

Let's Get Real

Noah J. Hanft

Excuse me . . . can we talk? No, I mean really. No one here needed to attend this conference to know that interchange has become as popular a target—at least with much of this crowd—as Michael Jackson is with late-night TV talk-show hosts.

Let's put aside for a minute what's funny and focus on what's real, because there is nothing funny about attacking a payments system that has provided extraordinary benefits to both consumers and merchants over the last 40 years. I grew up, professionally speaking, in the payments industry. What I have seen for those 20 years is that interchange, residing at the core of that industry, has been a home run—a home run for the global economy, for millions and millions of cardholders, and for the merchant community, whether they choose to admit it or not. MasterCard, and indeed that other four-party system, has brought extraordinary benefits to a vast cross-section of society all across the world. There is no evidence otherwise, and there is no legitimate basis to call for the regulation of interchange fees.

There is one—and only one—reason class-action lawyers are increasingly trying to align themselves with regulators in the United States, and only one reason they are out right now knocking on doors, making telephone calls, and searching for retailers to bring an interchange lawsuit. It is not about high interchange fees; it is about high attorneys' fees.

Yesterday, we all heard from one class-action lawyer, who is indeed highly articulate and well-spoken. But make no mistake about it, he might try to sound like a public-interest lawyer, but he and his fellow class-action lawyers appeal for clients so that they can extract enormous fees for themselves and their colleagues. There is no question about that. We've seen it. His speech vividly demonstrates that, at bottom, it is not about economic theories. It is not about market realities. It is about pure and simple money lust.

Today, I am not going to hide behind the niceties of economic arguments, because frankly, we've consistently won those and repeatedly justified what is self-evidence. Today, I am going to take the opportunity to tell it like it is. Don't get me wrong, everyone has to make a buck. But it is the hypocrisy of it that, quite frankly, is so galling. And the moral high ground is kind of hard for a class-action lawyer to claim when—Mr. Lloyd Constantine I am sure won't deny this—he brought a claim against MasterCard, attacking our chargeback system because of its antifraud protection, on behalf of a service provider representing Internet pornographers. That case was recently thrown out of court—on the pleadings, I might add.

So, today, I am here to set the record straight, arguing reality not rhetoric. I am going to place the facts simply before you. 1) Consumers and merchants get a great deal with MasterCard, pure and simple. 2) Interchange is essential to four-party systems and cannot be analyzed as a fragment isolated from the whole. 3) Interchange is highly beneficial, efficient, and pro-competitive. 4) No one, and I repeat no one, has ever found interchange to be illegal. And finally, 5) Since no one is arguing that the more expensive American Express (AmEx) fees should be regulated, as has been discussed earlier, and since interchange is the method as to how four-party systems compete with three-party systems, an attack on interchange fees is nothing more than an attack on corporate form.

So now, let's take a minute and look at our payments system with interchange residing at its core. That system is just the sort of innovative, beneficial advance that comes when the private sector competes with a governmental monopoly. That was the case here in the United States when banks were competing directly with only two general-purpose payment forms, which were controlled by the federal government: cash and checks. There were also products such as merchant proprietary cards, for instance the Sears card, and other forms of credit that merchants granted to preferred customers. It is notable that these same merchants and government entities are now shifting more and more of their corporate payments and their receivables to payment cards, such as MasterCard.

When speaking about government entities, it is ironic to note that some of those government entities include the Department of Justice and the European Commission, whose employees now carry MasterCard commercial products. This is because their systems have not improved over time and are not as beneficial, user-friendly, or inexpensive as MasterCard cards. Proprietary systems provide limited acceptance, they lack consumer protections, and they just have not been as innovative as the four-party systems.

By contrast, bank cards have been innovative and increased consumer and merchant benefits. This is true not just in the United States but around the world. The innovations, flexibility, and ingenuity involved in the MasterCard offering facilitated the creation of Internet shopping, as well as the ability for consumers to travel the globe with literally one piece of plastic in their pockets and buy whatever they want or need.

The reality is that the anti-interchange crusaders will assure everyone that this would have happened without interchange or with much lower interchange. But let's get real. What do they really know? They haven't built a system or created value for consumers or merchants. Most of them make a living moving from industry to industry, this time attacking a payments system that is fundamental to the global economy. Their game, at least many of them, is to make a buck and move on when they have extracted what they can. And they leave it to others to clean up their mess.

The fact is that the part of the industry they attack in interchange has provided the equilibrium—and they don't like that word equilibrium. It is the point of the four-party systems that has provided the equilibrium that actually makes the four-party payment systems work. What is clear is that MasterCard with interchange has been an extraordinary innovation. The success is not only for financial institutions that issue cards, but also for merchants, who see significantly higher sales, and consumers, who have more flexibility in choice than they could have imagined in days when they could only pay with cash or with check.

The growth in cardholders, merchants, and the number and volume of transactions is a testament to the extraordinary offering that is MasterCard. That offering is more than simply the sum of its component parts, and it is simply impossible through hindsight to speculate that the system would have developed in the same way if one or another feature of the system had developed differently.

It is equally impossible to be sure that the future development of four-party payment systems will continue to be beneficial to society if interchange is regulated. Interchange has always been set to maximize the output of the payment system, meaning more cards, more merchants, and more transactions. MasterCard has been extremely successful in achieving this objective.

It is convenient now for class-action lawyers and some regulators to claim that merchants only accept MasterCard cards because of its alleged market power, but this simply does not explain the growth of MasterCard from zero to over 23 million merchants in 35 years. They also conveniently forget that extremely large merchants such as Sam's, Neiman Marcus, and Costco in the

United States, and many smaller merchants do not accept MasterCard or Visa cards. This is a matter of merchant choice. Merchants have been accepting our cards for over 35 years for one very simple reason. They know they can increase sales by doing so. And they also know that it would be much more expensive for them to do it themselves, whether through a proprietary card or some other form of loan. No straight-talking merchant will argue this point: Each transaction on a proprietary card costs significantly more, because merchant proprietary programs are less efficient but still have the same costs as four-party systems.

In the MasterCard system, these costs are borne exclusively by issuing banks, not the merchants. Part of the value we offer to merchants is that all of this is managed for them. It is this extraordinary value and very low price that explains why merchants offer co-branded cards in lieu of, or in addition to, proprietary cards. Merchants also have reduced handling costs, bounced-check costs, and collection costs by accepting MasterCard.

Because we are replacing far more costly and less beneficial payment forms, it is both logical and appropriate to charge these merchants for the valuable service provided for them. Frankly, it would be counterintuitive not to. Virtually all private payment services companies charge fees to merchants in the form of a merchant discount. Just to name a few: AmEx, Diners Club, Star, NYCE, JCB, and even check-authorization and guarantee services. Make no mistake about it, all of the hype and attention focused on interchange is nothing more than a highly effective public relations effort by class-action lawyers to get higher fees for themselves and by a subset of merchants to seek lower fees—an understandable effort by merchants.

Once again, let's get real. For the merchant, it actually has nothing to do with the mechanism of interchange fees, but rather with their desire to cut costs. I completely understand that desire. Personally, I always prefer to pay less. However, that doesn't mean I get to, and it doesn't mean that regulators or the courts will force lower charges to me, and it certainly doesn't mean *anyone* is violating the law. If I don't want to buy the product, I don't have to. And I don't. And I don't expect anyone to sit down and explain to me how they set their prices and what costs are factored into those prices. If it is a price that I think is fair, I buy the product. Why should merchants be any different?

Some merchants don't accept MasterCard because of the price. Many more don't accept AmEx because of its higher price. Interestingly, in the United States, even more don't accept Discover or any of the PIN debit brands, even though, according to the merchants, those may be the cheapest options, because they don't see the value in accepting those brands. The reality is that

merchants accept the payment types that make sense for the consumers they serve. End of story. All the counter-arguments amount to—and the pun is most certainly intended—is one of the best global three-card monty games of all times. Coming from a *New Yorker*, that says a lot.

The notion that regulators or the courts can determine best how these rates should be set is kind of like suggesting that I should determine what fees class-action lawyers should be paid. It is very simple; pricing just is not the job of a regulator, a court, or a class-action lawyer. A private payment system is in the best position to set its own rates, to determine its own costs and value and to determine how to maximize output and efficiency. But the real issue is not cost; it is value. The merchant should pay what is an extremely small price for the phenomenal value they get from accepting MasterCard.

We have all heard the anti-interchange crusaders use the phrase “hidden tax.” It is a clever marketing turn-of-phrase. Everyone hates a tax. But then, every cost a merchant has could be called a hidden tax, because none of these costs are disclosed to consumers. Indeed, a merchant never tells the consumer a component cost of the item it sells. Does that mean each of these is a hidden tax?

Can anyone imagine walking into a store to buy a sweater and having the merchant say, “This sweater costs \$50, because I paid \$3 for the yarn, \$10 for the labor, \$3 for shipping, \$4 for employee time folding it, \$5 for the store’s lighting, \$2 to keep track of cash in my store, \$3 to deal with bad-check losses, and on and on, and I make a profit of \$20”? Of course not; that is ridiculous. If a consumer wants the sweater and thinks it is worth \$50, he or she buys it. The same is true for merchants with payments systems, whether they have interchange fees or not. It has nothing to do with component costs, and absolutely nothing about it is illegal or hidden.

Frankly, if we are truly talking about exposing hidden taxes, this conference should move to examining the hidden tax consumers (those in the United States anyway) pay every day. It is built into the cost of everything we buy. It is the amount that goes to pay the class-action commandos, and it represents a staggering amount—over 2 percent of the nation’s gross domestic product. But that is probably the subject for another conference, and, if we hold that one, I will be delighted to participate.

Regulators and courts should not be substituting their own judgments as to what price should be charged for those determined through market forces. No one understands this better than the merchants themselves. They certainly do not want the government setting the prices for goods and services they sell. So why do they (at least some of them) argue for government interven-

tion here? Is it really because they believe in the unfairness of the MasterCard joint venture and the four-party system? Or might it be something far more understandable and fundamental—a simple desire to pay less, no matter how good of a deal they already have.

MasterCard should be free to establish its own fees. Interchange is appropriate and fair, and frankly, merchants know it. It is nothing more and nothing less than the mechanism required in an open system like MasterCard and Visa to do the exact same thing that a closed system—for instance AmEx and Discover—can do on its own through a merchant discount fee. It is unfair and counter to the purpose of the competition laws to simply prefer one business model over another, especially where that business-model-to-be-regulated is the less expensive and more efficient one.

I would like to take a minute to debunk the myth that interchange is illegal. Each and every case or other challenge to interchange has found the opposite to be true. That is, interchange is legal and appropriate. Beginning with the United States in the mid-1980s, an acquiring bank, NaBanco, sued Visa in federal court, alleging that Visa's interchange system was a horizontal price fix. In the interest of time, I'm not going to get into all the allegations in the case, the decision, and the various interpretations of the case. But suffice it to say, NaBanco lost . . . and for good reason. To run a multiparty system, a default interchange rate is efficient and essential. No court decision has come out any other way.

Let's look at how interchange has been examined outside of the United States. The European Commission challenged Visa's interchange fees in 1999 in response to a complaint filed by EuroCommerce, a large merchant trade association. The commission alleged that Visa's setting of interchange fees constituted price fixing. However, after reviewing all the evidence and holding extensive hearings, the commission concluded that interchange fees were not price fixing. Instead, the commission focused on trying to lower the level of interchange fees by reaching an agreement with Visa. The commission has since brought the pending proceeding against MasterCard, presumably seeking to reduce the level of the fee.

About the time the commission commenced its proceeding against Visa, the Reserve Bank of Australia (RBA) designated the four-party credit card systems under the Australian Payments System Act, the regulation act. The RBA then proceeded to determine the manner in which MasterCard, Visa, and Bankcard can set credit card interchange fees. The RBA action followed the decision by the Australian Competition and Consumer Commission (ACCC) to drop a lawsuit in which it claimed the setting of interchange fees

amounted to price fixing. Both the ACCC and the European Commission dropped their price-fixing claims against interchange.

Another significant regulatory proceeding involving interchange fees is the investigation by the Office of Fair Trading (OFT) in the United Kingdom. That proceeding has been going on since 2001, during which time the OFT has issued three separate statements of objections, each one narrower in scope than the preceding one, as MasterCard and its members have rebutted the OFT's charges one by one. The OFT now is at the point of arguing that merchants receive no benefit from the MasterCard payment guarantee or from the interest-free period and, therefore, that these costs should not be considered in setting interchange fees. Of course, these are two of the primary elements of the products, and they are saying, "No benefit to the merchants." Well, I'll leave it at that.

As I said, we believe these matters should be left to the operators of the system and to the marketplace rather than being decided by regulators or courts, who have no particular expertise in what it takes to operate global four-party payment systems. But I do agree with the regulators on one key point: Interchange fees are necessary for four-party payment systems to function. I say that because it has been reported that at least four large class-action firms are out there pitching an interchange case to large merchants, as if that case were some product that could be offered for sale.

I mentioned before the RBA decision in Australia. With no disrespect meant, they have managed to make a real mess in Australia, putting in place a system that has already led to higher consumer fees and will inevitably lead to higher merchant fees.

The RBA certainly had success in achieving its stated objective of reducing growth in credit card issuance and usage, but it has done so by encouraging double-digit growth of Diners Club and AmEx charge cards, which for the first time are eclipsing the growth of the less costly and more efficient four-party payment cards. This growth has not been through penetration of new segments. It has been purely through banks converting MasterCard or Visa portfolios to AmEx or Diners Club to exploit the loophole left by the RBA. Of course, this will be more expensive for merchants in Australia. This is probably why the RBA has been imploring AmEx and Diners Club to lower their merchants' fees without success.

In fact, in Australia things have gotten worse. In 1999, the difference in average acceptance cost between AmEx and bank-issued cards such as MasterCard was just a little less than 1 percent. Today, it is nearly 1.5 percent. At the same time, in order to make up for the reduction in interchange

revenue, Australian issuers have increased cardholder fees and reduced service levels to cardholders. I have to hand it to the RBA. They have managed to find a way to hurt both cardholders and merchants at the same time.

And what about the next steps for the RBA? Apparently, they are going to take a pass on regulating AmEx and Diners Club. If the revenue to issue from AmEx and Diners Club transactions are not in every sense exactly the same thing as interchange fees in terms of antitrust laws and public policy, then something is amiss. That is probably why the RBA has implored AmEx and Diners Club to lower their merchant fees, to try to reverse some of the damage to consumer welfare that has been caused. Instead, the RBA has decided that it must regulate debit card interchange fees.

Simply cutting credit card interchange fees by nearly 50 percent hasn't done enough to benefit the PIN-based EFTPOS debit cards, the RBA's preferred form of payment, so the RBA has announced it will reduce Visa and MasterCard signature debit interchange fees to about 15 cents and raise EFTPOS interchange fees to about 5 cents.

EFTPOS interchange fees flow to merchants, not away from them. This has meant \$94 million to one particular merchant in Australia. Whether they will be able to do this or not depends on the outcome of a court case brought by merchants who are opposing the RBA's attempts to regulate EFTPOS. It seems that the very same merchants whose complaints led to the RBA regulating credit card interchange fees like interchange fees just fine and oppose government intervention when they are receiving the fees.

I guess it is a question of whose ox is gored, or stated differently, where you stand depends on where you sit. Some may think that I must have it wrong, it is not logical, it simply can't be right. But it is what the RBA has done or stated it intends to do.

Looking back at what the RBA's actions have been doing—or what we call at MasterCard, a lesson learned—here are the questions we would ask for someone else to consider what the RBA has done. First, does the regulator know enough about the payments business and interchange fees to actually improve things by supplanting consumer choice and market forces with regulation? Second, is that regulator prepared to upset the competitive balance between three- and four-party systems and between credit and debit cards? Third, if this happens, as in Australia, is the regulator prepared to regulate three-party systems (debit cards, ATM cards, and possibly cash and checks as well) in order to try to restore the competitive balance? And finally, is the regulator prepared to take the flack when consumers find out they are much worse off than they were before the intervention?

As I mentioned, regulators in the European Union, the United Kingdom, and elsewhere have been focusing on the level of interchange fees flowing from acquirer to issuer. I think these efforts are fundamentally misguided and the free markets should determine the level of interchange fees. The economists who attack interchange fees are simply regurgitating what the class-action lawyers have spoon-fed them. The only reason they have managed to sell these stories to the regulators is that those regulators have the objective of decreasing the availability and usage of credit. If that is their objective, then regulating interchange is the surest way to accomplish it.

But to couch these arguments in terms of antitrust riot violations and consumer benefit is nonsense. The uncontested purpose of MasterCard's interchange fees is to increase the use of MasterCard cards, not to decrease it. All the arguments about regulation of four-party systems benefiting consumers boils down to the view that consumers don't really know what is good for them or aren't smart enough to make the right choice.

Let's get real. Interchange rates set by government mandate are not compatible with sophisticated competition laws. These laws are designed to protect and to foster competition, to let market forces determine price, and to allow consumers to decide which products and services they want to use. Currently, interchange rates are set by the interplay of competitive forces.

In contrast, rates set by government decree will result in an increase in the use of the more expensive and less efficient three-party payment cards, reduced efficiency and reduced output of electronic payments, and increased costs to both consumers and merchants, hardly the objectives which the antitrust laws are supposed to serve. This is not mere hypothesis. It is exactly what is playing out in Australia today.

Besides the class-action lawyers, the beneficiaries of attacks on the four-party systems are the three-party systems. These systems are less efficient, and the costs go up for consumers and ultimately merchants when four-party systems are under attack, as demonstrated by the Australia experience.

Here is something interesting. The same class-action lawyers that claim to represent merchant interests are also representing the three-party systems in the United States. Looking to Australia as a guide, the beneficiaries are not consumers and they are not merchants, so that leaves the lawyers and the three-party systems.

Tom Hoening asked that we all be cordial as we go through these presentations. I wasn't going to call anyone out on the accuracy of his or her presentation. That was before Lloyd spoke. As Lloyd and I have chatted about this, we both know it is business, it is not personal. I have a fondness for Lloyd.

Sometimes, since I go back with him so many years, it is kind of like that uncle at a family function. He goes on and on. In a perverse way, you kind of enjoy his eccentric views. But the focus of Lloyd's comments was neither on the subject matter of this conference nor did it track with reality.

In the interest of time, I am not going to address point by point many of the mischaracterizations, either about the Wal-Mart case or his other comments. I'd be glad to talk to any of the lawyers, any of the regulators, or any of merchants about specifics in terms of the Wal-Mart case.

First, there were allegations in the Wal-Mart case concerning interchange. If Lloyd had a problem with interchange, as he now contends, how is it that he failed to address it in the settlement? It was a component in the Wal-Mart case, a settlement he negotiated on behalf of millions of merchants. It was a settlement that released MasterCard and Visa with respect to all interchange claims, including price fixing. The entire basis of Lloyd's arguments boils down to one contention: MasterCard and Visa abused their alleged market power. If that is the case, it is a competition law issue and not an issue for the Fed to regulate. In the end, it has nothing to do with policy discussion on interchange. In fact, the Department of Justice (DOJ) investigated interchange over a number of years prior to bringing their case in 1998. The DOJ has never challenged interchange.

While Lloyd spent a lot of time berating a plethora of governmental agencies for not attacking interchange, perhaps his most blatant misstatement was by omission when he asked, "Who can or who will be that hero who has the courage to take on the interchange system?" We all know the one man of whom he thought.

In conclusion, sift through all the arguments, including the sophisticated economic jargon, and you'll find that the essence of the interchange challenge is a simple desire by class-action lawyers to make piles of money and by merchants who think they will pay less. We should not be stifling competition and innovation to line the pockets of class-action lawyers. We should not be favoring more expensive, inefficient three-party systems.

I conclude with a simple message to those class-action lawyers and economists that are in their perverse boutique making their living vilifying interchange: Stop trying to grow your hidden tax and find something else to do with your time.

MasterCard provides an incredible service to the global community. It is one that is cherished by consumers. It should be celebrated, not regulated.

General Discussion: Let's Get Real

Chair Guillermo Ortiz

Mr. Ortiz: There is time for just one question for Mr. Hanft.

Mr. Trifilidis: You speak about the European Commission issues with Visa. I would like to have your copy of this decision, because it should be different from mine. My copy said that the commission found the interchange fee illegal. It gave an exemption. By getting the exemption it means they should have found it illegal.

Mr. Hanft: That is not correct. There was an exemption that was granted to Visa but there was not a finding of price fixing. We can talk about that offline, but that related to the level of the fee, not a finding of price fixing.

Mr. Ortiz: With that, we have to conclude this session.