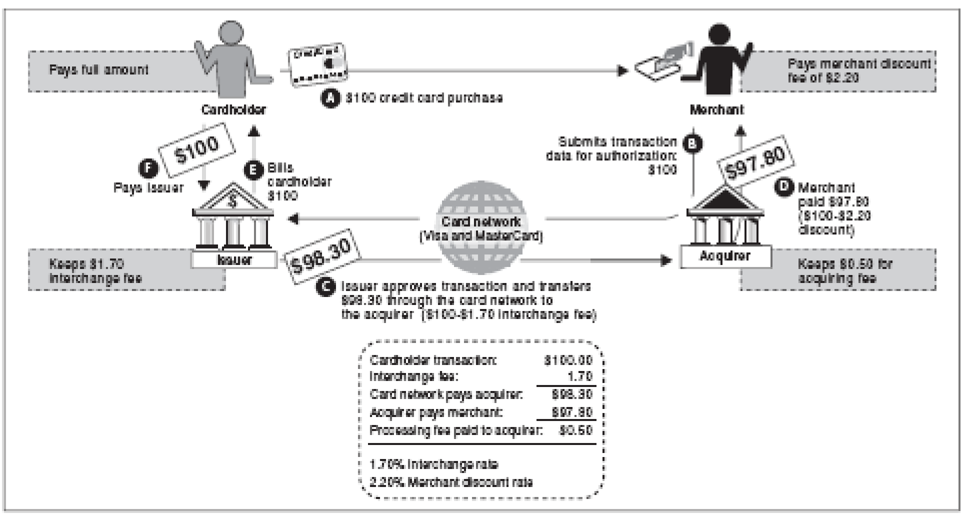
Interchange: How It Works

In a typical sales transaction, when a consumer purchases goods using a credit or debit card, the transaction is entered at the merchant's location (store or Internet), at which time the transaction is transmitted to the merchant's bank (acquiring bank) for verification. The acquiring bank presents the data to the system network, e.g., Visa or MasterCard[1], which contacts the consumer's bank that issued the card (issuing bank) to assess the consumer's account or credit line. The issuing bank then informs Visa or MasterCard to satisfy or decline payment, which is relayed to the merchant bank and subsequently to the merchant. This all takes place within seconds. If the transaction is authorized, funds will be credited to the merchant's account and the consumer exits the store with his goods. The customer is required to satisfy payment pursuant to his normal billing contract, or in the case of a debit transaction, the funds are withdrawn from his account.

The Government Accountability Office's diagram below describes the flow of a card transaction, in this scenario a credit card is referenced, but the transaction flow is identical for a debit card. In a hypothetical $100 dollar transaction, the merchant may receive approximately $97.80. Of the discounted $2.20, the issuing bank receives 70 percent to 90 percent as the interchange fee.[2] The remaining fees are divided among the acquiring bank and the card network. Debit card interchange rates are generally lower due to reduced credit risk in the transaction.



Interchange rates are set by the card network, and vary depending on category of use and type of risk associated with the transaction. Debit card interchange rates are lower than credit cards, with lesser fees assigned to PIN versus signature purchases. Rates also vary between swiped cards versus manually entered data. There is also a different fee structure for face-to-face transactions versus those over the Internet or telephone. Interchange fees differ still depending on the type of card used. Fees may also vary depending on size of the transaction. That said, some retailers such as Wal-Mart and large grocery chains have negotiated special interchange fees.

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[1] As a general rule, American Express and Discover operate differently, under a three-party payments system, wherein Amex and Discover act as both issuer and acquirer.
[2] The Interchange Fee Debate: Issues and Economics, James M. Lyon (2006).

Proponents of price caps have argued that merchants possess little or no bargaining power to negotiate rates and that merchants factor in interchange into their price of goods, leading to higher costs to consumers. Proponents further argue that card networks set high interchange rates due to their "overwhelming market power," an important issue in the context of anti-trust litigation. The banking industry has argued that interchange fees are necessary to cover those costs associated with extending credit, e.g., transactional risks and credit fraud, while also maintaining a reasonable return. The fee has supported the development of a system unparalleled in convenience, security, and efficiency, to the benefit of consumers, merchants, and financial services providers alike. Consumers receive 24/7- 365 days a year – access to capital and protection from fraud, in addition to enormous convenience. Merchants benefit from guaranteed payment, higher sales volume, and lower fraud costs. Financial institutions receive reasonable returns and the ability to meet the customers' financial needs.

Despite the arguments for price caps, the banking industry strongly holds that it is important to keep interchange rates balanced and that this view has benefits for the merchants. If interchange rates are too high, a result could be that merchants would not sign-up; it would simply be cost prohibitive. If rates are too low, issuers would not issue cards, in that the issuers would have no way to effectively cover those costs related to non-payment, late payment, fraud, advancing funds, and other transactional matters. When the appropriate balance is achieved, more cards are issued to consumers, and additional merchants join the system, benefiting merchants by giving them access to larger numbers of consumers, and advantaging consumers by giving them greater choices in places to shop. In short, interchange is a mechanism designed to attract the parties to participate in and benefit from an efficient payment system.