Avoiding Misapplication to American Express of the Proposed Debit Card Interchange Fee Rules: An Economic Assessment

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I. Introduction

My name is Robert D. Willig. I am a Professor of Economics and Public Affairs at the Woodrow Wilson School and the Economics Department of Princeton University. Previously, I was a Supervisor in the Economics Research Department of Bell Laboratories. My teaching and research have specialized in the fields of industrial organization, government-business relations, and welfare theory. From 1989 to 1991, I served as Chief Economist in the Antitrust Division of the US Department of Justice, where I led the development of the 1992 *Merger Guidelines*. I am the author of *Welfare Analysis of Policies Affecting Prices and Products,* and *Contestable Markets and the Theory of Industry Structure* (with William Baumol and John Panzar), and numerous articles, and I have served on the editorial boards of *The American Economic Review*, *The Journal of Industrial Economics* and the MIT Press Series on Regulation. I have served as a consultant and advisor for the Federal Trade Commission and the Department of Justice, for OECD, the Inter-American Development Bank, and the World Bank, and for governments of many nations.

Counsel for American Express Company ("American Express") has requested that I prepare this economic analysis of the Notice of Proposed Rulemaking ("NPRM") issued by the Board of Governors of the Federal Reserve System ("Board") concerning the implementation of the Durbin Amendment of the Dodd-Frank Act (the "Durbin Amendment").[1]

In this paper, I provide an economic assessment of the proposed rules relating to the regulation of prepaid card interchange fees and the symmetric application of regulations to non-traditional payment systems. The views expressed here are my own, based upon my expertise and experience with issues of regulation, competition and the public interest impacts of policies at the interface of government and business, as well as information provided by American Express.

II. Executive Summary

The Board proposes regulating the interchange fees for transactions using debit and prepaid cards. American Express, which does not issue debit cards, is the sole acquirer and

[1] Proposed Rule, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (December 28, 2010).

issuer of American Express prepaid cards in the US,[2] as well as the operator of the American Express network used by American Express prepaid cards. As noted later in this paper, American Express prepaid cards account for a very small fraction of the volume of US debit and prepaid card transactions.

Because of its integrated three-party network architecture for prepaid cards, American Express has no "interchange fee" paid by independent acquirers to compensate independent issuers. No market transactions in the operation of integrated three-party networks such as American Express reflect what could possibly be considered an "interchange fee" analogous to such fees in the context of four-party networks.

Moreover, there is no reliable regulatory formula to manufacture a surrogate for interchange fees in the context of American Express's three-party network, because the economic function performed by interchange fees in four-party networks does not exist in the American Express prepaid cards architecture. Four-party networks attempt to attract third-party issuers (and cardholders) as well as merchant acquirers (and merchants). In order to balance these two sides of the payment platform, whose services are provided by multiple independent parties, four-party networks generate cash flows between the two sides of the network. Interchange fees set by four-party networks are a key element of this balancing act. Increasing the interchange fee attracts more issuers (and thus cardholders) even as it increases cost to merchant acquirers (and thus merchants). Reducing the interchange fee does the opposite. Four-party networks set the interchange fee at a level intended to strike the right balance between the independent players on the two sides of the payment platform.

Integrated three-party payment platforms such as American Express also have to balance the card issuance/cardholder side with the merchant acquisition/merchant side. However, this is a purely internal process; there is no interchange fee for prepaid products that is used as a means of achieving such balance. Prices paid by cardholders and merchants are set without reference to an interchange fee. Thus, there is no element of the American Express prepaid card business structure that serves the same economic function as interchange fees in the context of four-party networks.

In addition, the issuance, acquisition and network functions of American Express prepaid cards share common costs and revenues with each other and with other businesses in American

[2] I understand that there is one unique arrangement in which a former joint venture partner of American Express continues to issue certain corporate incentive prepaid American Express cards, but there are no ongoing payments from American Express to the issuer relating to the cards that the entity issues.

Express's integrated structure. In order to manufacture an interchange fee for American Express prepaid cards for the purpose of regulation, the Board would need to find a meaningful – as a matter of economics and policy – and reliable formulaic way to allocate common costs, values and revenues to a hypothetical prepaid card interchange function that for American Express does not exist. Any attempt to do so using a regulatory formula would be arbitrary because there is no way that such a formula could reflect the necessary information on costs, economic value and revenues generated by the integrated issuance, acquisition and network functions of American Express.

The economics literature relevant to the analysis of payment cards networks highlights the difficulty of appropriately regulating interchange fees even in four-party networks. The risks of faulty regulation are substantially elevated in the context of three-party networks where regulators would be attempting to regulate a hypothetical interchange fee where none exists. In the case of four-party networks, the Board is attempting to regulate observed market-based interchange fees; there is no need to manufacture a regulatory surrogate for such fees. In contrast, for American Express, the Board would have to attempt to manufacture a formulaic surrogate for interchange fees that it would then regulate. Any such attempt would produce an unreliable and likely incorrect proxy for interchange fee for the reasons mentioned above. A mistaken proxy that reduces American Express's fees below its costs would force American Express to recover its costs or reduce its investments in ways that would be detrimental to the ability of American Express to compete effectively, and ultimately harm merchants and consumers as well.

In addition, I believe that if the price-setting or price-capping mechanism described in the NPRM were applied to American Express, the result would be seriously damaging to the Company's prepaid business and, again, ultimately to merchants and consumers. I understand that the proposed 12-cent cap is based on averaging the cost of processing debit and prepaid cards, with the cost of debit card processing being significantly lower than the cost of processing prepaid cards. Since there are many more debit card transactions than prepaid card transactions, the 12-cent cap is more likely to be reflective of the costs of debit cards than prepaid cards. If so, on average, issuers face a higher risk that the regulated cap will not cover their costs, let alone allow for a reasonable return, for prepaid card transactions than for debit card transactions. This is especially the case for American Express, which issues prepaid cards but no debit cards.

If confining regulation prevents American Express from recovering its transaction processing costs and if it were to attempt to recover its costs through other fees paid by prepaid cardholders, then even if merchants were to benefit in the short run from the proposed regulation, cardholders would be left worse off. Moreover, because sales of prepaid gift cards often occur at local supermarkets, drug stores and shopping malls, merchants that act as authorized sellers of prepaid gift cards would likely be harmed in the longer run if American Express were forced to reduce commissions offered to merchants who sell prepaid gift cards, thus inhibiting the ability of American Express to compete in this growing area. Merchants would also be harmed if American Express were forced to reduce investment in prepaid cards, thereby potentially reducing both the sale of cards and the sale of goods that would have been purchased with those cards. Finally, disinvestment by American Express would no doubt further weaken its ability to compete.

Given the absence of a reliable way to impose a "right" price or price ceiling on a hypothetical American Express interchange fee, the Board should allow competition to regulate American Express.

If, despite American Express's *de minimis* share of the universe of transactions potentially covered by the Durbin Amendment, and the infeasibility of appropriate formulaic regulation of American Express fees and the attendant risk of unintended negative consequences, the Board nonetheless believes that it needs to take some action to ensure that competitive forces continue to restrain American Express, an alternative approach to direct formulaic price regulation is to apply the principle of *forbearance.* Under this approach, the Board would monitor, on a periodic basis, the role of American Express as a small but innovative competitor in this space. If there were evidence that American Express's pricing (taking into account the costs and value of its products and services) was inconsistent with competitive levels, the Board could reconsider whether further action is warranted.

In any event, any new regulations should treat symmetrically American Express and other three-party, non-traditional network providers of debit transactions. Any exemption from regulations received by such non-traditional providers (because they do not conform to the traditional notions of a payment card network model) should also apply to American Express. Asymmetric regulation of players (like American Express and PayPal) who have very small shares of this line of business and who are clearly driven by competition would distort innovation and marketplace evolution.

III. Interchange Fee Regulations

1. American Express has no interchange fee, and there is no reliable regulatory formula to manufacture a surrogate.

The proposed interchange fee regulation cannot be appropriately applied to American Express's three-party architecture. Interchange, which is a fee set by four-party card networks such as Visa and MasterCard to compensate issuers when Visa and MasterCard debit and prepaid cards are used to make purchases at merchants, does not exist in the context of a closed loop network such as American Express's integrated card issuing, merchant acquiring and network business model. American Express is the sole acquirer and issuer[3] of American Express prepaid cards in the US as well as the operator of the American Express network, and there is no interchange fee structure to compensate third party issuers or acquirers. Instead, American Express charges merchants a "merchant discount" for transactions conducted with its prepaid cards. No market transactions in the operation of American Express reflect what could possibly be considered an "interchange fee."[4]

Moreover, there is no reliable regulatory formula to manufacture a surrogate for interchange fees in the context of American Express's three-party network for several reasons. First, the economic function performed by interchange fees in four-party networks does not exist in the American Express prepaid cards architecture. Four-party networks attempt to attract issuers (and cardholders) as well as merchant acquirers (and merchants). In order to balance these two sides of the payment platform, whose services are provided by multiple independent parties, four-party networks generate cash flows between the two sides of the network. Interchange fees set by four-party networks are a key element of this balancing act. Increasing

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[3] *See* footnote 2, *supra*.

[4] Even if American Express had third-party issuers of prepaid products, the American Express network would still have no separate and identifiable payment flows to third-party issuers that would be equivalent to interchange fee payments in four-party networks. Interchange fee payments are due, and flow, from acquirers to issuers in a four-party network and are merely facilitated by the network. I understand that the interchange fee in a four-party network is readily identifiable and separable from other network payment flows because it is paid to the issuer by the acquirer, is centrally established and imposed through the network's governance bodies, and sets the floor for the acquirers' price to the merchants. In sharp contrast, under the three-party architecture employed by American Express, I understand that all cash flows to the independent issuer are based on a holistically and bilaterally negotiated amalgam of fees payable directly between the network and the issuer that reflect the integrated services provided by American Express. Hence, these flows cannot reliably be separated by a regulatory formula into a surrogate for an interchange fee.

the interchange fee attracts more issuers (and thus cardholders) even as it increases cost to merchant acquirers (and thus merchants). Reducing the interchange fee does the opposite. Four-party networks set the interchange fee to strike the right balance between the independent players on the two sides of the payment platform. Integrated three-party payment platforms such as American Express also have to balance the cardholder side with the merchant side of the network. However, given the integrated nature of such platforms, there is no interchange fee that is used as a means of achieving such balance. Prices paid by cardholders and merchants are set without reference to an interchange fee.

Second, a reliable regulatory formula to identify a surrogate interchange fee is infeasible because prepaid cards share common costs and revenues with other businesses in American Express's integrated structure. I understand that American Express's issuing, network and merchant acquiring functions share significant costs and resources. For example, I understand that the American Express prepaid card division uses the Credit Authorization System ("CAS"), which is integrated into the American Express network, in order to manage fraud risks. More generally, I understand that the prepaid card business group is supported by staff and technology resources shared with American Express credit and charge card issuing, network and merchant acquiring businesses. Moreover, unlike the four-party networks, in which the issuing, acquiring and network businesses are operated by separate and unaffiliated entities, in an integrated company like American Express, decisions to incur costs and make financial investments in new initiatives are made on the basis of the interests of American Express as a whole, not just the distinct and independent interests of the prepaid card issuer, the acquirer and/or the network functions within American Express.

In order to manufacture an interchange fee for American Express for the purpose of regulation, the Board would need to find a meaningful (as a matter of economics and policy) and reliable formulaic way to allocate common costs, economic values and revenue generated by the integrated issuance, acquisition, and network functions to a hypothetical prepaid card interchange service that for American Express does not already exist. Under these circumstances, there is no reliable way that a regulator could develop and apply a regulatory formula to establish price caps such that these caps would be anything but arbitrary and unreliable because a three-party network like American Express's – unlike the four-party networks – simply has no interchange fee due to its integrated architecture and end-to-end business model.

As I explain below, the economics literature related to payment card networks highlights the difficulty of appropriately regulating interchange fees in four-party networks. The risks of faulty interchange fee regulation are substantially elevated in the context of three-party networks where regulators would be attempting to regulate a hypothetical interchange fee. In the case of four-party networks, regulators are attempting to regulate observed market-based interchange fees; there would be no need to construct a surrogate for such fees. Any attempt to construct a surrogate interchange fee using a regulatory formula to delineate some portion of the American Express merchant revenue from prepaid cards as a hypothetical interchange fee would produce an unreliable and likely incorrect proxy for the reasons mentioned above.

A mistaken proxy that in effect forces American Express's prepaid card merchant discount rate down to a level that does not enable American Express to recover its costs and achieve a reasonable return on its investments would result in misaligned incentives and would create a significant risk of harm to merchants and consumers. I explain this in the next section.

2. If the NPRM's seriously flawed price-setting or price-capping mechanism were applied to American Express, the result would be seriously harmful to the Company's prepaid business, merchants and consumers.

a. Proposed Board price formulae appear to be based primarily on costs of debit cards.

The Board proposes to regulate fees based on the average variable per-transaction costs of authorizing, clearing and settling, as well as a future adjustment for fraud prevention costs.[5] The Board's proposed fee cap of 12 cents per transaction, as reflected in the NPRM, appears to rely mainly on estimates of such costs for debit cards.[6] However, I understand that these costs are considerably higher for prepaid cards. Indeed, in the NPRM, the Board acknowledges this fact: "By transaction type, the median variable per-transaction processing cost was 6.7 cents for signature debit, 4.5 cents for PIN debit, and 25.8 cents for prepaid cards."[7]

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[5] 75 Fed. Reg. at 81,726.

[6] The 12-cent cap is based on costs reported by issuers who submitted data to the Board in response to a September 2010 Board survey of issuers and networks covered by the Durbin Amendment. 75 Fed. Reg. at 81,737. The NPRM provides few details regarding the calculation of the 12-cent cap. If the Board pooled debit and prepaid card transactions in this calculation, then since debit card transactions/issuers likely dominated the pool of transactions/issuers, the 12-cent cap would be based largely on the costs of debit card transactions. The Board acknowledges that the 12-cent cap does not differentiate between prepaid card transactions and other types of card transactions covered by the proposed rule. 75 Fed. Reg. at 81,737.

[7] 75 Fed. Reg. at 81,737-38. *See id.* at 81,725 n.26.

Additionally, the risks of fraud associated with American Express prepaid cards are higher than for typical debit cards for several reasons. First, debit card holders typically use debit cards for many transactions, and issuers monitor spend patterns on debit cards to detect and prevent fraud. I understand that this is not a tool available to prepaid card issuers because prepaid cards are typically used only a few times. For example, on average, American Express non-reloadable prepaid gift cards are used for just 2.6 transactions.

Second, the issuer of a debit card acquires information about the card holder at the time the cardholder opens the demand deposit account associated with the debit card. The issuer also has an on-going relationship with the cardholder as a result of the demand deposit account. This is not the case with non-reloadable prepaid gift cards, where American Express knows relatively little about either the purchaser or the end user of the card, and no on-going relationship is contemplated – when the funds on the card are depleted, no relationship continues. I understand that this relative anonymity of cardholders exposes such cards to a greater risk of fraud, and commensurately higher costs of preventing these risks. I understand that because of the higher fraud risk associated with prepaid cards, American Express has higher costs and spends relatively more resources on fraud prevention.

In any event, if the 12-cent cap is more likely to be reflective of the costs of debit cards than prepaid cards, then, on average, issuers face a higher risk of receiving compensation that does not cover their costs – let alone a reasonable return – for prepaid card transactions than for debit card transactions. This is especially the case for American Express, which issues prepaid cards but no debit cards. As such, a price-cap formula that does not recognize the higher costs associated with prepaid cards would impact American Express far more negatively than other networks (which have issuers that issue both debit and prepaid cards).

Those effects could cause a cascade of negative consequences, including suboptimal returns and disinvestment. Thus, having different formulae that recognize the higher costs of prepaid cards and permit issuers of such cards to recover their costs and earn a reasonable rate of return is essential to promote competition and efficiency. It should also be noted, however, that although the Board has recognized the potential need to have different price-cap formulae for prepaid and debit cards,[8] even differential price-cap formulae would be insufficient to prevent the competitive harm from inappropriate regulation of an integrated three-party network, for reasons stated above.

[8] 75 Fed. Reg. 81,737-38.

b. If applied to American Express prepaid cards, the proposed price regulations would be likely to harm merchants as well as consumers.

If American Express prepaid-card merchant discount fees were regulated at a level that did not take accurate account of costs (which, for the reasons stated above, is a real danger) and did not allow for a reasonable return (as addressed in the following section), then American Express would need either to try to recover its costs in some other distorted fashion, or, if it were unable to recover the costs of investments in the business, to stop issuing prepaid cards. If it were to attempt to recover its costs through other fees paid by prepaid cardholders, then even if merchants were to benefit in the short run from the proposed regulation, cardholders would be left worse off.

Besides increasing cardholder fees, American Express may be forced to attempt to replace any lost fees by decreasing the commission offered to merchants who sell prepaid gift cards, thus reducing their economic benefit from selling the card, and potentially reducing output in the sale of cards and output in the sale of goods that would have been purchased with those cards. Merchants might be harmed in other ways as well if American Express lost the ability to offer attractive terms and to innovate in ways that attract consumers to purchase the cards. I understand that merchants profit from increased and incremental sales to customers using American Express prepaid cards.[9] A reduced flow of consumers using American Express prepaid cards means less business for merchants who accept those American Express cards. For at least some merchants, these losses (and lost commissions) could substantially offset or even potentially outweigh the perceived benefits from a potential reduction in fees due to the application of the Durbin Amendment to American Express.

Misapplied regulation of American Express prepaid card fees that prevents American Express from recovering its costs, earning a reasonable profit and choosing its business model would impair its ability to innovate, serve customers and compete effectively. Such unintended consequences of faulty regulation can be observed in the public harms resulting from misdirected price regulations in some other industries. For example, it is generally agreed that non-economic governmental restrictions upon pricing conduct (as well as other forms of conduct and structure) in the railroad industry prior to the reforms brought by the *Staggers Rail Act* in 1980 were

[9] I understand that up to 30% of gift card sales are spent back at the American Express retail partner that sold the cards. I also understand that retail partners made tens of millions of dollars in fees from sales of gift cards in 2010 and that American Express gift cards entail little or no selling cost to retail partners.

responsible in large part for the poor financial condition of the railroads, for the deterioration of the rail plant, for the suppression and delay of cost-reducing innovations, for the mediocre quality of rail service and, most dramatically, for the disabling bankruptcies of major carriers.[10] After the beginnings of deregulation of the US railroad industry in the late 1970s, and especially with the passage of the *Staggers Rail Act*, the industry began a period of rapid output and productivity growth.[11] The 1999-2000 energy crisis in California is another example of serious problems caused (in part) by misdirected non-economic rate regulation -- in that case, the regulation (or flawed partial deregulation) of California's electricity markets.[12]

In both of these examples, many of the negative impacts stemmed from the fact that rate regulations in those industries did not permit key players (in these examples, railroads and electric utilities) to cover costs and generate adequate returns.[13] Not only were rates regulated by some ceilings that were too low relative to costs, but some important regulations impelled cross-subsidization that suppressed demand and stultified competitive reactions to market needs and opportunities. Similarly, faulty regulation of American Express prepaid card fees (as a result of an effort to regulate a surrogate for a non-existent "interchange fee") that prevents American Express from recovering its costs, earning a reasonable profit and choosing its business model would also impair its ability to innovate, serve customers and compete effectively.

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[10] Kessides Ioannis and Robert Willig. 1995. "Restructuring Regulation of the Rail Industry," in *Private Sector, Quarterly* No. 4, at 5 - 8; Kessides Ioannis and Robert Willig .1996. "Competition and Regulation in the Railroad Industry," in *Regulatory Policies and Reform: A Comparative Perspective*, C. Frischtak (ed.), World Bank; Kessides, Ioannis. 2004. *Reforming Public Infrastructure: Privatization, Regulation and Competition*, Oxford University Press, at 184-204.

[11] Bitzan, John D. and Theodore E. Keeler. 2007. "Economies of Density and Regulatory Change in the US Railroad Freight Industry," *Journal of Law and Economics*, Volume 50, at 157-179; Wilson, W. W. 1997. "Cost Savings and Productivity in the Railroad Industry," *Journal of Regulatory Economics*, Volume 11, at 21–40; Braeutigam, R. 1993. "Consequences of Regulatory Reform in the American Railroad Industry," *Southern Economic Journal*, Volume 59, at 468–80.

[12] Joskow, Paul. 2001. "California's Electricity Crisis," NBER Working Paper 8442. National Bureau of Economic Research, Cambridge, Mass; Borenstein, Severin.Winter 2002. "The Trouble with Electricity Markets: Understanding California's Restructuring Disaster," *Journal of Economic Perspectives*, Volume 16, at 191-211.

[13] *See* footnotes 10, 11 and 12, *supra.*

c. *Even if regulation of any part of American Express's prepaid card fees were mandated by the law, prices that are optimally regulated for the public interest are not based only on costs.*

Even if the language of the Durbin Amendment could be read to require the regulation of some portion of American Express's fees or revenues, the proposed methodology for determining fees, as it would apply to American Express, is far from optimal for the public interest, as a matter of economics. Optimally regulated prices do not rest on costs alone. For example, since (as noted above) some of the costs associated with American Express prepaid card issuance are shared with other card products or with elements of the network employed by credit and charge card transactions, then under optimal (Ramsey) pricing principles,[14] the portion of such shared costs allocated to prepaid card issuance would depend, in part, on the relative valuations placed on prepaid cards by all customers (here, both cardholders and merchants). For a regulator to allocate costs in order that they can be recovered in an economically efficient manner would require accurate information on not just the full panoply of American Express costs but also the relative values delivered to all users (including cardholders and merchants) by the various integrated functions. This is a task that would be inescapably arbitrary, unreliable and likely harmful if implemented by applying a confining regulatory formula to a non-existent interchange fee in the integrated American Express prepaid card network.

The economics literature relevant to the analysis of payment card networks predicts that the economically efficient level of transaction prices (i.e., prices that maximize social welfare and ensure a reasonable rate of return) will not be solely dependent on the costs of providing the services, but will also reflect other elements, including value to cardholders and merchants, interaction elasticities (i.e., the extent to which the presence of merchants on the network increases cardholders' value from participating in the network, and *vice versa*), and presence of important network externalities.[15] This means that prices to cardholders and merchants cannot each be compared solely to narrow measures of cost in order to assess whether prices are inefficiently elevated.

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[14] Ramsey prices maximize social welfare subject to the constraint that the market participants do not lose money. (*See* Viscusi, Kip, John Vernon, and Joseph Harrington. 2000. *Economics of Regulation and Antitrust*, MIT Press, at 350-53.)

[15] Rochet, J.C. and Jean Tirole. 2003. "Platform Competition in Two-Sided Markets," *Journal of the European Economic Association*, Volume 1, at 990–1029; Armstrong M. 2006. "Competition in Two-Sided Markets," *Rand Journal of Economics*, Volume 37, at 668-691; Evans, David and Richard Schmalensee. 2005. "The Economics of Interchange Fees and Their Regulation: An Overview," Kansas City Federal Reserve Bank Conference.

Given the complexity of determining efficient prices in payment card platforms, the relevant economics literature does not provide practical methods for a regulator to impose an efficient transactions price in this context.[16] Board economists have themselves discussed the difficulties of determining the "right" level of interchange, even for four-party networks that, unlike American Express, have explicit interchange rates as part of their business model:

- "Although no findings [of economic studies] are completely robust, most models suggest that, when merchant prices do not vary by payment method,…[i]n theory, privately-set interchange fees [which constitute the largest portion of transactions prices in four-party networks] can be either too high or too low relative to the efficient interchange fee, depending on a number of factors, including the cost and demand considerations underlying the merchant decision to accept cards and the extent of competition among issuing and acquiring banks."[17]
- Prager et al (2009) conclude that the "efficient interchange fee for a particular card network is difficult to determine empirically."[18]

These recognized difficulties with determining the right fee for four-party networks that price and offer interchange in the normal course of business are compounded when a regulator attempts to impose an "interchange fee" on an integrated three-party network that does not even have such a fee.

Finally, as I understand it, the Durbin Amendment calls for regulation under which interchange fees are "reasonable" and "proportional to costs." As a matter of economics, "proportional" does not mean "equal." For example, Ramsey prices are proportional to marginal costs without being equal to such costs. Moreover, it is "reasonable" for providers to recover their full costs of providing prepaid and debit-like transaction processing services as well as a reasonable return. Inasmuch as the regulations proposed by the Board would not allow American Express to recover its full costs of providing transaction processing services, not to mention a reasonable return on its investments, the regulated prices would not be "reasonable."

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[16] Evans, David and Richard Schmalensee. 2005. " The Economics of Interchange Fees and Their Regulation: An Overview," Kansas City Federal Reserve Bank Conference.

[17] Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski. 2009. "Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues," Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., at 4.

[18] *Ibid* at 3.

3. Given the lack of a reliable way to design and impose a regulated fee for a non-existent interchange service, the Board, consistent with the goals of the Durbin Amendment, should allow competition to govern American Express pricing.

For the reasons set forth above, because American Express operates an integrated network, acquiring and issuing business for its prepaid cards without an interchange fee, there is no economic basis for applying the Durbin Amendment's regulation of interchange fees to it. More broadly, competition is by far more effective, reliable and reasonable than arbitrary regulatory rules or formulae can be in ensuring that American Express's fees are reasonable and proportional to costs, as well as reflective of value, in a manner that best serves the interests of merchants, consumers and the overall economy.

Any inquiry into the extent to which American Express faces competition must begin by noting the small size of American Express prepaid card volume relative to payment cards generally and, more specifically, to the total volume of debit and prepaid cards that I understand are subject to the Durbin Amendment. Among the total debit and prepaid card transactions subject to the proposed regulation, American Express is a very small player, accounting for just 0.1 percent of the total volume of transactions in 2009.[19]

Within the context of its competition from credit, charge, debit and other forms of payment, I understand that American Express is subject to competition in its prepaid card business from the dominant open loop card networks (Visa/MasterCard), issuers (typically banks), program managers (such as Incomm, Black Hawk and Green Dot)[20] that support other reloadable and non-reloadable prepaid cards, and non-traditional payment networks such as PayPal. American Express also competes with issuers and acquirers of "closed-loop" prepaid cards (i.e., cards that can be used only in the stores affiliated with the firm that issued the card).

To maintain and grow its prepaid business, American Express has had to set competitive prices and to innovate. I understand that American Express has traditionally set its US merchant discount rates for prepaid cards at levels that are at or below the levels charged for Visa and

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[19] Debit and prepaid card transactions in the US totaled about $1.44 trillion in 2009. (The Nilson Report, May 2010, Issue 948.) American Express's prepaid charge volume in 2009 was $1.51 billion. (Information provided by American Express in response to Federal Reserve Board survey in 2010.)

[20] I understand that these program managers' fees would not be regulated under the Durbin Amendment because they are not "issuers" or networks. To the extent that American Express provides services that are competitive with these players' services, to be an effective competitor American Express must similarly be free to provide those services without the distorting effects of confining regulation.

MasterCard general purpose debit and prepaid cards, and well below the levels charged for general purpose credit and charge cards.

In addition to offering competitive prices, American Express has also been an important innovator in this space. I understand that American Express pioneered general use prepaid cards[21] when it introduced such cards in 2003. Since then, American Express has introduced other innovations that other industry participants have adopted. Examples include eliminating all maintenance, dormancy, and recurring fees on prepaid gift cards, and eliminating any expiration of funds on prepaid gift cards.[22] Further innovations include the "split tender" functionality[23] of prepaid cards, and "holiday shippers" (special displays used to sell gift cards during the holidays).

Thus, American Express has responded to competition and has itself been an important source of competition and innovation with respect to prepaid gift cards. Regulatory rules and pricing formulae imposed on American Express are not only unnecessary to assure that its prices are reasonable and proportional to costs, but would be destructive to the opportunities for consumer and merchant benefits achieved through innovation and improved products and services because innovation is driven by the prospects of earning profits from successful product developments, and formulaic cost-based price regulation effectively eliminates the possibility of returns necessary to justify risky investments in innovation. As explained earlier, American Express faces a greater risk of misplaced "interchange fee" regulation than four-party networks since American Express does not have an interchange fee and also because the price cap formula proposed by the Board does not appear to acknowledge the higher costs of prepaid cards.

If the Board believes that debit card interchange fees are artificially high, and that the debit card interchange fees of Visa and MasterCard will be reduced following the implementation of proposed fee caps, then under the Board's theory, American Express prepaid card merchant discount fees would likely be affected by those reduced prices. Put differently, competition as a result of reduced Visa and MasterCard debit card interchange fees, rather than

[21] "General-purpose" prepaid cards are cards that can be used in a wide variety of stores, not just stores affiliated with the issuer of a store prepaid card.

[22] I understand that American Express took this action well before the Credit CARD Act gift card rule became effective in August 2010 and went beyond what that rule requires, and that some competitors have since followed American Express's lead and eliminated back-end fees.

[23] If an American Express prepaid card holder attempts to purchase an item whose price exceeds the remaining card balance, the "split tender" feature of the card prevents the transaction from being rejected. Instead, the cashier would be prompted to ask the cardholder to pay by other means the portion of the price not covered by the card balance.

direct formulaic regulation of American Express's pricing, would put additional competitive pressure on American Express's prepaid card fees. Given the absence of a reliable way to impose a "right" price as a hypothetical American Express interchange fee, the Board should allow this competition to regulate American Express. Additional regulation of prepaid cards that prevents American Express from recovering reasonable costs associated with prepaid cards may impede the growth and innovation of American Express's prepaid card products at the incipient stage of the business, when growth and innovation are particularly important, or at worst, cause American Express to exit the business segment.

4. At most, the Board should apply forbearance and monitor competitive effects as appropriate.

In light of American Express's *de minimis* share of the total US debit and prepaid card volume potentially regulated by the Durbin Amendment and the difficulties of formulaic regulation in the absence of interchange fees, an alternative approach to direct formulaic price regulation is to apply the principle of *forbearance*. Under a forbearance approach, the Board would periodically monitor American Express's responsiveness to competition. If the Board were at some point to conclude that American Express's pricing was not consistent with competitive levels (with due regard to underlying costs and product value), the Board could consider whether further action is warranted. Forbearance instead of formulaic rate regulation would benefit merchants and consumers. Forbearance would also avoid the type of counterproductive price regulations experienced in the past in the context of industries such as railroads (as noted earlier).

The forbearance approach has been successfully adopted by other regulatory agencies. For example, the Federal Communications Commission (FCC) has adopted a policy of forbearance with respect to wireless communications.[24] The FCC, as part of its regulatory due diligence, regularly monitors the state of wireless competition. Wireless services have expanded and consumers have benefitted.[25] Railroad regulation provides another example of successful regulatory forbearance. Following the *1980 Staggers Rail Act*, which further deregulated the railroad industry and permitted the ICC selectively to adopt a forbearance approach to railway

[24] "The Third Way: A Narrowly Tailored Broadband Framework," Chairman Julius Genachowski, Federal Communications Commission, May 6, 2010.
[25] *See*, for example, Federal Communications Commission. January 2009. *13th Annual CMRS Report.*

regulation, rail transport rates have declined, costs have fallen, and the financial health of railroads has improved.[26]

The argument in favor of regulatory forbearance here is made all the more compelling by the fact that the relevant economics literature does not indicate that American Express's prepaid card fees should be presumed to be "too high" due to market failures. The economics literature related to transactions pricing in payment card platforms does not support the view that market (i.e., unregulated) transactions prices are necessarily or even tend to be elevated above socially optimal levels.[27] This is even less likely in the context of non-dominant prepaid card providers such as American Express.

Because the relevant economic literature does not imply the presumption that transactions prices in payment cards platforms are inefficiently high; because American Express has no interchange fee to regulate at all; because American Express is a small but innovative provider of prepaid cards and an important competitor to the dominant networks; because the risks of a mistake are high; and because (I understand) the law does not, in fact, mandate rate regulation of American Express, the Board should proceed with as much flexibility as possible towards allowing American Express's prepaid card business to work under the discipline of unimpeded competition rather than confining regulation. A heavy-handed and over-reaching intervention in American Express's prepaid card business to dramatically drive down one arbitrarily-derived component of price will likely have unintended negative repercussions on merchants and consumers. Given the difficulty – acknowledged by Board's economists – in arriving at the right prices or even the right direction for intervention in interchange fee setting in four-party networks, a difficulty that is further compounded for three-party networks for the reasons addressed above, regulatory forbearance for American Express's prepaid card business would be the better approach.

IV. Alternative Payment Systems

I understand that like American Express, non-traditional and emerging payment systems may operate closed loop payment networks with business models that are consistent with the structure of the three-party architecture. Any new regulations should treat symmetrically American Express and non-traditional closed loop network providers of "electronic debit

[26] Carlton, Dennis and Jeffrey Perloff. 2000. *Modern Industrial Organization.* Addison-Wesley, at 694-5; Viscusi *et al* (*see* footnote 14, *supra*) at 549; Willig, Robert and William Baumol. 1987. "Railroad Deregulation: Using Competition as a Guide," *Regulation,* Volume 11, at 28-36.
[27] *See* supra note 15.

transactions." Any exemption received by non-traditional providers with regard to "interchange" regulation should also apply to American Express. Especially where, as here, the traditional and non-traditional three-party networks are (1) small players among the providers of products potentially regulated under the Durbin Amendment and (2) subject to vigorous competition in that space, asymmetric regulation of just one such network would tilt and distort innovation and marketplace evolution. It would be potentially anticompetitive to impose regulation that could inhibit American Express's ability to innovate, while permitting others that are similarly situated to take advantage of such opportunities and constricting American Express's competitive response. For example, if another three-party network were to develop an offering that is compelling to consumers and/or merchants, but is economically suboptimal or impractical if subject to a regulated interchange fee, it would be anticompetitive effectively to prevent the regulated three-party network from competing with the other unregulated provider. Thus, three-party networks should be treated symmetrically.

American Express needs to compete with other three-party networks (especially fast-growing networks such as PayPal).[28] I understand that this is especially true in the context of rapidly growing mobile and on-line payments. Confining regulations would restrict the ability of American Express to compete with other non-traditional three-party networks, and, for the reasons explained above, American Express faces a higher risk of regulatory error than four-party networks. The competitive effectiveness of American Express would be further weakened if it were subject to regulation while non-traditional three-party networks were free of regulation.

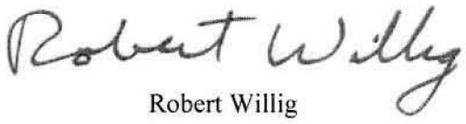
V. Concluding Remarks

The Board has recognized that three-party networks differ from four-party networks in ways that materially affect the implementation of the Durbin Amendment.[29] Indeed, the economics of the two types of networks are sufficiently different that regulating interchange fees in the context of three-party networks via the use of regulatory formulae is not feasible, and any

[28] With respect to PayPal, I understand that in addition to utilizing traditional payment card networks and the existing financial infrastructure of bank accounts to support its users' choice of funding transactions, PayPal also allows its users to fund electronic debit transactions through existing PayPal balance accounts that PayPal issues, manages and administers for its users. According to its parent eBay's 2010 10-K filing, PayPal balance transactions represent 17% of total payments volume on PayPal. If the Board determines that American Express should be regulated under the Durbin Amendment, then this facet of PayPal's business should be subject to regulation to the same extent.

[29] 75 Fed. Reg. at 81,727.

attempt to do so would likely harm the innovative efforts of American Express in its prepaid card business while harming the merchants and consumers who benefit from such cards today. Given the risks associated with confining formulaic regulation, and given also that the American Express prepaid card volume is insignificant relative to the volume of general purpose debit cards as well as prepaid cards, regulatory forbearance would be consistent with the policy objectives of the Durbin Amendment. In any event, any regulation should treat symmetrically American Express and other non-traditional closed loop, three-party network providers of "electronic debit transactions."



Date: February 22, 2011 Robert Willig