

May 16, 2008

The Honorable John Conyers  
US House of Representatives  
2426 Rayburn Building  
Washington, DC  
20515

Re: HR 5546.IH – “Credit Card Fair Fee Act of 2008”

Expert Testimony of Harold Montgomery, CEO, Calpian, Inc. and  
Cynthia Bailey, Editor in Chief, Transaction World Magazine  
Regarding Effects of Reductions of Credit Card Interchange Rates on the Credit Card  
Acquiring Industry Employment and Competition

Dear Congressman Conyers:

**PURPOSE**

The purpose of this letter is to provide you and The Judiciary Committee and its Antitrust Task Force additional information regarding the structure of the credit card acquiring business, how the industry provides card processing services to 5.2 small businesses in the US and what the impact of reductions in the interchange rates will be on the industry, small business and consumers.

**WITNESS QUALIFICATIONS**

Harold Montgomery is the CEO of Calpian, a Dallas, Texas based financier to the Independent Sales Organizations (ISOs) which provide credit card processing and support services to 5.2 small retail merchants in the US. Calpian provides growth financing to ISOs which in turn provide processing services to retailers. Calpian has invested \$60 million in ISOs promoting their growth, employment and successful competition in the market. Calpian is the largest such organization in the industry. The company deals with 200 ISOs and 40,000 retail merchants in the US. He received his BA and MBA degrees from Stanford University.

Cynthia Bailey is the Editor in Chief of Transaction World Magazine, the leading trade journal in the industry. She received her BA from William and Mary and her MBA from Georgia State University.

**STRUCTURE OF THE INDUSTRY**

Credit cards are issued to consumers via the issuing side of the business. Merchants process credit cards through point of sale equipment and credit card processors. The merchant processing business is known as the acquiring side of the business. While large merchants buy processing services directly from acquirers, card processing services are initially sold to small merchants by independent sales organizations (ISOs) operating under contracts with large processing companies such as First Data Resources, Elavon,

Global Processing and others. The mission of the ISO is to place credit card processing services in small to medium sized retail locations throughout the US. This process has resulted in ubiquity of acceptance of credit cards in the US, an important element of the value proposition for consumer cardholders. Retailers pay a percentage discount rate on every retail transaction conducted by credit card for card processing service. The fee structure has three parts:

1. Interchange and assessments (the subject of the referenced legislation). 100% of interchange passes through the acquiring process and to the issuing side of the industry. The acquiring side of the business does not benefit directly from interchange.
2. A percentage fee which pays the ISO to provide ongoing service to the account.
3. An incremental fee to pay for the actual processing services.

ISO's provide processing services and support to 5.2 million merchants in the US, processing \$138 billion in annual charge volume (2005). See Figure 1.

Larger merchants deal directly with processors for their services. See Figure 2.

The ISO portion of the merchant acquiring industry employs an estimated 45,000 people nationwide on both a full and part time basis.

### **IMPORTANCE OF INTERCHANGE FOR SMALL MERCHANTS AND ISOs**

Interchange is the wholesale cost of processing that the acquiring/processing industry pays to support card marketing and risk management programs on the issuing side. Interchange provides a benefit to the acquiring side in the following ways:

1. Effective consumer marketing ensures maximum penetration of cards into the consumer population.
2. Effective risk management programs on the issuing side, minimizing fraud and therefore ensuring consumer confidence and continued card use.
3. Constant innovation and improvement in card development and management by the issuing side which ensures maximum card penetration and use. (rewards programs, etc.)

ISO's sell credit card processing services to merchants in a very competitive manner, ensuring low price and high service to each merchant. Gradually, prices for credit card services have declined over time due to competitive pressures in the market, ensuring that merchants receive the maximum benefit for the price they pay for services. Consumers benefit from this natural decline in prices since merchants can pass savings on to them. See Figure 3 for a price decline demonstration over time.

### **EFFECT OF INTERCHANGE REDUCTIONS ON SMALL MERCHANTS AND ISOs**

Of course merchants would prefer to have all the benefits of the card system with none of the cost, but that's an unrealistic position to take. Merchants have the choice to accept credit cards or not. Each merchant makes a calculation about whether card acceptance is

a net benefit to each business or not. Interchange is simply the cost of the credit card system we have. Interchange and other fees are equivalent to the cost of handling any payment type. There are analogous and in fact higher costs when handling cash and checks. Neither method is as efficient, convenient safe or as fast as credit cards. A reduction in interchange pricing would negatively affect all players in the credit card industry in the following ways:

1. Reduction in card marketing. Reduces cards in consumers hands, limits consumer access to credit and therefore spending. Hurts retail stores in general and small retail disproportionately.
2. Reduction in innovation of card types and rewards structures limits consumer choice. Hurts retail stores in general and small retail merchants disproportionately.
3. Limits funds available for technology investment for processing infrastructure. As global commerce unfolds with increasing rapidity, increased investment in processing infrastructure is required to keep pace with change.
4. Reductions in interchange will negatively affect issuers whose profits are substantially composed of interchange fees. Many issuers derived in excess of 100% of their annual profits from interchange and therefore cannot sustain a reduction in rates. Substantial reductions in interchange would force some issuers out of business reducing consumer choice, and card penetration, which is bad for retail. Small business would suffer disproportionately.
5. As security of the payment system becomes more important, increased investment in technology which guarantees the safety of consumer information will come from interchange, benefiting all parties in the system.
6. Reductions in interchange invites the possibility that serving small merchants with card processing services may become uneconomical for support organizations catering to that class of merchant. If so, then small merchants would be penalized through a lack of card processing service. This would diminish small merchant competitive advantage and consumer choice.

## **RECOMMENDATIONS**

The proposed legislation should not be enacted for the following reasons:

1. Interchange is fair and beneficial to all parties in the payment system.
2. The method by which interchange is currently set is fair and ensures that the needs of retailers are taken into account in a reasonable way.
3. Interchange should be set between interested parties in the industry and not by a panel. A panel would be subject to undue political or special interest influence.
4. Market Forces should be allowed to work in the natural way. Currently, market forces bring prices down and improve service levels over time.

Thank you for considering this information for purposes of your hearings/debate. As this is introductory information, we are happy to provide more in-depth data, statistics and trends should the committee find it helpful.

Please don't hesitate to contact us if that be the case,

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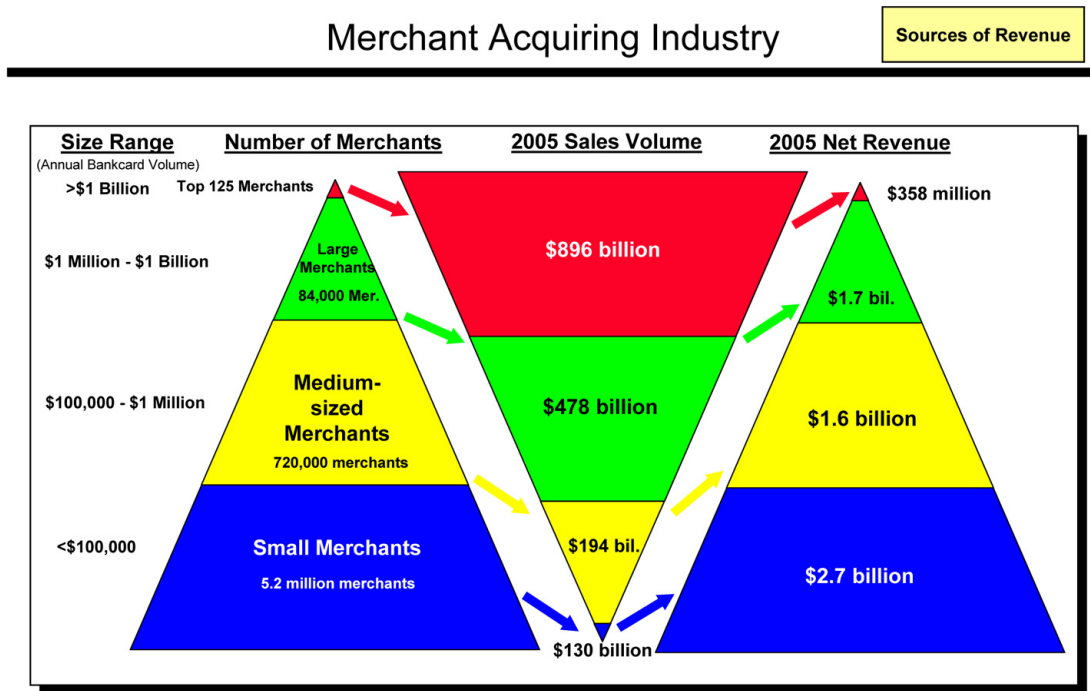
Sincerely,

Harold Montgomery

Cynthia Bailey

FIGURE 1

Small merchants generate \$138 Billion in annual Visa MasterCard charge volume and pay \$2.7 Billion in charge fees to process credit card transactions on these networks (excludes Discover and American Express). This suggests an average processing rate of 1.96% of dollar charge volume. That number includes interchange and service/support fees from ISO's. The increment over interchange is ISO revenues. ISO's support small merchants with their payment processing needs. These merchants process an average of \$26,500 per year, and need payment support services due to their inherent lack of support and training infrastructure.



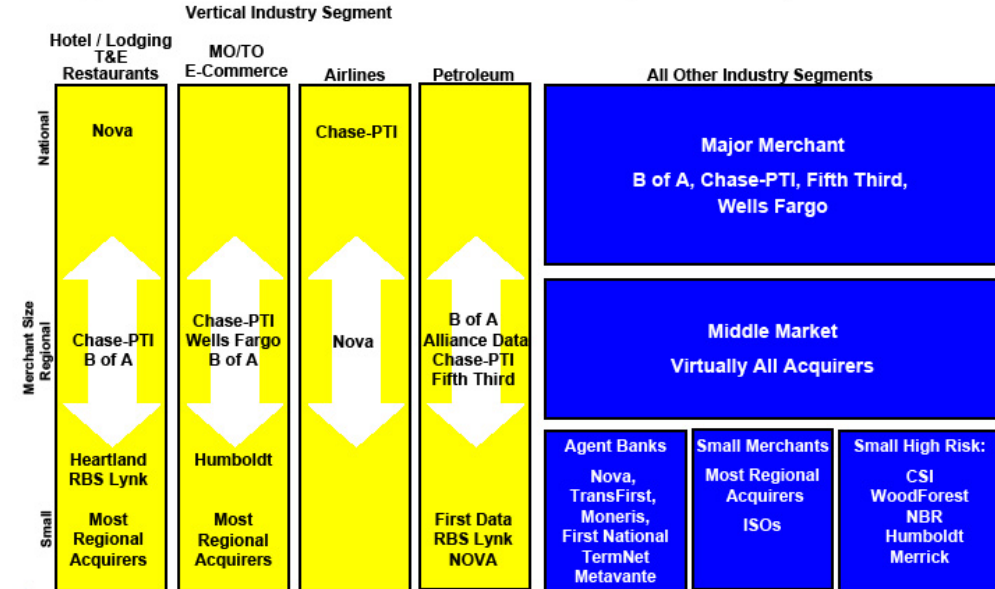
Sources: First Annapolis Consulting analysis and The Nilson Report.

**FIGURE**  
**2**

**Acquiring Strategies**

**Niche Strategies**

Acquirers have focused on defensible niches to compete effectively for merchants.



**First Annapolis.**

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ISOs fit here, delivering card processing services to small merchants.

**FIGURE 3**

Retail merchant credit card processing costs have fallen over time. This chart shows that over an 18 month period from September 2005 to February 2007, merchant processing costs fell from approximately \$50 per month to \$25 per month through natural competitive forces. This data represents merchant processing cost after Interchange.

