Update...

What a difference a year makes.

In May 2005, the Federal Reserve Bank of Kansas City hosted a conference on interchange fees, which are a part of credit and debit card transactions.

Featured on the cover of TEN's Summer 2005 edition, the conference was organized by the Bank's Payments System Research Department as a forum to explore what role, if any, public authorities should play in regulating these fees. A mix of industry participants, antitrust authorities, central bankers and academics gathered to discuss an issue that was rapidly becoming a heated topic for merchants, banks and card associations.

In the year since, it is an issue that has gone from heated to boiling.

Participants barely had returned home from the conference site in Santa Fe, N.M., when several small businesses filed a class action lawsuit against the card associations and large banks in June alleging interchange fees were illegally fixed. A group of supermarket chains and pharmacies filed a similar suit in July, and a group of retail store associations followed with their own class action suit in September. By October, there were 47 pending antitrust cases related to interchange, and all were consolidated into a single case. In the meantime, the issue was the focus of a Congressional subcommittee hearing.

"Given what we heard in Santa Fe, I don't think anyone is especially surprised at the developments of the past year," says Stuart Weiner, vice president and director of Payments System Research at the Federal Reserve Bank of Kansas City. "We heard a lot of impassioned arguments at the conference, and these arguments, if anything, have become even more pronounced since the conference."

In the past year, Weiner and Fumiko Hayashi, senior economist, have made a dozen presentations about interchange fees to various groups, including the European Central Bank and the Bank of Finland.

The presentations, as well as additional ongoing research by the Bank's staff, stem from the Federal Reserve's concerns about the efficiency and safety of the payments system from a public policy standpoint. When it comes to interchange fees, the Federal Reserve holds a unique position—a neutral party with no financial stake.

Interchange

Although debate over the otherwise-obscure fees has started receiving mainstream media attention in recent months, consumers who are not regular readers of industry trade publications may be unaware of the fees that have been levied by the card associations for decades.

The MasterCard and Visa card networks are what are known as four-party systems because each card transaction involves four parties: the consumer, the bank that issued the card to the consumer, the merchant and the merchant's bank.

When a purchase is made in a four-party system, the merchant sends the card information to its bank, which then, via networks such as MasterCard or Visa, contacts the card-issuing bank. The card-issuing bank then will bill the consumer for the amount of the purchase and send payment to the merchant's bank.

However, the payment will not reflect the full amount of the purchase. The card-issuing bank will retain a fee, known as interchange, which currently averages a little less than 2 percent in the United States.

Although the fee may sound nominal, the increasing use of debit and credit cards has caused the total amount paid in interchange fees to approach an estimated $30 billion annually. Merchants have argued that the fees cost the average U.S. household more than $200 a year.

In testimony to a Congressional subcommittee earlier this year, the president and chief executive officer of the National Association of Convenience Stores said card companies charge about five cents in interchange fees on a gallon of gas.

"These fees have actually been of concern for a number of years and have now escalated to the point that they are the third-highest operating cost to my industry—behind only payroll and rent," Henry Armour told the Subcommittee on Commerce, Trade and Consumer Protection during a February hearing.

Armour's comments came only weeks after The Washington Times published a guest column by William Sheedy, executive vice president of Visa USA, which said card sales provide merchants with such benefits as faster and more efficient sales; simpler bookkeeping; and, on average, larger customer tickets.

"Merchants, not consumers, pay the cost of card acceptance because they benefit from the value and services they receive from the global payments system, to keep the infrastructure strong and secure and support critical fraud detection technologies," wrote Sheedy, who also participated in a panel discussion at the Bank's Santa Fe conference.

Two-sided market

Credit and debit card industries are examples of two-sided markets in that they contain two sets of end users, each reliant on the other for the market to operate: in this case, cardholders and merchants.

The interchange fee is an instrument that card networks such as MasterCard and

Visa can use to achieve a desired balance of cardholder usage versus merchant acceptance. They transfer revenues from one side of the market to the other to generate the desired level of card activity.

Merchants pushing for regulation of interchange argue that the fees amount to collusion by the banks and card associations. Visa has more than 20,000 member financial institutions that issue the cards and market Visa products. MasterCard, which is offering a 46 percent stake in the company in a public stock offering, has more than 23,000 financial institution members.

In testimony to the Congressional subcommittee on behalf of a coalition of card networks and banks during the February hearing, Timothy J. Muris argued that the fees serve an important purpose.

"The early emergence of the interchange fee and its continued presence in the payment card industry testify to the inherent logic of interchange fees in equilibrating the two sides of the market, and not, as critics contend, to harm consumers," said Muris, a former chairman of the Federal Trade Commission.

Worldwide

Developments in the issue of interchange have not been limited to the United States.

In March, Mexican banks, under pressure from that country's central bank, agreed to lower credit card interchange fees to about 1.84 percent from 2.16 percent a year ago. It was the second such move in Mexico within an 18-month period. The first move was discussed by Mexico's central bank Governor Guillermo Ortíz during comments at the Santa Fe conference. Prior to the first move, fees were averaging more than 2.4 percent in Mexico.

In November 2005, Australia announced new standards for interchange fees that will take effect this November to bring all credit card schemes under the same fee cap. Currently, Australia does regulate interchange fees, but under three different caps.

Philip Lowe, the Reserve Bank of Australia's assistant governor of financial systems, also participated in the same panel with Ortíz, telling attendees his Bank was confident that fee caps put into effect in November 2003 would flow through to lower prices for goods. The Australian Bank's calculations suggested the Consumer Price Index would be 0.1 to 0.2 of a percentage point lower under the new fees than would have been otherwise expected.

In January, a Wall Street Journal editorial focused on the issue of interchange fees was critical of regulation in Australia and other nations.

"Studies indicate that lower retail prices haven't materialized. Instead, retailers have mostly pocketed the savings, while Visa and other card companies have withdrawn the popular rebates and bonus awards while increasing the annual fees they charge to cardholders," the editorial said.

As for the situation in the United States, The Journal's editorial quoted research from the Federal Reserve Bank of Kansas City that found rising interchange fees in the United States have corresponded with increasingly lucrative incentive packages and reward programs.

"Higher interchange fees allow issuers to provide more generous reward programs to cardholders," Hayashi and Weiner wrote, "but of course, reward programs are costly."

That might be one of the few statements upon which all sides can agree.

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BY TIM TODD, EDITOR

FURTHER RESOURCES

SANTA FE CONFERENCE PROCEEDINGS

COMPETITION AND CREDIT AND DEBIT CARD INTERCHANGE FEES: A CROSS-COUNTRY ANALYSIS, BY FUMIKO HAYASHI AND STUART E. WEINER

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