

The Need
for
The Comprehensive Reform of the U.S. Credit Card Industry
and
The Establishment of a Natural Disaster Trust Fund

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INTRODUCTION

The failure to regulate the U.S. credit card industry in a comprehensive manner and the lack of an adequately funded Natural Disaster Trust Fund are threats to our nation's economy.

Issuing credit cards has become a highly concentrated and profitable industry. The top four credit card issuers, Citigroup, Bank of America, JP Morgan Chase, and Capital One, account for more than 70% of all credit cards in circulation.

Credit card issuers receive 2.10% of every transaction from merchants in the form of an interchange fee. The interchange fee is set by the credit card processors: Visa, MasterCard, and American Express, which together control 93% of all card transactions in the U.S. Although Visa and MasterCard set the rates, it is their member banks, the issuers of the credit cards, that actually receive the interchange fees. Visa and MasterCard, along with the retailer's bank, levy their own processing fees on top of the interchange fee, increasing the total fee to approximately three percent of every transaction. In 2008, credit card issuers extracted approximately \$48 billion in solely interchange fees from merchants. This is twice the amount paid by consumers in credit card late fees. Interchange fees now comprise more than one-quarter of all credit card revenue and more than the total collected by banks in credit card late fees, over-the-limit fees, and ATM fees combined. These interchange fees, which amounted to \$427 per household in 2008, are ultimately passed on in the form of higher prices to all consumers, whether the consumer uses a credit card or not. To induce consumers to use credit cards for more transactions, banks have created numerous rewards programs that give cardholders frequent flyer miles or other benefits every time they use their card. Rewards cards carry much higher fees than other cards, because these "rewards" are financed largely through the interchange fee paid by merchants. A low-income single-parent shopper paying with cash ends up subsidizing the free airline miles given to a high-income shopper using an American Express Delta Skymiles card.

Credit card issuers make money on every credit card transaction, regardless of whether the consumer ultimately pays a finance charge. Just as with subprime mortgages, the current credit card business model creates a perverse incentive for credit card issuers to lend indiscriminately and ignore delinquencies.

According to a 2006 report by Chicago's Diamond Management and Technology Consultants Inc. ("Diamond"), only 13% of interchange fees go to processing, which is allegedly the interchange fee's original purpose, while the rest goes to paying for reward programs, and profits. According to Diamond, interchange costs are "paid for by merchants without directly benefiting them or their customer relationships. In fact, these rewards programs drive consumers to payment choices that are the most expensive for merchants."

Many countries have brought antitrust suits against card issuers or otherwise used their regulatory authority to limit interchange fees. The list includes Australia, Brazil, Colombia, Germany, Honduras, Hungary, Israel, Mexico, New Zealand, Norway, Poland, Portugal, Romania, Singapore, South Africa, Spain, Sweden, Switzerland and the United Kingdom. As interchange fee revenue has fallen in these countries, more credit cards, especially rewards cards, now carry annual fees. A significant benefit for credit card users in these countries is that interest rates have fallen, because banks are now using lower interest rates, rather than rewards, to compete for customers and drive transaction volume.

However, unlike other countries, the U.S. does not regulate interchange fees. While the Fed regulates the banks that issue credit cards, it doesn't regulate the credit card industry or price competition in general. As Chairman Alan Greenspan wrote in a 2005 letter, "The Board's regulatory authority does not currently encompass regulating the interchange fees established by payments networks." The Department of Justice and the Federal Trade Commission, meanwhile, have given no indication that they plan to act. As a result, *the average interchange fee in the U.S. is seven times the regulated interchange fee set by Visa and MasterCard in countries throughout the rest of the world.*

Due to the fact the interchange fee is based on transaction volume, it creates an incentive for banks to issue as many cards as possible, regardless of the creditworthiness of the borrower. By creating a huge revenue stream unrelated to credit risk, interchange fees encourage credit card issuers to engage in reckless lending. Regulating interchange fees would not only protect small businesses. It would create a more efficient and competitive credit card market for consumers and eliminate a powerful incentive for banks to issue credit cards indiscriminately and to ignore delinquencies.

The problem is further compounded by securitization, in which banks package and sell credit card debt to investors (just as they've done with mortgages). The banks continue to make money on interchange fees, while the investors assume all the risk of cardholders defaulting.

The manner in which our nation attempts to fund the recovery of areas devastated by natural disasters is even more disconcerting than its failure to comprehensively regulate the credit card industry. For example, New Orleans will lose approximately \$1 billion in allocated GO Zone bond financing at the end of this year. The Gulf Opportunity Act of 2005 gave Louisiana the authority to issue approximately \$7.9 billion in tax-exempt private activity bonds ("GO Zone Bonds") that could be used for acquisition, construction, reconstruction, and renovation of

nonresidential real property, qualified residential rental projects, and public utility property in 31 parishes across southern Louisiana. The State Bond Commission set aside approximately \$1.3 billion for projects in New Orleans. Although \$497 million has been earmarked to developers who hope to complete financing of their projects in the near future, only \$55.6 million of GO Zone bonds has been issued for projects in New Orleans. Unfortunately, while GO Zone bonds would be attractive to investors during a healthy economy, tight credit markets and difficulty finding investors willing to buy the GO Zone bonds have made it virtually impossible for developers to use the bonds.

Non-refundable tax credits are a viable financing incentive if potential investors have taxable income. Bonds are a viable tool if banks are ready and willing to lend. Unfortunately, our current economy lacks both a sufficient number of investors with taxable income and banks ready and willing to lend.

Congress has found that our nation needs transformational energy-related technologies to overcome the threats posed by climate change and energy security, arising from its reliance on traditional uses of fossil fuels and the dominant use of oil in transportation. Likewise, Congress should find our nation needs a transformational business model to overcome the threats to our economy posed by our failure to: (a) regulate the U.S. credit card industry in a comprehensive manner; and (b) establish an adequately funded Natural Disaster Trust Fund.

This article argues that legislation to reduce the interchange fee from the current 2.10% to 0.6% will bring the U.S. interchange fee in line with our trading partners and also provide adequate funding for the establishment of a Natural Disaster Trust Fund. In 2008, such legislation would have saved merchants (and thus consumers) \$34.3 billion in interchange fees.

THE NEED FOR THE COMPREHENSIVE REFORM OF THE U.S. CREDIT CARD INDUSTRY

Background

Credit cards started to become popular in 1958 with go-it-alone travel and entertainment ("T&E") networks in which one entity served as issuer, acquirer, and network, e.g., American Express, Diners Club, and Carte Blanche.

The financial institutions that issued T&E cards did not operate retail branch banks. Before 1994, federal banking regulations prevented the formation of banks with national retail operations. The McFadden Act of 1927 prohibited interstate branching by allowing national banks to branch only within the state in which it was situated, so there were no banks in the United States with national presences. Thus, for retail banks to get into the credit card business on a national scale, multi-issuer networks were necessary. Banks in multiple states banded together in card associations or as franchisees of card brands in order to offer nationally accepted card payment products. Two dominant multi-issuer networks arose in the 1960s: BankAmericard (now Visa) and InterBank (now MasterCard).

The absence of national bank brands meant that merchants did not know the reliability and reputation of banks from outside of their state and were hesitant to rely on them for payment. Yet a credit card would be of limited utility if it could not be used nationally, especially in locations where the cardholder's bank was not located. Thus, for multi-issuer networks, an honor-all-cards rule and a no-differentiation rule were necessary to ensure that a card issued by a member bank in California would be honored by a merchant in Maine and treated the same as a card issued by a member bank in Maine, the same way the Federal Reserve mandates that all checks clear at par. Honor-all-cards and no-differentiation rules have been around for multi-issuer networks since the birth of the BankAmericard network in 1966.

In 1975, Diners Club offered the first corporate card. In 1984, Diners Club created the first rewards program, and American Express created the first platinum card. As single-issuer networks began to introduce more expensive products, they needed honor-all-cards and no-differentiation rules to assure that new products would be accepted.

Likewise, during the 1990s, MasterCard and Visa issuers began to expand their rewards and corporate card programs as well as creating different interchange tiers; when the interchange fee was first introduced in 1971, there was a single rate for all transactions at all merchants. Honor-all-cards and no-differentiation rules took on a new function for multi-issuer networks with the diffusion of higher-end MasterCard and Visa cards.

The change in the role of the honor-all-cards and no-differentiation rules occurred during the 1990s, at the same time that the Riegle-Neal Act and the Gramm-Leach-Bliley Act rescinded the interstate branch banking restrictions that necessitated their creation and their multi-issuer networks. With the end of restrictions on interstate branch banking, banks with national retail presences began to emerge, vitiating the need for multi-issuer networks. Likewise, the concern about inconsistent card acceptance within brands faded away as merchants became familiar with the brands, and realized that payment did not depend on the identity of the issuer, but was guaranteed by the system.

U.S. Credit Card Business Model

Credit card product design makes it possible to lend profitably even to high risk consumers. A traditional creditor lends money with an eye to recovering its principal and making a profit from the interest. Such a lender cannot lend to overly risky customers, as loss of principal is devastating to its business model. As a result, a traditional lender will engage in robust underwriting of its loans. Credit card issuers hardly engage in robust underwriting; credit cards are almost all stated income loans, which have come to be better known as "liar loans," in the mortgage context. While card issuers will look at credit scores and credit reporting information, this is extremely thin as underwriting goes—there is no validated information on income and assets or non-credit-reported debts.

Card issuers are able to engage in unsecured stated-income lending because many employ a non-traditional lending strategy, one that Professor Ronald Mann of Columbia Law School has termed "the sweatbox." Sweatbox lending does not require return of the principal. Instead, the

sweatbox lender makes enough money off of interest and fees that even if it loses the principal, it will still make a handsome profit. *See* Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL.L. REV. 375, 392-97 (2007). Thus, a sweatbox lender will be willing to make loans that are unsustainable in the long run, so long as it can extract sufficient profit before the consumer defaults.

Julie L. Williams, former Acting Comptroller of the Currency, "Today the focus for lenders is not so much on consumer loans being repaid, but on the loan as a perpetual earning asset...it's not repayment of the amount of the debt that is the focus, but rather the income the credit relationship generates through periodic payments on the loan, associated fees, and cross-selling opportunities."

Credit card price structures are a key part of the sweatbox model. Credit cards not only have high interest rates, but they have extremely high back-end fees that are unrelated to costs, such as late fees and over-limit fees, plus a host of billing tricks and traps that function as hidden price points. Tricks and traps directly generated over \$12 billion in revenue for the card industry in 2007, which was over 30% of the industry's pre-tax profits. By shifting the cost of credit away from prominent, up-front price points like purchase APR to back-end fees and penalty APRs and billing tricks and traps, card issuers encourage greater use of cards, thereby increasing the number of consumers who enter the sweatbox.

All lenders lend for profit, of course, but a lender who lends with an eye to getting its principal repaid and making a profit from the interest is a very different type of lender than one who lends with an eye to turning the consumer into a "perpetual earning asset."

No matter how greedy a lender is, a lender that is looking to get back its principal, cannot squeeze a consumer too hard lest it push the consumer into default. A lender that doesn't care about getting principal repaid, as much as about extracting maximum payments from the consumer will squeeze much harder. This business model resulted in things like the "interest only" and "pay option ARM" mortgages that are currently wreaking havoc on the economy. It is an inherently reckless business model because even if lenders do not want consumers to default, they lack sufficient information to make sure that they do not end up pushing the consumer into default. The sweatbox lending model is predatory and unsuited for sustainable lending.

Most credit cards in the United States are run on the following bank-controlled networks: MasterCard, Visa, American Express, and Discover. In 2006, Visa had a 53 percent market share of U.S. combined consumer and commercial payment card purchase volume, followed by MasterCard with 30 percent, American Express with 13 percent, and Discover with 4 percent.

Historically, MasterCard and Visa were non-stock corporations owned by their member banks, essentially joint ventures. Since 2006 and 2008, respectively, MasterCard and Visa have been publicly traded corporations with complex, multi-class stock ownership structures combining public and bank ownership and, in the case of MasterCard, also charitable foundation ownership. *See* Adam J. Levitin, *Payment Wars: The Merchant-Bank Struggle for Control of Payment*

Systems, 12 STAN. J.L. BUS. & FIN. 425, 463–67 (2007), for an analysis of MasterCard's new ownership structure. Visa's IPO was the largest in U.S. history. See Anuj Gangahar, *Visa Stages Largest Ever US IPO*, FIN. TIMES (London), Mar. 18, 2008.

MasterCard's and Visa's networks consist of three parties that link the transaction between the consumer and the merchant. First, there are the banks that issue cards to consumers called the issuer banks. Second, there are the banks at which merchants maintain their accounts. These are called the acquirer banks because they functionally purchase merchants' accounts receivable created by consumers' card transactions with merchants. Issuers and acquirers typically belong to MasterCard and Visa networks. Intermediating between issuers and acquirers is the network association, which performs authorization, clearing, and settlement ("ACS") services. Before their IPOs, voting on governance issues was in proportion to annual sales volumes, so MasterCard and Visa have traditionally been dominated by the large issuers.

Two-Sided Networks and The Network Effect

Credit card issuers have two distinct types of customers, namely, credit cardholders and merchants. This type of business model is referred to as a two-sided network. New two-sided networks have a chicken-and-egg problem - it is impossible to attract one type of customer without having first attracted the other. Merchants will not accept a card unless consumers demand to use the card, and consumers will not carry a card unless merchants accept it. The ability to maximize on different price elasticities through cost allocation between the two types of customers in a two-sided network is a significant tool for getting such a network off the ground.

The network effect is the phenomenon in which the value of the network product depends on the number of users of the product. Put another way, a network's value to its participants depends on the network's size. For example, a single telephone is of no value because it cannot be used to communicate with anyone else. The more telephones there are in the world, however, the more valuable it is to have a telephone. Conversely, a reduction in the number of telephones reduces the value of owning a telephone.

Payment networks are able to allocate costs between the two types of participants through the fees they charge each type of customer. Merchant discount rates determine the costs for merchants, while annual fees, interest rates, and back-end or transaction fees determine the costs for consumers. In multiparty networks like MasterCard and Visa, the network does not control these direct price points - issuers set the fees and interest rates, and acquirers set the merchant discount fees. The network, however, can affect the relative cost allocation through the interchange fee, which in turn sets a base for the merchant discount fee.

Avoidance of negative network effects is the primary argument that has been put forth in defense of both interchange fees and merchant restraint rules, particularly no-surcharge rules. As the argument goes, by passing on the marginal cost of credit card transactions to cardholders, merchants would destroy the network's careful balancing of price elasticities. Consumers are less willing to bear the cost of credit cards than merchants, and would shift to other payment systems

if the costs of credit card transacting become too high. If consumers shifted away from credit cards, card acceptance would be less attractive to merchants, which would make the card less attractive to consumers, setting off a downward “death spiral” for the network.

Merchants were willing to tolerate relatively high interchange fees in the early days of credit card networks both because the number and the volume of card transactions were relatively small and because they experienced a marginal benefit from card acceptance as cards enabled greater spending by masses of credit-constrained consumers. In the early days of credit cards, if consumers had been required to pay more at point of sale for using cards, it is unlikely that credit cards would have become a mass-market product. No-surcharge rules allowed the card networks to retain control over the perceived allocation of costs within the network and impose a cross-subsidy on non-cardholders so as to grow the network.

Now, however, credit card networks are past the chicken-and-egg problem that plagues new two-sided networks. Credit cards are now widely accepted by merchants and used by consumers. Credit cards are an established product that does not need subsidization to thrive. Mature credit card networks still exhibit network effects. But network effects present different concerns depending on context, and a nascent payment system in a market with a limited number of competing products, none of which are strong substitutes, is a very different context than a mature payment system competing with other payment networks.

Network effects are network - that is, brand - specific. There is no generic credit card network effect. Credit card networks compete with each other for cardholders and merchants. To the extent that a cardholder or merchant switches from Visa to Discover, there is a negative network externality on the Visa network’s remaining participants, but this is offset by a positive network externality for the Discover network’s participants. As between particular credit card brands, competition policy should not care which one succeeds. Antitrust law is, after all, about protecting “*competition, not competitors.*” *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962).

Likewise, credit card brands compete with other payment systems that are reasonably strong substitutes for each other for transacting purposes, particularly card-based debit and ACH systems, which are very strong substitutes for credit cards as transacting mechanisms. They offer similar convenience and better security against fraud. While the maximum liability for unauthorized transactions is higher for debit cards in the United States, a debit card fraud does not affect a consumer’s credit report, unlike a credit card fraud.

Credit card merchant restraints, which once eased the entry of credit cards into the payments marketplace, are now a barrier to entry for new payment systems. There is social welfare value in having a networked product when there is no reasonable alternative. But when consumers have a choice among competing networked products, there is no inherent value to the existence of any particular network.

The network effects concern is simply inapplicable in the context of mature payment networks

competing against other mature payment networks. Any negative network externality is offset by a positive one when cardholders or merchants switch payment systems. For any given volume of transactions, it is a zero sum game; short of bartering, consumers always need payment systems. Therefore, net social welfare remains constant. It is not an all-or-nothing proposition of having payment systems or not, but a question of which payment system. That question should be answered by the free market.

We also know that credit card networks can operate profitably in the absence of no-surcharge rules, so the network effects concern is simply a concern about networks' level of profitability, not viability. Six European countries have individually banned no-surcharge rules, and MasterCard has recently voluntarily rescinded its no-surcharge rule for all of Europe, yet continues to operate profitably throughout the continent. In short, there is ample experiential proof that established credit card networks do not need no-surcharge rules to thrive.

Merchants have no reason to care whether a MasterCard is issued by Citibank or Citizens Bank or whether a Visa is issued by Bank of America or Chase. The essential variation in credit cards within a brand for a merchant is not the identity of the issuer, but the cost of accepting the card, which is set by the acquirer. The only reason for a merchant to refuse to honor a particular card within a brand is because it is more expensive to accept than another of the brand's cards. The function served today by honor-all-cards rules is not ensuring the viability of a multi-issuer network, but rather ensuring networks' ability to issue high-cost cards.

If the honor-all-cards rule was eliminated, merchants would likely refuse to accept cards that had high interchange fees (and hence high merchant discount fees). This refusal would create substantial market pressure on card issuers to stop issuing high interchange fee cards. Indeed, absent an honor-all-cards rule, there would likely be no more than de minimis interchange fee variation among cards within a brand; were it otherwise, merchants would simply refuse the higher interchange cards of the brand unless they saw a corresponding benefit to accepting higher interchange cards.

There is no credible theoretical justification for merchant restraints: They are naked restraints on trade that distort competition among payment systems and encourage greater levels of credit card usage at higher prices.

Merchant Restraints

Merchants who accept payment cards agree in their contracts with their acquirer banks to be bound by the card networks' rules, although the rules are available to merchants only in abridged form, if at all. The networks employ a number of rules, referred to as merchant restraints, to increase card usage at the expense of other payment systems and to limit price competition within the credit card industry in order to maintain higher interchange rates. Each network has its own set of rules, but all are substantially similar.

Merchant restraints can be classified into two broad categories of interconnected rules. The first category consists of rules that restrict the way in which merchants can price credit cards. There

are three rules in this category: no-surcharge rules, no-differentiation rules (also known as the all-products rule), and no-discrimination rules.

No-surcharge rules forbid merchants to impose a surcharge for the use of credit cards, thus linking the price consumers are charged for using credit cards with the price charged for using other payment systems. In effect, this means that consumers almost never see an explicit price for using a particular payment system. Instead, the price of payment is bundled in with that of the goods or services being purchased.

Whereas no-surcharge rules link credit card prices with other payment systems' prices, no-differentiation rules link the prices of different types of credit cards within a brand. No-differentiation rules prohibit merchants from charging different prices for particular types of cards within a brand, even though costs to merchants vary significantly within brands. Consumers pay the same price to transact with all types of MasterCard, Visa cards, American Express cards, and Discover cards. Likewise, transactions on rewards cards and corporate cards do not cost cardholders more than transactions on regular consumer cards, even though the use of these cards can cost merchants twice as much.

As a catchall, merchants are forbidden from discriminating against the card association's cards in any way. Thus, merchants may not discourage the use of brands' cards through non-pricing methods. No-surcharge rules, no-differentiation rules, and no-discrimination rules prevent merchants from passing on the marginal cost of a consumer's choice of payment system to that consumer. Thus, consumers are not forced to internalize the full costs of their choice of payment system. Instead, at the point of sale, all payment systems, as well as all card brands and all card types within card brands, have the same costs to consumers. Therefore, consumers choose among payment systems without factoring in point-of-sale costs.

The second category of merchant restraints consists of rules that restrict merchants' ability to selectively accept particular credit cards or to selectively accept credit cards for particular transactions. These rules are the honor-all-cards rule (also known as the all-banks or all-issuers rule), the all-outlets rule, and the no-minimum- and no-maximum-amount rule. The honor-all-cards rule requires merchants to accept all credit cards bearing the card association's brand, while the all-outlets rule requires merchants to accept cards at all their locations, regardless of different business models (for example, Internet store, main-line retail, and discount outlet).

Honor-all-cards, all-outlets, and no-minimum- and no-maximum amount rules prevent merchants from picking and choosing what sort of cards they will accept within a card brand and for which transactions they will accept credit cards. Card acceptance is an all-or-none proposition within a brand, even though the costs to merchants of card acceptance vary enormously among cards within a brand and by transaction size.

The net effects of the card associations' rules are: (1) to force merchants to charge the same price for goods or services, regardless of a consumer's payment method; (2) to prevent merchants from steering consumers to cheaper payment options; and (3) to increase the number of credit

card transactions, which as a result increases the interchange fees and ultimately interest income for issuers.

Merchant restraints also prevent consumers from accounting for the cost of payment systems when deciding which one to use. Instead, consumers decide based solely on factors such as convenience, bundled rewards, image, and float. These factors tend to favor credit card transactions over other payment systems. Higher purchase volume increases issuers' income on the front-end in terms of interchange fees and on the back-end in terms of more interest, late fees, and penalties.

For consumers, by making credit cards appear relatively cheaper to other payment systems, merchant restraints encourage higher usage of credit cards than would otherwise occur. This in turn leads to more credit card consumers paying interest and penalty fees, which contributes to consumer bankruptcies, low savings rates, decreased purchasing power, and inflation.

For merchants, the problem is that while the costs of credit card acceptance have been rising due to rewards and corporate cards, the benefits to merchants of card acceptance have remained static or declined. Credit card acceptance is, overall, generally in the interest of merchants, so merchants continue to accept credit cards. But the acceptance of particular types of credit cards is not in the interest of merchants. Because of merchant restraint rules, merchants are unable to either opt out of accepting the high-cost rewards and corporate cards or to pass along the marginal cost to those consumers who choose to use rewards or corporate cards.

The history of no-surcharge and no-discount rules shows they were created not to protect credit card networks from negative network externalities, but instead as a response to a specific regulatory and economic environment and the need to mask the high cost of cards to evade usury laws and the marketing problems of explicitly priced loans.

The Truth-in-Lending Act ("TILA") of 1968 required lenders, including credit card issuers, to disclose the cost of credit ex ante through two uniform components: the finance charge and the annual percentage rate ("APR"). TILA deemed any difference between the price of a cash transaction and a credit transaction, whether by cash discount or credit surcharge, to be part of the cost of credit, which had to be included in mandatory ex ante disclosures.

Compliance with TILA no longer serves to explain the existence of no-surcharge rules. TILA no longer counts a credit card surcharge or a cash discount toward the APR, so the legal problem created by TILA is no longer extant. The sole reason for no-surcharge rules is that the card networks benefit from disguising the cost of cards to consumers and imposing an externality on merchants and non-cardholders.

Interchange Fee

The usury problems created by surcharging historically point to an explanation of the original function of the interchange fee: It was designed to increase issuer compensation at a time when issuers could not charge higher interest rates because of usury laws. Interchange was devised to

evade state usury laws, and TILA's inclusion of indirect charges on consumers as finance charges threatened the system, necessitating no-surcharge and no-discount rules. Thus it seems likely that both no-surcharge and no-discount rules, the centerpieces of merchant restraints, were devised to avoid legal and marketing problems that threatened the fundamental economics of early credit card issuance.

The two-sided nature of credit card networks provides the starting point for understanding the original function of interchange as a mechanism to avoid usury violations while still providing issuers with a sufficient return so that they would participate in networks. A common account of interchange fees purpose is that they are needed to maximize the size of the network by playing on different price elasticities for merchants and consumers. But interchange fees are technically fees paid by acquirer banks to issuer banks; they are not direct transfers from merchants to consumers.

The fact that interchange fees are technically a transfer among banks (even if they are ultimately passed on to the merchants and thus consumers) is significant. Why would one set up a system in which banks were transferring fees to each other, and why would the fee go from the acquirer to the issuer instead of vice-versa? If the interchange fee is really to cover the costs of processing transactional paper, as one court has stated, then why is it paid from the acquirer to the issuer? Both parties have costs in handling the transaction. Yet all U.S. credit card systems have acquirers paying issuers. This tells us something quite important about the origins of the interchange fee, namely that it was necessary in order to make credit card issuance economically viable when usury restrictions were still applicable to all banks and card pricing and underwriting models were quite primitive.

In order to be viable, a network needed to sign up a sufficient number of merchants and consumers. Some banks (acquirers) specialized in signing up merchants, while others (issuers) specialized in signing up consumers. It seems that it was relatively easy to find acquirers, in part because of the limited risk assumed by an acquirer, which is typically protected by a balance against which it can set-off debts. Issuers, on the other hand, faced a serious credit risk in making unsecured loans to consumers. In the early days of card networks, credit scoring was non-existent and underwriting technology and techniques were primitive; card issuers lacked their current ability to undertake sophisticated computer analysis of reams of consumer data to find pricing strategies that would maximize revenues by targeting products to consumer behavior patterns. Accordingly, card lending was a riskier business than today, and card issuers issued far fewer cards, only issued them to people deemed to be highly creditworthy, and relied heavily on credit limits to control credit risk by limiting the size of their exposure for any individual.

To the extent that issuers wished to compensate for this risk by charging higher interest rates, they were limited, before 1978, by state usury laws. Other potential income sources for issuers, such as fee income, were also limited. In the early years credit card pricing was much simpler than today - typically cards had an annual fee and a single flat rate. The contingent, back-end weighted fee structure had not yet been devised. This meant that absent other revenue sources, credit card issuance might not be a profitable undertaking - the risks outweighed the returns - and

it would be hard for a network to recruit issuers and thus cardholders.

The difficulties in making credit card issuance profitable in the early years can be seen from a comparison to proprietary non-network credit cards issued by merchants (gas stations and department stores being the most notable examples). These cards, which did not have interchange fees (because all transactions were “on us”), were generally break-even or even money-losing affairs. Instead of serving as an independent profit center, cards were loyalty devices to encourage consumers to frequent a particular merchant, much like free parking.

Before the advent of multi-bank networks, individual banks had their own card programs in which they served as both issuer and acquirer, like American Express and Discover. In these early single-bank card programs, the majority of income was from merchant fees, not from interest, in part because relatively few card users were revolvers so issuers had major float expenses. This meant that if the functions of issuer and acquirer were split between separate banks, the major source of revenue would be with the acquirer bank. Accordingly, without the interchange fee, stand-alone issuers economics would resemble those of proprietary cards - break-even or money-losing ventures, but without even the redeeming benefit of customer loyalty. Not surprisingly, most of the pre-interchange fee general purpose cards were unsuccessful.

The creation of uniform interchange fees in 1971 (and with predecessor fees dating back to 1966) offered a solution to the economic quandary of early card networks. Given the limitations imposed by usury laws and the primitive pricing and underwriting models of early credit card programs, it might not have been possible to recruit issuer-only banks to card networks absent interchange revenue (or some other proxy for it). The interchange fee offered a way to make card issuance sufficiently profitable for banks such that they would go out and solicit consumers to become cardholders. To wit, say that usury laws capped the interest rate that could be charged at 20 percent annually. But with a 3 percent interchange fee on a 30-day extension of credit, the issuer would be able to make an effective return of 36 percent annually for purchases paid off at the end of the float period and 56 percent annually for revolving balances. The interchange fee changed the economics of early card issuance and helped cement it as a profitable undertaking by allowing issuers to get far higher returns than they could with usury restrictions. Interchange allowed card networks to wire around the economic constraint of usury laws. But this could only work if merchants were forbidden from passing the fee (as included in the merchant discount fee) on to card users. Otherwise, interchange would appear to be an indirect charge on consumers by issuers that might trigger state usury law violations.

In 1978, the Supreme Court’s *Marquette* decision gutted state usury laws, but interchange didn’t go away. Instead, it became gravy for card issuers, who were able to raise their interest rates while maintaining steady interchange revenue. From 1966 to 1978, merchants and consumers got used to interchange fees (and merchant discount fees) as part of the standard card pricing structure. To be sure, cards still had limited market penetration, but once the economic foundation was laid in the 1970s, there was no one pushing to change cards’ economic model post-*Marquette*, even though its original *raison d’être* had ceased to exist. Consumers and

merchants didn't understand the economic model, and banks had no incentive to change, especially as change would have meant confronting consumers with even higher interest rates, which would put issuers belonging to the first mover network at a huge competitive disadvantage.

Costs of Credit Card Transactions

Merchants pay banks a fee on every credit card transaction. *These credit card transactions cost American merchants an average of six times the total cost of cash transactions. The variation in fees among credit cards is also large, with some cards, such as rewards cards, costing merchants twice as much as others.*

Credit card transactions have several cost components, the manipulation of which affects demand for the product from both types of consumers - merchants and cardholders. When a consumer makes a purchase with a card, the merchant's account at the acquiring bank is credited with the purchase amount, less an amount known as the merchant discount fee. The merchant discount fee typically consists of both a flat rate amount, ranging from a few cents to a dollar, and a percentage amount. The total merchant discount fee usually amounts to 2 to 3 percent, but tends to be higher, in the range of 3 to 4 percent for non-U.S. merchants and for mail-order, Internet, or telephone-order merchants. Rates can even be as high as 15 percent for merchants who present a particularly high risk because of low transaction volume, limited credit history, or the nature of their business.

Of the merchant discount fee, part is retained by the acquirer bank and part is remitted to the network association. The network association keeps a small part of this remittance (known as the network assessment, or switch fee) to cover the costs of clearing the transaction and remits most of it, in turn, to the issuing bank. The remittance to the issuer is called the interchange fee, although this term is often misapplied to all the fees involved in the network, including the merchant discount fee. At some point after the transaction has been completed, the issuer will bill the cardholder for the full purchase amount. Typically there will be an interest-free grace period (the float period) before the cardholder has to pay the bill; if the cardholder pays late, the issuer will assess interest and fees.

The interchange fee is set by the card network. Fees are typically a flat fee of a 5 to 15 cents and a percentage fee of 1 to 3 percent. The precise fee depends on (1) the merchant's industry, (2) the size of the merchant, and (3) the level of rewards on the consumer's credit card. In other words, the interchange fee, which is technically not a fee paid by merchants, but an interbank fee, is set based on merchant and consumer characteristics.

The purpose of the interchange fee is a matter of debate; it might well have changed over time. The interchange fee's original purpose might have been to cover the costs of issuing cards, fraud, and funds during the float period. Alternatively, it might have been a way to allow issuers to evade usury laws. Regardless, the interchange fee is not a clearing fee. Whatever its original purpose, 44 percent of the interchange fee now goes to fund rewards programs, and interchange fee rates are not set based on the networks' costs. Instead they are set based on the value

provided to merchants - that is, whatever price the network thinks the market will bear.

The interchange fee sets the floor for the merchant discount fee. The merchant discount fee is always the interchange fee plus an additional percentage taken by the acquirer bank. Many acquirers explicitly price their services as interchange plus a particular percentage fee. The merchant discount fee will vary above and beyond the interchange fee based on the merchant's risk profile and the acquirers' profit component. Thus, merchant discount fees are low in stable, high-volume, but low-margin industries like groceries, but extremely high for fraud-prone businesses like low-volume, adult Internet sites.

Even though interchange is technically a fee paid by acquirers to issuers, the economic reality, and indeed the pricing structure, of interchange fees belies this formality and shows interchange to really be a pass-thru fee imposed on merchants. Interchange fees are scheduled according to merchants' business profiles. If interchange were really only a fee paid by acquirers to issuers, merchants' business profiles would be irrelevant, only the acquirers' own risk profiles should matter for pricing.

Given that some interchange fee categories are specifically crafted to cover only one or two merchants, the economic reality of interchange is that it is a pass-thru fee imposed by issuers on merchants, not on acquirers.

A few facts provided by the Home Depot (Chicago Fed's 2009 Payment Systems Conference):

- The Home Depot paid more in interchange fees than for employee health care last year.
- Interchange fees are The Home Depot's third largest operating cost.
- The Home Depot's interchange fees have risen 16% in recent years, while purchase volume has increased 10%.
- Cutting interchange fees in half would put another 5 full-time employees on the floor of every Home Depot store.

Interchange fee income combines with the card networks' merchant restraint rules to increase the number and volume of card transactions, thus increasing not only interchange revenue, but also interest revenue and late fees. Slowed growth in interest income has placed pressure on card issuers to increase their interchange fee income. Card issuers have responded by issuing more higher interchange rate cards.

Securitization

Banks have shifted much of the credit card loan risk to investors through securitization. When credit card issuers securitize credit card debt, they transform the credit card debt into a pool of assets used to pay off bonds. If the pool turns out not to be large enough, the bond investors take the loss. But if there's a surplus, it goes to the card issuer.

To illustrate, credit card securitization deals typically require that the card issuer retain an un-tranched 7% stake in the securitized pool. Many issuers will keep a higher stake. Suppose an

issue has a 15% stake in a pool and the pool needs to pay \$100 million in bonds. If the pool generates revenue of \$110 million, the card issuer gets \$25 million (\$10 million in excess spread + 15% of \$100 million). If the pool only generates \$90 million in revenue, however, the card issuer losses only \$1.5 million (15% of \$10 million in losses).

Because the card issuer retains control of the terms of securitized accounts, it can easily increase their volatility by applying and increasing penalty interest rates and fees. Some consumers will default as a result of higher rates and fees, but others will simply pay more. Because the card issuer has all of the upside and only a fraction of the downside, there is an incentive for the card issuer to crank up the interest rates and fees.

In short, while credit card issuers sell off most of the default risk, they keep any upside that comes from inflating their fees and rates. If the higher fees and rates cause more defaults, it is investors who bear the loss. If the higher fees result in more income, however, it is the credit card issuer, not the investors, who benefit. Credit card securitization creates a heads I win, tails you lose situation and leads banks to increase fees and interest rates on securitized debt. Interchange and securitization thus make it possible for credit card issuers to engage in less careful underwriting, which allows them to apply the "sweatbox" to even more consumers, including ones who are less economically stable.

Credit Card Litigation

Merchant restraints violate Section 1 of the Sherman Antitrust Act. Section 1 provides, "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce . . . is . . . illegal." Section 1 of the Sherman Act is not read literally to bar every contract, conspiracy, or combination in restraint on trade. Instead, it is interpreted to bar only unreasonable restraints on trade. *Texaco Inc. v. Dagher*, 547 U.S. 1, 5 (2006) (citing *State Oil Co. v. Khan*, 522 U.S. 3, 10 (1997)).

Merchant restraints also violate Section 2 of the Sherman Antitrust Act, 15 U.S.C. § 2 (2000). Section 2 of the Sherman Act provides that "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce . . . shall be deemed guilty of a felony . . ." As defined by the Supreme Court: The offense of monopoly under Section 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident. *United States v. Grinnell Corp.*, 384 U.S. 563, 570–71 (1966). Arguably, merchant restraints are the device by which credit card networks jointly monopolize or attempt to monopolize the payments industry. The gravamen of such charges is that merchant restraints expand credit cards' share of the total payment system's market share at the expense of other payment systems. This charge, of course, depends on payment systems forming the relevant market, as opposed to solely credit cards being the relevant market. If the relevant market is payment systems, not just credit cards (and arguably even if it is just credit cards), it appears that credit card networks do have the power to control prices, even if they only make up under 30 percent of the payment systems market, the usual

threshold for monopolization analysis. Merchant restraints set the relative level of all payment systems at point of sale by equalizing them, and then through rewards programs, credit card networks actually offer consumers the cheapest transacting system. This system has the same effect as being able to set absolute prices. In doing so, credit card networks manage to exclude or at least limit their competition. Card networks' ability to control prices in this manner is hardly the result of a superior product, business acumen, or historic accident, but instead the result of calculated business decisions.

In 2003, the United States Court of Appeals for the Second Circuit ruled that MasterCard and Visa could not prevent their member banks from issuing American Express cards too. The end of this so-called dual exclusivity permitted American Express and Discover to compete with MasterCard and Visa for issuers. Ironically, the resulting competition between networks for issuers has also pushed up interchange rates. American Express offers third-party issuers individually negotiated per transaction fee structures that are often higher than the interchange rates offered by MasterCard and Visa. MasterCard and Visa have had to raise their interchange rates to compete with American Express for issuers, creating a race to the top in credit card pricing, the direct costs of which are borne by merchants.

The merchants have resorted to the nuclear option, filing a massive antitrust class action against Visa and MasterCard as well as the large banks dominating the credit card industry. (In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, 398 F. Supp. 2d 1356 (Jud. Pan. Multi. Lit. 2005) (consolidating cases for pre-trial discovery). On April 24, 2006, numerous merchants filed a consolidated complaint in class action litigation challenging collectively set interchange fees. Notably, while interchange fees have been held not to violate antitrust laws, *National Bancard Corp. (NaBanco) v. Visa U.S.A., Inc.*, 779 F.2d 592, 601-05 (11th Cir. 1986); *Kendall v. Visa U.S.A.*, 518 F.3d 1042 (9th Cir. 2008), no court has yet ruled on merchant restraints.

Credit card litigation usually takes years to resolve and historically has proven to merely result in settlements which permit credit card issuers to continue business as usual.

The Need for Comprehensive Card Reform

The failure to regulate the U.S. credit card industry in a *comprehensive* manner is a threat to our nation's economy.

The Credit CARD Act of 2009 is meant to protect consumers from credit card industry practices which critics contend trap card users under mountains of debt. Although a step in the right direction, this legislation fails to address the issues confronting merchants (and thus consumers), namely, merchant restraints and the interchange fee. A comprehensive, rather than a piecemeal, approach is required if meaningful credit card reform legislation is to be passed.

The deceptive and anticompetitive practices of the two credit card associations (Visa and MasterCard) and the large banks dominating the credit card industry have injured both consumers and merchants for many years. Interchange fees are hidden taxes paid by all

Americans, regardless of whether they use credit, debit, checks or cash. These fees impose the greatest hardship on the most vulnerable consumers – the millions of American consumers without credit cards or banking relationships. These consumers basically subsidize credit card usage by paying inflated prices – prices inflated by the billions of dollars of anticompetitive interchange fees.

The credit card market lacks both transparency and competition. Accurate and transparent information is necessary for consumers to make accurate choices. When information is readily available, consumers can make choices that effectively compel credit card issuers to compete for their purchases.

The credit card market lacks the accurate and transparent information necessary for both consumers and merchants to make informed choices. It lacks adequate information for consumers to detect the fraudulent and exploitative practices of many card-issuers. For merchants, it lacks adequate information because the associations prevent merchants from accurately informing consumers of the costs of credit card acceptance or attempting to direct them to more efficient and lower priced payment mechanisms. Moreover, the banks and associations engage in other deceptive practices to increase the interchange problem. Since the costs of accepting cards are passed on in the overall costs of goods, all consumers – affluent, working-class, and poor – ultimately pay these hidden charges. Low-income Americans, most without bank affiliations, are paying more for goods and services to fund credit card company programs for which they are not even eligible.

From a consumer's perspective, the credit card market lacks competition because a small set of card-issuers dominate the market and establish a set of deceptive practices that harm consumers. From a merchant's perspective, the credit card market lacks competition because merchants have no alternative but to accept the card associations' cards even when the associations significantly increase prices.

The Need for Standardized and Simplified Credit Card Regulation

Credit cards are different from virtually every other consumer financial product in their complexity. Unlike other common consumer credit products credit cards have a bewildering array of explicit price points for consumers, including: annual fees, merchant fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default interest rates, late fees, over-limit fees, balance transfer fees, cash advance fees, international transaction fees, and telephone payment fees, etc. Interest rates should be comparable using TILA disclosure forms, but in practice TILA forms are of little use because inscrutable cardholder agreements with universal cross-default clauses make it impossible for a consumer to understand the true interest rate on a card. Moreover, teaser introductory APR offers, often of 0 percent, mask the true interest rate.

The card industry's complex pricing structure is specifically designed to avoid commoditization. Commoditized industries - where sellers compete solely on the basis of price for the sale of identical products - have low profit margins.

Credit card issuers divert competition from commoditizable price points to bundled rewards and other features like identity theft protection, which are difficult to value and thus less prone to commoditization. Rewards are hard to commoditize. Calculating the bundled pricing of credit and affinity programs is far too complex for consumers, and because of the private nature of financial transactions, there is only limited inter-consumer signaling. Consumers cannot rationally choose between credit cards based on net cost and benefit; instead, they choose based solely on perceived benefit.

The sheer number of explicit price points make it difficult for consumers to accurately and easily gauge the total cost of using credit cards. Consumers are not capable of doing the on-the-spot calculations necessary to figure out whether or not to use any particular credit card for any particular transaction. There is too much information that the consumer must process. Even if the consumer could process all this information, it simply would not be worthwhile to do for every transaction.

Consumers' difficulty in determining the cost of credit cards is compounded by credit cards' hidden price points in the form of billing practices, such as universal cross-default, unilateral term changes, residual interest, two-cycle billing, unlimited over-limit fees, application of payments to the lowest interest rate balance, non-standard use of terms like "fixed rate" and "Prime rate," and unclear policies as to precisely when a payment is due. These billing practices make credit card pricing to vary based not only on objective indices, but also on the card issuers' subjective whim. Credit card billing practices alter the application of the explicit price points and make the effective cost of using credit cards higher than disclosed. These billing practices further obfuscate the true cost of using credit and make it virtually impossible for a consumer to make a fully informed decision about whether to use credit and, if so, which credit card product to use.

Historically, the credit card industry has shown itself to be remarkably resourceful in designing its products around regulation. There is no reason to believe this will change. Congress, or a dedicated federal regulatory agency like a consumer financial product safety commission, will always be playing catch-up in a never-ending game of regulation and innovation.

A comprehensive approach should be taken to credit card reform legislation. Standardization of credit cardholder agreement terms and simplified pricing will disrupt the status quo by allowing for the creation of a transparent and competitive credit card market. All of credit cards' myriad price points can be boiled down into three price terms: an availability fee, a transaction fee, and an interest rate. Congress would do well to mandate that these and only these three fees may be charged by card issuers, and to require standardization of key cardholder agreement terms, just as is currently done with insurance policies. Credit card issuers would be free to compete and price as they wish within this focused structure.

The benefits of mandating standardization and simplification of credit card price structures are that consumers would be able to easily and simply compare cards on an "apples-to-apples" basis that would give them the entire picture of the costs involved with a card. There would be no worries about the fine print and no hidden fees or price points designed to take advantage of

consumers' tendency to overestimate their future ability to repay and underestimate the costs of delayed fees and interest.

By simplifying card pricing structure, consumers would be able to at least pick the lowest cost card in either category, and this would push down interest rates (and eliminate back-end fees). Without inefficiently high interest rates and backend fees, the sweatbox lending model cannot work, and the card industry would have to go back to safer, more sustainable, and non-predatory traditional lending models.

THE NEED TO ESTABLISH A NATURAL DISASTER TRUST FUND

New Orleans will lose approximately \$1 billion in allocated GO Zone bond financing at the end of this year. The Gulf Opportunity Act of 2005 gave Louisiana the authority to issue approximately \$7.9 billion in tax-exempt private activity bonds ("GO Zone Bonds") that could be used for acquisition, construction, reconstruction, and renovation of nonresidential real property, qualified residential rental projects, and public utility property in 31 parishes across southern Louisiana. The State Bond Commission set aside approximately \$1.3 billion for projects in New Orleans. Although \$497 million has been earmarked to developers who hope to complete financing of their projects in the near future, only \$55.6 million of GO Zone bonds has been issued for projects in New Orleans.

Unlike traditional tax-exempt bonds that are issued for public projects such as streets, utilities and public schools, GO Zone bonds are not payable from taxes or any other public funds whatsoever, but instead are payable solely by the private developer for whom the bonds are issued. The developers must arrange to sell or place the GO Zone bonds for their project based solely on their own creditworthiness and collateral. There is absolutely no public guarantee, subsidy or investment of public money. Since interest on GO Zone Bonds is tax-exempt to investors, the program reduces the borrowing costs to the developers, usually by about 2%. This is the only "incentive" that the GO Zone bond program offers.

While GO Zone bonds would be attractive to investors during a healthy economy, tight credit markets and difficulty finding investors willing to buy the GO Zone bonds have made it virtually impossible for developers to use the bonds. Stephen Moret, Louisiana Economic Development Secretary, further notes that higher costs of doing business in New Orleans, most notably insurance and labor, have limited business development and interest in GO Zone bonds.

At the end of 2009, unused bond allocations set aside specifically for New Orleans will go into a competitive pool. Projects in New Orleans will remain eligible but must compete with proposals from around the state, including areas less damaged by hurricanes Katrina and Rita.

How will New Orleans be able to maximize job creation and stimulate economic development during the current economic downturn? The comprehensive reform of the U.S. credit card industry may provide the solution.

HOW TO FUND AND EFFICIENTLY UTILIZE A NATURAL DISASTER TRUST FUND

The Highway Trust Fund is the principal mechanism for funding federal highway and transit programs through receipts from excise taxes charged to highway users, such as taxes on motor fuels. In a similar manner, a Natural Disaster Trust Fund ("NDTF") could be the principal mechanism for funding specific recovery and redevelopment projects in areas damaged by natural disasters through receipts from a tax on interchange fees.

In 2008, credit card issuers extracted approximately \$48 billion in interchange fees from U.S. merchants. Unlike other countries, the U.S. does not regulate interchange fees. The average interchange fee in the U.S. is approximately 2.10% of the value of the sale. The average interchange fee in countries throughout the rest of the world is approximately 0.3% of the value of the sale.

Using 2008 figures, if the interchange fee charged by credit card issuers was decreased (via comprehensive credit card reform legislation) from the current 2.10% to 0.60%, that would result in an annual savings of approximately \$34.3 billion for U.S. merchants and consumers. Credit card issuers could retain 0.3% as a processing fee, the remaining 0.3% could be a "tax" used to fund a NDTF. In 2008, this would have generated \$6.86 billion in funding for a NDTF.

Historically, Congress responds in a knee-jerk fashion to natural disasters by passing emergency aid or disaster relief bills in the wake of earthquakes, floods, hurricanes and other catastrophes. Merely throwing money at a disaster is not the solution. Accordingly, the manner in which our government utilizes the funds from a NDTF is just as important as how the NDTF is funded. The moneys in a NDTF should be leveraged to ensure the proper and complete recovery and redevelopment of a natural disaster area.

One possible manner in which NDTF funds may be leveraged is by modeling the NDTF after the the Community Development Financial Institutions Fund ("CDFI Fund"), specifically the CDFI Fund's New Markets Tax Credit ("NMTC") program. The NMTC program was created in December, 2000 to provide tax incentives to induce private-sector, market-driven investment in businesses and real estate development projects located in low-income urban and rural communities across the nation. The NMTC program is attracting critically needed private-sector capital to hard-to-finance but vital projects in the nation's low-income communities. The NMTC program permits taxpayers to receive a credit against federal income taxes for making qualified equity investments in designated Community Development Entities ("CDEs"). Substantially all of the qualified equity investment must in turn be used by the CDE to provide investments in low-income communities.

In addition to the leveraging of taxpayer resources, accountability to the public is an important aspect of the NMTC program. Entities that are selected through the merit-based application review must not only demonstrate that they are accountable to the communities they serve, by including representatives from those communities on their governing or advisory boards, but they must also demonstrate their accountability to the American taxpayer. Entities awarded New

Markets Tax Credits must regularly report to the CDFI Fund the projects they are investing in, and they must meet certain financial and other performance goals or risk losing their allocation of tax credits. The CDFI Fund makes information on NMTC activities available to the public through annual reports made available to the public via its website.

The CDFI Fund's data shows that for every \$1 in foregone tax revenue under the NMTC program, over \$14 is being invested in important projects providing needed jobs and revitalizing these communities.

"Not only does the New Markets Tax Credit Program encourage the flow of low-cost and flexible private-sector investment into some of our country's most economically distressed communities, but it also serves as a great example of how the public and private sectors can responsibly work together," said Treasury Secretary Timothy Geithner. In a similar manner, a NDTF should encourage the flow of low-cost and flexible private-sector investment into our country's economically distressed natural disaster areas.

A second possible manner in which NDTF funds may be leveraged is by offering *refundable* tax credits to investors and other stakeholders in areas affected by a natural disaster.

The interchange fee is a tax, just not a tax subject to political control or for which there is any discernible social benefit. It is a hidden tax paid by all Americans, regardless of whether they use credit, debit, checks or cash. Decreasing, and imposing a transparent tax on, the interchange fee would have the same stimulus effect of a tax break, but without an impact on the federal budget.

CONCLUSION

The failure to regulate the U.S. credit card industry in a comprehensive manner is a threat to our nation's economy.

Historically, the credit card industry has shown itself to be remarkably resourceful in designing its products around regulation. There is no reason to believe this will change. Congress, or a dedicated federal regulatory agency like a consumer financial product safety commission, will always be playing catch-up in a never-ending game of regulation and innovation. Credit card reform legislation should be comprehensive, standardized, simplified and transparent.

A comprehensive, rather than a piecemeal, approach should be taken to credit card reform legislation. The Credit CARD Act of 2009 is meant to protect consumers from credit card industry practices which critics contend trap card users under mountains of debt. Although a step in the right direction, this legislation fails to address the issues confronting merchants (and thus consumers): merchant restraints and the interchange fee.

Merchant restraints prevent merchants from informing consumers on the costs of payment and limit the ability of merchants to direct consumers to the safest, lowest cost, and most efficient

forms of payment. The primary defense of merchant restraint rules, namely, the need to protect against a negative network externality, is both historically inaccurate and inapplicable in the current competitive environment. Merchant restraints are naked restraints on trade that were created in response to federal branch banking, Truth-in-Lending, and state usury regulations, rather than in response to network economic concerns. Lacking a positive pro-competitive justification, merchant restraints should be banned as antitrust violations.

Interchange fees amount to a hidden tax on consumers. All consumers, even those who pay with cash and checks, pay more at the store and more at the pump because these interchange fees are passed on in the overall cost of goods sold. In the U.S., interchange fees have continued to skyrocket while other transaction costs have decreased over time with economies of scale and advances in technology. *The average interchange fee in the U.S. is seven times the regulated interchange fee set by Visa and MasterCard in countries throughout the rest of the world.* Now that card-based lending has proven to be immensely profitable, the interchange fees that in the early days served as an essential hedge against risk are now used by card issuers to subsidize their marketing efforts, increase profits, and exercise market power over merchants. The use of interchange fees has allowed card companies to issue lines of credit without properly assessing risk. This guaranteed source of revenue has fueled the proliferation of cards to the point where the average consumer has nine cards today.

Standardization of credit cardholder agreement terms and simplified pricing will disrupt the status quo by allowing for the creation of a transparent and competitive credit card market. All of credit cards' myriad price points can be boiled down into three price terms: an availability fee, a transaction fee, and an interest rate. Congress should mandate that these and only these three fees may be charged by card issuers, and to require standardization of key cardholder agreement terms, just as is currently done with insurance policies. Credit card issuers would be free to compete and price as they wish within this focused structure.

The benefits of mandating standardization and simplification of credit card price structures are that consumers would be able to easily and simply compare cards on an "apples-to-apples" basis that would give them the entire picture of the costs involved with a card. There would be no worries about the fine print and no hidden fees or price points designed to take advantage of consumers' tendency to overestimate their future ability to repay and underestimate the costs of delayed fees and interest. By simplifying card pricing structure, consumers would be able to at least pick the lowest cost card in either category, and this would push down interest rates (and eliminate back-end fees). Without inefficiently high interest rates and backend fees, the sweatbox lending model cannot work, and the card industry would have to go back to safer, more sustainable, and non-predatory traditional lending models.

The lack of an adequately funded NDTF is a threat to our nation's economy. Historically, Congress responds in a knee-jerk fashion to natural disasters by passing emergency aid or disaster relief bills in the wake of earthquakes, floods, hurricanes and other catastrophes. A NDTF would be the principal mechanism for funding specific recovery and redevelopment projects in areas damaged by natural disasters through receipts from a tax on interchange fees.

Using 2008 figures, if the interchange fee charged by credit card issuers was decreased (via comprehensive credit card reform legislation) from the current 2.10% to 0.60%, that would result in an annual savings of approximately \$34.3 billion for U.S. merchants and consumers. Credit card issuers could retain 0.3% as a processing fee, the remaining 0.3% could be a "tax" used to fund a NDTF. In 2008, this would have generated \$6.86 billion in funding for a NDTF.

NDTF funds may be leveraged by modeling the NDTF after the CDFI Fund, specifically the CDFI Fund's NMTC program. NDTF funds may be further leveraged by offering *refundable* tax credits to investors and other stakeholders in areas affected by a natural disaster.

APPENDICES

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About the Author

Brian J. Donovan is an engineer and attorney with over thirty-four years of international business experience. Mr. Donovan is C.E.O. of Renergie, Inc. ("Renergie"). Renergie was formed on March 22, 2006 for the purpose of raising capital to develop, construct, own and operate a network of ten small advanced biofuel manufacturing facilities ("SABMFs") in the parishes of the State of Louisiana which were devastated by hurricanes Katrina and Rita. Each SABMF has a production capacity of five million gallons per year of fuel-grade ethanol. Renergie's unique "field-to-pump" strategy is to produce non-corn ethanol locally and directly market non-corn ethanol locally.

Mr. Donovan drafted the "Advanced Biofuel Industry Development Initiative" for the State of Louisiana. On June 21, 2008, Louisiana Governor Bobby Jindal signed into law the Advanced Biofuel Industry Development Initiative ("Act 382"). Act 382, the most comprehensive and far-reaching state legislation in the U.S. enacted to develop a statewide advanced biofuel industry, is based upon Renergie's "Field-to-Pump" strategy. On February 24, 2009, the U.S. EPA granted Renergie a first-of-its-kind waiver for the purpose of testing hydrous E10, E20, E30 & E85 ethanol blends in non-flex-fuel vehicles and flex-fuel vehicles in Louisiana. On-site blending pumps, in lieu of splash blending, are used for this test.

Mr. Donovan, a member of The Florida Bar, The U.S. District Court, Middle District of Florida and The United States Court of Appeals for the Eleventh Circuit, holds a J.D. from Syracuse University College of Law (where he was recipient of the "Global Law & Practice Award" as the outstanding graduate in the areas of International Law and International Business Law) and a B.S., with honors, in Marine/Mechanical and Nuclear Engineering from the United States Merchant Marine Academy.

Mr. Donovan does not represent, nor has he received any compensation from, any party in regard to credit card regulatory issues.