The Evolution of Interchange Fees

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The Evolution of Interchange Fees

The wrath of the current economic crisis has taken its toll on every person and business nationwide. It's difficult to find someone who has not been personally affected or knows someone who has been personally affected by this crisis. While foreclosures continue to skyrocket and the unemployment rate increases, it is important to not only bring attention to people losing their homes and jobs, but also businesses who continue to struggle trying to make ends meet. Consumers have less money to spend which means businesses receive fewer sales. Ultimately, businesses are finding that not only do they have a decrease in profits overall, but credit card sales are up which is a lose-lose. Consumers have traded cash for credit cards, not because they want points or rewards but because this is their only avenue to be able to purchase goods and services. Some may speculate in a down economy it is the network providers such as Visa and MasterCard who are thriving due to increased credit card usage since on every purchase; these providers receive a portion of the sale. While businesses maintain their sales to a certain extent due to credit cards, these businesses also lose a portion of every sale when a credit card is used. If a customer pays in cash, the merchant receives the entire profit, if a customer pays with a credit or debit card, the merchant loses a portion of the profit through an interchange fee.

The interchange fee is the percentage tacked on to each sale when a credit or debit card is used. Two decades ago, there were a handful of interchange rates. Today merchants face about 200, and the percentage changes depending on the sort of plastic the customer uses. Merchants argue that "reward" cards, those that offer free miles and other perks are the most expensive because the money for those cards comes from the merchants through interchange fees. Interchange fees are set by credit card networks such as Visa and MasterCard but are collected from retailers by credit card issuers such as Citigroup and Bank of America. Interchange fees range from 1.6% to 2.5%.

Interchange fees totaled $48 billion in 2008, according to the National Retail Federation and accounted for 19% of revenue for card issuing banks according to trade magazine Cards and Payments. Interchange fee profit is up each year from 33% in 2006, to $42 billion in 2007, to what is stated above in 2008. As an estimate, California roughly spent $4.8 billion on interchange fees in 2008. Interchange fees costs Americans an average of $2 on every $100 they spend on using a card. In addition, according to the National Retail Federation, interchange fees cost households an average of $427 in 2008. Visa and MasterCard together account for about 71% of U.S. credit card purchase volume in 2008, American Express for about 24% and Discover for 5% as shown in the Nilson Report. According to the American Bankers Association, since 2005 more than half of total retail transactions have been paid for using either debit or credit cards.

BACKGROUND

In the late 1950s, Bank of America came out with the first credit card allowing cardholders to make purchases up to a credit limit and pay the balance off over time. To increase the number of consumers carrying the card and to reach retailers outside of Bank of America's area of operations, other banks were given the opportunity to license Bank of America's credit card. As the network of banks issuing these credit cards expanded, the network was converted into a membership-owned corporation that became the Visa network. MasterCard began in 1966 as an association of member-owned banks. American Express launched its card network in 1958, and in the 1980s, Discover, then a business unit of Sears, issued Discover card. In 2006, MasterCard became a publicly traded company with a board of directors with a majority of directors that are independent from their financial institution customers. Visa became a publicly traded company in 2008, and its financial institution members became common stockholders with a minority of shares.

Customers can choose between using their pin or signature for making purchases. If a customer uses a signature then the payment is transferred directly from the cardholder's account to the merchant's account. If a customer uses their debit card, the payment comes from the cardholder's checking account. Credit cards allow cardholders to access borrowed funds to make a purchase and generally have a grace period between the purchase of an item and the payment date. Then the cardholder can pay the charges in full or extend the loan and keep making charges to the credit limit. Cardholders who do not pay for the charges in full are assessed finance charges by their financial institution and pay interest on the remaining balance. According to the GAO report, credit cards offer cardholders several benefits, including:

- faster transactions,
- the convenience of not having to carry cash or a checkbook,
- a convenient source of unsecured credit that allows consumers to finance their purchases over time,
- an interest-free period to finance purchases if balances are paid on time,
- improved theft and loss prevention as compared with cash and easier dispute resolution in the event of problems, and
- an easy record-keeping mechanism that can be useful for budgeting, planning, and income tax preparation.

According toe the Card Industry Directory, in 2007, U.S. consumers held more than 694 million credit cards from Visa, MasterCard, American Express, and Discover with the total value of transactions for which these cards were used exceeded $1.9 trillion.

According to The Nilson Report the 10 largest credit cards issuers in 2008 were: JP Morgan Chase, Bank of America, Citi, American Express, Capitol One, Discover, Wells Fargo, HSBC, U.S. Bank and USAA Savings. About 75% of community banks, 49% of credit unions and 13% of thrifts issue credit cards.

The largest credit networks in the United States are Visa, MasterCard, American Express and Discover. Visa and MasterCard function differently than American Express and Discover by involving 4 parties in a credit card transaction. The parties are the financial institution that issued a cardholder's card, the cardholder, the merchant that accepts the cardholder's card and an acquiring financial institution. The acquiring financial institution contracts with the bank and the merchant to enable credit card transactions. American Express and Discover only use three parties who are the cardholder, the merchant and one company that acts as both the issuing and acquiring entities.

Interchange fees began in the 1960s as a way for banks to cover the cost of processing credit card transactions. Interchange fees account for the largest portion of the fees for acceptance of Visa and MasterCard credit cards.

Every time a consumer uses a credit card or debit card at any merchant including the internet, the merchant is charged a fee. The fee gets divided in three ways: between the merchant's bank, the consumer's bank and the credit card company. The fee collected covers processing fees, fraud protection, billing statements and other expenses, such as system innovations. As much as 90% of the fee comprises of the interchange fee which is the payment made by the merchant's bank to the consumer's bank. The interchange fee is passed on to all consumers in the form of higher prices for goods and services, whether the consumers purchase items by credit card, check or cash. Visa and MasterCard publish new interchange rates about twice a year. American Express and Discover do not publish the rates they charge merchants but instead generally negotiate these charges with merchants on an individual basis.

Community banks and credit unions rely on interchange fees as a significant source of revenue for their credit card operations and interchange fees remain one of the most profitable among the large banks. Credit unions and community banks have a higher portion of cardholders who do not carry a balance or incur penalty fees so they have to rely more on interchange fee revenues than revenues from fee income and interest payments.

According to Visa and MasterCard, four main factors determine which interchange fee rates apply to a given transaction on their networks:

- Type of card: Different rates apply to different types of cards. Visa and MasterCard have separate interchange fee rates for general purpose consumer cards, rewards credit cards, commercial credit cards (issued to businesses), and debit cards. Debit card interchange fees generally are lower than those for credit cards. Among credit cards, premium cards such as those offering rewards and commercial cards generally have higher rates than those for standard or traditional cards.

- Merchant category: Card networks classify merchants according to their line of business. Network officials told us they develop lower interchange fee rates for industries that do not accept cards to encourage merchants in certain categories to accept cards. For example, grocery stores and utilities have lower interchange fees as a special incentive from the networks. Interchange fee rates are higher for merchants in industries such as travel and entertainment, in which network officials report customers spend more with their credit cards, providing the merchant with higher value.

- Merchant size (transaction volume): Merchants with large volumes of card transactions generally have lower interchange fee rates. Visa categorizes some merchants into three tiers based on transactions and sales volume, with top-tier merchants receiving the lowest rate. Visa and MasterCard officials told us that the lower rates also were designed to promote the use of their cards over other credit cards and forms of payment.

- Processing mode: Interchange fee rates also vary depending on how card transactions are processed. For example, transactions that occur without the card being physically present, such as on the Internet, have higher interchange fee rates because of the higher risk of fraud. Similarly, swiping a card through a card terminal, rather than manually entering the account number, would lower a merchant's interchange rate. The swiped transaction provides more information to the issuer authorizing the sale, and issuers and card networks consider such transactions to be less risky because the card was present.

According to the Federal Reserve, since interchange fees are paid by the merchant's financial institution and not directly assessed to consumers, these fees are not required to be disclosed to consumers.

The federal regulation of financial services is comprised of various agencies which all oversee different aspects of the financial industry. The Federal Reserve oversees credit card issuers that are chartered as state banks and are also members of the Federal Reserve System. The Office of the Comptroller of the Currency (OCC) supervises card issuers chartered as national banks. Other regulators are the Federal Deposit Insurance Corporation (FDIC), which oversees state-chartered banks with federally insured deposits that are not members of the Federal Reserve System; the Office of Thrift Supervision, which oversees federally chartered and state-chartered savings associations with federally insured deposits; and the National Credit Union Administration, which oversees federally chartered and state-chartered credit unions whose accounts are federally insured. As part of their oversight, these regulators review card issuers' compliance with the Truth In Lending Act (TILA) Federal Reserve: Regulation Z—the primary federal law pertaining to the extension of consumer credit—and ensure that an institution's credit card operations do not pose a threat to the institution's safety and soundness. The Federal Trade Commission (FTC) generally has responsibility for enforcing TILA and other consumer protection laws for credit card issuers that are not subject to the enforcement authority of other federal regulators. To the extent that the imposition of interchange fees would constitute an anticompetitive or unfair business practice prohibited by the antitrust laws or the Federal Trade Commission Act, the Department of Justice (DOJ) and FTC, respectively, could take measures to ensure compliance with those laws.

The proponents of regulating interchange fees argue that interchange fees are excessive and have a huge impact on their already small profit margins, forcing them to pass the cost onto the consumers.

Those that prefer status quo argue their services provide merchants with a much needed service as more Americans choose to pay for their purchases with a credit or debit card.

According to the Merchants Payment Coalition, compared to the rest of the world, U.S. swipe fees are: more than two times the rates in the United Kingdom and New Zealand; four times the rates in Australia; and over six times the cross border rates in recently agreed upon by MasterCard and the European Union.

U.S. GOVERNMENT ACCOUNTABILITY OFFICE REPORT

On November 19, 2009, the GAO released a report titled, "Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges." The GAO is an independent, nonpartisan agency that works for Congress. Often called the "congressional watchdog," GAO investigates how the federal government spends taxpayer dollars. The mission of the GAO is to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people.

The intent of the report was to investigate how merchant fees have changed over time, the competitive nature of the credit card market, the benefits and costs to merchants of accepting cards, and the potential impact of several options to reduce merchant fees. The GAO report considers for different options for lowering interchange fees which included:

- limiting or capping the fees directly,
- requiring disclosure of these fees to consumers,
- loosening card network restrictions on merchants; and,
- granting antitrust waivers.

The GAO report found:

- Credit card interchange fee rates have risen over time, though the movement of these fees differs considerably across credit card types. Interchange fee costs for Visa's and MasterCard's premium cards have increased about 24% since they were introduced in 2005. Interchange fee costs for basic credit cards have stayed roughly the same since 2005, with a 3% percent decline for MasterCard and none for Visa.

- Consumers who do not use credit cards may be paying higher prices for goods and services as merchants pass on their increasing card acceptance costs to all of their customers.

- If lower interchange fees did exist, it would be difficult to determine whether the cost saving would be past on to the consumers. Consumers might also face higher card usage costs if issuers raised other fees or interest rates to compensate for lost interchange fees income. Federal Reserve economists noted that the extent to which merchants would pass on their interchange fee savings likely would depend on competitiveness of the market in which the merchants operate.

- Issuers pass on increased revenue from interchange fees to their cardholders in the form of greater rewards. 71% of cardholders held a rewards card in 2008.

- According to public Federal Reserve data, premium credit card interchange fee rates have increased by about 24% since 2005, while the rates for non-premium cards have remained relatively stable over this time period.

- Small issuing banks are more reliant on interchange income than large issuing banks.

The report also points out the card network rules. Visa, MasterCard, American Express and Discover have card acceptance rules that limit the options that merchants have for accepting or denying cards. The various rules include but may not apply to all the networks:

- No surcharges: Merchants may not impose a surcharge on consumers for the use of credit cards or cards with higher interchange fees.

- Honor all cards: Merchants are required to accept all credit cards within a network's brand.

- No discrimination/differentiation: Merchants may not differentiate between cards within a network or discourage the use of cards within a network.

- No minimum or maximum charges: Merchants may not impose a price floor or price ceiling on credit card transactions.

- Preferred treatment: Merchants may not direct consumers away from or to a certain network's cards.

Challenges with regulating interchange fees:

- Setting limits to interchange fees. If the limit is based on cost, as was done in Australia, determining which costs should be considered in problematic and considerable expense could be involved with collecting and analyzing the necessary data.

- Requiring disclosure of interchange fees to consumers could result in lower effective fees paid by merchants, but only if the consumer decide to use this information to decrease their usage of the credit cards that are expensive for merchants to accept.

- Loosening card network restrictions on merchants has the potential to lower the costs that merchants face but it is unclear to what degree merchants would actually take advantage of rule changes.

- Granting antitrust waivers to merchant groups and payment service providers but the Department of Justice is wary of granting such antitrust waivers.

THE HISPANIC INSTITUTE STUDY

In November, 2009, The Hispanic Institute released a study titled, "Trickle-Up Wealth Transfer: Cross-subsidization in the payment card market." The Hispanic Institute is a nonprofit organization focused on providing an effective education forum for an informed and empowered Hispanic America.

The Hispanic Institute conducted a telephone survey of a cross-section of United States household and asked about spending on gasoline and groceries. The Institute looked at the distribution of rewards within the population and found that rewards are not distributed equitably. The study found:

- Card rewards accrue disproportionately to wealthier households even after adjusting for spending;

- Education increased household awards;

- White households received higher rewards than African-American and Hispanic households; and,

- Households without a bank account received lower rewards.

The Hispanic Institute believes due to the difference in rewards rates amongst different population groups, the current structure of the credit card system forces lower income and minority consumers to transfer hundreds of millions of dollars to higher income consumers.

The Institute recommended the following:

- Lowering allowed interchange fees;

- Allowing merchants to impose price discounting depending on payment methods;

- Disallowing contracts that force merchants to accept all cards;

- Setting interchange fees uniformly regardless of rewards; and,

- Setting a baseline fees and allowing merchants to voluntarily participate or exempt themselves from any card rewards programs.

CURRENT FEDERAL LEGISLATION

At this time, interchange fees are not regulated in the United States. Currently, the federal government has three pieces of pending legislation which would regulate interchange fees.

<u>H.R. 2695- "Credit Card Fair Fee Act of 2009"</u>

- Allows retailers limited anti-trust immunity to collectively negotiate interchange rates with the credit card companies.
- Calls for traditional anti-trust protections that would help retailers from employing tactics such as a group boycott.

- Could result in individual negotiations, but any agreement would be made publicly available.

- Gives the U.S. Attorney General oversight authority of the negotiations and the ability to prompt both parties into the negotiations if either party fails to come to the table.

- Banks and credit unions with less than $1 billion in assets can opt out of the negotiation process.

- Covers card companies with 20% or greater market share.

Overall, this bill does not impose direct regulations or caps on merchant fees; it simply mandates that a negotiation session must occur and that merchant groups can negotiate collectively. If a voluntary agreement is not reached between the parties, then a not-so-positive report will be sent to Congress if the Attorney General feels as though one party has negotiated in poor faith.

<u>S. 1212-" Credit Card Fair Fee Act of 2009"</u>

S.1212 is very similar to H.R. 2695 with two differences:

- If negotiations fail, or if either party fails to come to the table, the Federal Trade Commission and Department of Justice appoint a 3 judge panel of experts to oversee the negotiations process. Each party presents a rate they feel to be fair and reasonable. The judge then determines which of the two rates they deem to be most fair.

- Covers card companies with 10% or greater market share, thereby extending its regulatory jurisdiction in the credit card market to include Visa, MasterCard and American Express systems.

<u>H.R. 2382- "Credit Card Interchange Fees Act of 2009"</u>

- Amends the Truth in Lending Act by prohibiting contractual restrictions placed on merchants and improving transparency regarding the terms and conditions of these contracts.

- Merchants would no longer have to pay higher interchange fees on premium credit cards. Premium includes any cards that provide rewards to the cardholder.

- Merchants would no longer be required to honor all cards of a network but instead could accept or refuse specific card on the basis of their cost to accept.
- Merchants with multiple locations could choose not to accept cards at any given location.

- Merchants could display retail prices and steer customer payment methods at their discretion.

- Merchants could set their own transaction minimums/maximums and not be required to pay chargeback fees when transactions exceed previously authorized maximums.

- Merchants could have their payment transactions routed in the way of their choosing, presumably to minimize their processing fee.

- Merchants would not have to pay penalties for failing to meet minimum number of transactions.

- The bill does not set specific caps on interchange or merchant discount fees but many of the provisions in this act are directed toward allowing merchants to accept lower-fee payments without losing access to an electronic payment network.

THE CREDIT CARD ACT of 2009

On May 22, 2009, President Obama signed into law the Credit Card Accountability Responsibility and Disclosure Act of 2009. This law clamps down on unfair and deceptive credit card practices. Between now and when the tighter rules take effect, credit card companies have hiked fees, rates and penalties.

Summary of the Credit Card Act of 2009:

Consumer Protection

- Retroactive interest rate increases are banned except when a cardholder is more than 60 days late paying a credit card bill.
- Credit card issuer must review the cardholder's account six months after increasing the interest rate, and return the APR to the previous lower level if the cardholder has been on-time with payment.
- Interest rate cannot be increased within the first 12 months, and promotional rates must have a minimum of 6 months in duration.
- Advance notice of 45 days prior to significant changes in credit card terms: this includes the benefits and reward structure of a credit card.
- The practice of universal default and double-cycle billing are no longer allowed.
- Over credit limit fees are now prohibited unless consumers specifically agree to allow transaction to go through instead of being denied.
- Bills must be sent out no later than 21 days before the due date.
- Cardholder payments must be credited as on-time if the payment is received by 5 P.M. on the due date.
- Enhanced Consumer Disclosures.
- Clear disclosure on how long it would take to pay off a credit card balance if cardholder makes only the minimum payment each month.
- Clear disclosure on the total cost in interest and principal payments if a cardholder makes only the minimum payment each month.
- Late payment deadline and postmark date are required to be clearly shown and disclosed to cardholders.

Protection of Young Consumers

- Credit cards cannot be issued to people under the age of 21 unless they have an adult co-signer or show proof that they have the means to repay the debt (proof of reasonable income).

- College students will be required to receive permission from parents or guardians in order to increase credit limit on joint accounts they hold with those adults.

- People under the age of 21 will now be protected from pre-screened credit card offers unless they specifically opt-in for offers.

Gift Cards

- Gift cards are now required to remain active for at least five years from the day of their activation.

- Dormancy or inactivity fees on gift cards can no longer be imposed unless there have been no activity in a 12-month period.

- Dormancy or inactivity fees must be clearly disclosed to gift card buyers.

- If the gift card expires after 5 years, the terms of expiration needs to be clearly disclosed to gift card buyers.

Effective Date

- The majority of the new rules will be taken into effect 9 months after the signing of the bill, which puts the effective date on February 2010.

- The rule on 45 days advance notice of major changes in account terms will take effect 90 days after the bill's enactment, beginning September 2009.

STATEWIDE AND OTHER COUNTRIES

A number of other states are looking into passing resolutions asking congress to take actions regulating interchange fees. Vermont passed a resolution in 2008 and Alabama, Minnesota and Tennessee are looking into introducing resolutions.

While interchange fees are not regulated in the United States, as of September 2009, more than 30 countries have acted or are considering acting to address competition or card cost concerns involving payment cards. The other countries include: Argentina, Australia, Austria, Brazil, Canada, Chile, Colombia, Denmark, Finland, France, Germany, Hungary, Israel, Italy, Mexico, New Zealand, Norway, Panama, the People's Republic of China, Poland, Portugal, Romania, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom, as well as others in the European Commission.

The actions taken in the various countries include the following:

- regulating relationships between merchants and 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 issuers or acquirers; and
- conducting investigations into the functioning of the payment card market, including legal antitrust proceedings.

The details of these programs will be discussed further below.

AUSTRAILIA

Australia began examining interchange fees in 1997 and found in 2000 that competition among card networks is not working as it should. Due to the hidden nature of the swipe fees and the absence of informed consumer choice of payment method, the Reserve Bank of Australia determined in 2001 that the interchange rates systems were subject to regulation under a piece of financial legislation passed in 1998. Australia mandated a reduction in interchange fees and enacted a series of interchange reforms that were intended to improve the efficiency of the overall payments system and to promote competition. Other changes include: an increase in the transparency of the system; remove or modify restrictions that hinder competitive forces; liberalize access arrangements; and promote price signals to consumers that are conducive to the efficient evolution of the payment system. Changes went into effect in November, 2003 and since then the interchange fees have fallen about .45 percentage points since that time.

If the United States paid the same credit and debit card interchange fees as consumers in Australia, then the net benefit for American consumers would have totaled $125 billion over the last 4 years.

THE EUROPEAN UNION

In addition to Australia, the European Union has recently made significant changes to interchange fees. In December, 2007, the European Commission ruled that MasterCard's cross-border interchange fee breached the European Union antitrust rules. The commission concluded that fees inflated the cost of card acceptance by retailers without leading to proven efficiencies. In April of 2009, MasterCard agreed to reduce the Multilateral interchange fees for cross-border card payments rates by about half to 0.3% which is less than one-sixth the average U.S. rate. MasterCard also agreed to repeal its recent scheme fee increases for cross border transactions as well as increase transparency and efficiency in the credit card market.

NEW ZEALAND

In November, 2006, New Zealand's Commerce Commission ruled that the interchange fee process was in violation of the restrictive trade practices provisions of the Commerce Act. In August, 2009, Visa and MasterCard each agreed to a series of reforms designed to improve interchange process transparency, foster competition, and increase access to information for both consumers and retailers. More specifically, the reforms allow credit card issuers to individually set the interchange rates that will apply to transactions using their credit cards which will ensure that information is publicly available and allowing merchants to apply surcharges to payments made by credit cards or by specific types of credit cards. Merchants are also able to encourage customers to pay by other means including allowing merchants to offer discounts for cash payments.

CANADA

In March, 2009, the Competition Bureau of Canada explored whether Visa and MasterCard breached the nation's Competition Act. In June, 2009, after a lengthy investigation, the Canadian Senate's Committee on Banking, Trade and Commerce released a report concluding that it was necessary to reform the swipe fee process to improve transparency and increase direct negotiation between merchants and Visa and MasterCard member banks. While the report recommends more oversight and accountability by the Canadian Government over the credit and debit markets and interchange system, no legislative action has been taken.