a similar business model. Visa's business model does not implicate the antitrust laws any more than theirs do.

IV. Price Controls Harm Consumers

Price controls often harm the people they are supposed to protect. Lawmakers, regulators and courts in the United States have declined the invitation to impose price caps, but regulators in some parts of the world have not exercised similar restraint. The impact of regulation elsewhere shows that consumers in the United States would in fact be hurt by artificial price controls on interchange.

Three years ago, the Reserve Bank of Australia imposed artificial price caps on interchange fees set by Visa, MasterCard and another bank-owned payment system. The Reserve Bank cut rates by 43 percent, from 0.95 percent to 0.55 percent. The Reserve Bank did not regulate the price that American Express charges merchants or modify the internal transfer that American Express makes from its internal acquiring side to its issuing side (i.e., the American Express "interchange" fee). Nor did it benchmark the total price that merchants should pay to accept four-party payment systems to what American Express charges its merchants.

The regulatory intervention has had precisely the expected effect. Cardholders in Australia are paying more for payment cards than they did before through higher annual fees and finance charges. They are also getting less in terms of reward programs and other rebates. Merchants, meanwhile, have seen their cost of payment card acceptance drop some. But there is no evidence that they have passed this decrease in cost on to consumers in the form of lower retail prices. In fact, the Reserve Bank, which had promised that retail prices would decline as a result of its intervention, has given up trying to prove the existence of the promised decline.

The same thing would likely happen here if the retailers and national chains behind these lawsuits were to get their way. If retailers persuade some arm of the Federal government to cap Visa's interchange rates, annual fees and interest rates will go up, and rewards programs and other benefits will decline. Retailers may see their costs decline, though the decline would be likely be offset by another unintended consequence. The regulatory burden would push volume toward unregulated--and often higher priced--competitors. Large issuers would likely turn to whatever systems were exempted from the rate cap, and those systems would see their volume increase at Visa's expense. Consumers, Visa and the large and small community banks and credit unions that depend on the Visa platform to compete with the industry's financial behemoths would lose out.

Artificial price controls are not the answer, as there can be no denying the tremendous growth and health in the payment markets. The merchants behind these lawsuits may continue to make their antitrust arguments in the Courts, but again we believe the right balance in value and costs as between merchants and cardholders is a business matter, driven by supply and demand in the relevant markets. Indeed, the Courts have specifically looked at interchange in the past, and in each Court decision have decided that interchange does not pose an antitrust problem and indeed promotes healthy competition, efficiency and innovation. In National Bankcard Corp. (NaBanco) v. Visa U.S.A. Inc., 779 F.2d 592 (11th Cir. 1986), Reyn's Pasta Bella v. Visa U.S.A., 259 F. Supp. 2d 992 (N.D. Cal. 2003), and Kendall v. Visa U.S.A. Inc., Slip. Op., 2005 WL 2216941 (N.D. Cal. 2005), distinguished Courts have all rejected antitrust claims regarding interchange. We expect the same outcome in the more than 50 separate new cases filed by the plaintiff's bar. But the main point here is that plaintiffs can seek their remedy in Court, and there is no need for Congress to intervene in advance of judicial resolution by imposing artificial price controls.

IV. A Word On Transparency

As I mentioned at the outset, Visa takes its relationship with its merchant partners quite seriously. In the past years, Visa's most senior executives have made a point of getting out to the merchant community and hearing their concerns directly. We have heard merchant's concerns about the transparency of our operations and governance, and Visa has taken concrete steps to address these concerns.

Retailers have argued for the last several years that they are subject to Visa's rules but do not have access to those rules and, thus, cannot determine whether they have complied with them As a legal matter, this argument makes little sense since Visa's rules do not apply to merchants or, for that matter, to cardholders. Instead they only apply to Visa's financial institution members. Merchants are bound by the contracts they sign with financial institutions to accept Visa cards, and they have every right to demand that those financial institutions explain the obligations that they have assumed by signing up to accept Visa cards. But formalities aside, we have heard the complaint, and we have acted. Beginning in September, merchants that want to see the rules will be able to get a copy. We are proud of our network, and happy to include merchants among those who have access to our operating regulations.

In keeping with good governance, Visa has also diversified its Board of Directors. Visa is organized as a non-stock membership corporation and throughout its history, its Board of Directors has been made up of people drawn from the executive ranks of its member financial institutions. Earlier this year, Visa amended its by-laws and corporate charter to require that a majority of the Board be independent of the Visa membership. These directors have also been given the responsibility of setting interchange rates. The first group of independent directors has joined the Board, and they have assumed responsibility for setting rates.

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In the past thirty years, Visa has built the most efficient, reliable and secure payment system in the United States. We are very proud to be part of driving this Country's economic growth, and delivering tremendous value to cardholders and merchants. With no indication of market dysfunction and with more cardholders and merchants participating in the system every day, there is no antitrust problem and no reason for this Congress to intervene in a healthy market. Mr. Chairman, I wish to thank the Committee for giving me this opportunity to address it and I am prepared to answer any questions which you might have.