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Regulations on interchange fee in the European Union and the United States: An overview

This paper examines the impact of the reductions in interchange fees in the United States of America and the European Union. First, the author describes payment card schemes and interchange fees. The focus of this analysis were the regulations of the amount of interchange fees that issuers receive in the United States and the European Union, as well as the legal acts that regulate this subject. The United States experience with the Durbin Amendment provides a useful test case for understanding the costs of interchange fees and interchange fee price controls, so the impact of those regulations on card scheme participants were described. The paper ends with conclusions in which emphasis was placed on ensuring adequate protection to cardholders.

Keywords: interchange fee, payment card, issuer, cardholder, consumer protection

JEL classification: K12, K22

Regulacje opłaty *interchange* w Unii Europejskiej i Stanach Zjednoczonych. Wybrane zagadnienia

Artykuł opisuje skutki zmniejszenia wysokości opłat *interchange* w Stanach Zjednoczonych Ameryki oraz w Unii Europejskiej. Opisuje system płatności kartą płatniczą oraz opłaty pobierane w związku z wykonywaniem i rozliczaniem transakcji. W dalszej kolejności skupia się na analizie regulacji odnoszących się do opłaty *interchange*, w tym uchwalonych aktów prawnych. Doświadczenia rynku finansowego Stanów Zjednoczonych wynikające z wprowadzenia tzw. Poprawki Durbina dostarczają istotnych danych pozwalających na zrozumienie kosztów opłaty *interchange* dla uczestników rynku usług płatniczych. Artykuł zakończony jest wnioskami, w których główny akcent skupia się na zapewnieniu odpowiedniej ochrony posiadaczom kart płatniczych.

Słowa kluczowe: opłata *interchange*, karta płatnicza, wydawca, posiadacz karty płatniczej, ochrona konsumenta

Klasyfikacja JEL: K12, K22

Introduction

Electronic payments are rapidly replacing traditional payment technologies. Contactless, mobile and peer-to-peer payments are mentioned as the future payment media of a cashless society. The emergence of payment cards has been one of the most notable developments in consumer banking and the retail payments industry. Since their introduction, payment cards have grown to become the most popular non-cash retail payment instrument by number of transactions.

By enabling faster, more secure and efficient transactions, payment cards have been a key element in enhancing greater integration of the financial markets – both in the European Union and the United States of America. It also promoted growth of other activities, especially e-commerce and Internet shopping. For consumers, the attractiveness of payment cards reflects high speed, ease of use, and wide acceptance as well as relatively low cost of transactions.

There are three main categories of payment cards: credit, debit and charge card. The common notion of payment cards is the time at which a transaction is debited. Debit cards enable cardholders to make purchases and withdraw cash from ATMs and have these transactions directly and immediately charged to their payment accounts ('pay now' model). Credit cards enable cardholders to make purchases and withdraw cash from ATMs up to a prearranged credit limit ('pay after' model). This granted credit may be settled in full by the end of a specified period (charge card), or settled in part, with the balance comprising a form of credit on which interest is usually charged (credit card). There are also prepaid cards – payment instruments in which the cardholder has to make a certain amount of funding available before the card can be used ('pay before' model) [Cyman, 2011].

Making settlements with payment cards is possible due to card schemes. They may be defined as the set of functions, procedures, arrangements, rules and devices that enable a cardholder to effect a payment and/or cash withdrawal transaction with a third party other than the card issuer.

The most popular model of such a scheme is four-party model (four-party card scheme). It is used by the vast majority of card schemes in Europe and the United States. A transaction involves four main parties: the consumer, the issuer (the consumer's bank), the merchant, the acquirer (the merchant's bank), and additionally the card network (such as Visa or MasterCard) [Chakravorti, 2003]. In this scheme, issuer opens and manages the cardholder's account, books transactions, authorises card transactions and provides statements for the cardholder. Acquirer opens and manages the card payment acceptor's account, forwards authorisation requests to a switch, books transactions, charges service fees and produces statements for the merchant. Cardholder is the person or entity that makes an agreement with an issuer in order to obtain a payment card. Merchant is

a retailer or any other entity, firm or corporation that enters into an agreement with an acquirer to accept payment cards as payment for goods and services (including cash withdrawals) which will result in a transfer of funds in its favour.

There also exist schemes based on three-party model, in which the governance authority acts both as issuer and acquirer and has a direct contractual relationship with both the cardholder and the card payment acceptor. Three-party card schemes include, for example, American Express and Diners Club International, as well as some national credit card schemes. Two-party model is a scheme in which the payment instruments may be used only for payments made to issuer – for example, some loyalty cards – and is not the subject of this paper.

In all card schemes different obligations bear costs and fees. The acquirer charges the merchant a fee to receive compensation for offered services and to recover the interchange fee to be paid to the card. Card issuers can charge cardholder fees (for example for the issuance of the card). Card network can charge scheme fees to card issuers and to acquirers for membership in the card scheme. Card issuers (and sometimes cardholders) receive, in some cases, incentive payments, and can be required by merchant to pay a surcharge for the use of specific payment cards (if the card scheme and the relevant legal framework would allow it). Both in the EU and US payment card systems seem to have generally required merchants that accept their cards to agree not to impose a surcharge on consumers who use those cards.

The interchange fee is set by a card network by the merchant's bank to the cardholder's bank for its role in processing the transaction. It is paid every time a card payment is made. Economically, the interchange fee is a transaction cost for the acquirer and transaction revenue for the issuer when its cardholder uses the card at a merchant.

Banks and acquirers explain this fee by the costs related to the production of cards, proceeding transactions and the mechanism for supporting the payment card network. In their opinion, common interchange fee facilitates the establishment and maintenance of the system and allows to offer attractive fee structures and terms to cardholders. It also enables to introduce innovations in card payments. The relationship between interchange fees and innovation is a key policy issue for regulators and competition authorities. For example, the Bank for International Settlements states: 'So far, there is little to be found in the theoretical and empirical literature that sheds light on the relationship between interchange fees and innovation. The scarcity of the literature dealing with the impact of interchange fees on innovation suggests that further research is needed' [BIS, 2011].

Merchants obliged to pay interchange fees have long objected to the existence and level of this fees. They argue that the setting of interchange fees generates additional rents for issuers, which exceed realistic processing costs and inflate their

costs of payment card transactions above the costs of other payments. Ultimately, these fees generate higher prices for all consumers. In the opinion of some, payment systems should have an interchange fee of zero; others claim that it should be set at a level that reimburses the bank for some of the costs it incurs. High fees for card transactions reduce willingness to accept cards and may limit the number of transactions for which consumers can pay with them.

1. Interchange fee in the United States

Interchange fee was first introduced in the United States in 1971, when BankAmericard credit card system (the predecessor of Visa) established an interchange fee to deal with transactions in which issuing and acquiring banks were different. The development of debit cards made them an increasingly important part of the payment system. The financial crisis of 2008 made the interchange fee the subject of a heated debate and has triggered antitrust investigations and legislative activity.

On May 7, 2010, Senator Richard Durbin proposed an amendment to the draft bill to regulate debit-card interchange fees, formally introduced into the Senate on May 12. According to the sponsor of the Durbin Amendment, the exemption was intended to '[preserve] the ability of small banks and credit unions to compete with big banks in issuing cards' by ensuring that '[t]hose institutions would not lose any interchange revenues that they currently receive' [Kay, Manuszak, Vojtech, 2014]. This bill was called the 'Wall Street Reform and Consumer Protection Act' and included the Durbin Amendment as Section 1075. It was signed into law by President Barack Obama on July 21, 2010. The legislation is often referred to as the 'Dodd-Frank Act', after its Senate and House sponsors.

Section 1075 of the Dodd-Frank Act requires that the Federal Reserve Board prescribe regulation of the amount of interchange fees that issuers receive and identifies various factors that the Board should consider, including the cost of authorization, clearing, and settlement. It provides that the amount of any interchange transaction fee that any covered issuer (banks with more than US$ 10 billion in assets) may charge on a debit card must be 'reasonable and proportional to the cost incurred by the issuer with respect to the transaction'.

Regulation proposed by the Board caps debit card interchange fees for certain transactions at 21 cents plus 0.05% of the transaction value. This cap provides a significant reduction of prevailing interchange fees, about a 45% decline per transaction, on average, for covered transactions [Fed, 2010].

On November 22, 2011, a coalition of retailers and retailer associations filed a federal lawsuit in the D.C. District Court, alleging that the Federal Reserve's final rule was incompatible with the statute [NACS, 2011]. There was a litigation settle-

ment proposed [Levitin, 2012], but eventually summary judgment for the retailers was granted on July 31, 2013. The Federal Reserve was ordered to recalculate the interchange fee cap, excluding certain costs, and to revise the routing rule to require each debit card to support authorization through two different networks for each supported payment type. On August 21, 2013, the Federal Reserve filed notice that it would appeal the decision. On September 19, 2013, the court stayed his order pending the resolution of this appeal, meaning that the Federal Reserve's rule would remain in place.

2. Interchange fee in the European Union

The Eurosystem's public stance on interchange fees is neutral. Interchange fees are an issue within the field of competence of the European Commission. However, the Eurosystem shares the view that it is crucial for the success of the Single Euro Payment Area (SEPA) that cards could be used throughout the area to make payments without any geographical differentiation. Clarity in the framework for cards, in particular with respect to interchange fees, is likely to enhance the creation of an open market environment for card schemes.

Different national practices concerning charging for the use of a payment instruments have led to heterogeneity of the Union's payments market. It became a source of confusion for consumers, in particular in the e-commerce and cross-border context. Some Member States – Denmark, Finland, Luxemburg, and the Netherlands – operate without interchange fee [ECB, 2011].

The first decision by the Commission in the card sector was taken in September 2000, when the Commission formally objected to the current Visa interchange fee which the Visa Board could set at a level it sees fit and which is considered to be a business secret and, therefore, not transparent. As an answer, Visa proposed the 'no-discrimination' rule, which prohibits retailers from giving a discount for transactions made by other means than the card and sanctioned the 'Honour All Cards' rule which obliges merchants to accept all cards with the VISA logo. Visa had also proposed to gradually reduce its fees (from 1.1% to 0.7% on average), a reduction that would come into force before the end of 2007, and declared to cap the interchange fees at the level of costs for certain services. Visa had also proposed to improve the transparency of commissions and authorise banks to communicate the interchange fee to their customers. In 2002, an exemption was given to Visa for its multilateral interchange fees (MIFs). On December 31, 2007, this exemption expired, forcing Visa to prove the legality of its practices in order to establish whether the exemption should be renewed.

On March 26, 2008, the Commission initiated formal legal proceedings against Visa Europe Limited for anti-competitive practices. The proceedings concerned the multilateral interchange fees paid on cross-border transactions within the European Economic Area and the 'Honour All Cards' rule. Visa proposed to cap fees on debit cards at 0.2% for internal and cross-border transactions, a proposal which the Commission made obligatory in December 2010. In May 2013, Visa proposed to cap its MIF at 0.3% of the value of the transaction for credit cards.

Exchanges between the Commission and MasterCard go back to the two 'Statements of Objections' pronounced in 2006 and followed by consultations, after which the Commission decided to widen the scope of its research. In 2007, this led to a denunciation of the multilateral interchange fees which, according to the Commission, constituted an obstacle to competition. This decision concerned both credit and debit cards with the MasterCard and Maestro logos used for cross-border transactions. In a decision taken on December 19, 2007, the Commission therefore asked MasterCard to abolish multilateral interchange fees within 6 months.

The Commission judged that the price increase resulting from the introduction of multilateral interchange fee was an obstacle to price competition. This obstacle was not counter-balanced by any improvement in the service to the consumer. MasterCard failed to produce evidence supporting the claim that this fee enabled technological or economic progress. The Commission noticed that in some countries, where bank cards operate without interchange fee, development has been just as rapid. Finally, it commented that the abolition of MIF would make the SEPA more competitive.

Following this, MasterCard referred the matter to the Court to obtain the quashing of the decision. The Court, however, agreed with the Commission (May 29, 2012) and gave MasterCard 6 months to comply with the Commission's requirements under pain of heavy penalties (a fine of 3.5% of its daily consolidated world turnover). The Court rejected the argument that multilateral interchange fees are essential to the viability of the system. Financial institutions have many benefits as a result of the MasterCard system and would continue to issue them even without the fee. The Court claimed that those fees are an obstacle to price competition to the detriment of merchants, that an exemption on the grounds of economic and technological progress in the payment system would not be justified, and that there was 'a tendency to overestimate the costs borne by the financial institutions for the issuing of payment cards and, moreover, to propose an inadequate evaluation of the advantages enjoyed by the merchants thanks to these payment methods' [Garello, 2013].

On July 24, 2013, the European Commission adopted a legislative package in the field of payments. This package contained proposals to revise the Payments

Services Directive 2 and a Regulation on Multilateral Interchange Fees. Both proposals seek to make the payments framework better serve the needs of the payments market by facilitating competition, innovation and security.

Directive 2015/2366 (Payment Service Directive 2) noticed that in the recent years a significant progress has been achieved in integrating retail payments in the Union, in particular in the context of the Union acts on payments. It underlined the importance of Regulation 2015/751 and stated that in any case the Member States shall ensure that the payee shall not request charges for the use of payment instruments for which interchange fees are regulated under Chapter II of this Regulation [EU, 2015a].

Regulation 2015/751 on interchange fees for card-based payment transactions introduces, in particular, rules on the charging of interchange fees for card-based transactions and aims to further accelerate the achievement of an effective integrated market for card-based payments. It states that payment service providers shall not offer or request a per transaction interchange fee of more than 0.2% of the value of the transaction for any debit card transaction and 0.3% of the value of the transaction for any credit card transaction [EU, 2015b].

For domestic credit card transactions, the Member States may define a lower per transaction interchange fee cap. Regulation prohibited territorial restrictions within the EU. Payee's payment service provider must provide the payee with a breakdown of the charges for a card transaction including the interchange fee and the merchant services charge, so as to make interchange fee transparent for card scheme participants.

3. The impact of interchange fee regulations on card scheme participants

The purpose of regulations introduced in the United States of America and the European Union was to protect consumers from fees which were considered to be too high. An important public policy issue for these regulations is how they ultimately impact consumers. To address this issue, it is necessary to consider whether the consumer gain on the merchant side exceeds, or falls short of, the consumer loss on the bank side.

As the result of the Durbin Amendment to the Dodd-Frank Wall Street Reform, the income of large banks was reduced by more than US$ 7 billion a year (some authors estimate this cost at nearly US$ 14 billion) [Kay, Manuszak, Vojtech, 2014], or more than 5% of core total noninterest income [Evans, Chang, Joyce, 2013]. As multi-product institutions, banks had multiple margins on which to ameliorate this effect. Covered banks have recouped these losses in indirect ways,

for example by reducing the availability of fee-free current accounts. The total number of banks offering free current accounts fell by 50% between 2009 and 2013. In comparison, fee-free banking actually increased at banks not subject to the Durbin Amendment. The minimum monthly holding required on fee-free current accounts more than tripled between 2009 and 2012, from around US$ 250 to over US$ 750. Average monthly fees on (non-free) current accounts doubled between 2009 and 2013, from around US$ 6 to more than US$ 12. Consumers have shifted their payment usage from debit cards to credit and prepaid cards, which were not subjected to price controls.

Loss of access to free checking contributed to an increase in the unbanked population of approximately 1 million people, mainly among low-income families. As a recent report from the United States Congressional Research Service concluded, '[p]reliminary evidence suggests that, since 2009, some consumers experienced either higher charges or less availability of retail payment services provided by depository institutions', identifying the effect of the Durbin Amendment as one of the factors contributing to those effects [Getter, 2014]. The impact of the Durbin Amendment has especially negative consequences for many low-income consumers [Zywicki, Manne, Morris, 2014]. For the majority of consumers, any savings in the form of reduced retail prices or other offsetting factors have been smaller than the increase in the costs they face [Evans, Litan, Schmalensee, 2011]. As consumers are sensitive to price in their choice of payment device, the increases in costs of some payment devices relative to others will have a great effect on shifting payment patterns. In some estimations, based on the expectations of investors, the present discounted value of the losses for consumers as a result of the implementation of the Durbin Amendment is between US$ 22 and US$ 25 billion [Evans, Chang, Joyce, 2013].

Conclusions

The United States experience with the Durbin Amendment provides a useful test case for understanding the costs of interchange fees and interchange fee price controls. It helps to predict what the likely effect of price controls will be for the EU. By examining the effects of the Durbin Amendment on banks covered by the fee caps (those with US$ 10 billion or more in assets) across time, it is possible to gain insights into the likely dynamics of the imposition of similar restrictions in the EU.

The evidence from the United States suggests that the effect of interchange fee regulation depends on many factors, especially the degree of competition in retail banking and in general retail. The line between covered and exempt banks en-

ables us to see how banks subject and not subject (banks with less than US$ 10 billion in assets) to the regulation responded in comparison. Moreover, as the Durbin Amendment applies only to debit cards but not credit cards and prepaid cards, the effect of interchange fee can be examined by comparison to these unregulated alternatives.

Nothing suggests that the abolition or reduction of interchange fees in the US enhanced consumer protection. It is important to examine the marginal social benefits and costs of alternative payment systems as they vary across transactions [Evans, Schmalensee, 2005]. For payment market, lower interchange leads to greater card usage, while higher interchange fees reduce card usage as fewer merchants accept them. Leaning on the experience of the US, it is important to ensure adequate protection of the consumer. Research were conducted in order to establish an acceptable level of interchange fee for all card scheme players [Korsagaard, 2014], but further studies on the impact of the fee reduction on consumers will be necessary.

In the European Union, interchange fees regulations have to enhance the development of a single market. The success of the Single Euro Payment Area depends on effective settlement systems. Payment cards are commonly used payment instruments and costs associated with using them may have important influence on the shape of the SEPA. Clarity in the framework for cards, in particular with respect to interchange fees, is likely to enhance the creation of an open market environment for card schemes. It is however necessary to analyse the impact of implemented rules on consumer protection in the European Union, with a special focus on the risk of transferring costs of limited interchange fee from credit institutions to the cardholder.

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