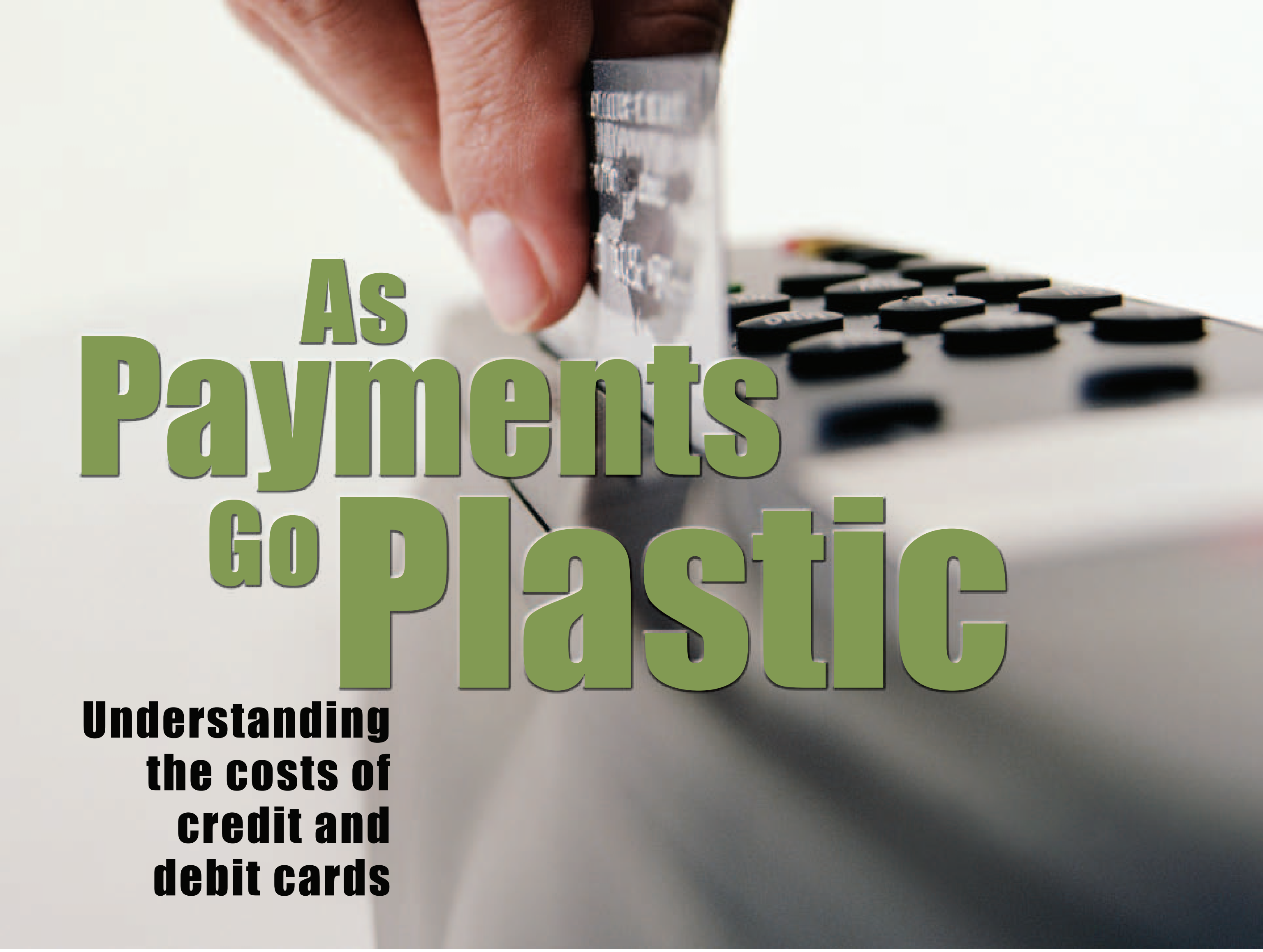

As Payments Go Plastic

Understanding the costs of credit and debit cards

BY TONI LAPP, SENIOR WRITER

In Santa Fe, New Mexico, recently, a passerby browsing a street vendor's wares asked, "Do you take credit cards?"

"No," he said. Then he quipped, "This is sacred ground," referring to the sidewalk surrounding the centuries-old Palace of the Governors.

Ironically, a topic that has become sacred ground in the payments industry was under discussion nearby at a conference organized by the Federal Reserve Bank of Kansas City: Interchange.

The fee that merchants' banks pay for handling credit and debit card payments has become the center of heated debate between retailers and the credit card industry. The purpose of the conference was to discuss what role, if any, public authorities should have to intervene in the markets for credit and debit card payments. In addition, regulators from other countries, academics and industry participants had the opportunity to exchange views to further understand what drives these markets.

Both credit and debit cards have been growing strongly in recent years.

The distinction between the two is that credit card transactions are, in effect, short-term loans, whereas debit card transactions are immediately withdrawn from the cardholders' accounts. Interchange fees are involved in both transactions.

Held May 4-6, the meeting came just weeks after a round of increases in interchange fees from MasterCard and Visa. A recent Morgan Stanley report found that the weighted average for Visa and MasterCard credit interchange had increased from 1.58 percent of the value of a transaction in 1998 to 1.75 percent in 2004. Some of the new rates are as high as 2.9 percent, particularly for new higher-rate premium cards, which credit card giants have been pushing over lower-rate standard cards.

Authorities in Australia, Mexico and the United Kingdom have examined and, in Australia's case, acted to force reductions of interchange rates in those countries, yet the fees are the highest in the United States. Some wonder why there have been no regulatory moves here. New entrants to the industry are rare, and accusations of antitrust have been made. In the United States, the last company to enter the market was Discover Card, in 1985.

Whither interchange

Credit card companies maintain that interchange has provided issuers the funding to promote cards as a more convenient way to pay for purchases. Credit cards bring higher sales, quicker checkout and lower risk versus handling cash or checks.

Merchants, on the other hand, complain about the fees cutting into their profit margin and artificially raising the price of goods for all consumers, whether they pay with cash or plastic.

Certain aspects of the industry have confounded economists, who lament the complexity of the fee structures and the lack of solid data.

For instance, the role that competition plays in setting fees is in question. In most industries, competition brings down prices. But this hasn't been the case with interchange; indeed, the more competitors there are, the higher the fees seem to climb.

When someone talks about a competitive market, they talk about a market in which price is set by supply and demand, says Mallory Duncan, general counsel of the National Retail Federation. "The problem is (retailers) are nowhere in the equation with interchange fees."

Duncan calls the fees a "hidden tax" on consumers.

"Say a retailer is willing to sell a product for $99 in dirty, old cash," says Duncan. "If they're going to sell to someone with a credit card they'll have to charge $101."

One merchant says consumers are ill-informed.

> "In most industries, competition brings down prices. But this hasn't been the case with interchange."

"I don't think customers understand the expenses to the merchant, and that in turn, it affects (the customers') bottom line," said Marilyn Taylor, owner of M. Taylor gift store in Prairie Village, Kan.

Taylor says she was exasperated to see a mail insert from one bank's credit card encouraging customers to charge small purchases and offering an incentive—entry for a contest—for each charged purchase under $25.

But Noah Hanft, general counsel of MasterCard International points to the benefits that merchants realize: reduced costs for cash handling, bounced checks, and collections.

"Because we are replacing far more costly and less beneficial payment forms, it is both logical and appropriate to charge these merchants for the extraordinarily valuable service provided to them," he said.

The business model

Credit card companies are similar to dating services in their function, suggest two economists. In their paper presented at the Santa Fe conference, David S. Evans and

Further Resources: INTERCHANGE FEES

THE FOLLOWING PAPERS AND REMARKS were presented during the International Payments Policy Conference, "Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities?" sponsored by the Federal Reserve Bank of Kansas City. Full text of the papers can be downloaded at www.kansascityfed.org/FRFS/PSR/2005/05prg.htm.

CONFERENCE OVERVIEW/CLOSING REMARKS, by Hendrik J. Brouwer, Executive Director of Nederlandsche Bank N.V.

INTERCHANGE FEES IN VARIOUS COUNTRIES: DEVELOPMENTS AND DETERMINANTS, by Stuart E. Weiner, Vice President and Director of Payments System Research, Federal Reserve Bank of Kansas City, and Julian Wright, Associate Professor, National University of Singapore

INTERCHANGE FEES IN VARIOUS COUNTRIES: COMMENTS ON WEINER AND WRIGHT, by Alan S. Frankel, Senior Vice President, Lexecon

ECONOMIC RATIONALE FOR INTERCHANGE FEES, by David S. Evans, Vice Chairman, LECG Europe, and Richard Schmalensee, Dean, Sloan School of Management, Massachusetts Institute of Technology

INTERCHANGE FEES MYSTERIES, by Jean-Charles Rochet, Professor, University of Toulouse

THE NEED FOR FEDERAL RESERVE AND ANTITRUST INTERVENTION IN THE FAILED U.S. DEBIT AND CREDIT CARD MARKETS, by Lloyd Constantine, Chairman, Constantine Cannon PC

INTERCHANGE FEES IN CREDIT AND DEBIT CARD INDUSTRIES: WHAT ROLE FOR PUBLIC AUTHORITIES?, by John Gove, Director, TransAction Resources Pty Ltd

INTERPAY, AN INTRODUCTION, by B.J. Haasdijk, Chief Executive Officer, Interpay

INTERCHANGE REIMBURSEMENT FEES DELIVERING VALUE AND DRIVING INNOVATION, by William Sheedy, Executive Vice President, Visa U.S.A.

"LET'S GET REAL", an address by Noah J. Hanft, General Counsel and Corporate Secretary, MasterCard International

PUBLIC POLICY AND THE INVISIBLE PRICE: COMPETITION LAW, REGULATION AND INTERCHANGE FEE, by John Vickers, Chairman of the Board, Office of Fair Trading

PAYMENTS SYSTEM REFORM: THE AUSTRALIAN EXPERIENCE, by Philip Lowe, Assistant Governor, Reserve Bank of Australia

INTERCHANGE IN A CHANGING MARKET: OBSERVATIONS FROM THE EURO AREA PERSPECTIVE, by Gertrude Tumpel-Gugerell, Member of the Executive Board, European Central Bank

OTHER PAPERS AND REMARKS from the conference will be added to the website as they become available.

Richard Schmalensee used that parallel to illustrate a two-sided platform—one in which the business is a matchmaking intermediary that adds value by bringing individuals of two types together. Skewed pricing occurs when the intermediary strives to balance participation to increase the volume of transactions or customers—for instance, allowing women free memberships to a dating service in order to attract men.

Data have been insufficient to support a conclusion on the effects of the fees, said Stuart Weiner, vice president and director of the Federal Reserve Bank of Kansas City's Payments System Research Department. The business model of credit card companies such

as MasterCard and Visa is unique in that it serves dual customers: cardholders and issuing banks.

"The nature of these markets isn't well understood," said Weiner. "In a two-sided market it's possible that free market forces could actually raise interchange fees."

In this scenario, credit card companies are competing for issuers; thus the higher the interchange fee, the more attractive a card becomes to issuing banks.

An October 2004 Supreme Court ruling found that MasterCard and Visa violated antitrust laws by barring banks that issued their cards from also issuing other cards; within months, two banks had already moved to issue American Express.

"In light of the enhanced competition, Visa and MasterCard have to raise their rates so other banks don't jump on the bandwagon to issue American Express," says Weiner.

Credit industry insiders say merchants paint a misleading picture. The effect of interchange rate increases has been overstated, said Hanft of MasterCard.

"Interchange has always been set to maximize the outputs of the payments system, meaning, more cards, more merchants and more transactions," he said.

Research shows that consumers who use credit cards make larger expenditures than those paying with cash, he noted.

Some large retailers choose not to accept MasterCard; it's their choice, says Hanft.

However, some small merchants say they don't have any choice but to cater to consumers' preference for plastic.

"It becomes a customer service issue," said Taylor, proprietor of M. Taylor. "You don't want to cause ill will."

The players

Not all card transactions are created equal. A number of factors will affect the fee a merchant pays on credit card and debit card transactions: a merchant's average ticket value, the annual volume, and whether they take sales in person, via the Internet or by phone.

Most payment card transactions involve four parties: the cardholder, the bank that issued the card (the "issuer"), the merchant who receives payment, and the bank that deals with the merchant (the "acquirer").

With a typical purchase, the acquirer will deduct a percentage known as the "merchant discount" from the sale. For instance, if the discount rate is 2 percent, the acquirer will pay the merchant 98 percent of the purchase. If the interchange rate is 1.7 percent, the issuer would deduct this from the amount of the transaction and pay the acquirer 98.3 percent of the transaction. Thus, the issuer would net 1.7 percent and the acquirer 0.3 percent from the transaction.

Not all payment card transactions follow the four-party scheme. Historically, Discover Card and American Express have been three-party schemes, having direct relationships with cardholders and merchants (although with a Supreme Court ruling this is changing). The issuer and acquirer are the same entity, therefore there are no interchange fees. Instead, American Express charges merchant discount fees of about 2.5 percent. Discover Card is regarded as having the lowest merchant discount fee.

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Credit Cards: from inception to interchange

Billions of dollars worth of products are bought and sold today without a single dollar bill being exchanged, but this hasn't always been the case. Individual stores were the first to see the benefit of offering a store card that made credit available to preferred customers.

"Promoting customers' loyalty was the rationale behind many of the first credit cards," said Richard Sullivan, economist in the Federal Reserve Bank of Kansas City's Payments System Research Department. The automobile suddenly gave people mobility to shop at a number of retailers in a day; thus oil companies and department stores offered credit to lure customers from competitors.

Such lines of credit were limited to purchases at that particular merchant, however.

The precursor to the modern multi-store credit card, Diners' Club, began in 1950 as an intermediary between merchants and customers. The companies that accepted the arrangement paid Diners' Club 7 percent for each transaction; cardholders paid an annual fee of $3. Diners' Club would bill the cardholders and pay the restaurants the total minus the merchant discount fee–a unitary system in its simplest form.

Diners' Club had to relax its fee when it began expanding its merchant base beyond restaurants. Hotels and airlines balked at paying 7 percent of each sale, so the charge was abandoned in favor of a sliding fee structure that varied according to average ticket charge.

In 1958, American Express and Bank of America (whose BankAmericard later became Visa) entered the scene. Initially, both organizations operated as a unitary system, in that they acted as issuer (dealing with cardholders) and acquirer (dealing with merchants) themselves.

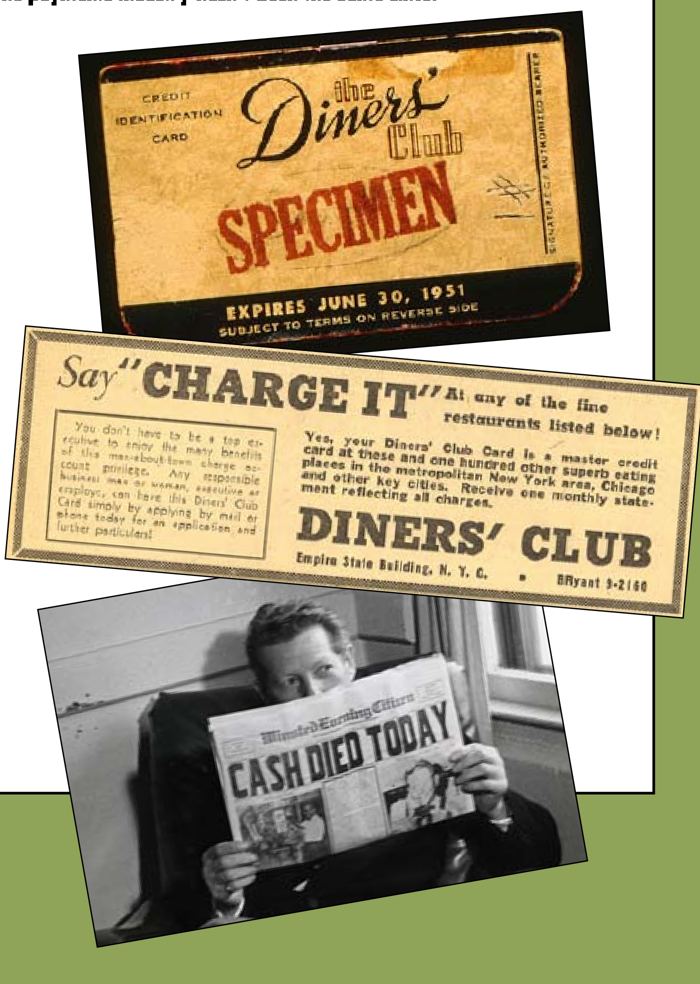
American Express targeted a niche of "travel and entertainment" consumers with a card that could be used in hotels and restaurants. BankAmericard went after a broader group of retailers by decreasing its merchant fees.

In 1966, Bank of America rolled out a franchise in which other banks were enlisted as issuers. Bank of America required the acquiring bank to pass the full merchant discount to the issuing bank, an arrangement that was flawed. Acquiring banks received no revenue for transactions made by cards they did not issue. These terms gave acquiring banks incentive to be less than honest about their merchant discount. And because acquiring banks received nothing in a two-bank transaction, there was little incentive to add merchants.

The BankAmericard system became a membership corporation in 1970, and thus, the multi-party system was born. The interchange fee was established soon after to facilitate transactions in which acquiring banks and issuing banks were different.

Although National Bancard Corp., or NaBanco–an organization that specialized in acquiring and processing merchant credit card transactions–filed suit in 1979, contending that those fees amounted to price-fixing, an appeals court ruled in Visa's favor in 1986, and the model has stood ever since.

Credit card pioneer Diners' Club introduced its card in 1950, and the payments industry hasn't been the same since.



Rewards

In a radio spot for one bank's Visa card, two friends are feuding because one paid for lunch with his card and earned reward points. They decide the other friend will pay for lunch for the next week so he, too, can earn reward points.

Are consumers expecting a free lunch? "Everyone would like to get something for free," said Duncan of the retailers federation. "But consumers are not getting a free lunch. They're paying for these rewards every time they make a purchase, whether it's with cash or with a card."

Taylor says credit card incentives are increasingly prompting her customers to whip out the plastic. "They'll ask which cards we accept, and then say, 'Oh, I get airline miles for that one,' and pay with that," she said.

The issue at hand, says Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, is what is in the public's best interest. Historically, the free market has been sacred ground for the U.S. economy.

Will the Federal Reserve System intervene in the battle over interchange? "Economists talk about market failure as a rationale for intervening in the market," said Weiner of the Bank's Payments System Research Department. "But such a conclusion would require considerably more knowledge about the market. Our focus is to become better informed."

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Interchange Fees on Credit and Debit Cards

for a $50 Transaction

—American Banker and ATM & Debit News

NETWORK	1999	2000	2001	2002	2003	2004
Mastercard (Credit)	$0.79	$0.79	$0.79	$0.80	$0.80	$0.88
Visa (Credit)	$0.74	$0.74	$0.74	$0.79	$0.82	$0.87
Mastercard (Signature Debit)	$0.78	$0.78	$0.78	$0.79	$0.59	$0.68
Visa (Signature Debit)	$0.73	$0.73	$0.73	$0.73	$0.49	$0.68
Star (PIN Debit)	$0.08	$0.17	$0.17	$0.34	$0.34	$0.45
NYCE (PIN Debit)	$0.08	$0.13	$0.13	$0.34	$0.40	$0.43
Pulse (PIN Debit)	$0.10	$0.10	$0.10	$0.15	$0.18	$0.18
Interlink (PIN Debit)	$0.20	$0.20	$0.20	$0.45	$0.45	$0.45
Maestro (PIN Debit)	$0.10	$0.10	$0.10	$0.10	$0.29	$0.45
Accel/Exchange (PIN Debit)	$0.08	$0.08	$0.08	$0.18	$0.18	$0.40
Shazam (PIN Debit)	$0.00	$0.00	$0.10	$0.10	$0.10	$0.10
Networks (PIN Debit)	$0.15	$0.15	$0.15	$0.15	$0.15	$0.15

These fees are for a typical retail store and may vary for a number of reasons. Debit card charges at a grocery store and credit card charges at a gas station or convenience store will be different.