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CREDIT AND DEBIT CARDS

Federal Agencies Benefit from Card Acceptance, but Have Limited Ability to Control Interchange Fee Costs

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Highlights

Highlights of GAO-10-821T, a report to Financial Services & General Government Subcommittee, Committee on Appropriations, U.S. Senate

Why GAO Did This Study

Federal entities—agencies, corporations, and others—are growing users of credit and debit cards, as both “merchants” (receiving payments) and purchasers. Federal entities, like other merchants that accept cards, incur fees—called merchant discount fees—to process card transactions. For Visa and MasterCard transactions, a large portion of these fees— referred to as interchange fees—goes to the card-issuing banks. This statement addresses (1) the amounts of revenue that federal entities have collected using credit and debit cards and the costs of such acceptance, (2) these entities’ efforts to reduce their interchange fee costs, including negotiations, and (3) the extent to which card network rules affect these entities and other card accepters’ ability to reduce interchange fee costs. The information for this statement was drawn from *Credit and Debit Cards: Federal Entities Are Taking Actions to Limit Their Interchange Fees, but Additional Revenue Collection Cost Savings May Exist* (GAO-08-558) and *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges* (GAO-10-45). GAO analyzed data on accepting and using cards from the Department of the Treasury (Treasury), Amtrak, the Postal Service, and General Services Administration (GSA); and interviewed non-federal merchants, card networks, banks, academics, and others. GAO also obtained updated 2009 revenues and costs from Treasury, Amtrak, and the Postal Service, and purchases from GSA.

View GAO-10-821T or key components.
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What GAO Found

As federal entities’ card revenues have increased, so have their associated costs. In fiscal year 2007, federal entities collected more than $27 billion in revenues through credit and debit card transactions and reported paying at least $433 million in merchant discount fees, which include the interchange fees associated with Visa and MasterCard transactions. Since GAO originally reported in 2008, total card acceptance costs for the U.S. Postal Service and Amtrak grew from $182 million in 2007 to $204 million in fiscal year 2009. Card costs for Treasury’s Financial Management Service (FMS) grew from $101 million to $116 million during this same period. Federal entity officials told us that the benefits of accepting cards include more satisfied customers, fewer bad checks and cash thefts, and improved operational efficiency. In addition to accepting cards, federal entities also use cards to make purchases for supplies or employee travel expenses, and these purchases totaled about $30 billion in fiscal year 2009. Federal entity officials noted that using cards provides a variety of benefits, including lower administrative costs and rebates of a small percentage of the card purchases that they make, which totaled about $255 million in 2009.

Federal entities have worked to control the costs associated with card acceptance fees. Card networks already offer interchange rates for government transactions that are lower than those for many other merchants’ transactions, but Treasury also requires the banks that process federal entities’ card transactions to ensure that these receive the lowest interchange rates for which they are eligible. Some federal entities have attempted to negotiate with the card networks to lower interchange rates applicable to their transactions, but with limited success. Similarly, GAO’s more recent work indicated that non-federal merchants have also experienced little success in negotiating with card networks to lower these fees.

Various card network rules have been a major factor limiting federal entities’ and merchants’ ability to negotiate lower interchange fees. Each of the major card networks—Visa, MasterCard, American Express, and Discover—have various card acceptance rules that prohibit card accepters from imposing surcharges on cards, refusing to accept certain cards—such as rewards cards with higher associated interchange fees, or establishing minimum or maximum charges. Although various options have been debated for lowering interchange fees, merchants and others GAO interviewed most supported removing certain card network rules. If interchange fees were lowered, card users might benefit from lower prices for goods and services, but lower interchange revenues for card issuers could prompt them to increase cardholder costs, offer less generous rewards, or curtail cardholder credit availability—although consumers and federal entities could still enjoy various other benefits of using cards, such as convenience and efficiency.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss issues relating to the extent to which federal entities accept payments from credit and debit cards and the associated costs, including interchange fees. Each time a consumer uses a credit card to make a purchase, a portion of the sale—known as the merchant discount fee— is deducted and distributed among the merchant or federal entity's financial institution, the financial institution that issued the card, and the card network that processed the transaction. The majority of this amount generally is called the interchange fee and goes to the financial institution that issued the card, which reported using the revenues from these fees to cover their costs of maintaining card programs. More specifically, I will discuss recent work we have conducted related to these fees, including (1) the amounts of revenue that federal entities have collected using credit and debit cards and the costs of such acceptance, (2) efforts such entities have made to reduce their interchange fee costs, including negotiations, and (3) the extent to which card network rules affect card accepters' ability to reduce interchange fee costs.[1]

In summary, we reported in 2008 that as the volume of federal entities' card payment revenues have increased, so have their associated costs. In fiscal year 2007, federal entities collected a total of more than $27 billion in revenues through credit and debit card transactions and reported paying at least $433 million in merchant discount fees, which include the interchange fees associated with Visa and MasterCard transactions.[2] Federal entity officials told us that the benefits of accepting cards include more satisfied customers, fewer bad checks and cash thefts, and improved operational efficiency. In addition to accepting cards, federal entities use cards to purchase supplies and pay for employee travel and transportation expenses. Card purchases by federal entities totaled more than $27 billion in fiscal year 2007. Since we originally reported, total card acceptance costs for the U.S. Postal Service and Amtrak grew from $182 million in 2007 to $204 million in fiscal year 2009. Card costs for the Department of the Treasury's Financial Management Service (FMS) grew from $101

[1]See *Credit and Debit Cards: Federal Entities Are Taking Actions to Limit Their Interchange Fees, but Additional Revenue Collection Cost Savings May Exist*, GAO-08-558 (Washington, D.C.; May. 15, 2008), and *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges*, GAO-10-45 (Washington, D.C.; Nov. 19, 2009).

[2]Dollar values on the costs and revenues associated with card acceptance for fiscal years 2005 through fiscal year 2007 are current values and have not been adjusted for inflation.

million to $116 million during this same period. Federal entity officials told us that benefits of card use include lower administrative costs when compared with the slower, more labor-intensive purchasing methods previously used. Furthermore, federal entities obtain rebates of a small percentage of the card purchases that they make, which totaled approximately $175 million in fiscal year 2007, and grew to $255 million in fiscal year 2009. Although receiving various benefits, federal entities using cards to make purchases have had to implement controls and procedures to prevent misuse.

As card acceptance has become more common, federal entities worked to control the associated fees. The card networks already offer interchange rates for government transactions that are lower than those for many other merchants' transactions. Additionally, FMS, which processes the card transactions for numerous federal executive, legislative, and judicial branch agencies and other federal entities, requires the banks that process its card transactions—known as acquiring banks—to monitor how transactions are processed to ensure that these transactions receive the lowest interchange rates for which they are eligible. Some federal entities have attempted to negotiate with the card networks to lower interchange rates for their transactions, with varying success. Similarly, our more recent work indicated that non-federal merchants also have experienced little success in negotiating lower fees with card networks.

Card network rules restrict their abilities to differentiate among the cards they accept or take other actions and are a major factor limiting the leverage that federal entities and merchants have to negotiate lower interchange fees. Each of the major card networks—Visa, MasterCard, American Express, and Discover—have card acceptance rules—generally known as anti-steering rules—that limit the options that federal entities and merchants have for accepting or denying cards, including prohibiting them from:

- imposing surcharges on cards,
- refusing to accept certain cards—such as rewards cards with higher associated interchange fees, or
- establishing minimum or maximum charges.

According to merchants and some academic researchers, these rules constrain the ability of federal entities and merchants to limit the costs of credit card acceptance. For example, by not being able to charge more for credit cards generally, for a particular network's cards, or for higher interchange fee cards, these entities are unable to steer customers towards lower-cost forms of payment or recoup some of their costs for higher-cost cards. In addition, without the ability to influence customers' payment choices, these entities are unable to use their influence with the networks to encourage them to lower interchange and other fees in general, or offer more lower-fee cards. In contrast, representatives of issuers and card networks told us that the network rules are designed to promote the wide acceptance of their cards and ensure that their cardholders have a positive experience with the card.

Although various options have been debated for lowering interchange fees, removing the anti-steering rules appeared to receive the most support from the large and small merchants and merchant trade associations with whom we spoke.[3] Removing these rules could allow merchants to send signals to cardholders about which cards increase merchant acceptance costs, which also could improve merchants' leverage in negotiating their payment costs. The ability to charge more for or refuse certain cards also could cause cardholders using rewards cards to be more aware of and to bear more of the cost of the rewards from which they benefit. If interchange fees for merchants were lowered, consumers could benefit from lower prices for goods and services, but proving such an effect is difficult. Lower interchange fee revenues for card issuers could prompt them to increase cardholder costs, offer less generous rewards, or curtail cardholder credit availability.

Scope and Methodology

To examine the benefits and costs associated with federal entities' acceptance of cards, we analyzed data for executive, legislative, and judicial branch agencies; government corporations; and other federal instrumentalities that accept credit and debit cards for payment. FMS processes the card transactions for the majority of executive, judicial, and legislative branch agencies and federal commissions, boards, and other entities and pays the associated fees for these entities. We also reviewed data from several federal entities for which FMS does not settle

[3] See GAO-10-45. The merchants and associations also supported restricting interchange fees with a cap or other limit.

transactions: Amtrak, the U.S. Postal Service, and others.[4] To determine the impact on federal entities of using cards to make purchases, we reviewed policies and procedures developed for the General Services Agency (GSA) card program that federal entities can use to make purchases (known as the SmartPay program), collected and analyzed data on card use from GSA, and reviewed our prior reports and interviewed officials from five entities that were among those with the highest volume of card use in fiscal year 2006. To learn about the impact of interchange fees on other merchants, we conducted interviews with more than 80 organizations, including U.S. federal banking and other regulators, academic researchers, and industry participants. We also interviewed and obtained information from regulatory officials in Australia. For this statement, we also obtained updated 2009 revenues and costs from FMS, Amtrak, and the Postal Service, and purchases from GSA. We conducted the work on which this statement is based from June 2007 to May 2008, from May 2009 to November 2009, and in June 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[4]These other entities included nonappropriated fund instrumentalities (NAFI) of the Department of Defense and Department of Homeland Security which operate retail stores or recreational facilities for the military. The data we collected from federal entities were the best data available; however, because of limitations in and differences among the record keeping of the entities, the data may not be complete for all years, may treat some costs inconsistently, and in one case contain estimated, rather than actual, values. We reviewed the data for completeness and accuracy and determined that none of these limitations materially affect the findings we report.

Federal Entities Receive Numerous Benefits Associated with Card Acceptance, but Also Pay Interchange Fees and Other Costs

The volume of revenues accepted through credit and debit card payments was growing for the group of federal entities we reviewed. Data on revenues that Treasury's FMS collects show that while credit and debit card transactions accounted for 0.23 percent of the total federal government revenues FMS collected in fiscal year 2007, its card collections had grown by almost 28 percent in 2 years—from approximately $5.5 billion in fiscal year 2005 to almost $7.1 billion in fiscal year 2007 (in current dollars). Revenues that the U.S. Postal Service and Amtrak—which have their own arrangements for processing their transactions— collected on credit and debit cards grew from $9.3 billion in 2005 to $11.5 billion by 2007. As shown in table 1, the card revenues from these organizations and various other federal entities from which we collected data grew from $22.3 billion in 2005 to $27.1 billion by 2007.

Table 1: Credit and Debit Card Revenues Collected and Merchant Discount Fees Paid by Federal Entities, Fiscal Years 2005–2007 (in Current Dollars)

Fiscal year	Entity	Credit and debit card revenues collected (dollars in billions)	Merchant discount fees paid[a] (dollars in millions)	Average merchant discount rate
2005	FMS	$5.5	$70	1.26%
	NAFIs (all)	7.5	128	1.72
	U.S. Postal Service and Amtrak	9.3	143	1.54
	Total	22.3	341	1.53
2006	FMS	6.3	89	1.41
	NAFIs (all)	8.3	139	1.67
	U.S. Postal Service and Amtrak	10.4	160	1.54
	Total	25.0	387	1.55
2007	FMS	7.1	101	1.43
	NAFIs (all)	8.5	150	1.75
	U.S. Postal Service and Amtrak	11.5	182	1.58
	Total	**$27.1**	**$433**	**1.60%**

Source: GAO analysis of federal entity data.

Note: Not all entities from which we collected data operate on the federal fiscal year of October 1 - September 30; therefore, the data presented for fiscal years represent some costs associated with dates that fall outside of the federal fiscal year.

[a]We use the term “merchant discount fee” throughout this report to refer to the card acceptance fees paid by federal entities. For FMS, the merchant discount fees are not “discounted” from the amount of the card payment. Instead, FMS settles card transactions “at par,” and all costs associated with card acceptance are paid separately.

As the volume of revenues from card payments have increased, so have the total amounts of merchant discount fees paid by the federal entities from which we collected data. These federal entities reported paying almost $433 million in merchant discount fees in fiscal year 2007 (see table 1). This figure represents an almost 12 percent increase over the amount paid in fiscal year 2006 and an almost 27 percent increase over fiscal year 2005. The average merchant discount rate increased about 4 percent from fiscal year 2005 to fiscal year 2007. Since we originally reported, total card revenues for the U.S. Postal Service and Amtrak rose to $12.4 billion and those for FMS rose to $8.6 billion in fiscal year 2009; the card acceptance costs for the Postal Service and Amtrak grew to $203.7 million and for FMS to $116 million.

Among the entities included in our review, Amtrak, FMS, and the Postal Service provided data specifically showing the amount of interchange fees associated with their Visa and MasterCard transactions (their acquiring banks provide them with these data).[5] The three entities paid approximately $205 million in interchange fees during fiscal year 2007, out of a total of $218 million in merchant discount fees specifically for MasterCard and Visa transactions.[6] These interchange fees accounted for the majority of total merchant discount fees these entities paid for accepting all card types. As card revenues and merchant discount fees increased for the three entities, so did the interchange fees they paid. Interchange fees increased by almost 36 percent, from almost $151 million in fiscal year 2005 to $205 million in fiscal year 2007 (in fiscal year 2006, they were $179 million).

[5]Merchants (or federal entities) enter into relationships with acquiring banks to provide card processing services for Visa or MasterCard (or both).

[6]This estimate for interchange fees paid includes fees associated with debit transactions using personal identification numbers (PIN) as well as MasterCard and Visa credit and signature debit transactions. We were not able to determine the portion of the PIN debit interchange fees that were specifically paid for Visa and MasterCard PIN debit transactions. It is possible that some of the PIN debit transactions reported by these entities were routed through other debit networks and, therefore, are not necessarily Visa and MasterCard transactions. Also, some federal entities included quarterly fees paid to Visa and MasterCard in the interchange fees figures they reported; therefore, our estimated interchange fee amount includes these fees.

In our most recent report on interchange fees issues, we reported that non-federal merchants also were experiencing increasing card acceptance costs, which they largely attributed to increased volumes of payments being made by consumers with cards, but also as a result of customers' increased use of rewards cards. Staff from these merchants expressed concerns that the increasing use of rewards cards was increasing merchants' costs without providing the commensurate benefits of increased sales.

For some payments made using cards, the government does not bear merchant discount costs.[7] For example, consumers can pay their income and business taxes to the Internal Revenue Service (IRS) using cards. IRS has agreements with two private third-party entities to process payments for individuals or businesses that choose to use a credit or debit card to make a tax payment. The private entities charge a convenience fee of 2.49 percent of the total tax payment, a portion of which covers the merchant discount fees the entities pay to their acquiring banks. In fiscal year 2007, these merchant discount fees totaled about $47.5 million for approximately $2.4 billion in tax payments, an 85 percent increase in tax payments made with credit and debit cards from fiscal year 2005.

In addition to the interchange and processing fees that make up the merchant discount fee, federal entities face other costs associated with the acceptance of credit and debit cards. While FMS pays the merchant discount fees associated with card transactions for entities for which it settles transactions, it does not pay for the costs associated with equipment and software; these costs are the responsibility of the entities. For example, entities must pay for point-of-sale terminals, keypads for PIN debit card transactions, computers, modems, and printers, and pay for their installation and maintenance. Other costs of accepting cards include complying with industry security standards, training employees to process and reconcile card transactions, and experiencing losses associated with fraudulent use of cards. However, some entities provided information that indicated these additional costs were not significant compared to merchant discount fees.

[7] We did not include such transactions in compiling the total merchant discount fees paid by federal entities for card acceptance. Instead, we provide this information as an example of additional fees that are paid by consumers for card acceptance associated with government payments.

Federal Entity Officials Cited Various Benefits from Accepting Cards

The ability to accept credit and debit cards provides a variety of benefits to federal entities, including greater customer satisfaction and improved internal operations. Officials at several federal entities noted that card acceptance helped to ensure that the federal entities would remain competitive with private-sector organizations. Federal officials with whom we spoke mentioned benefits such as improved customer satisfaction with their organizations because consumers liked to use their cards for convenience, credit card reward programs, and security reasons. Accepting cards also has enabled entities to conduct business through the Internet, which can reduce labor costs associated with sales and also can provide greater convenience to customers. For example, officials from the U.S. Mint stated that about 50 percent of their sales occurred through their Web site. Some entities also stated that the ability to accept cards has increased their sales volume.

Federal entity officials also noted that accepting cards reduced the amount spent on processing other forms of payment. By accepting cards, federal entities incurred less expense in transporting cash, lower losses from theft of cash, and had fewer bad check expenses. For example, officials at the Department of the Interior noted that cash transport costs could be high for some remote parks and wildlife refuges. Several federal officials also stated that accepting cards has reduced the costs associated with processing checks, and that funds were deposited in accounts faster when customers use credit or debit cards than when they used checks. Additionally, Amtrak officials told us that accepting cards on trains for ticket, food, and beverage sales resulted in fewer instances of employee theft of cash.

Finally, many officials cited that card acceptance improved internal operations. For example, officials at the Department of the Interior stated that payments made by credit cards result in a more streamlined bookkeeping approach because card sales involved less paperwork (for reconciliation) than other payment forms. Defense Commissary Agency (DeCA) officials also stated that they believed that the labor associated with reconciling sales declined as a result of the reduced cash volume. The officials mentioned additional operational efficiencies, including reductions in costs and exposure to fraud and errors from misplacing or miscounting cash and checks. Some officials stated that the efficiencies gained as a result of card acceptance allowed them to reallocate staff to different and more productive uses. For example, officials at the Department of the Interior explained that accepting cards at automated kiosks allowed them to reallocate some staff that used to collect entrance fees. Amtrak officials also stated that customers' ability to purchase tickets using cards, especially through the Amtrak Web site, has reduced their labor costs.

The federal entities we contacted were not able to provide comprehensive data on any cost savings from accepting cards. We identified various government, academic, and industry studies that compared the cost of processing for different forms of payment; however, many of these studies found that precise estimates were difficult to calculate. Additionally, while most of the studies we reviewed found cash to be the least expensive payment form to process, the methodologies used in the studies were not consistent and the data contained in many of them were outdated.[8]

Card Usage by Federal Entities Provides Numerous Benefits, but Creates Control Challenges

In addition to accepting cards as payment, federal entities are also users of credit cards. More than 350 federal entities participate in GSA's SmartPay program—which provides purchase, travel, and fleet cards for these entities to use. Federal entities pay no direct costs for the general use of cards. According to card network officials, the banks that issue cards to federal entities are compensated in part by the interchange fees they receive when a government entity or employee uses a card to make a purchase. In fiscal year 2007, federal entities used cards to purchase more than $27 billion in goods and services, and since we originally reported this amount has grown to $30 billion as of fiscal year 2009. Most of this spending occurred using purchase cards, which account for nearly 70 percent of total federal entity card spending, while travel card use accounts for about one-quarter of card spending, and fleet card use about 5 percent.

Card use by federal entities is expected to continue growing as the entities identify additional ways of using cards and use new payment technologies. For example, officials from the Department of Veterans Affairs (VA) told us that they have been working with the bank that issues the department's purchase cards to find new ways to increase card usage. For example, in

[8]David B. Humphrey and Allen N. Berger. "Market Failure and Resource Use: Economic Incentives to Use Different Payment Instruments," in *The U.S. Payment System: Efficiency, Risk and the Role of the Federal Reserve: Proceedings of a Symposium on the U.S. Payment System Sponsored by the Federal Reserve Bank of Richmond*, ed. David B. Humphrey, (Boston: Kluwer Academic Publishers, 1990). D. D. Garcia-Swartz, R. W. Hahn, and A. Layne-Farrar, "The Move toward a Cashless Society: Calculating the Costs and Benefits," *Review of Network Economics*, 5, no. 2 (2006). D. Humphrey, M. Willesson, T. Lindblom, and G. Bergendahl, "What Does It Cost to Make a Payment," *Review of Network Economics*, 2, no. 2, (2003).

2003 they developed a process for making payments through the card system to non-VA medical providers for services to veterans who were unable to visit a VA center for medical care, reducing the number of checks they issued and increasing the number of electronic payments they made and the rebates they received for using their cards. Additionally, officials stated that VA has been reviewing its purchase records to attempt to shift more purchasing to vendors that accept cards. Similarly, the U.S. Army has developed an automated payment system that uses purchase cards for most of the $400 million per year it pays schools and other institutions for soldiers' tuition assistance. GSA officials also expect the new products and services that will be available under the SmartPay 2 program—the follow-on to SmartPay—will lead to increases in overall card spending. These products include prepaid cards, contactless cards, and cards in foreign currencies.[9]

According to federal entity officials with whom we spoke, administrative cost savings are one of the primary benefits associated with card usage—compared with procurement methods that cards partially replaced, such as purchase orders, imprest funds, and blanket purchase agreements. For example, obtaining goods or services under a purchase order system requires that a purchase request be filled out and approved, then sent to a procurement office, which issues it to a vendor. However, when government entities use a card, cardholders can purchase goods or services directly, review their statements at the end of the billing cycle, and forward the statements to approving officials. Officials from the Department of Agriculture said that if cards were not used, staff would need to complete purchase orders for the 1.5 million transactions per year that currently are made using purchase cards. Officials from the Department of Homeland Security estimated that the department would require from four to five times the current number of staff to operate its travel card program if the agency paid for travel expenses without cards. In addition, officials at the Department of Agriculture stated that new tools, such as an automated process to reset charge card passwords, might further reduce the costs of administering their program.

Federal entities receive another benefit of card use through rebates from the banks that issue their cards. Rebate amounts, after adjusting for

[9]A prepaid card is one that is programmed to have a monetary value, and charges to that card cannot exceed the balance. Contactless cards store data on a microchip embedded in the card, which can be read by passing the card in front of a special card reader.

inflation, had almost doubled since fiscal year 2002 to $175 million in fiscal year 2007, and were $255 million in fiscal year 2009. Rebate amounts to federal entities are based on a number of factors, mainly the volume of net spending on cards and how quickly balances on the cards are paid. GSA establishes a minimum rebate rate that federal entities should receive, but entities can negotiate with their issuing banks for additional amounts. From 1998 through 2007, the minimum rate was 6 basis points of the net volume of spending on the cards, while under SmartPay 2, the minimum rebate rate increased to 8 basis points. A GSA official stated that typically in federal entities' negotiations with issuing banks, the rebate rate is increased as an incentive for an entity to choose a particular bank to issue its cards. According to the GSA official, some entities have negotiated for specialized services rather than increased rebate amounts, and GSA encourages entities to examine their programs holistically when negotiating terms. Federal entities differ in how they use their rebates. Two of the federal entities we spoke with return the rebates directly to the location that originated the relevant transaction, one adds the rebates into general income for the entity, and one other allocates rebates to a working capital fund for initiatives of general benefit to the entity.

Officials at the federal entities with whom we met cited only a few drawbacks associated with the use of cards, although officials from some entities mentioned the risk of fraud and misuse. These officials told us that the risk of fraud or abuse was less than or equal to that under previously used procurement systems. Although instances of fraud and misuse on cards may be infrequent, we and several inspectors general have reported internal control weaknesses in charge card programs at federal entities and instances of fraud and abuse. For the most part, fraud and misuse can be limited through strong internal controls in card programs of federal entities. GSA and the Office of Management and Budget (OMB) have issued guidance on internal controls intended to reduce the risk of misuse of cards. For example, GSA develops guidance through training courses for federal entities and publishes guidelines for oversight and information on detecting misuse and fraud. Additionally, OMB has issued several memorandums related to oversight of card programs. Finally, officials from some of the federal entities told us that the tools and data that their card-issuing banks provided helped them reduce the risk of misuse of cards by enabling them to track and limit the types of purchases made on the cards.

Federal Entities Have Worked to Reduce Card Acceptance Costs, but Efforts to Negotiate Lower Interchange Fees Have Had Limited Success

As card acceptance has grown, federal entities have used several methods to manage their costs and reduce the fees associated with card transactions. First, both Visa and MasterCard have a designated merchant category for federal entities, in which the interchange rates are lower than those for many other merchant categories. As long as federal entities' transactions meet all applicable processing requirements—for example, they must be submitted for final settlement in a timely manner—the entities are charged the interchange rate applicable to those merchant categories. For example, as of April 2008, if transactions met all applicable processing requirements, government entities accepting a MasterCard consumer credit card as payment would pay an interchange fee of 1.55 percent of the transaction amount plus $0.10, and for a Visa consumer credit card, 1.43 percent plus $0.05. (In comparison, the interchange rate for a MasterCard general purpose consumer credit card transaction at some fast food stores is 1.90 percent.) In some cases, card transactions at federal entities can be assessed a lower rate. For example, FMS officials told us that DeCA transactions qualify to be processed using the interchange rate for the supermarket merchant category, which can range from 1.27 percent to 1.48 percent plus $0.05 for MasterCard general purpose consumer credit card transactions, depending on the volume of card transactions processed.

Because the method in which the card is accepted, transaction volume, and other factors can affect interchange rates, many federal entities have taken steps to ensure that the acceptance and processing procedures they follow result in the most advantageous interchange rates applying to their transactions. For example, Amtrak officials explained that by replacing card machines (which embossed paper receipts) with wireless card terminals on trains, they were able to significantly reduce the interchange rates that applied to transactions made on trains, because the electronic transaction qualified for a lower interchange rate than the paper transactions. Moreover, FMS officials explained that their acquiring bank was responsible for monitoring how card transactions were processed and the interchange rates assessed. The bank provides FMS with daily and monthly reports that provide various levels of detail on the interchange fees paid. Both the bank and FMS officials review these reports to identify instances in which transactions may have been charged a higher interchange rate—known as a downgrade—because they were not processed under the requirements necessary to qualify for a lower rate.

Several federal entities have attempted to control fees associated with card acceptance by expanding their ability to accept PIN debit card payments. PIN debit transactions generally are assessed lower interchange rates than “signature” debits, and therefore some federal entities are beginning to put in place the technology necessary to accept these transactions. While federal entities would have to purchase the equipment needed to process PIN debit transactions (for example, PIN pads), one entity told us that the much lower interchange rates associated with PIN debit transactions justified the investment. An FMS official stated that the only entity for which it processes card transactions that currently can accept PIN debit cards is DeCA; however, as entities undergo equipment upgrades, FMS works with them to identify equipment that may lower overall collection costs. For example, one federal entity has been developing a new terminal system for card collections, and as part of this process, FMS has encouraged the entity to implement a system that can process PIN debit transactions. Additionally, some of the military NAFIs with which we spoke adopted technologies for accepting PIN debit cards, stating that they too recognized the cost savings associated with these transactions.

Federal Entities Have Had Limited Success in Negotiating Lower Interchange Fee Costs

Federal entities have acted to reduce card acceptance costs by negotiating with their acquiring banks for lower merchant discount rates or with card networks for lower interchange rates. Some of the federal entities we reviewed have realized card acceptance savings by negotiating new acquiring bank services contracts. These entities were able to negotiate lower rates for the processing component of the merchant discount rate applied to their transactions. For example, by signing a new acquiring bank agreement, one federal entity received a substantial reduction in the processing fee component of its merchant discount rate. Also, to obtain a more favorable merchant discount rate for their transactions, officials from some of the military service NAFIs have been working together to try to negotiate a lower merchant discount rate with American Express on the basis of the volume of transactions they provide to that company.

Officials at some of the entities with whom we spoke stated that they did not believe they could negotiate effectively with the largest card networks— MasterCard and Visa—for lower interchange rates. One of the primary ways of negotiating lower rates would be to refuse to take a particular network’s card. However, many of the federal entity officials told us that consumers expect to be able to use cards to make payments, and some stated that they did not think they could stop accepting cards. For example, Amtrak officials stated that customers paying with cards accounted for about 85 percent of their sales and that if they did not accept cards, ridership would decline significantly. Some federal entities stated that they have attempted to negotiate, but have had varying levels of success:

- FMS officials told us that they tried to negotiate lower interchange rates with both Visa and MasterCard by stating that some factors that were included in rate determinations did not necessarily apply to federal government transactions. For example, FMS officials argued that the federal entities that participate in the Card Acquiring Service pose less risk than other merchant types and that there is no risk of delinquency on the part of the Treasury. FMS officials stated that their negotiations were not successful and that they were not able to negotiate lower interchange rates.

- Officials from the Postal Service also explained their attempts to negotiate with the card networks. They stated that they believed lower interchange rates should be applied to their transactions for the following reasons. First, the Postal Service estimated that it has been one of the top U.S. merchants in terms of card transaction volume. Second, it poses less risk of fraud than some other merchants because most of its transactions are face-to-face. Third, the Postal Service operates a large retail network with 35,000 offices, self-service terminals, mail and phone orders, and a Web site that receives approximately 30 million hits per month and provides a great amount of visibility for the networks. Fourth, the Postal Service has its own law enforcement agency that investigates instances of fraud, including fraudulent use of cards where merchandise travels through the mail. These investigations result in the recovery of merchandise as well as stolen card data and in some cases the arrest of international criminals to the benefit of the credit card industry. They noted that the benefit of such services to the card networks were not reflected in the interchange rates for Postal Service transactions. The officials did state that they have had some limited success in negotiations, resulting in some small cost savings.

- Officials from another federal entity told us that they have had some success in receiving funds from one of the networks as a result of a joint marketing program. The funds could be used to reduce interchange costs or for additional marketing efforts; however, confidentiality agreements bind the details of the negotiations, which are considered proprietary information. The officials explained that negotiations of this type are not typical of federal entities because of the limited marketing opportunities available to most government entities.

Although some federal entities have had some success in negotiating lower interchange rates for their transactions, whether additional opportunities exist for further reductions in interchange rates is unclear. According to officials of MasterCard and Visa, factors they consider when setting interchange rates include whether the industry or sector represents a new market for credit and debit cards. According to these officials, government payments are a market in which they hope to increase card acceptance and transaction volumes; thus, the interchange rates that they set for government transactions are lower than those of many other merchant categories. Additionally, officials at MasterCard and Visa told us that opportunities exist for merchants, including federal entities, to negotiate for lower interchange rates. For example, the MasterCard officials cited an instance in which, in response to rapidly rising gasoline prices, they worked with gasoline merchants to develop a cap on the interchange fees for petroleum purchases. Officials from both networks explained that they have staff dedicated to developing customized arrangements with merchants and that these negotiations involve identifying mutually beneficial arrangements. We found it difficult to assess whether federal entities could negotiate rate reductions based on their relative transaction volume or aggregate card revenues, because we could not identify any publicly available data we could use to determine how the federal government's total transaction volume or aggregate card revenues compared with other large merchants.

Merchants Similarly Have Had Limited Success in Reducing Their Interchange Fee Costs

In our most recent report on interchange fee issues, we reported that merchants had had similar difficulties in negotiating lower interchange fee rates. We found that merchants did have greater ability to lower the processing fee portions of their merchant discount fee as the result of greater competition among banks offering such services. Increased competition for acquiring services provides merchants with considerable choice and opportunities to negotiate and lower some card acceptance costs. Hundreds of financial institutions and other firms compete as acquirers to provide card processing services. Merchants of varying sizes that we interviewed reported that they have multiple acquiring banks and processors competing for their business and have been able to lower the acquiring fee portion of their merchant discount fees in recent years.

Although merchants have reported success in negotiating their acquiring costs, several of the merchants we interviewed told us that their ability to lower their interchange fee costs—which represents the bulk of their card acceptance costs—was limited. These merchants generally paid the rates listed in the Visa and MasterCard networks' default interchange fee schedules. Although the ability to refuse to accept Visa and MasterCard should provide merchants with the leverage to negotiate lower interchange fees, merchants reported that they could not refuse to take such cards because of customer demand. For example, some merchants told us that if they did not accept credit cards from Visa or MasterCard, their sales would decrease and they would lose business to competitors that did accept those cards. Without this ability, merchants told us that they generally have not been very successful in obtaining meaningful reductions in Visa and MasterCard interchange fees. According to staff from Visa and MasterCard, their networks are willing to negotiate with merchants. For example, officials from one network told us that their network has negotiated with merchants with sales that represented 26 percent of their overall processing volume. Only one of the large merchants we interviewed told us that their company had received a limited and temporary reduction in their interchange fee costs as a result of negotiations with Visa or MasterCard following the settlement of a lawsuit.

Card Network Rules Are a Major Factor Limiting Card Accepters' Ability to Negotiate Lower Interchange Fees

Card network rules also limit the leverage that federal entities and merchants have to negotiate lower interchange fees. Each of the major card networks—Visa, MasterCard, American Express, and Discover—has various card acceptance rules—generally known as anti-steering rules—that limit the options that card accepters have for accepting or denying cards.[10] These rules include:

- no surcharges—card accepters may not impose a surcharge on consumers for the use of credit cards or cards with higher interchange fees;
- honor all cards—card accepters are required to accept all credit cards within a network's brand;
- no discrimination/differentiation—card accepters may not differentiate between credit cards within a network nor discourage the use of cards within a network;
- no minimum or maximum charges—card accepters may not impose a price floor or price ceiling on credit card transactions; and

[10] Not all of the networks have each of these rules, but if a merchant accepts cards from each of these networks, they are subject to all of them. Visa, MasterCard, and American Express have posted some of their rules on their Web sites; Discover's rules are not available online.

- preferred treatment—card accepters may not direct consumers away from or to a certain network's cards.

Some academic researchers and merchant representatives argue that these rules constrain card accepters' ability to limit the costs of credit card acceptance. For example, without the ability to surcharge for credit cards generally, for a particular network's cards, or for higher interchange fee cards, card accepters, including federal entities, are unable to steer customers towards lower-cost forms of payment or recoup some of their costs for higher-cost cards. In addition, without the ability to influence customers' payment choices, card accepters are unable to use their influence with the networks to encourage them to lower interchange and other fees in general, or offer more lower-fee cards. In contrast, representatives of issuers and card networks told us that the network rules are designed to promote the wide acceptance of their cards and ensure that their cardholders have a positive experience with the card.

Removal of Anti-Steering Rules Seen as Improving Merchants' Ability to Negotiate with Card Networks, but Impact of Lower Interchange Rates on Consumers Is Unclear

Although various options have been debated for seeking to lower interchange fees, removing the networks' anti-steering rules was one of the options that appeared to receive the most support from the large and small merchants and merchant trade associations with whom we spoke.[11] Removing the anti-steering rules appears to have various advantages, including providing merchants with the ability to send signals to cardholders about which cards increase merchant acceptance costs, a change that could improve merchants' leverage in negotiating their payment costs. Merchants' ability to surcharge or refuse certain cards also could cause cardholders using rewards cards to be more aware of and to bear more of the cost of the rewards from which they currently benefit. This option also may require the least intervention, as merchants could decide whether to add surcharges or refuse certain cards based on their customer mix.

Merchants told us that they have faced increased costs from accepting credit cards in recent years, partly because of the increasing number of customers using credit cards and partly because of the increase in average interchange fees, particularly for higher-fee rewards cards. With lower card acceptance costs, merchants may pass on their interchange fee

[11]See GAO-10-45. The other option that was most supported was restricting interchange fees with a cap or other limit.

savings through lower prices to consumers; however, the extent to which they would do so is unclear.[12] Representatives of merchants we interviewed told us that they generally passed any increased costs—including the costs of accepting credit cards—to their consumers through higher retail prices. Thus, all their customers may be paying higher prices for goods and services, whether using a credit card or not.

If interchange fees were lowered for merchants, consumers could benefit from lower prices for goods and services, but proving such an effect is difficult. For example, Australian regulators estimated that capping interchange fees in their country resulted in lower interchange fees for their merchants by about 1.1 billion Australian dollars for the period of March 2007 through February 2008. They acknowledged that providing conclusive evidence of the extent to which these savings have resulted in lower retail prices was difficult because so many factors affect prices at any one time. Moreover, the degree of savings depended on whether or not merchants were increasing their prices because of higher interchange fee costs. Some merchant representatives we interviewed told us that merchants would take different steps to improve customer service if interchange fees were lowered, such as hiring more employees. Customers also might not experience lower prices if merchants' overall costs did not decrease. Several industry participants speculated that if merchants were allowed to refuse higher-cost cards, merchants would lose sales from customers using premium credit cards. Network and issuer officials told us such customers spend more than customers using basic credit cards. A study of the Australian reforms by several economists reported that because the actual decrease in merchant costs was very small, merchants may have hesitated to lower prices, especially when their other costs might have been changing.[13]

Lowering interchange fee revenues for issuers could prompt issuers to increase cardholder costs or curtail cardholder credit availability. In Australia, issuers reduced rewards and raised annual fees following that country's interchange fee cap. In addition, with less interchange fee

[12]For example, Federal Reserve economists told us that the extent to which merchants would pass on their interchange fee savings likely would depend on the competitiveness of the markets in which the merchants operate.

[13]See Howard Chang, David S. Evans, and Daniel D. Garcia-Swartz, "The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia," *Review of Network Economics*, 4, no. 4 (December 2005).

income, representatives of smaller issuers such as community banks and credit unions told us that they likely would not offer rewards cards and therefore would be unable to compete with larger issuers. One credit union official told us that the credit union could not offer credit cards because of the expense involved with running such a program. In addition, representatives of credit unions and community banks we interviewed said that they benefited from a network system that developed interchange rates to attract both merchants and issuers. Allowing merchants to refuse certain cards or negotiate rates directly with the issuers would eliminate smaller institutions from the process. Representatives of larger issuers told us that with less revenue from interchange fees, they would consider reducing the amount of credit they make available to cardholders. Australian officials reported that since their reforms were instituted, the number of credit card accounts in Australia has continued to increase and smaller credit unions have remained in the credit card business, albeit with some of their operations outsourced.

Banks' lower interchange fee revenue and the removal of certain anti-steering rules could also negatively affect federal entities. For instance, a GSA official told us that banks facing reduced interchange fee revenue might reduce the amount of rebates federal entities receive for using purchase cards. In addition, he said that the "honor all cards" rule ensures universal acceptance of GSA purchase cards—an important consideration for timely purchase of goods for first responders.

Although interchange fees are not regulated at the federal level in the United States, these fees and card network rules, including the anti-steering rules, have been the subject of various actions by foreign regulators, the Department of Justice (DOJ), and private litigation. The Federal Reserve, under the Truth in Lending Act, is responsible for creating and enforcing requirements relating to the disclosure of terms and conditions of consumer credit, including credit cards, but because interchange fees are paid by merchants' banks and not directly assessed to consumers, such fees are not required to be disclosed to consumers. Although not specifically regulating credit card interchange fees, DOJ and the Federal Trade Commission have jurisdiction over credit card networks and issuers as part of enforcing U.S. antitrust laws or the Federal Trade Commission Act. In 1998, DOJ sued Visa and MasterCard for alleged antitrust violations regarding, among other things, how these networks' rules in effect prevented issuers from issuing cards on competitors' networks.[14] DOJ officials reported that they currently have another investigation under way involving potentially anti-competitive network rules such as those that prevent merchants from steering customers to other forms of payment, levying surcharges for card transactions, or discriminating against cards by type. DOJ staff told us they have requested information from American Express, Discover, MasterCard, and Visa as part of this investigation. They were not able to provide an estimate for when any formal action resulting from the investigation, if any, might occur. Interchange fees and other card network practices also have been the subject of private lawsuits. Since the mid-1980s, various lawsuits alleging problems with interchange fees and other card network practices have been litigated or remain pending.

In addition, as of September 2009, more than 30 countries have acted or are considering acting to address competition or card cost concerns involving payment cards.[15] Some actions taken by these countries include:

- regulating relationships between merchants, issuers, and card networks, such as prohibiting card networks from imposing certain rules on merchants;
- establishing maximum interchange fees or capping average interchange fees;
- allowing more institutions to enter the credit card market by changing the requirements to allow more institutions to qualify to act as an issuer or acquirer; and
- conducting investigations into the functioning of the payment card market, including legal antitrust proceedings.

[14]See United States v. Visa U.S.A., Inc., 344 F.3d 229 (2d Cir. 2003), aff'g,, 163 F . Supp. 2d . 322 (S.D.N.Y. 2001), Cert. Denied, 543 U.S. 811 (2004).

[15]Federal Reserve economists and others report that these countries include Argentina, Australia, Austria, Brazil, Canada, Chile, Colombia, Denmark, Finland, France, Germany, Hungary, Israel, Italy, Mexico, New Zealand, Norway, Panama, People's Republic of China, Poland, Portugal, Romania, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Turkey, and the United Kingdom, as well as the European Commission. See Terri Bradford and Fumiko Hayashi, "Developments in Interchange Fees in the U.S. and Abroad," Payment System Research Briefing (Federal Reserve Bank of Kansas City,: April 2008); and GAO-08-558.

Federal agencies accept cards and pay the associated costs. They also use cards and obtain various benefits as a result. Efforts to reduce interchange fees by addressing anti-steering rules could lower federal entities' interchange fee costs. If interchange fees were lowered, consumers and federal entities might benefit from lower prices for goods and services, but lower interchange revenues for card issuers could prompt them to increase cardholder costs, offer less generous rewards, or curtail cardholder credit availability, although consumers and federal entities could still enjoy various other benefits of using cards, such as convenience and efficiency.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to discuss these critically important issues and would be happy to answer any questions that you may have. Thank you.

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