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Battle over interchange spreads

A new set of marching orders for Visa Inc. and MasterCard Worldwide has been handed down in Europe, including caps on interchange. Proponents predict the new rules, approved by the European Union in March 2015, will result in an estimated $6.8 billion hit to the card industry's collective balance sheet.

Historically, the European card market has been fragmented, with interchange rates differing from country to country The new rules are intended to address the fragmentation and make the card business more competitive. "Today, only competition rules limit the fees set by banks and payment card schemes, which are hidden from the consumer and neither retailers nor consumers can influence," the European Commission said when it released the new rules. "The Regulation will help the card payments industry move from its current business practices to a new more competitive system, to the benefit of consumers, merchants and banks."

The regulation caps debit card interchange at 0.2 percent of the transaction and credit card interchange at 0.3 percent throughout the 28-member EU, beginning Dec. 9, 2015. Commercial cards are exempt from the regulation, as are three-party payment schemes, such as American Express Co. and Diner's Club International. However, the exemption for three-party schemes expires in December 2018.

The new regulation also addresses:

- **Anti-steering rules:** As of June 8, the card brands cannot restrict merchants from encouraging customers to use specific payment methods.
- **Billing practices:** Beginning Dec. 9, 2016, processors must provide billing statements to merchants that break down charges for individual transactions, including interchange and merchant services charges.
- **Honor-all-cards rules:** Effective in June 2016, these will be abolished.
- **Other billing practices:** Processors will be required to support unblended pricing options beginning in June 2016, for example.

Ajay Banga, President and Chief Executive Officer at MasterCard, tried to put a positive spin on the new regulation in a June 2 presentation at the Deutsche Bank Global Financial Services Investor Conference. According to a transcript of the meeting provided by Seeking Alpha, Banga said, "There are lots of merchants in Europe who either suppress card accepting or don't take a card at all because of what they perceive to be an interchange rate that is disadvantageous to them. At 30 basis points on credit and 20 on debit, most of them will admit that it's cheaper than cash today."

Making sense of interchange

The EU is not the first government body to force changes in card companies' rules and interchange rates. The Australian government got the ball rolling back in 2004, capping permissible interchange on credit and debit cards. The Reserve Bank of Australia, that country's central bank, also told MasterCard and Visa to deep six rules requiring merchants to accept all of a brand's cards, and those prohibiting merchants from surcharging card payments.

The U.S. Congress took up the issue of interchange in 2010. Rather than impose sweeping changes on both credit- and debit-card pricing, as some merchant groups had urged, Congress passed the Durbin Amendment to the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, which instructed the Federal Reserve to develop and implement a formula for capping debit card interchange.

Few things in the business of card payments can evoke the kind of emotions that get stirred up by interchange. One reason is the complexity inherent in interchange pricing. Fees can vary based on type of merchant, products sold, information captured and chargeback experiences, among other factors. Complicating the process further, interchange is not quoted as a simple fee; rather each category is expressed as a flat fee plus a percentage of the ticket.

The card brands are adamant that it's a fair system of pricing. "Not only does interchange balance the benefits and costs of electronic payments, interchange also ensures that each participant pays their fair share of costs associated with processing and protecting payment card transactions," MasterCard stated on its website.

Merchants aren't convinced. They routinely challenge the card brands in the courts and halls of government. The Durbin Amendment, for example, gained the attention of Congress because of PR and lobbying campaigns backed by some of the largest retailers which, among other things, likened interchange to a tax on card payments.

More recently, in May 2015, a group of convenience stores and other retailers filed a lawsuit in U.S. District Court in Texas accusing MasterCard and Visa of conspiracy and restraint of trade in the setting of credit and debit card interchange, according to Law 360, a legal news service. The allegations mirror closely a lawsuit that, in 2013, resulted in settlement agreements in which MasterCard and Visa agreed to pay $5.7 billion to disgruntled merchants.

Card issuers, which help set interchange fees and receive interchange payments through the Visa and MasterCard structure, are in business to make money So they lack any real incentive to alter the status quo. Plus, interchange is only one component (albeit the base component) of the merchant discount fee. Acquirer fees are added to interchange, along with card brand assessments, dues, and gateway and other fees.

"In the old days interchange was fairly easy to calculate and rationalize and only applied to credit cards," said long-time industry consultant Paul Martaus. Card acceptance and processing were largely paper-based, labor-intensive and slow. Interchange was calculated to reimburse card-issuing banks for the cost of funds for the time between when the merchant received good funds from an issuer and the cardholder either paid off the charge or the transaction began accruing interest. The risk of default was also factored into interchange.

The evolution of electronic data capture devices at the POS and sophisticated networks and support technologies changed all that. "Traditional interchange calculations went out the window," Martaus said.

These days interchange is predicated on dozens of factors including type of card (credit, debit, rewards, commercial), type of merchant (supermarkets, quick service restaurants, general retail, full-service restaurants), riskiness of merchant, card brand (MasterCard, Visa), POS environment (card present, card-not-present, unattended), overall transaction volumes, and whether the card was swiped or the card information was keyed in by hand.

The card brands publish detailed schedules of interchange reimbursement fees twice each year These individual rates – there are hundreds – establish the base rate upon which all other acquiring and processing fees are added, which combined, come up with the merchant discount rate.

It's difficult to compare interchange rates between brands because Visa and MasterCard don't always use the same terminology For example, Visa credit cards can fall into one of four programs, and each of those programs feature different fees related to the type of card used. The highest interchange rate (2.1 percent of the ticket plus 10 cents) for supermarkets is associated with Visa Preferred cards. Traditional Rewards cards are priced significantly lower, between 1.15 percent plus five cents and 1.22 percent plus a nickel.

"Visa uses interchange reimbursement fees as transfer fees between financial institutions to balance and grow the payment system for the benefit of all participants," the company stated in the introduction to its published fee schedule. That document contains 10 pages of pricing matrices.

MasterCard's interchange fee schedule takes up 11 pages. It lists four possible categories of supermarket transactions, with fees ranging from 1.15 percent plus five cents to 1.9 percent plus 10 cents per transaction. Transaction volumes are also factored in by both brands, although the thresholds are not identical.

"MasterCard derives no direct benefit from interchange fees," MasterCard stated on its website. In fact, MasterCard said it aims to be unbiased. "Flexible interchange rates are essential to ensuring that merchants and consumers receive maximum value for electronic payments at the lowest cost," the company added.

Legacy systems aren't up to task

"We have the most complex interchange schedule in the developed world," said Dan Caniglia, Senior Product Owner and Solution Consultant at Planet Group Inc. "For many of the processors, managing and coding old legacy systems to properly support interchange is challenging." For example, some banks utilize platforms that were created for card issuing. And many of these are proprietary systems.

One result is wide variations in interchange fees assessed for the same transactions. "I've seen the same transaction qualify for CPS Rewards 1 on one legacy platform and for CPS Rewards 2 on another for the exact same merchant category code and the exact same transactional data," Caniglia said. "That's a significant variance in interchange fees. Extrapolate that across a large portfolio, and that is quite meaningful and has a material financial impact."

The financial impact is not just on merchants. It can be a losing proposition for acquirers, ISOs and their sales partners, too. And years of software fixes to support new functionality and fee schedules have taken a toll on the processing platforms that interact with the MasterCard and Visa networks.

Brett Mansdorf, Managing Partner at Majestic Bancard LLC, agreed. "We're talking about changing thousands of lines of code [for each fix]," he said. "I've seen some that have required changes to over a million lines of code. Errors happen all the time." But Mansdorf is not convinced interchange complexity is simply about technology. "Interchange is complex because they [the card brands and issuers] want it that way," he said.

Good data is crucial

Data – specifically, how much data about a card, the cardholder, the merchant and the transaction can be captured and transmitted to the card networks – is a key determinant of interchange. Those that simply provide a merchant name, transaction amount and basic card data pay the highest interchange rates. Adding details, such as tax amount, merchant postal code, state code and tax ID, drives the cost down. Adding more details (product codes, item descriptions, and ship from and ship to postal codes) drives the price down further

Many acquirers and ISOs help merchants control interchange costs. Majestic, for example, offers what Mansdorf described as a "managed effective rate," which provides clients with a degree of pricing certainty month to month. The merchant is quoted a rate (say 1.65 percent), based on past experiences, which holds unless something "drastic" happens, such as the merchant starts key entering significant numbers of transactions that were previously swiped. "It's largely a way to simplify things for them," Mansdorf said.

Merchants have little control over interchange, but with help from their acquiring partners they can influence how their transactions are received. "While acquiring banks and ISOs can't control the actual interchange fee defined by the card schemes, they can help lower their overall interchange expense," Caniglia said. It comes down to having a back-end processing system designed to optimize interchange.

"Effectively managing interchange with a sophisticated interchange management system is becoming more important as the number and complexity of interchange programs continue to increase," Caniglia said, adding that Acquire 360, its "interchange centric" platform, is being used by numerous ISOs and acquirers that have taken processing in house and want to help clients contain interchange fees.

Merchants transmit through the platform as much data as they can capture. "We look at, review and audit all the data that is received and process each transaction by selecting the most favorable interchange rate allowed," Caniglia noted. TransFirst revealed in 2013 that it uses Planet Group's technology for TransClear, a proprietary back-end processing system.

In the end, education is paramount. This includes informing merchants on how to close batches in a timely manner, authorization techniques, and the importance of being vigilant about obtaining additional details on clients and transactions.

SIDE NOTE: Debating Durbin costs and gains

Who has benefited most from the debit card interchange caps implemented under the Durbin Amendment: consumers or merchants? It depends on who is doing the math. The Durbin Amendment, passed as part of the 2010 Dodd-Frank Act, capped allowable interchange on most debit cards and took hold in 2011. The measure succeeded in large part due to the lobbying efforts of retailers and other consumer-facing businesses that insisted the measure would result in lower prices for consumers.

In an April 29, 2014 post to the Congress Blog, a feature of *The Hill* newspaper, Lyle Beckwith, Senior Vice President for Government Relations at the National Association of Convenience Stores, offered data suggesting the promise had been fulfilled. "[A] study by economist Robert Shapiro estimated consumers saved almost $6 billion in the first year of reform and those savings supported more than 37,000 jobs," he wrote.

This contrasts markedly with results of a consumer survey released in September 2014 by the Electronic Payments Coalition. Ninety-four percent of consumers surveyed by Phoenix Marketing International for the EPC last year reported prices had increased or stayed about the same in 16 categories of stores – including pharmacies, supermarkets, restaurants, home improvement stores and gas stations – since Durbin's debit caps took effect.

Research released in October 2013 by Global Economics Group LLC indicated that the all-in cost to consumers – increases at the register plus price hikes at banks seeking to recoup lost interchange – exceeded $22 billion in the first two years of Durbin debit caps.