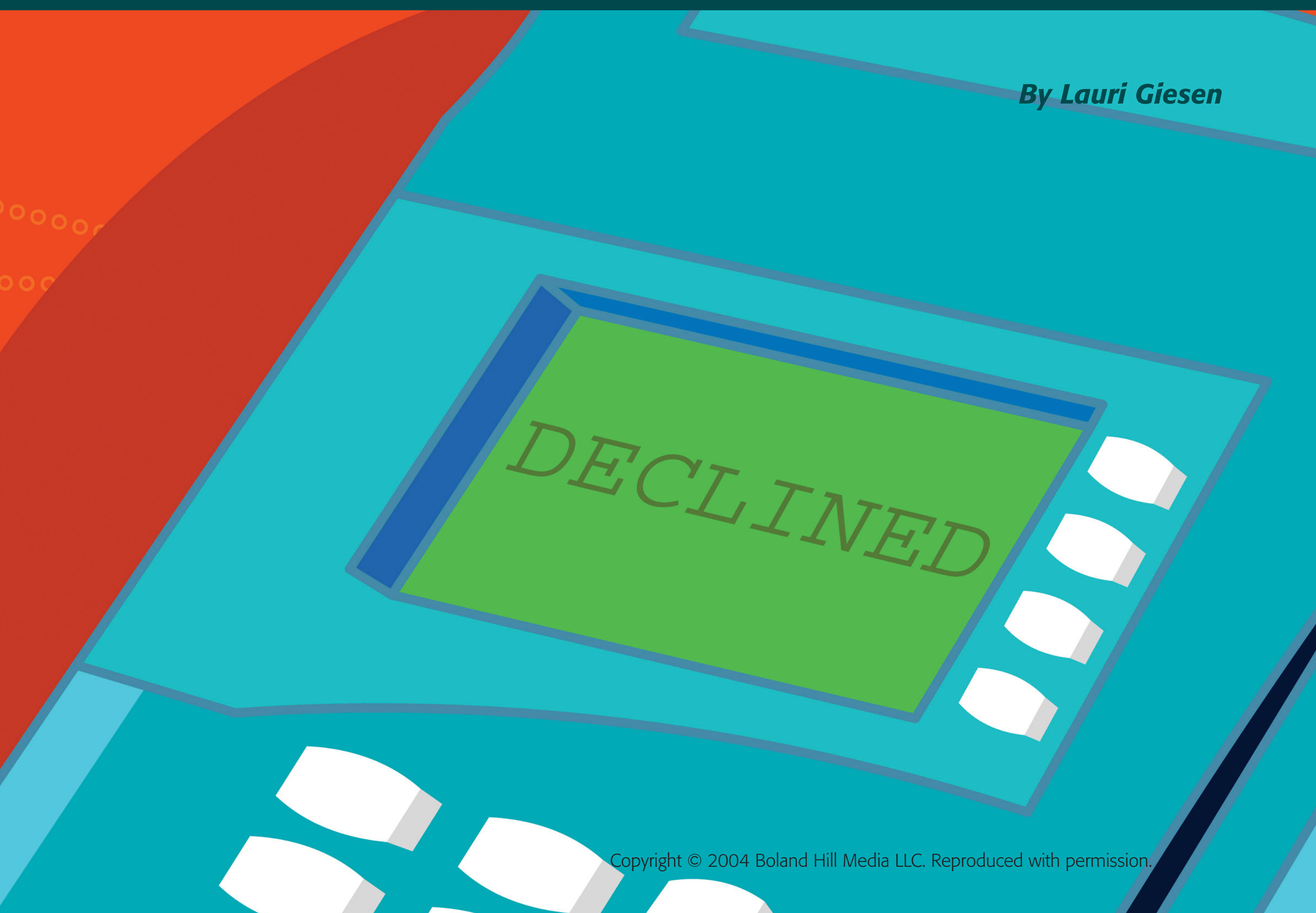
The Murky

By Lauri Giesen



Future of Interchange

A pricing mechanism meant to balance the interests of various parties to a card transaction has come under increasing attack from merchants as transactions have become nearly completely electronic. The only certainty in this debate is that settling it will be a messy business.

Interchange. Since the beginning of the credit card industry, it has been instrumental to making plastic payments work. By providing for a flow of income from retailers to card issuers, it provides the incentive to get the banks that issue the cards to push their products into as many consumer hands as possible and then to get them to use those cards at as many places as possible. And it covers the costs of developing and managing the programs, providing usage incentives, funding credit lines, and covering bad credit losses.

But interchange has come under attack these days. Retailers argue that the rates charged in the U.S. have been increasing so much in recent years that they simply can't afford them any more. They claim the fees they pay are not in line with issuers' actual costs and that retailers have to pay for bad credit decisions made by the banks.

Meanwhile, some legal experts question whether having bank associations, which are essentially made up of competitors, setting the rates isn't in violation of anti-trust laws. True, interchange was upheld by the courts in a landmark case 18 years ago, but some argue that the industry has changed a lot since then. Furthermore, regulatory agencies outside the U.S. have slashed interchange rates, causing some industry observers to predict something similar will happen in the U.S.

Only a few years ago, hardly anyone thought about interchange. It was simply taken for granted as if it were the background radiation of the card business. But now, the onset of the electronic age in consumer transactions has made the pricing mechanism seem a blunt instrument with a questionable future. Certainly, there's no shortage of those who predict that, whatever happens to the system itself, rates will be forced down, either by market pressure, regulators, or the courts—costing issuers billions of dollars in revenue and possibly imposing new costs on consumers.

At best, no one can now say for sure they know what will happen to interchange. “There is pressure on interest rates, uncertainty about what the courts and regulators will do, and pressure from retailers,” says H. Leon Majors, president of ESP Consulting. “That creates an atmosphere of uncertainty.”

Interchange Junkies?

There is certainly a lot at stake. According to estimates from Morgan Stanley’s equity research department, card interchange in the U.S. amounts to about $24 billion annually in revenue for issuers (table, page tk). And if issuers were forced to lower their rates in a manner similar to what has happened in Australia and the European Community, about $13 billion of that could be at risk, according to the equities firm.

For individual issuers, that could be alarming. A study by Bernstein Investment Research and Management estimates that interchange revenue accounts for 33% of risk-adjusted card revenue at MBNA Corp., one of the nation’s largest card issuers. That is up from 26% in 1997. The sizable increase was driven by an 18% annual increase in card spending and a 4% annual increase in the rate itself, according to the report.

The case of MBNA, in the opinion of some experts, illustrates why the interchange mechanism may well survive pressure from regulators, courts, and merchants and their acquirers, not only intact but without much change. “Interchange will be around for a long time because banks are addicted to it,” says Paul Martaus, president of Martaus & Associates, a consulting firm that specializes in merchant acquiring.

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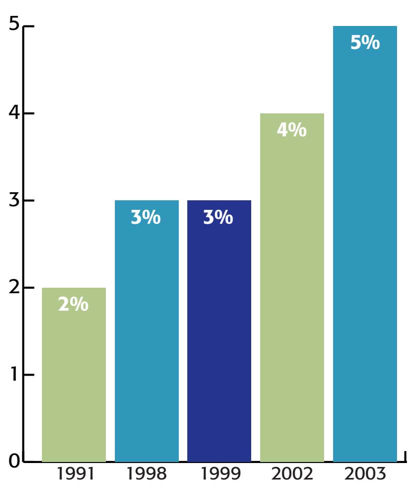
“Issuers need this to survive.”

Supporters of interchange point out that, for all the complaints and lawsuits coming from retailers, the number of retail establishments that accept credit and debit cards is still growing rapidly, with considerable progress being made to get merchants in new product categories to get with the plastic program—including fast-food outlets, utility companies, and parking lots.

Furthermore, they argue that if interchange rates were to be slashed as much as they have been in such countries as Australia, the burden of funding credit card programs would have to be switched over to cardholders. And that, they argue, would cause consumers to cut back on use of the cards and undermine the foundations of electronic payment

Even Wal-Mart Pays More

(estimated cost of card acceptance as a percentage of pre-tax income)



Source: Sanford C. Bernstein & Co. estimates

But while it remains to be seen whether interchange will cease to function in its current form, it is certain that the battle over the future of interchange will be waged in the next few years. And many believe the biggest battles won’t be waged as much in the marketplace as in the courts.

Despite last year’s settlement of a huge class-action lawsuit led by Wal-Mart Stores Inc. over credit and debit card acceptance, which ended Visa and MasterCard’s so-called honor-all-cards rule and temporarily lowered debit card interchange, the issue of credit and debit card interchange is far from over in the courts.

Not all retailers involved in the lawsuit agreed to accept the out-of-court settlement that Visa and MasterCard reached with key litigants. Half a dozen retail chains, including Home Depot Inc. and Toys R Us Inc., are still fighting out card rules with the associations, and they have expanded their complaint to include the issue of credit card interchange. Some legal experts believe these “opt-out” lawsuits could ultimately force the card networks to scrap the interchange system of pricing. Other merchants have started actions of their own in recent months, based on other legal theories, including the notion that it is a form of price fixing.

Laughing Banks

“Will the courts allow interchange? That’s the $64-billion dollar question,” says David Balto, a Washington, D.C.-based anti-trust attorney with Robins, Kaplan, Miller & Ciresi L.L.P.and former policy director at the Federal Trade Commission. “We’re going to see this issue battled out in the courts over the next several years. Ultimately, though, I believe interchange will be banned on anti-trust grounds. What the card associations are doing in setting interchange rates is not permitted in any other industry.”

While many supporters of interchange point to the 1986 decision in NaBanco vs. Visa, where the courts upheld interchange against an antitrust challenge, Balto says there have been enough changes in the industry since the mid-'80s for the courts to reverse the earlier ruling, if given a chance. According to Balto, the NaBanco precedent no longer applies on at least four points:

1. The courts ruled that interchange was necessary to cover issuer costs. But today, with electronic authorization, fraud and processing costs are lower, yet rates have gone up.

2. The courts found that it would be impracticable for thousands of banks to set unique rates. But today with consolidation on both the issuing and acquiring sides of the industry, a case can be made that such pricing is now feasible.

3. The courts found that Visa and MasterCard do not have market power, or the ability to control prices. But in recent cases, including the Wal-Mart litigation, the courts have found that Visa does have market power.

4. The courts assumed that banks and merchants could bypass the bank card system and hence avoid interchange. But Visa has sued First Data Corp. to stop the processor from operating a network that would offer just such a bypass.

Others believe that interchange is dying from wounds inflicted by the transition to electronic processing. "Interchange has lasted a lot longer than I thought it ever would," says Joe Wallace, a Chicago-based payments-system expert. "More litigation is likely to take place. I can't imagine the judge who oversaw the Wal-Mart case is happy with how things worked out."

Many industry players expected that the Wal-Mart suit would finally settle the interchange issue even though interchange was not spelled out in the original filing. But instead, the settlement simply required the bank card associations to cut rates on signature-based debit cards temporarily. In the end, signature-debit rates fell by about 30% for about six months and then rebounded about 10% from the lower rate.

Meanwhile, the card associations raised credit card interchange and electronic funds transfer networks that process debit card transactions linked to personal identification numbers raised their rates for PIN debit. Many retailers are paying about the same or even more for electronic transactions than they were paying before the settlement. And the interchange mechanism remains untouched.

> "A small number of huge retailers are doing well. Smaller merchants are just getting drilled."

The retailers also received about $3 billion from the associations in settlement, but not everyone believes that was sufficient. "The major banks were laughing all the way to the bank," says Wallace. "The $3 billion is a fraction of the $10 to $12 billion in additional revenue they got from the signature debit product." Moreover, the card associations won an important concession in the settlement: that no retailer participating in the class can again contest any pricing at issue prior to Jan. 1, 2004.

And not all merchants benefited equally from the settlement. "Retailers didn't get anything from that lawsuit. Wal-Mart got it all," says consultant Martaus. That's because shortly after the settlement Wal-Mart reportedly wrung drastic price concessions out of the two associations, based on the massive flow of transactions it controls (MasterCard apparently required more persuading than Visa; Wal-Mart simply stopped accepting MasterCard's signature-based card until the network came to terms).

The parties won't talk about the terms, but Morgan Stanley figures Wal-Mart succeeded in forcing its credit card discount rate under 1%, or less than half the bank card average. In the bank card systems, the discount is what a merchant pays after its acquirer has marked up the interchange rate.

A Defeatist Attitude

That may whet the appetite of other chains to negotiate likewise for better rates, but few retailers, if any, enjoy the market clout and volume of Wal-Mart. Indeed, the Bernstein study shows that credit card interchange rates are rising at an average of 4% annually and are likely to continue at a similar rate for at least the next two years.

"Wal-Mart set a precedent, but most retailers don't have the scale and significance to be able to negotiate more favorable rates the way Wal-Mart has," says Stuart Zlotnikoff, senior vice president of the National Grocers Association, which represents mid-size and small independent supermarkets.

"The large merchants will continue to keep the pressure on the associations and issuers to get better rates," says ESP's Majors. "But the little guys will not have many choices with card acceptance and they'll need to take the cards to compete."

Others agree that smaller retailers got little or nothing out of the settlement, and argue that they may head to court to compensate for their lack of negotiating strength. "The outcome of the Wal-Mart litigation has been the institutionalization of an 'eat-what-you-kill' philosophy," David R. Schneider, executive vice president of the Pulse EFT network, said at a community banking conference this summer. "A small number of huge retailers are doing well. Smaller merchants are just getting drilled. There's going to be more lawsuits."

Indeed, many retailers have taken a somewhat defeatist attitude about interchange and instead are looking to see how they can encourage customers to try alternative payment options to credit cards. Some are looking at debit payments processed through the automated clearing house system, while others are investigating electronic check programs that rely on biometric identification or alternative lines of credit.

"We're not going to see interchange go away," says an executive of a regional supermarket chain. "If anything, it just keeps getting higher. There is not much we can do but try to drive customers to other payments with lower transaction costs."

While some have argued that retailers who don't like interchange rates should stop taking credit cards, the supermarket executive says that is not a realistic tactic. Says he: "No one wants to be in the position to say to a customer, 'No, we won't take your card."

But some believe it may come to that.

"The pressure is really on the second- and third-tier operators," says the NGA's Zlotnikoff. "It is getting to the point where many retailers cannot tolerate higher rates. The marketplace is going to have to demand a reduction in rates."

Indeed, the Bernstein report shows how interchange can impact earnings at even the biggest chains. It estimates the cost of accepting credit and debit cards now accounts for 5% of the pretax operating profit at Wal-Mart in the U.S., up from 2% in 1991 (chart, page tk). Many merchants say card fees are their fastest-rising expense, and Zlotnikoff says they're close to equaling profits for smaller grocers.

A Delicate Balance

But for all the threats and bluster about interchange pricing, the number of retailers that accept electronic payments continues to grow at record numbers, with large strides currently being made in such new markets as fast-food outlets, utilities, and government agencies

"Interchange requires balancing the economic needs of the merchants and the issuers. The fact that there are hundreds of millions of cards in the U.S. with millions of merchants accepting those is testament to the fact that we believe we have gotten that balance right," says Josh Floum, Visa executive vice president and general counsel. "If the balance was out of whack, we wouldn't be getting the growth we're seeing today in terms of new merchants that are accepting our cards."

But what bothers a lot of retailers about interchange rates is that the fees have grown well beyond the major costs of issuing cards that the interchange system was originally designed to cover: processing, the cost of money, and bad debt. With electronic card transactions having all but supplanted paper-based payments, they say, interchange should be plunging, if not withering away into irrelevance. "Interchange is not performance-oriented and it is not tied to costs. In fact, rates have gone up while issuers' processing costs have been going down," says Zlotnikoff.

Balto, the attorney, observes that the recent substantial increases in interchange suggests there is a serious competitive problem in the card industry. "Interchange was initially set based on costs," he says. "But those rates have increased dramatically even though costs have fallen. Where firms can raise prices in this fashion, that suggests that competition is broken"

A big factor in influencing interchange rates has been rising credit losses. But many merchants and acquirers argue the banks then are just pushing the burden of their bad credit decisions onto retailers. "Issuers need interchange to make up for their bad credit decisions," says Martaus.

But Visa executives argue that there is a lot more to what goes into interchange decisions than processing costs and credit losses. And they argue retailers should pay for the total value they receive from a guaranteed payment and the fact that consumers with credit cards are likely to buy more goods than they can immediately afford, resulting in more money in the retailers' pocket.

"Covering credit losses is a small component of the value we bring to our retail customers," says Floum. "Issuers have to bear the costs of product innovation, delivering the service, covering chargeback protections, providing incentives, guarding against fraud, and guaranteeing payment. Retailers who focus only on credit loss are losing sight

The Total Tab for Interchange

	Average Merchant Discount	Average Interchange Rate	Interchange Revenue
Visa	2.0%	1.5%	$9.8 billion
MasterCard	2.0%	1.5%	7.7 billion
AmEx	2.5%	2.0%	5.2 billion
Discover	1.5%	1.0%	1.0 billion
Total			$23.7 billion

Note: AmEx and Discover do not maintain interchange rates. Figures shown represent estimates of the proportion of revenues corresponding to interchange charged by Visa and MasterCard, assuming merchant acquisition costs are comparable.

Source: Morgan Stanley

of the value that we bring to them in having an efficient, guaranteed payment that allows their customers to make purchases with an instant credit line. They forget that they typically get a ticket lift every time someone pays with a credit card."

Still, it's hard for most merchants to accept that argument when it comes to debit cards, where there is no question of bad debt or float for the issuer. "Card issuers need to create revenue to cover what they claim it takes to cover their costs, but it seems those charges have been out of line," says John K. Lannan, co-founder and president of Debitman Card Inc., a Chico, Calif.-based firm that offers retailers an ACH-based alternative to bank-issued PIN debit. "Especially on the debit side, it seems to make more sense to move to a fixed cost—or flat transaction fee--since it costs about the same to process a transaction regardless of how much it is for."

Inspiration from Abroad

But some argue that issuers shouldn't be required to justify pricing on the basis of the direct cost of providing the credit or debit card service. After all, they say, sellers in other industries, such as food service and hospitality, aren't under any such burden. Here, the price is based on perceived value rather than the cost of raw goods. "I can't understand it when I hear retailers say that issuers should base interchange on their direct costs. That is an argument I would expect from Ralph Nader, not a businessman," says David S. Evans, vice chairman of LECG Europe Consulting Co. and a well-known exponent of the interchange system. "Issuers should not have to justify their fees on their direct costs. When I go into a store to buy something, I don't expect the store owner to justify the price charged based on the cost of raw goods."

Also, some supporters of the current interchange model say rates have not kept up with the increase in credit losses. "If you look at interchange historically, rates today are much lower than they used to be. In the early 1950s, rates were at about 7% and in the late '50s, they were at 5%. Today, the average is about 1.8% if you consider all the special rates," says John Gould, director of consumer credit for consulting firm TowerGroup, which is owned by MasterCard. "Furthermore, both Visa and MasterCard have rates considerably below that of American Express."

Gould argues that the rates merchants pay today are in line with what those same merchants would pay if they were lending the money themselves to consumers to pay for goods purchased.

Furthermore, Gould argues that retailers' claims that they're paying for bad credit policies by the banks are ridiculous in light of their own track records with credit. "Visa and MasterCard are wonderful targets for the retailers, but the argument does not hold up," he says. "If you look at the chargeoffs by retailers for bad credit, you'll see the banks are doing a much better job of controlling credit chargeoffs than the retailers have ever done."

Still, many are pondering how long the card networks in the U.S. can continue to impose interchange—either at current rates or in its current form--when the mechanism has recently come under intense regulatory scrutiny elsewhere. In Australia, the Reserve Bank of Australia mandated interchange reductions that cut rates by about two-thirds. And in the UK, the Office of Fair Trading is pressuring Visa and MasterCard to reduce interchange rates.

"The rest of the world has woken up to the fact that interchange rates don't reflect the real cost of issuing credit cards. How can we justify the fact that U.S. rates are two times what retailers pay in the rest of the world?" asks Wallace.

Of course, the legal theories and regulatory attitudes toward business in the U.K. and Australia are quite different from what prevails domestically, as many defenders of interchange point out. "We have a very different business climate and approach to anti-trust than in those other countries," says LECG's Evans. "Anti-trust regulation in the U.S. has always been less hostile to creative business practices than elsewhere. Plus, in the U.S. we already have a court precedent with the Nabanco suit that makes it much harder for a court to rule against interchange."

But while this point could well prove true, the threat in the U.S. may come, not from regulators, but from disgruntled merchants and eager plaintiffs' attorneys, egged on at least in part by developments overseas. "The biggest implication of foreign regulatory actions may be that they inspire merchants and class action lawyers to think of ways to attack U.S. interchange rates," write Kenneth Posner and Athina Meehan, Morgan Stanley researchers, in an April 2004 report.

In that report, the researchers note that if the U.S. were to follow the Australian model and slash interchange rates from the current average of 1.5% to 0.5%, there would be a loss of revenue to issuers of $13 billion. Morgan Stanley is predicting a 20% probability for this scenario in the U.S.

If rates are forced down—either by courts or regulatory fiat—the result may only be higher costs for consumers as issuers seek alternative products. "When the European Community got through with its social engineering and lowered interchange in the U.K., five major card issuers switched over to American Express because AmEx has a proprietary network and can charge whatever rates it wants." And consumers would be forced to pick up more of the cost burden through either card fees or transaction fees.

'Shenanigans'

But retailers argue that consumers already bear much of the cost of card interchange through higher prices charged by retailers to cover those fees. It's just that consumers don't always know that they're paying more. "Consumers are in the dark about how this works and what costs are passed on to them," says the NGA's Zlofnikoff.

Attorney Balto thinks it might be good for consumers to pay more of the direct cost of issuing credit cards, if only because such transparency could lead to more competition on price. "Consumers already bear some of the cost by the higher prices they pay retailers, but that cost is not transparent to them," he reasons. "If they were charged specific fees, the cost of using credit cards would be more transparent. And whenever charges are fully transparent, there is greater pressure to reduce those charges."

But Visa argues a shift toward a greater cost burden directly on consumers would be a big mistake. "It is not appropriate that merchants get a free ride," says Floum. Furthermore, the cardholder already does pay through card fees and interest charges."

Possibly even more important, some argue, is that higher direct consumer fees could mean fewer consumers will apply for or use their cards. "If more of the costs were borne directly by the consumer, it would mean that consumers might use their cards less and then who would benefit?" asks Daniel Tarman, senior vice president with Visa.

Nor has anyone seriously suggested what should replace the interchange system, if it were to ultimately crumble. Consolidation on both the issuing and acquiring sides of the business may well have made direct pricing relationships among issuers, acquirers, and merchants more practical than it was years ago, but that's far from saying such arrangements would work as well for all parties as interchange does.

Still, whether the courts force change or interchange continues in its current form, it is unlikely that the debate will quiet down. Says long-time interchange critic Wallace: "Interchange was probably necessary in the early days, but these shenanigans have gone on long enough." DT