Working Draft
For Public Comment
comments@thecre.com

FAIR PAYMENT:
How Smaller Businesses Can Level the Payment Card Processing Field

I. The Big Business Advantage: Economies of Scale

Economies of scale are defined as "the phenomenon where the average costs per unit of output decrease with the increase in the scale or magnitude of the output being produced by a firm."[1] In short, bigger companies often have a cost advantage over smaller ones in producing mass market goods and services. Similarly, larger companies enjoy price advantages over smaller firms in the cost of obtaining a wide range of goods and services including products for retail sale, health insurance, information technology, and payment card processing services.

Smaller firms frequently have their own types of advantages compared to larger companies, particularly in the areas of innovation and flexibility. Nonetheless, smaller companies would be more competitive if their per-unit costs were closer to those paid by the larger entities.

II. Immediate Action to Lower Transaction Processing Costs

This paper will explain how smaller retailers can immediately take steps to reduce their payment card processing costs and bring them into line with the fees paid by larger businesses. This paper also explains why regulation of payment card transaction processing costs would not help consumers which is not surprising since the intervention proposals call for creating a new antitrust exemption that would apply to even the largest companies. **The paper also explains how the Merchants Payments Coalition (MPC) can develop a structured process to allow their members to use their economic clout to further lower processing costs**.

III. Why Merchants Accept Payment Cards

When merchants accept a credit or debit card, they pay a fee to obtain a wide range of services including transaction processing, bad debt protection, and fraud protection. By accepting these cards, retailers are not only providing their customers with payment convenience and flexibility, they are also providing themselves with protection against everything from the costs and risks (thievery) of cash transactions, to protection against bad debt, bounced checks, and identity theft by customers as well as quicker cash flow. Bad debt in particular is an increasingly costly expense. Bloomberg News reported that "U.S. credit-card

[1] http://stats.oecd.org/glossary/detail.asp?ID=3203.

defaults rose to a record in August" 2009 of almost 11.5%.[2] The news service also noted that "more losses may lie ahead as delinquencies climbed for the first time since March, according to Moody's Investors Service."

Thus, the benefits for retailers from accepting payments cards, in addition to higher sales, can be divided into two categories. The first type of benefit are those implicit in reducing or eliminating the need to handle cash. The second type of benefits are the services that are purchased through the transaction processing fee which covers banks taking over the risks associated with partial or non-payment by consumers, countless varieties of fraud, as well as the provision of transaction-specific paperwork/ recordkeeping services.

IV. The Consensus Against New Regulation of Transaction Processing Services

Much of the support for federal intervention in the setting of interchange fees was based on a misunderstanding of a widely publicized study by Diamond Management & Technology Consultants ("Diamond Report").[3]

The Diamond Report was initially cited by political leaders and business officials as providing evidence supporting legislation that would create a new antitrust exemption for retailers and authorize federal intervention in setting interchange fees. After Diamond Consultants denounced the misconstruing of their study by proponents of interchange legislation, the Center for Regulatory Effectiveness ("CRE") analyzed the report's findings and is using them to demonstrate that regulation of interchange fees would be counterproductive and harm consumers. CRE's conclusions are further supported by a more recent study by the Congressional Research Service ("CRS") and by a review of the relevant economic literature.

<u>Based on a review of the transaction processing cost issue, CRE is recommending measures for smaller retailers to take immediately to lower their interchange costs as well as actions their trade association representatives should take to achieve further reductions in payment costs</u>.

V. Misuse of the Diamond Report to Support Federal Regulation of Interchange

Political and business political leaders have frequently cited the Diamond Report as providing analytic support for proposed legislation that would:

1. Create a new antitrust exemption for some of the nation's largest corporations; and

---

[2] http://www.bloomberg.com/apps/news?pid=20601087&sid=aa71n7jSFj80#.

[3] A. Dawson and C. Hugener, "A New Business Model for Card Payments," Diamond Management & Technology Consultants.

2. Authorize federal intervention in determining the fees and services exchanged between retailers and payment card systems.

Examples of key leaders who have cited the Diamond Report in support of federal intervention in setting interchange fees include:

- **United States Senator**. In a letter to the CEO of a major card network, the sponsor of the Senate version of the interchange bill stated:

  – "Interchange fees have been the subject of considerable Congressional interest in recent months. ... A recent analysis by Diamond Management and Technology Consultants estimated that only 13 percent of collected interchange fee amounts are used to pay for the costs of transaction processing...."[4]

- **Witnesses Before the House Judiciary Committee**. The Diamond Report was cited by multiple major stakeholders in their testimony before the House Judiciary Committee. These organizations explained that the Diamond Report was a key research paper for understanding interchange fees. For example, the National Grocers Association said:

  – "The recent 'Diamond Study' of interchange examined, among other issues, the costs presently being borne by consumers and merchants under the present interchange system."[5]

  Other major business associations who cited the Diamond Report in their testimony as justifying federal intervention in setting interchange fees included:

  – The National Retail Federation;[6] and

  – The National Association of Convenience Stores[7].

Additional major business trade groups that have also specifically cited that Diamond Report as justifying the legislation authorizing federal intervention in setting interchange rates include:

- The National Restaurant Association ("NRA"), which referenced the Diamond Report and its estimate of transaction processing costs in the NRA's list of recommended "Talking Points" for the public to include in emails to legislators in support of interchange legislation;[8]

---

[4] Sen. Dick Durbin, May 23, 2008 http://durbin.senate.gov/showRelease.cfm?releaseId=298800.

[5] Prepared Statement of the National Grocers Association at the Hearing before the Antitrust Task Force of the Committee of the Judiciary, House of Representatives, July 19, 2007, p. 138.

[6] Hearing, p. 48.

[7] Ibid., p. 134.

[8] http://capwiz.com/restaurant2/issues/alert/?alertid=11129911.

- The Food Marketing Institute ("FMI") which cited the Diamond Report in a press release supporting the House legislation;[9] and

- The Merchants Payments Coalition ("MPC"), a trade group representing a variety of retail trade associations such as the National Council of Chain Restaurants and the National Association of Chain Drug Stores, which included a chart from the Diamond Report on its website dedicated to passage of the proposed legislation.[10]

The Center for Regulatory Effectiveness **agrees** with these specific conclusions from the Diamond : 1) competition in the payments marketplace is significantly increasing; and 2) competition will likely result in "issuers and associations...be[ing] forced to lower interchange rates...." Competition in the payments marketplace should guide federal policy on interchange fees.

VI. The Diamond Report: Competition is Transforming the Payment Card Industry

Instead of a call for legislation or regulation, the Diamond Report is just the opposite; a warning to payment card issuers and networks that competition from new payment systems and increased market power by retailers imperils their business.

The three key points made by the Diamond Report are:

1. Competition is forcing lower interchange rates, a process already underway;

2. Merchants are gaining power relative to payment card companies; and

3. Large, sophisticated retailers are poised to reshape the payments industry.

A. *Competition is Already Lowering Processing Fees*

The Diamond Report explains that: 1) competition will significantly increase without government intervention; 2) competition is already lowering interchange rates; and, thus 3) card systems will need to adapt to maintain their business.

- "Already we have seen both Visa and MasterCard move to reconstitute their price-setting bodies in ways that are likely to be more friendly to merchants."[11]

---

[9] http://www.fmi.org/news_releases/index.cfm?fuseaction=mediatext&id=945.

[10] http://www.unfaircreditcardfees.com/site/page/fightfees.

[11] Diamond Report, p. 7.

- "This pressure on the card associations and issuers can only intensify. Driven by investor demands for improved performance, merchants can be expected to take advantage of the low-cost alternatives to the status quo that already exist.... Innovations from other quarters can also be expected because of this market opportunity."[12]

- "These disruptions will set in process other changes that cannot be foreseen. It is clear, however, that issuing banks and the associations need to prepare for a world of change."[13]

B. *Merchants' Increasing Economic Power is Forcing Changes by Payment Card Systems*

- "Consolidation of retailing has led to fewer, larger, more influential merchants. Not only are these companies under constant pressure to improve performance, but they are also equal partners in the payment cards equation."[14]

- "Once transparency comes to credit card pricing models—as it ultimately does to virtually every industry and now may be beginning here with the recent decision by MasterCard to publish interchange tables—merchants will use the information to force an unbundling of interchange fee structures, The interchange structure as we know it will disappear, replaced by a system where merchants pay directly for value they receive."[15]

C. *Large Retailers Are Poised to Reshape the Payments Industry*

- "Large merchants will assume more of their own payment processing. Wal-Mart Stores Inc. is taking this step now...."[16]

- "It will eventually be a small step for one of them [large retailers] to decide they need a particular card company less than the reverse. When one or more major merchant stops accepting general purpose credit cards and signature debit, it will send a shudder through the card industry."[17]

---

[12] Ibid., p. 6.

[13] Ibid., p. 11.

[14] Ibid., p. 7. [Emphasis added]

[15] Ibid., p. 10. [Emphasis added]

[16] Ibid., p. 11.

[17] Ibid., p. 7.

VII. Diamond Makes Explicit Their Opposition to Federal Intervention in Interchange Fees

The Diamond Report was a warning to card systems that competition and increased market power by large retailers was forcing changes to their pricing model and reducing consumer costs. The Report has been misinterpreted by supporters of legislation that would circumvent the competitively-driven process underway by creating a new antitrust exemption for merchants and payment card networks.

As a result of the misuse and out-of-context quoting from their report, Diamond Management and Technology Consultants published a document objecting to the misleading, inappropriate use of their study and explaining that it is market-based mechanisms – not government intervention – that will provide merchants and consumers with improved value:

- "For many reasons, making references to our analysis is inappropriate. ... Competition within the credit card industry will further promote innovations and this exchange of value between issuers and merchants."[18]

- "Furthermore, the 13 percent figure (for processing) and the as much as 44 percent figure (for issuer rewards) that have been quoted from the study do not include all of the costs of the payments system, nor do the figures reflect how issuers actually spend interchange fees.... There are many costs, including credit losses, fraud losses and operating costs to pay for statements, online access and other costs that are not included in those percentages."[19]

- "In closing, we find it unfortunate that a report that was actually intended to provide valuable insights to our clients, inform their business strategies and enhance innovation could be deployed by others to stifle innovation and hamper free market forces."[20]

VIII. The Congressional Research Service Economic Analysis of Interchange Fees

In September 2008, Congressional Research Service ("CRS") published a study, "Payment Card Interchange Fees: An Economic Assessment"[21] which made two key points:

1. Cost-based regulation of interchange would not yield an optimum payment fee structure; and

2. There is no evidence that retailers share interchange savings with consumer costs.

---

[18] "Diamond's position on news coverage about interchange fees:" found at http://www.diamondconsultants.com/PublicSite/company/press/news/Others/Interchange_6-12-08.pdf

[19] Ibid. [Emphasis added]

[20] Ibid.

[21] http://thecre.com/pdf/CRS%20Report%20Interchange%20Fees.pdf.

The CRS analysis also highlighted that there has been little discussion about establishing a mechanism for ensuring that at least a portion of any reductions in interchange fees are passed along to consumers.

A. Cost-Based Regulation Doesn't Work

The Senate version of interchange intervention legislation proposed in the 111th Congress calls for cost-based regulation. Moreover, the bill calls for establishing a new kind of federal judge, "Electronic Payment System Judges," that would be appointed by jointly by the Attorney General and the Chairman of the Federal Trade and who would not be subject to Senate confirmation.

Among the unusual powers that would be granted to the new breed of judges is that they "may issue regulations to carry out the duties of the Electronic Payment System Judges under this Act.[22]

While the regulations would be subject to approval by the Attorney General and FTC Chairman, it is not at all clear that they would need to be developed in accordance with public participation, small business protection and other requirements of the "good government" laws, *e.g*., the Administrative Procedure Act, Regulatory Flexibility Act and Data Quality Act, which apply when regulations are issued by agencies, not judges.

Thus, the legislation would create antitrust exemptions that would allow even the largest businesses to cut deals while potentially bypassing the small business and consumer protection processes in the normal regulatory process.

With respect to creating a cost-based regulatory system, the bill states that the Electronic Payment System Judges shall "consider the costs of transaction authorization, clearance, and settlement that are necessary to operate and to access an electronic payment system" as well as "normal rate of return in a hypothetical perfectly competitive marketplace...."[23]

The legislation proposes cost-based regulation to set interchange fees even though the CRS analysis clearly stated that cost-based regulation is not only a generally inappropriate basis for price regulation but also that such regulation would be particularly inappropriate for setting interchange prices in "two-sided markets" such as exists for payment cards where, even hypothetically, there cannot be a single "perfectly competitive marketplace." As the report explains:

- "economists have pointed out that price regulations based on costs have historically been plagued with practical problems even in industries in which theory would predict that the optimal price can be based on cost. The practical reason for these theories' failure to

[22] S. 1212, 111th Congress, 1st Session, Sec. 5(b)(4).

[23] Ibid., Sec. 3(c)(3)(C)(i)(II).

determine the optimal price based on costs is that a firm has little incentive to cut cost if its revenues are tied to those costs."[24]

The report goes on the to explain that in addition to the general problem with cost-based regulation discussed above, "in the case of interchange fees, economic theory also suggests that cost-based regulation would not be expected to produce the optimal interchange fee."[25]

As CRS further explained:

- "Economists have shown that, because of the nature of the credit card market, it would be very unlikely that the optimal interchange fee could be reached by setting it at zero or determining it strictly on a cost-based measure."[26]

B. *Two-Sided Markets Require Special Consideration*

CRS' explanation of why cost-based regulation is particularly inappropriate for interchange fees is based on the specific structure credit-card market which is:

- "a two-sided market where suppliers compete for two types of customers with different demand responses, like a newspaper that must attract both readers and advertisers. In the payment card market, banks must attract cardholders and merchants, and a transfer of revenues is usually necessary to provide card-issuing banks an incentive to issue more cards, which provide more payment card users to merchants."[27]

CRS' discussion of two-sided markets is crucial for understanding why the proposed interchange legislation is fundamentally flawed. CRS explains that in two-sided market there "are effectively two demand and supply curves to determine the optimal price."[28] The proposed legislation, however, does not account for these two separate supply and demand curves. Instead, the legislation calls on judges, in absence of an agreement between payment card companies and merchants, to set interchange fees that would "most closely represent the rates and terms that would be negotiated in a hypothetical perfectly competitive marketplace for access to an electronic payment system between a willing buyer with no market power and a willing seller with no market power."[29]

---

[24] Ibid., p. CRS-6.

[25] Ibid.

[26] Ibid., p. CRS-6.

[27] Ibid., Summary.

[28] Ibid., p. CRS-6.

[29] S. 1212, Sec. 3(b).

Thus, the proposed legislative mandate does not account for the fact that, irrespective of market power, there are two completely different types of willing buyers (consumers and retailers) with different elasticities of demand.

As CRS explains, citing a study by David Evans and Richard Schmalensee on the economics of interchange fees, the two sided nature of the payment card market means that,

> "*Maximizing output requires issuers and acquirers to set prices in a way that will provide proper incentives for cardholders to use and merchants to accept the payment card. Balancing costs in some fashion would achieve this result only if the elasticity of demand on both sides were equal. Furthermore, setting the fee to zero would maximize output only if on both sides of the two-sided market costs and demand were equal. Because neither is likely to be true, one should not expect either a cost based or zero interchange fee to be optimal.*"[30]

Moreover,

- "In both the newspaper and the payment card cases, revenue transfers are necessary to maximize overall social welfare."[31]

In short, the legislation calls on federal judges to make pricing decisions based on an economic theory that is, in this circumstance, theoretically inappropriate.

C. *Merchants Don't Share Interchange Savings with Consumers*

A few countries including Australia and the U.K. have experimented with limiting interchange fees. As CRS explains, there is no evidence that retailers have shared any of their savings with consumers:

- "In countries where interchange fees are capped, the governments have been relying on merchants to voluntarily lower prices. Yet, there is no formal evidence that merchants have lowered their prices because of the lower interchange fee caps."[32]

The Implications section of the CRS analysis asks, but does provide an answer to, the question of how to ensure consumers benefit from a reduction in interchange fees. CRS notes that there has been little discussion of this issue. CRS again explains that, in the absence of a mechanism for passing interchange savings to consumers, rate caps may well simply redistribute wealth from banks to retailers:

---

[30] Ibid., p. CRS-6.

[31] Ibid. [Emphasis added]

[32] Ibid., Summary. [Emphasis added]

- "What mechanism might be used to make sure that the price of the goods and services is lowered to reflect the lower interchange fees? Although experience has shown that interchange fees can be lowered by regulatory caps and other government restrictions, there has been little discussion of how to pass the excess fees back to the cardholders. If the government just lowers the fee with the expectation that merchants will pass the savings back to cardholders, it might not occur. The government's regulatory caps would be redistributing revenues from the issuing banks to merchants."[33]

D. *Economic Basis for Opposing Interchange Fee Regulation*

CRS' report on interchange fees builds on long-standing economic analyses of two-sided markets in general and interchange fees ("IFs") in specific as well as analysis of the problems resulting from cost-based regulation. For example, the CRS paper is in accord with an influential European study of payment card interchange fees by Jean-Charles Rochet and Jean Tirole, "An Economic Analysis of the Determination of Interchange Fees in Payment Card Systems."[34]

The Rochet and Tirole paper notes that in "several regions of the world (European Union, Australia, Israel), the mode of determination of IFs has come under scrutiny by competition authorities, often at the instigation of large retailers' associations" and explains that one of the purposes of the paper is "to examine the case for a public regulation of interchange fees."[35] The authors state,

> "*In agreement with Katz (2001), we in particular explain why there is no economic rationale for cost-based regulation of IFs.*"[36]

No Demonstration of Market Failure

Rochet and Tirole begin with the standard model for determining if regulation is warranted.

> "*The standard approach to public intervention in industries involves two steps:*
>
> *(1) the theoretical identification of a serious market failure and the validation of its empirical relevance,*

---

[33] Ibid., p. CRS-10.

[34] Jean-Charles Rochet and Jean Tirole, "An Economic Analysis of the Determination of Interchange Fees in Payment Card Systems," Review of Network Economics, vol. 2, No. 2., June 2003, pp. 69-79.

[35] Ibid., p. 69.

[36] Ibid.

(2) the identification of the least distortionary way of addressing the market failure and a check that the remedy will not be worse than the illness."[37]

The 2003 Rochet-Tirole paper explains there is not even the theoretical work to demonstrate a market failure with respect to interchange fees let alone explain how it could be improved through government intervention. It is important to note that the more recent fall 2008 CRS study also did not identify any market failures. Rochet-Tirole explain that:

"*Proponents of a regulation of the IF must first build a theoretical paradigm that gathers broad intellectual consensus and demonstrates a clear market failure, show that the resulting distortions have a clear sign and a sizeable impact on welfare, and propose a form of regulation that is consistent with the underlying theory and is better that nonintervention. So far, no such theoretical paradigm has been achieved. On the contrary, recent academic work concurs to establishing that there is no systematic bias in the IFs selected by cooperative networks: there is no reason to think that privately optimal IFs are higher or lower than socially optimal ones.*"[38]

Rochet and Tirole explain, even more bluntly, why the economics of the payment cards markets needs to be understood before attempts are made to impose regulatory solutions on perceived problems:

"***Misunderstanding the economics of the problem and imposing cost-based regulation could impose substantial distortions in the industry***."[39]

The Logical Extension of Interchange Fee Regulation

CRS' opposition to cost-based regulation in two-sided markets was consistent with Rochet-Tirole. Rochet-Tirole explain why such cost-based regulation is inappropriate and go on to explain some of the implications of applying cost-based regulation in other two-sided markets, thus illustrating the law of unintended consequences.

"*A cost-based regulation of the IF would be an unfortunate precedent for two-sided markets. The same logic would then imply that advertisers' fees paid to TV networks, newspapers and portals should be regulated on a cost basis so as to stop the subsidization of eyeballs by advertisers...and the social gatherings should be regulated so as to prevent payments to or free entry for attractive participants (e.g., celebrities) while others pay for entry.*"[40]

---

[37] Ibid., p. 70.

[38] Ibid., p. 71. [Emphasis added.]

[39] Ibid. [Emphasis added.]

[40] Ibid.

Thus, both Rochet-Tirole and CRS make clear that the notion of cost-based regulation of interchange fees needs to be fundamentally reconsidered.

Ending the Level Playing Field Among Payment Cards

One of the issues analyzed by Rochet-Tirole is the difference in setting interchange fees between proprietary payment card systems, *e.g*., American Express, Discover, and cooperative payment card associations, *e.g*., Visa, Mastercard. The authors' discussion of the differences between proprietary and cooperative card associations is relevant to regulatory considerations since such regulation would end the level playing field for payment cards between the two types of systems.

> "*To perform the balancing act in the context of the payment-card industry, proprietary systems can directly set end-user prices and use the no-discrimination rule (NDR) that prevents merchants from charging different prices for card and cash transactions. In contrast, payment card associations can use only IFs and the NDR as indirect means of bringing both sides of the market "on board". Incidentally, it seems odd for competition conscious authorities to deprive open-access cooperatives of the ability to use the instruments (IF and NDR) that are necessary to perform the balancing act, and thereby to* ***destroy the level-playing field*** *in their competition with closed-access, for-profit platforms that do resort to an (implicit) IF and to the NDR.*"[41]

It should be noted that the House version of the proposed interchange intervention legislation[42] would exempt American Express on the grounds that they are too small to be covered.[43] As the US Delegation to the OECD's Competition Committee noted in a June 2009 document for a Roundtable on Two-Sided Markets, "American Express sets the highest prices to merchants of all of the credit card networks...."[44]

The official US position paper for an OECD Roundtable cites Rochet and Tirole's work on two-sided markets in its discussion of competition. The US notes that "A central question for competition policy is how competition affects prices. ... In a two-sided market, it is possible for

---

[41] Ibid., p. 70. [Emphasis added.]

[42] H.R. 2695, 111th Congress, 1st Session.

[43] The House version of the proposed legislation defines a covered electronic payment system as one that was used for at least 20 percent of the combined dollar value of U.S. credit card, signature-based debit card, and PIN-based debit card payments processed in the applicable calendar year...." According to a September 25, 2008 Bloomberg News story, American Express has 17% of the market. http://www.bloomberg.com/apps/news?pid=20601087&sid=adHxiaGa8gLs&refer=home

[44] Organisation for Economic Co-operation and Development, DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS COMPETITION COMMITTEE, ROUNDTABLE ON TWO-SIDED MARKETS, "Note by the Delegation of the United States," p. 5.

competition between platforms to have different effects on each side of the market, making conclusions about prices less clear."[45]

In discussing the nature and implications of a two-sided market, the government document, echoing Rochet-Tirole, explains that,

> "*A feature of many two-sided markets is a highly skewed pricing structure. That is, one group of customers pays a high price to use the platform, while the other group pays a very low or even negative price. For example, newspapers, web portals (e.g., Google or Yahoo.com), and websites offering information or entertainment content are often provided to readers for free, while advertisers pay the fees that cover the newspaper's or website's costs of production.*"[46]

The fundamental policy conclusions about regulation and interchange fees can be found in the paper "Merchant Benefits and Public Policy towards Interchange: An Economic Assessment" by Margaret E. Guerin-Calvert and Janusz A. Ordover, available from The Federal Reserve Bank of New York. In the paper, the authors explain,

> "*In sum, economics theory and experience with regulatory interventions in many countries indicate that heavy-handed cost-based regulation of prices is the public policy of last resort. It should only be adopted when there is a cognized market failure of the sort that cannot be remedied by less interventionist means. There is no evidence that such market failure exists in the markets for the provision of credit or debit card network services. The most appropriate role for competition policy in the realm of payments systems is to promote and ensure market conditions that foster vigorous competition among payment networks and among different means of payment and to remove unnecessary impediments to such competition at the merchant and cardholder level. Arbitrary and artificial allocations of responsibilities for cost-recovery to merchants based on the narrow definitions of "benefits" that inure to them from credit and debit payment systems is not consistent with either economics or sound public policy. Empirical evidence on the benefits from innovation and investment in card networks shows that society, consumers, as well as merchants benefit directly and indirectly from such investments.*"[47]

IX. Why Interchange Legislation Would Not Benefit Consumers

---

[45] Ibid., p. 4.

[46] Ibid., p. 3.

[47] Margaret E. Guerin-Calvert and Janusz A. Ordove, "Merchant Benefits and Public Policy towards Interchange:An Economic Assessment," p. 31 (emphasis added) found at http://www.newyorkfed.org/research/conference/2005/antitrust/Guerin_Calvert_Ordover.pdf.

There are three primary reasons why legislation establishing federal intervention in interchange fees would not benefit consumers:

A. *Rent Seeking Harms Consumers*.

"Rent seeking" is the technical term for business interests which try to use the legal/regulatory system for their own gain. As the *Economist* magazine explains, rent seeking is defined as,

> "*Cutting yourself a bigger slice of the cake rather than making the cake bigger. Trying to make more money without producing more for customers.*"[48]

The *Economist* goes on to explain that,

> "*as they do not create any value, rent-seeking activities can impose large costs on an economy.*"[49]

The Diamond Report indicated that reductions in interchange fees are not shared with consumers. More recently, these findings were supplemented by the Congressional Research Service which also found no evidence that interchange savings are shared with consumers. Even more significantly, CRS found that there had been "little discussion" of a mechanism that would ensure at least some interchange savings were passed back to consumers. Without an integral benefit-sharing mechanism, interchange regulation would simply transfer funds from one industry to another, *i.e*., constitute a successful example of rent seeking by the retail industry.

B. *Cost-Based Regulation Produces Unintended Consequences*.

The CRS study and Rochet-Tirole paper explained why cost-based regulation in a two-sided market does not produce socially optimal results. A point worth reiterating is that both papers cited the news industry, as well as payment cards, as examples of two-sided markets where such regulation would be harmful. It should also be noted that there is significant overlap between business groups supporting interchange fees and news advertisers. CRE carefully watches developments that could further harm America's newspapers.[50] While slippery-slope arguments are often treacherous, if rent-seekers are able to gain regulation of interchange fees it is not unreasonable to consider the possibility that they may try similar tactics with the news industry's advertising rates.

C. *Antitrust Exemptions Don't Help Consumers*.

---

[48] http://www.economist.com/research/Economics/alphabetic.cfm?letter=R.

[49] Ibid.

[50] http://www.thecre.com/wdw/2006/20061023.html.

The proposed interchange regulation bills would create an exemption for merchants and payment card companies from:

- The Clayton Act;
- State antitrust laws; and
- Section "5 of the Federal Trade Commission Act (15 U.S.C. 45) to the extent such section 5 applies to unfair methods of competition...."[51]

The exemption would be to allow the companies to "jointly negotiate and agree upon the fees and terms for access to the covered electronic payment system...."[52]

While it is true that there have been distinguished free-market economists who opposed antitrust laws,[53] given the current economic situation, now is probably not the optimal time for new experiments in freeing businesses from any provisions of federal and state antitrust protections.

The Way Forward

This paper will now focus on explaining how smaller retailers can take advantage of the payment card processing equivalent of a cooperative buying club to leverage their strength and reduce processing costs. Merchants can take advantage of these leveraged processing services to immediately lower their interchange fees without creating new laws, regulations, judgeships or antitrust exemptions.

X. Negotiated-Rate Card Processing Programs: Saving Businesses Money

Negotiated-rate card processing programs, also known as merchant credit card processing programs, allow smaller business to leverage one of their greatest strengths, their combined purchasing capability. Simply put, these programs allow smaller business to take advantage of the economies and scale, and the negotiating leverage with card processors, enjoyed by larger retailers by pooling their transactions. Since the programs negotiate fees with payment card processors on behalf of their combined clientele, they are able to offer smaller firms lower processing costs than they would otherwise be able to obtain on their own.

---

[51] H.R. 2695, 111th Congress, Sec. 2(a)(3). Similar language may be found in S. 1212, Sec 2(5).

[52] S. 1212, Sec. 3(b)(1)(A). Similar language may be found in H.R. 2695, Sec. 2(b).

[53] http://www.cato.org/pubs/policy_report/v21n2/friedman.html.

These negotiated-rate processing programs are often offered by small business advocacy organizations who work with a third-party processor. In other instances, some large retailers also team with processors to offer these programs.

Smaller retailers can choose from different card processing program depending on where they are located and to which business associations they belong. Organizations offering leverage card processing programs include:

- The National Federation of Independent Business (NFIB);
- Local Chambers of Commerce;
- Trade associations;
- Major retailers.

The following are several examples of programs available now to help smaller retailers cut their payment card transactions processing costs.

A. The National Federation of Independent Business

NFIB recognizes that explains that "Some small-business owners find it difficult to accept the idea of giving away a percentage of each sale, which is what you have to do when you process a sale on a credit card. ... But keep in mind, these fees are just part of the costs of doing business, and offering your customers the convenience of paying by credit card can potentially improve your cash flow."[54]

NFIB discusses both the benefits for small business of accepting payment cards and the advantages of using a merchant card processor.

> "*In most cases, the merchant processor will automatically deposit money collected directly into your checking account each night which leads to improved cash flow and fewer trips to the bank to make deposits.*
>
> *Your average transaction amount could actually increase since credit cards make it easier for consumers to spend more at checkout. If they aren't carrying enough cash or don't have enough cash in their checking account, a credit card makes it easier to spend.*
>
> *If your competitors are accepting credit cards, you could be losing sales if you aren't offering the same service.*

---

[54] http://www.nfib.com/tabid/96/tabid/56/Default.aspx?cmsid=28497&v=1.

If you are worried that the transaction fees will negatively affect your bottom line, you could increase your prices slightly or offer an incentive discount for those who pay cash.

Add-on services such as the ability to verify checks or sell gift cards can also improve your business. Offering gift cards can be very lucrative for all kinds of businesses, and most processors offer these on their menu of services."

In addition to providing general advice to small business on choosing a merchant card processor, NFIB offers a negotiated-rate processing service to their members. As NFIB explains,

"*Keep more profit on every credit card sale with NFIB's negotiated nationwide MasterCard and Visa processing rates. The program includes processing for all major credit and debit cards in virtually any business environment: retail, business-to-business, mail/telephone orders, Internet transactions, and mobile payments collected in the field.*"[55]

Of particular relevance to smaller businesses, the NFIB program states,

"*NFIB members that signed up for the credit card processing program in 2006 found average projected savings of $1,424 for the year, reducing overall processing costs an average of 17 percent.*"

B. Cincinnati USA Regional Chamber

The Cincinnati Chamber represents almost 6,000 businesses in southwestern Ohio, northern Kentucky and southeastern Indiana. Among the benefits offered to members by the Chamber is negotiated-rate payment card processing.

"*The Cincinnati USA Regional Chamber and Infintech have joined forces to offer a Group Rate Program for businesses who process electronic payments. Lower your business expenses by leveraging the buying power of the entire Chamber membership.*

Proven Savings
In the past year, Chamber members saved over $400,000 in processing costs compared to the existing providers.

Power of the Program
The Chamber's superior "cost-plus" pricing model is intended to expose the true costs for processing electronic payments, thus eliminating the potential for

---

[55] http://www.nfib.com/tabid/536/Default.aspx.

"after-the-fact" rate increases by the processor. The processor rate you're offered through the Chamber will remain the same for the duration of your membership!"[56]

C. Greater Omaha Chamber of Commerce

The Chamber states that one of the benefits of membership is card processing services.

"*The First National Merchant Solutions credit card processing program is an exclusive program based on collective sales volume.*

- *Rates as low as 1.532 percent*
- *No monthly minimum processing fee*
- *Comprehensive online reporting*
- *Full suite of check acceptance solutions*
- *An account in which your credit card deposits earn interest*"[57]

D. Greater Akron Chamber

This Ohio-based Chamber explains that,

"*Through the MemberChoice Plan, the Greater Akron Chamber has negotiated discounts for our members on a variety of products and services that every business needs...to help our members maximize the value of their dollars. The Chamber has added Electronic Merchant Systems (EMS) to its MemberChoice portfolio, to provide chamber members a discounted rate on payment processing services.*

...They process and safeguard many types of electronic payment transactions including all major credit cards, debit cards, electronic business transfers (EBT), stored-value, and electronic check services. Additional offerings include fully customized electronic gift cards, branded reward cards, turn-key eCommerce solutions, a unique petro program (fleet card), and dynamic currency conversion. To ensure maximum return, EMS will educate you, the merchant, on the best techniques and methods to accept noncash forms of payment. To help protect your bottom line, they provide suspicious transaction assistance and chargeback assistance at no cost."[58]

E. NACS (formerly the National Association of Convenience Stores)

---

[56] http://www.cincinnatichamber.com/cham_a.aspx?menu_id=126&id=7756&ekmensel=3ed1b7ac_126_138_7756_7.

[57] http://www.omahachamber.org/Chamber/MemberSavings.aspx.

[58] http://www.greaterakronchamber.org/cms/resource_library/files/9d3503e3e6582176/ems.pdf.

NACS, a major retail trade association, offers its members a discounted card processing based on the combined economic strength of their members. As NACS explains,

> "*The NACS Card Processing Program is designed to reduce card processing fees for convenience store and petroleum marketers.*
>
> *Retailers who enroll in this program should receive reduced fees because of the processing efficiencies and the aggregation of their transactions with NACS members and others in the industry.*"[59]

F. Costco

Costco, one of the country's largest retailers, is offering their members payment card processing services. The company advertises, "Take Credit for Less! Costco has partnered with Elavon to make accepting credit cards affordable." Monthly statement fees and the application fee are waived for Costco's Executive Members. A testimonial from a dental lab states,

> "*We are saving up to $360 a year in monthly fees alone. There are no hidden fees or surprise charges, and the customer service has been incredible!*"[60]

G. Sam's Club

Sam's Club is another major retail powerhouse that has teamed a card processing speciality firm to offer discounted payment card services. Sam's Club sells payment card processing hardware as well as services and offers prospective customers who have "questions about credit card processing" a toll free number to speak to "an industry expert."[61]

XI. The Merchants Payments Coalition – Positioned to Negotiate Further Rate Reductions

As the above examples illustrate, organizations can negotiate reduced payment card processing costs for their members though their collective purchasing power. The MPC, which lists about 100 trade associations as its members and represents countless companies of every size, has the ability to use the massive economic clout of their membership to help them achieve further reductions in payment card processing costs – without creating new antitrust exemptions or waiving existing small business and consumer legal protections.

Specifically, MPC should structure a negotiating process between their members and card processing companies. While individual business and trade associations have some leverage in

---

[59] http://www.nacsonline.com/NACS/Resources/CreditCardFees/Pages/NACSCPP_Details.aspx.

[60] http://www.elavon.com/acquiring/costco/.

[61] http://www.samsclubms.com/

negotiating with processors, they cannot come close to matching the combined economic power of the MPC's members.

It is incumbent on the MPC, as a business association committed to reducing payment card transaction processing costs, to use their organizational and economic capabilities to institute a structured negotiation process program for their members to allow them further lower their processing costs – savings which can and should be passed on to their customers.

XII. Conclusions

- Regulation of interchange fees would harm consumers.
- There is no evidence that retailers share interchange savings with consumers.
- Interchange costs, and consumer prices, can be reduced without legislation and without creating new exemptions from antitrust laws.

XIII. Recommendations

- The Merchants Payments Coalition should establish a structured negotiating process providing a forum allowing their members to negotiate lower transaction costs with payments card processors.

About CRE

CRE is a regulatory watchdog established in 1996 by former senior career officials from the Office of Management and Budget ("OMB").[62] In its role as a watchdog, CRE intervenes in regulatory proceedings through the comment process, filing Data Quality Petitions and other mechanisms. As part of its work to improve the effectiveness of the regulatory process, CRE was the primary proponent of the Data Quality Act ("DQA").[63]

CRE has identified the interchange regulatory proposal as requiring watchdog oversight since:

- America's consumers are in crisis; and

---

[62] http://www.thecre.com/emerging/Jim_Tozzi_Bio.html.

[63] http://www.thecre.com/pdf/20021111_fedtimes-tozzi.pdf.

- CRE has an extensive record in acting as a watchdog on legislative and regulatory proposals affecting payment systems.[64, 65]

[64] http://www.thecre.com/pdf/Banking%20Report.pdf.

[65] http://www.federalreserve.gov/SECRS/2008/September/20080909/R-1298/R-1298_256_1.pdf.