payments system research briefing

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An Update on Interchange Legislation in the United States

by Christian Hung, Research Associate II

While consumer protection legislation relating to payment cards and other electronic payments has had a long history in the United States, congressional interest in the merchant relationship with the electronic payments industry is relatively recent. There is currently much debate as to whether interchange fees ought to be regulated in some manner in the United States, and since 2008, several bills pertaining to interchange fees have been introduced to congressional committees. This *Briefing* provides a summary of recent developments in interchange legislation as well as the recently released Government Accountibility Office (GAO) report detailing its findings on interchange fees.

Background[1]

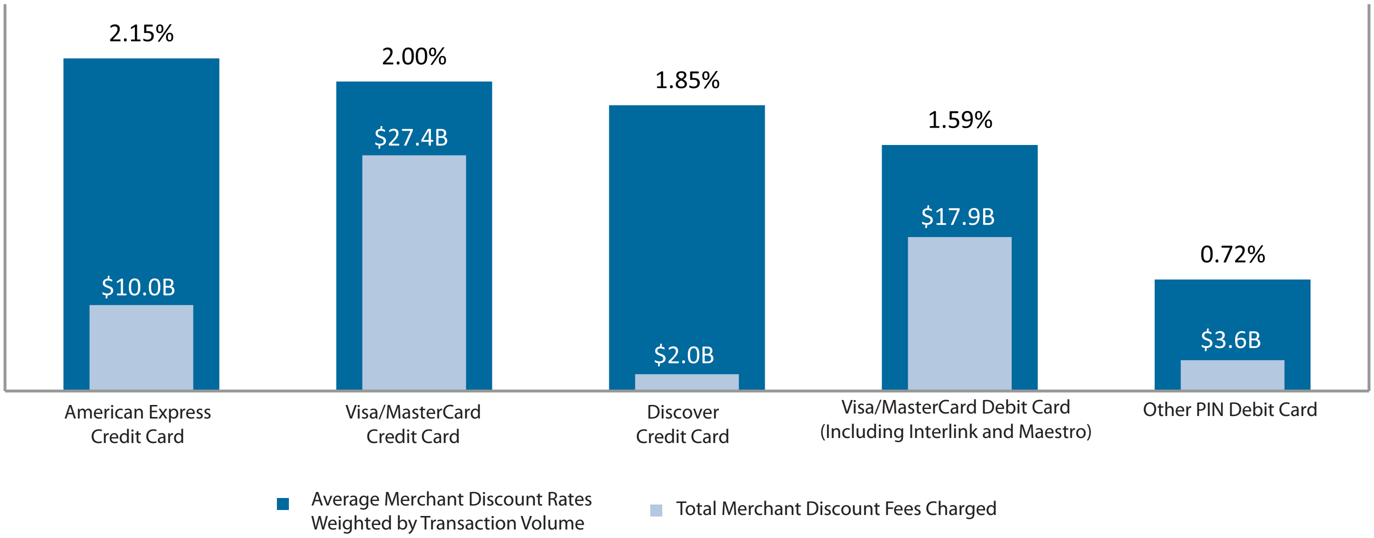
The sum total of the fees that merchants pay to accept payment cards is often referred to as the "merchant discount," and a large portion of the merchant discount is made up of the interchange fee.[2] While varying greatly, the interchange fee is usually calculated as a percentage of the transaction value when a merchant accepts a credit or debit card as payment for goods and services. This revenue is ultimately collected by the bank that issued the card to the paying customer. U.S. merchants paid just over $60 billion in merchant discount fees in 2008.[3] The chart on page 2 shows average merchant discount rates and the total amount of merchant discount fees charged to merchants for each general purpose card type in 2008.

Current Legislation

Three major interchange-related pieces of legislation are pending in Congress: a House of Representatives version of the Credit Card Fair Fee Act of 2009, a Senate version of the Credit Card Fair Fee Act of 2009, and the Credit Card Interchange Fees Act of 2009.[4]

H.R. 2695, currently being discussed in legislative committee, is the House version of the Credit Card Fair Fee Act of 2009. This bill is very similar to an act of the same name approved in legislative committee in 2008 but not ultimately voted on by the full House of Representatives. The bill calls for an antitrust exemption for merchant groups allowing them to collectively negotiate their merchant discount fees[5] with the electronic payment providers. The bill considers providers to be card networks, member issuing banks, and member acquiring banks. The Attorney General would proctor any such negotiations and report to Congress, giving its opinion on the effects of any agreements on competition as well as how these terms compare to those in place in other countries. H.R. 2695 dictates that the card network in question, as well as the 10 largest merchants, issuing banks, and

Merchant Discount Fees in 2008



Source: The Nilson Report, Issue #936

acquiring banks must also disclose cost and contract information to the Attorney General in preparation for the negotiations. Of note is that this bill applies only to card systems with at least 20% market share (by dollar value)–which, by recent market share statistics, effectively restricts its domain to negotiations with the Visa and MasterCard systems. Credit unions and banks with assets of less than $1 billion have the ability to opt out of these negotiations. If enacted, the provisions under this act go into effect immediately.

H.R. 2695 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. Under this bill, there are no tangible consequences for either party if a voluntary agreement is not reached, other than a less-than-favorable report to Congress if the Attorney General feels as though one party has negotiated in poor faith.

S. 1212, also currently being discussed in legislative committee, is the Senate version of the Credit Card Fair Fee Act of 2009 and bears a strong resemblance to a version of the Credit Card Fair Fee Act of 2008 that did not make it past legislative committee in 2008. In addition to the provisions stated in the House bill, this version would substitute a three-judge panel known as the "Electronic Payment System Judges" for the attorney general as moderator of negotiations. This panel would ultimately select one set of fees and terms at the conclusion of the negotiating process. This choice of fees and terms would be from one of the two final proposals presented by the merchant group and the electronic payment provider group, respectively. S. 1212, unlike H.R. 2695, applies to card systems with at least 10% market share (by dollar value), thereby extending its regulatory jurisdiction in the credit card market to include the Visa, MasterCard, and American Express systems, according to recent market share statistics. If passed, the new fees and terms negotiated under S. 1212 would take effect beginning January 2011.

The addition of the three-judge panel to the negotiating process in S. 1212 introduces limited powers of regulation.[6] However, the language of S. 1212 does not make explicit some of the details on how the three-judge panel would go about rendering a final decision on the structure of fees and terms. Among the criteria listed that the judges ought to consider are "a normal rate of return in a hypothetical perfectly competitive marketplace" and "cost-based differences in types of credit card and debit card transactions." In the field of economics, perfect competition is a well-defined term for standard markets. As many economists have pointed out, however, the market for electronic payment services is not standard. This market contains non-standard elements, including what are known as "two-sided market" characteristics,[7] so it is not clear how a panel of judges will interpret this criterion in its ruling. The cost criterion that the judges are charged to consider is also open to discussion. It is not clear whether only the marginal costs of processing a payment are to be considered, or if other costs will also be considered, such as technological investment, credit losses, or the cost of providing rewards programs.

The Credit Card Interchange Fees Act of 2009 (H.R. 2382) is a reintroduction of a 2008 bill of the same name. The 2009 bill is still being discussed in legislative committee. This bill seeks to amend the Truth in Lending Act by prohibiting contractual restrictions placed on merchants and improving transparency regarding the terms and conditions of these contracts. The principal effects of the provisions under this act would be:

- Merchants would no longer have to pay higher interchange fees on "premium" credit cards. The definition of "premium" seems to include 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 types 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 a minimum number of transactions.

To improve transparency, the bill requires that all rules, terms, and conditions must be made available to the merchant without restrictions as to how the merchant uses the information. The Federal Trade Commission would review and issue regulations to ensure that the terms of any contracts are not unfair or deceptive. The FTC would also collect and publish information on prevailing terms, conditions and fees (including interchange) charged by each network.

While the Credit Card Interchange Fees Act would not set specific caps on interchange or merchant discount fees directly, 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 and GAO Report

On May 22, 2009, President Obama signed into law the Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act of 2009. While dealing primarily with consumer protection issues, this law included language that required the GAO to conduct a study on interchange fees. This report was released on November 19, 2009.

The GAO's objectives for this report were to describe 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. In investigating these topics, the GAO consulted data and interviews provided by various participants in the payments industry, including merchant groups and all four major credit card networks, as well as data provided by Federal Reserve staff. The GAO notes, however, that the amount of public data available is limited.

The GAO report finds that in total, credit card interchange fee rates have been rising over time, though the movement of these fees differs considerably across credit card types. The report notes that, according to public Federal Reserve data, premium credit card interchange fee rates (corresponding to the cards that offer rewards) have increased by about 24% since 2005, while the rates for non-premium cards have remained relatively stable over this time period. The GAO also finds that small issuing banks may be more reliant on interchange income than large issuing banks.

The GAO report does not offer strong conclusions as to the benefits that the current environment in the credit card market may provide to merchants and consumers. Rather, much of the report is dedicated to presenting the network and merchant advocate arguments that came out of the GAO's interviews with representatives from these groups. For example, while the GAO notes that some consumers (credit card users) have probably benefited from competition in the credit card market, it finds it difficult to determine to what extent merchants and non-credit card users benefit or are harmed by this atmosphere. Merchants may gain additional sales from consumers who spend on credit and see savings in labor costs, but these benefits may be overshadowed by the magnitude of the fees that they pay to accept these payments. Consumers who do not use credit cards may be seeing higher prices, but determining what savings these consumers would see if interchange fees were lowered is difficult.

The GAO considers four general mechanisms for lowering interchange fees: 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 does not explicitly favor one approach over another, and it does not express an opinion on whether any regulatory action at all would be better or worse than the status quo. The report cautions that any approach that has the effect of lowering interchange fees has potential drawbacks as well as potential benefits. It suggests that a lower interchange fee may benefit merchants through lower merchant fees and non-credit card users through lower prices (if merchants pass some of these savings on to their customers), but credit card users may be made worse off through lower rewards and/or restricted credit. And with less interchange revenue, some small issuers have indicated that it may be more difficult to compete with large issuers. In addition to these considerations, the GAO notes particular challenges associated with each regulatory approach:

- Setting limits to interchanges fees, notes the GAO, is complicated by the process of determining what the proper limit ought to be. Even if the limit is based on cost, as was done by the Reserve Bank of Australia, for example, determining which costs should be considered is problematic, and considerable expense could be involved with collecting and analyzing the necessary data to do so.
- Requiring disclosure of interchange fees to consumers could result in lower effective fees paid by merchants, but only if consumers decide to use this information to decrease their usage of the credit cards that are expensive for merchants to accept. The GAO also notes that there is a cost burden for whichever party is responsible for the disclosure of the fee information, as this will likely require technology updates.
- Loosening card network restrictions on merchants has the potential to lower the costs that merchants face, but the GAO also indicates that it is unclear to what degree merchants would actually take advantage of rule changes, such as the ability to surcharge credit card users. Some merchants may not take advantage of this ability out of fear of losing business to merchants who do not choose to surcharge, and some merchants have noted that it is difficult to distinguish at the point of sale what type of card their customers are paying with.
- Granting antitrust waivers to merchant groups and payment service providers is the approach most similar to the House and Senate versions of the Credit Card Fair Fee Act of 2009, though each of these acts has very specific methods of implementation that the GAO report does not discuss. The GAO reports that granting antitrust waivers may give merchants enough leverage to lower the interchange fees that they incur, but one significant hurdle to this approach is that the Department of Justice is wary of granting such antitrust waivers, and this action has only been justified in very rare circumstances.

Summary

The U.S. Congress is currently considering legislative efforts to lower interchange fees. The GAO report released on November 19 notes that while some interchange fee rates have been rising in recent years, decisions to regulate these fees are multifaceted. In light of these developments, the issue of interchange legislation is likely to remain an important one for the foreseeable future.

Useful resources for readers desiring more information about current interchange legislation are:

H.R.2695, The Credit Card Fair Fee Act of 2009:
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h2695ih.txt.pdf

S.1212, The Credit Card Fair Fee Act of 2009:
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s1212is.txt.pdf

H.R.2382, The Credit Card Interchange Fees Act of 2009:
http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h2382ih.txt.pdf

The GAO Report:
http://www.gao.gov/new.items/d1045.pdf

Endnotes

[1]For a detailed account of issues surrounding interchange fees, see *Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities? Proceedings of Federal Reserve Bank of Kansas City International Payments Conference*, Santa Fe, NM, May 2005, available at: http://www.kc.frb.org/home/subwebnav.cfm?level=3&theID=11322&SubWeb=10683.

[2]Certain card networks such as American Express and Discover, due to their network structure, do not have interchange fees per se, but they have similar merchant discount rates.

[3]The Nilson Report, issue #936.

[4]While the titles of these bills suggest that they are concerned with credit cards, many of their provisions presumably apply to debit cards as well.

[5]The bill uses the language "rates and terms" for access to the electronic payment system; the merchant discount rate is an important component of these rates and terms.

[6]Since the judges are limited to choosing a proposal made by either the merchant group or the provider group, this bill is arguably a weaker form of regulation than the direct regulations put in place by many other countries. For a summary of regulatory actions abroad, see: Terri Bradford and Fumiko Hayashi, "Developments in Interchanges Fees in the United States and Abroad," Federal Reserve Bank of Kansas City *Briefing*, May 2008, available at: http://www.kc.frb.org/Publicat/PSR/Briefings/PSR-BriefingApr08.pdf.

[7]A two-sided market is a market in which there are two distinct types of end users, (in this case, merchants and cardholders) and the "price" for the good or service being sold is split between these two types of consumers. For discussion, see: Stuart E. Weiner and Julian Wright, "Interchange Fees in Various Countries: Developments and Determinants," in *Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities? Proceedings of Federal Reserve Bank of Kansas City International Payments Conference*, Santa Fe, NM, May 2005, available at: http://www.kc.frb.org/econres/PSR/psrconferences/2005/Weiner-Wright.pdf.

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The Payments System Research function of the Federal Reserve Bank of Kansas City is responsible for monitoring and analyzing payments system developments. Staff includes:

Terri Bradford
Payments System Research Specialist
Terri.R.Bradford@kc.frb.org
816-881-2001

Fumiko Hayashi
Senior Economist
Fumiko.Hayashi@kc.frb.org
816-881-6851

Christian Hung
Research Associate II
Christian.Hung@kc.frb.org
816-881-4721

Paul Rotilie
Research Associate II
Paul.Rotilie@kc.frb.org
816-881-2357

Rick Sullivan
Senior Economist
Rick.J.Sullivan@kc.frb.org
816-881-2372

Zhu Wang
Senior Economist
Zhu.Wang@kc.frb.org
816-881-4742

Stuart E. Weiner
Vice President and Director
Stuart.E.Weiner@kc.frb.org
816-881-2201