An Analysis through Visa and MasterCard Interchange Fee System

Eco. 335

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Introduction

Visa and MasterCard were accused to exercise anticompetitive actions in the credit card payment system they imposed. Swipe charges paid by merchants kept increasing. Every year they pay over $50 billion (Robins, Kaplan, Miller & Ciresi L.L.P 2010). Visa and MasterCard defending the high charges as costs required to clear payment charges and hedge against fraud risk.

Credit cards and debit cards system became complicated. With the increase in the uses of them, many financial institutions find it an attractive way to increase profit. A tremendous amount of revenue been generated through them for banks and networks like Visa and MasterCard. However, this system also absorbs the surplus of customers and merchants who are the main users. As a result, roughly 7 million merchants filed antitrust case against Visa and MasterCard network system. The merchants claimed that these networks are conducting anticompetitive practices (Kavilanz 2012). Those small retailers preferred to deal with these networks since 78% of American consumers hold credit cards (Shapiro and Vellucci 2012). Besides, the ambiguity of the complicated system made it harder to bargain.

In order for merchants to use the network service, a swipe fee (interchange fee) is charged. In 2009, interchange rate ranged between 1% and 3% and kept rising (Shapiro and Vellucci 2012). This supposed to cover for fraud risk, transaction costs, and other overhead expenses. The amount charged was in additional to associates fee paid to the network of Visa, MasterCard, Discover, and America Express.

Visa and MasterCard dominate the market with 85.7% market share[1] on consumer cards. Thus rejecting these network cards will cause retailers to lose many customers. Therefore, they choose to pay the high interchange fees instead. Because of these high fees, banks revenue increased and they started offering more incentives to subscribers. As a result, interchange fees increased when the competition among card issuing banks increased reinforcing other credit card networks to raise the fees.

By 2011 the Durbin amendment[2] took place aiming to regulate interchange fees. It was introduced hoping to rectify prices through capping the fees and increasing competition between credit card networks that will reduce Visa and MasterCard market power. Unfortunately, the result was not as expected and small retailers were affected badly.

The case closed through settlement in July, 2012 and disappointed many merchants. For them it did not provide the required transparency to consumers and merchants. The payment transaction system for credit cards is still not regulated efficiently. The network enjoying the monopolized market is who sets the interchange rules lacking regulations in this side.

[1] Further illustration on market share is followed. Source (Shapiro and Vellucci 2012)
[2] An addition to The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Credit Card Payment System and Interchange fees

When credit card popularity started to rise in the 1970s, only 16% of households were using them (Dieser 2005). By then, the payment system was quite simple involving four parties: customer, customer bank, merchant, and merchant bank. The merchant was able to determine immediately if the sale can be processed or not electronically using customer card information. If accepted, the merchant collects the amount from his bank deducting merchant fee. The merchant bank later will claim the amount paid to merchant from the customer bank minus interchange fee. The cycle ends up billing the customer the amount of purchases.

By that time the billing charges and fees were not as complicated as it is now. Visa and MasterCard started as big competitors before they reform a union through the network including Discover and American Express. Reforming a network in a market that did not have the functionality to compete at a similar level gave it a competitive advantage. Since network success depends upon attracting the highest number of merchants and cardholders, gaining market trust made it harder for a new network to enter and compete. Having this network into the market caused changes in the accounting operations of credit cards. The payment transactions that used to have four parties, had to add one more. This made processing the transactions much more complicated than before, yet profitable.

When a customer uses a credit card to pay, the Visa or MasterCard network is used to process the transaction. For this service, the merchant bank charges the merchant what is called a "merchant discount fee". The merchant's bank (acquiring bank) pays this fee to the customer's bank for using the network billing the amount to the customer. From what is billed to customer, a portion will go to the customer bank and is called merchant discount fee or interchange fee. This will cover for various transaction costs counting for risk and profit as well. The remaining will go to the network as associate fee. Figure 1 illustrates the payment system using a network.

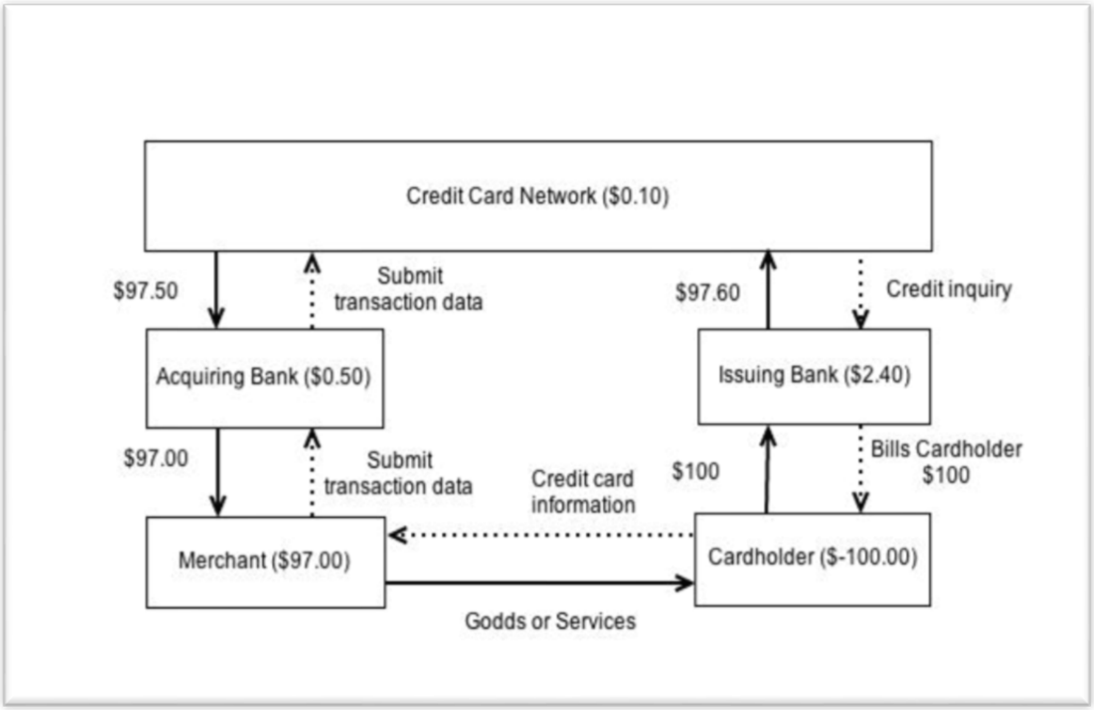

Figure 1 - Credit Card Payment Transaction[3]

Figure 1 shows 3% interchange fee for $100 charge. The interchange fee charges different types of fee payment systems depending on: card type, merchant category, volume of merchant sales, and how the transaction is processed. The fee can be flat fee per transaction, transaction value percentage, or even both (Shapiro and Vellucci 2012). However, the main purpose for the interchange fees is to provide issuing banks with revenue to increase their customer's base. The advertising and credit cards processing

[3] (Shapiro and Vellucci 2012)

costs of banks were covered in an exchange for promoting credit cards and getting customers satisfaction.

This system helps customers delay their payments and allow them current purchases they cannot afford. The service paid by the network kept increasing to encourage banks competing and increase cardholder number. By 1998 cardholder reached 68% and in 1999 the fees exceeded $10 billion. Visa and MasterCard defense was to meet the increase in costs though no evidence provided (Dieser 2005). During this period Visa average interchange fee was 2.95% versus 3.25% for MasterCard. This wasn't the case for Discover and America Express due for acting like a network and issuing/acquiring at the same time.

National Retail Federation reported the volume increase in fees paid by merchants from 2004 to 2008 to use the network. The report shows around double in total fees by Visa and MasterCard from $26 to $48. As come to the customers the cardholders number also increased radically by 57% from 2000 to 2006. Furthermore, credit card payment transaction raised by 59% in 1999 through 2010 (Shapiro and Vellucci 2012).

As a result, competition among banks increased taking advantage on raising the interchange rates although the calculation system remained unclear for merchants. Visa and MasterCard claimed that rates remained stable. Through researchers the rates were found higher by more than 50% from less then 2% to 3.25%.

Market Power

Visa and MasterCard together holds 62.3% of commercial cards. This high market share limits the choices of both merchants and customers. They dominate the market with high percentage constraining merchant's choices restricting them on four network participants: Visa, MasterCard, America Express, and Discover. It imposes high costs to withdraw from the market as a customer as well merchants. Visa and MasterCard alone hold 86% from total consumers' cards. Such fact will affect a merchant if chooses to withdraw creating huge losses as suffering from losing many customers.

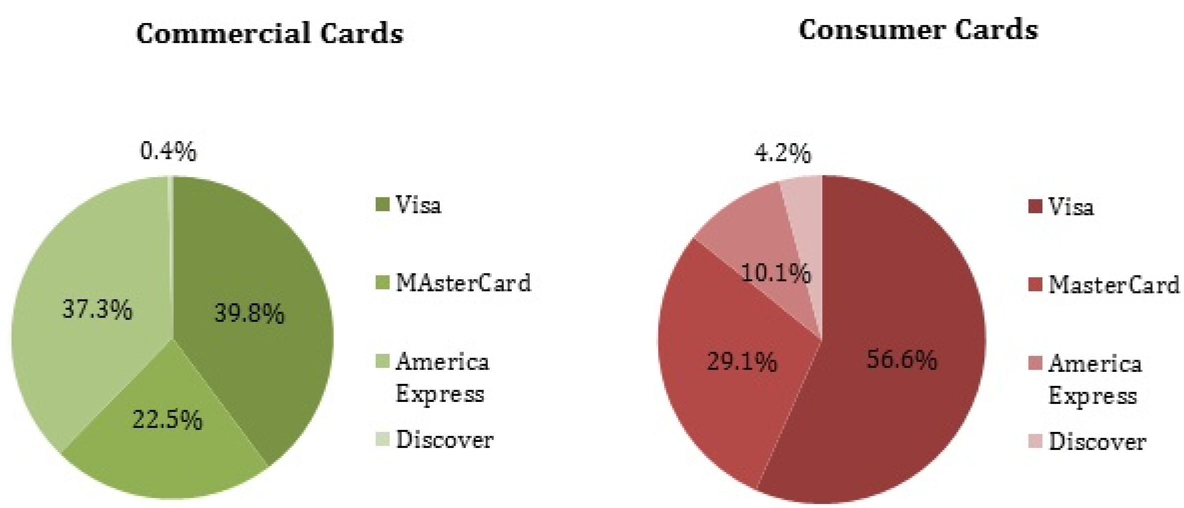

Figure 2 - Credit Card Network Market Share[4]

The high volume increase in shares reflected banks internal competition. Based on the network policies, banks are getting high portion from the interchange fees. These fees are sufficient enough to attract new banks to enter the network. With high competition it might seem that it will oppose downward pressure to reduce the fees. Not as expected fees

[4] (Shapiro and Vellucci 2012)

kept rising in order to cover financing costs of attracting more cardholders. Important to add, that fees are applicable to any payment used either through debit card or credit card. Yet, debit cards create lower interchange fees but on the other hand they provide the holder with less reward scheme.

Additionally, market power generated to credit card network and banks enabled them to set the rules giving less authority to merchants. Merchants could not negotiates in imposed fees and have to accept all different card types if they are affiliated with a network member. Off course banks has the privilege to offer rewards for certain type for cards and then set higher interchange fees from merchants.

Was Durbin Amendment effective?

It is obvious how the credit card payment system entails high economic losses. Fees kept rising unreasonably and due to high market shares many parties lacked the negotiation power. In October, 2011 the Durbin amendment took place trying to increase competition in the debt processing networks to pressure market and lower the prices. In addition, the amendment introduced a cap for interchange fees of 21 cents plus 0.05% if competition wasn't effective enough to lower fees[5]. The amendment, which was added to the 2010 Consumer Protection Act, meant to help small merchants from anticompetitive pricing.

The Federal Reserve believes that debit card interchange "swipe" fees are higher than the cost of fraud. As Visa and MasterCard tried to convince on the opposite, the advanced technology weaken their statements. Through capping The Federal Reserve

[5] An additional cent can be charged if certain security criteria are met.

introduced a system that will regulate the market far from the anticompetitive network provides. They were also able to introduce competition by restricting minimum two networks on each debit card. However, the amendment did not cover credit card high swipe fees which worked against the amendment purpose.

The response from the network to the new regulation was surprising. After the amendment Visa and MasterCard enforces new flat fee equal to the maximum cap amount introduced by the Fed. Moreover, Visa announced new fee for the retailers to use their network. A "Network Participation Fee" that is a flat fee if paid retailers can enjoy lower variable interchange fee as an incentive. Responding to that, the congressional leadership received a letter from the American Bankers Association stating that:

"The consequences of the so-called Durbin Amendment to the Dodd Frank Act (imposing price controls on debit card transactions) are instructive. More than two years after its enactment, the net effect of that Amendment has been an increase in profits at big-box retailers, *higher* costs to small merchants, significant reductions in the revenue available to banks to serve local communities, and ***no sign of the lower retail prices consumers were promised***. We do not believe it is in the interest of policymakers or the consumers they represent to repeat the mistakes of the past by expanding price controls to more aspects of our economy." (American Bankers Association 2012)

The Settlement

In 2005 an antitrust case was filed against Visa, MasterCard, and American Express related to their interchange fees "swipe fees". The simultaneous increase by more than 25% from 1995 to 2005 prevented merchants from offering discounts and incentives to customers. The contract set by the network contains rules such as prohibiting merchants from offering discounts to customers that chooses not to use Visa unless it's equally available to Visa transaction.

The case was brought by retailers for the following reasons:

- For particular brand, card type, or form of payment they were unable to offer customers discounts or any sort of benefit.
- Cannot express a card or form of payment preference.
- Cannot post information and communicate to customers a preference to use certain card or form of payment.
- Cannot communicate to customers about the costs merchants incurs for payments

The merchants freedom to encourage and involve in the swipe fee process constrained when the accept using the network. By filling the case they hoped to get back their rights in proposing conduct rules.

The case took seven years in courts until a settlement of $7.25 billion was proposed by the Department of Justice (DOJ). In a paper by Levitin[6], he argued that this case is not about damages. Alternatively, it will ignore the unregulated interchange fees and even might cause huge future monetary damages by un-transparent system. The deal got the objection of The National Retail Federation who tried unsuccessfully to block the settlement.

Keeping the interchange fees unregulated will enables the network to force some restrictions, even though retailers will be granted negotiation power to bargain collectively on the fee charged. While the Durbin Amendment found the debit card market has less competition, the settlement enforced nothing to increase network competition for credit cards. The settlement from Visa and MasterCard prospective will take out the risk of judgmental decision to increase market competition.

[6] Law professor at Georgetown University Law Center. Discussed in details in his research “An Analysis of the Proposed Interchange fee litigation Settlement”.

A proposed governing in the settlement was for Visa and MasterCard to alter their surcharge rules. Under the network rules merchants are not permitted to control surcharging. It caps the surcharge to lower than the 1.8% merchant discount fee. By this merchants must provide the customer with a notice for the surcharge limited to a brand or a product. Controversially, no definition was provided on the meaning of card products and how to differentiate between them. Assuming a merchant succeeded to resolve such ambiguity; such awareness will result in angry consumers and might drive them away.

Public and small retailer's interest may not be maximized through the settlement. The transparency opposed is not efficient to preserve their privileges. Ultimately, no solution provided to regulate a system that is harming competition, new entrants, small retailers, and customers.

Conclusion

There is no doubt that credit card and debit card uses by customers will increase in the future. The ease and usefulness it provides predicts that. The lack of awareness many parties purposely possess gaining them profitable businesses will play apart in this too. Through this paper it was discussed how economically inefficient the many high fees the credit card network impose. Visa and MasterCard being the dominant of the market with almost very few un-powerful rivals has no incentive to reduce any costs. There is high demand from consumer's side and merchants locked in between.

In addition the settlement did not address a solution for all the problems addressed by merchants. The market regulates in an anticompetitive way that reduces new entrants. The competition is weak and small retailers – even with surcharge privilege – cannot get the advantage of the settlement. Visa and MasterCard can entitle the network for a new fee charge. Absorbing cardholder and merchants surplus reduces social welfare with high deadweight loss in the economy.

The structure of credit card market and banks roles contributes to the pressure to form regulations. Even when regulatory wants to legalize the market, the credit card types and reward scheme available make things complicated. Regulations if very tight may reduce the innovation and free market competition definition. It might be possible that after seven years of courts battle the case will be open again due to the high ambiguity involved.

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