Regulators Pursue Caps on Debit Card 'Swipe' Fees

BY RENEE HALTOM

Most consumers are blissfully unaware of the complex web of agreements, infrastructure, and communications it takes to complete a single debit or credit card transaction. Merchants and card companies have been feeling less blissful as they have sparred over the fees associated with transactions. Debit card swipe fees have been the latest subject of conflict.

When you swipe your debit card at the grocery checkout, the retailer sends word of the payment to its bank via the swipe machine. The retailer's bank then contacts your bank to make sure you have sufficient funds. The banks don't communicate directly, however. They go through an outside network that processes debit transactions, facilitates approval, and settles balances between banks. (The four largest PIN debit card networks are Star, Pulse, Interlink, and Maestro; the latter two are owned by Visa and MasterCard, respectively. Debit transactions authorized via signature are operated by Visa, MasterCard, and Discover.)

Fees are charged at each step to cover the costs of processing the transaction. The "swipe" or "interchange" fee — set by the card network, paid from the merchant's bank, and pocketed by your card-issuing bank — is the largest of the fees, and has been rising over time. To collect the fee, your bank skims a portion from the amount that is debited from your account to pay the merchant. (Most credit card transactions work similarly, but recent regulatory scrutiny has focused on debit cards.)

Merchants generally don't alter their prices based on payment type. That means merchants effectively can receive different amounts of revenue for the same good based on whether it was purchased with a debit card, a credit card, or nonelectronic means like cash or check. The Retail Industry Leaders Association argues that card networks exert monopoly power to extract unduly high fees and then use those fees to bolster marketing efforts and offer card rewards to draw higher-income consumers. The National Retail Federation argues that interchange fees result in higher overall prices for goods, estimating they cost the average U.S. household $427 each year.

The average debit card interchange fee was 44 cents per transaction in 2009, according to the Federal Reserve Board of Governors. With 38 billion debit card payments in 2009, the revenue adds up. Interchange revenue received by Visa and MasterCard — together more than 80 percent of the purchase volume when counting both debit and credit payments — was somewhere between $35 billion and $45 billion in 2007, perhaps double the level of 2002, according to a study by Fed economists.

Fee revenue has gone up in part because debit cards are used more often than ever before. But fee *rates* have also gone up, though the exact amount is difficult to measure (fee schedules were kept private until recently, and fees vary by merchant type). The July 2010 Dodd-Frank financial reform legislation required the Fed to set limits on debit card interchange fees at a level that is "reasonable and proportional" to the costs card issuers face to process each transaction.

Economists say there may be an efficiency case for fees being higher than direct costs. Card transactions are a two-sided market: Both the consumer and merchant must come to the table for a transaction to take place. For that to happen voluntarily, both parties must experience a net benefit from participating in a debit transaction. If the total benefits to all parties outweigh losses — even if those benefits are concentrated on one side of the market — the transaction would improve welfare for society as a whole.

The network can, in theory, use interchange fees to balance demand between the two sides of the market. Transferring economic rents from some parties to others can induce economically efficient transactions. Interchange fee revenue is often used to fund rewards and discounts that entice consumers to pay with debit cards.

That's one rationale banker groups cite to defend interchange fees. Banks would compensate for caps by abolishing free checking, increasing fees, and cutting rewards programs, the American Bankers Association says. The industry group argues that could lead to fewer consumers carrying cards, potentially hurting merchants, too, through decreased sales.

Even if there is a potential economic justification for higher interchange fees, the efficient setting of fee rates is an open question. It would be difficult to accurately estimate how consumers and merchants value card services — given millions of different merchants and consumers — in order to identify the efficient fee level.

The Dodd-Frank legislation required the Fed to take a stand on that issue. The Board of Governors announced a final rule in June 2011 that included a debit interchange fee cap equal to the sum of 21 cents per transaction and 0.05 percent of the transaction value — roughly half what fees historically have been. The new standards include several other nuances relating to fees and will go into effect in October 2011.

The decision didn't come easy. An initial draft of the rule, submitted in December 2010, generated more than 11,000 comment letters from the industry and the public. Fed Chairman Ben Bernanke said with the June release that implementing the interchange fee caps had been one of the most difficult Dodd-Frank regulatory reform provisions the Fed had undertaken to date. **RF**