



# Interchange Ills

*Payments professionals must understand the sickness, not just the symptoms*

By Marc D'Annunzio and Anthony Balloon

MasterCard and Visa have been making headlines recently. More often than not, the news has focused on the prolonged battle over interchange fees—the fees charged by issuing banks to acquiring banks for transactions routed through the card associations' networks. Both planned IPOs to financially protect themselves from potential liability arising from interchange antitrust litigation. MasterCard earmarked \$650 million of its IPO proceeds for ongoing legal costs, and Visa followed suit with \$3 billion.

On one side of the debate are merchants pushing for reductions in interchange fees and, therefore, lower costs. On the other side are the card associations and their member banks, who counter that merchants may pass little of the savings from an interchange reduction on to the consumer. In the middle are government regulators, who frequently view interchange fees with a critical, if not skeptical, eye.

## Regulation Efforts

In the United States, the proposed Credit Card Fee Act of 2008, which was introduced in the House of Representatives in March, has received much attention. This bill would require credit and debit card networks to negotiate with merchants to set lower interchange rates. If the card associations and the merchants cannot reach agreement on these rates, then a panel of “electronic payment system judges” appointed by the U.S. Department of Justice and the Federal Trade Commission would set the interchange rates.

The United States isn't alone in examining and proposing to regulate interchange, either. In 2003, the Reserve Bank of Australia established a regulatory framework for interchange fees, which resulted in interchange fees being reduced across the board by roughly 40 percent. In December, the European Commission determined that MasterCard's cross-bor-

der multilateral interchange fee for consumer credit and debit transactions violated EU competition laws. MasterCard was given a six-month transition period to roll out new rates. MasterCard's appeal of this decision is pending.

Regulators and other critics claim that interchange fees are set arbitrarily and have no relation to the underlying costs associated with processing a transaction. They also say that interchange agreements act as a barrier to potential market entrants by closing off opportunities for non-bank parties to access the card associations and process transactions for the corresponding cards.

Critics also contend that interchange acts as a “tax” on cash transactions and other alternative methods of payment. Merchants set prices artificially high to ensure recovery of interchange fees because card association rules prohibit them from imposing surcharges for card transactions and from setting minimum transaction amounts to accept cards. As a result, customers who use other payment methods subsidize card usage because they pay the same price as customers who pay with cards without incurring the corresponding cost to the merchant.

Merchants stand to benefit the most from regulation. In Australia, the mandated reductions have saved merchants about \$480 million annually. The majority of these reductions, however, do not appear to have been passed on to consumers in the form of lower prices. Indeed, MasterCard makes a similar argument in its appeal to the European Commission—namely, that if the goal is to benefit consumers, regulating interchange falls short because merchants will not pass on those lower costs.

## Prognosis Unclear

Any regulatory solution, however, is likely to be less than ideal. Given the complexity of interchange fees and of the payments industry generally, it seems

unlikely that regulators or judges could fashion an effective, long-term solution by simply mandating reduced fees. Any approach must take into account the fundamental characteristics of the market and avoid interfering with its competitive development.

The U.S. market already has begun to offer additional payments, such as the Tempo Payments Card and the SaftPay system. In addition, the EU's Single Euro Payment Area (SEPA) promises to benefit European consumers and merchants alike by removing barriers to entry and promoting competition among banks, payment service providers, card associations, and other payment networks.

If regulation is thought to be necessary, any regulatory approach should focus primarily on increasing the transparency of card transactions. For example, if regulation encouraged merchants to more widely offer discounts for other types of payment (such as cash), consumers would have a better indicator of the cost of card transactions relative to alternative forms of payment. To be clear, though, any approach should focus on the unique characteristics of the payments market rather than just mandating a lower price.

Issuers, acquirers, payment processors, and merchants literally cannot afford to sit these debates out. While the precise outcomes of those debates remain unclear, it seems likely that regulatory scrutiny—whether by price control or other means—is here to stay. **TT**

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*Marc D'Annunzio is the co-chair of the Payments Practice Group of McKenna Long & Aldridge LLP. Tony Balloon, an associate in the firm's Brussels office, also is a member of the Payments Practice Group. Reach them at [mdannunzio@mckennalong.com](mailto:mdannunzio@mckennalong.com) and [tballoon@mckennalong.com](mailto:tballoon@mckennalong.com). The views expressed in this article are solely their views and not necessarily the views of the firm or its clients.*