



# OLR RESEARCH REPORT

January 7, 2013

2013-R-0015

## **MERCHANT FEES FOR CREDIT CARD AND DEBIT CARD TRANSACTIONS**

By: Katherine Dwyer, Legislative Analyst II

You asked what fees a Connecticut merchant is charged when a customer pays for a purchase with a debit card or credit card.

### **SUMMARY**

In order to process credit cards and debit cards, a merchant must negotiate a “merchant discount fee” either with his or her financial institution or, for Discover and American Express, with the credit card company directly. The negotiated fee is then subtracted from each customer transaction with a credit or debit card. The “interchange transaction fee,” which is paid to the credit or debit card issuer, makes up the largest percentage of the merchant discount fee and is the focus of this report.

In 2011, the Federal Reserve adopted Regulation II, which limits the amount of interchange fees that debit card issuers can charge for transactions. The rule limits the interchange fee to a maximum of 21 cents plus .05% of the transaction value. The rule exempts financial institutions with less than \$10 billion in assets. To date, there are no such laws or regulations limiting the interchange transaction fees an issuer may charge for credit card purchases. Since credit card interchange fees vary significantly from one card to another and from one merchant to another, some merchants may pay higher fees for credit card transactions while others pay higher fees for debit card transactions.

## **CREDIT CARD TRANSACTIONS**

A 2009 Government Accountability Office (GAO) [report](#) describes the various credit card transaction practices. According to the report, “[m]erchants’ costs of payment for card acceptance involve several different fees that are divided among the parties involved in a credit card transaction. The parties involved in processing credit card transactions vary depending on the network used by the card.” The four primary credit card networks in the United States are Visa, Mastercard, Discover, and American Express. Although the report is from 2009, a review of the credit cards’ websites confirmed that these practices are still current.

### ***Visa and Mastercard***

There are four parties involved in Visa and Mastercard (the two largest networks) transactions: the cardholder, the financial institution that issued the card, the merchant, and the merchant's financial institution (the acquirer).

In order to be able to process Visas and Mastercards, the merchant must contract with the acquirer. In such a contract, the acquirer agrees to process the credit cards and the merchant agrees to pay a “merchant discount fee” that will apply to the transactions. According to the GAO report, the interchange fee makes up most of the merchant discount fee and the acquirer ultimately pays that portion of the merchant discount fee to the credit card issuer.

The report also cites four factors used to determine which interchange fee rates apply to a given transaction on their networks. These factors, which are also listed on the [Visa](#) and [Mastercard](#) websites, include the:

1. type of card: the rates for premium cards and cards offering rewards are typically higher than the rates for standard cards;
2. merchant category: card networks offer different rates for different lines of business, with lower rates for industries that do not typically accept credit cards, according to the GAO report;
3. merchant size: card networks tend to charge lower rates for merchants with high volumes of card transactions; and

4. processing mode: merchants typically pay higher fees for internet transactions because there is a greater risk of fraud than there is for transactions in which the customer and the card are physically present.

### ***Discover and American Express***

Discover and American Express transactions involve three parties: the cardholder, the merchant, and the credit card company that acts as both the issuer and the acquirer. In order to process Discover and American Express credit cards, the merchant must negotiate a merchant discount fee directly with the credit card company.

Neither the GAO report nor the credit cards' websites specify factors used to determine which interchange fee rates apply to a given transaction on the Discover or American Express networks.

## **DEBIT CARD TRANSACTIONS**

### ***Transaction Process***

A recent [article](#) from the North Carolina Banking Institute described the transaction process and fees for debit card purchases:

- The card holder provides a debit card to the merchant at the point of sale.
- The merchant's bank (the acquirer) sends an electronic authorization request to the payment network (usually Visa or Mastercard).
- If the customer enters a personal identification number (PIN) during the transaction, the network contacts the customer's bank to be sure that there are sufficient funds to cover the purchase.
- If the customer chooses to sign for the transaction instead of entering a PIN, the network determines if the customer's total purchases over the previous two to three weeks exceeded the bank's preset limit. The network then either sends an approval or decline back to the merchant. Funds are immediately deducted from the customer's account for PIN transactions and the funds are deducted within two to three days for signature transactions.

A merchant must negotiate a discount fee, most of which is an interchange transaction fee, with the acquiring financial institution in order to process debit card transactions, just as they do for credit card transactions. The acquiring financial institution, in turn, pays the interchange transaction fee to the debit card's issuing bank.

### ***Dodd-Frank Act and the Federal Reserve***

According to a Consumer Payments Research Center (CPRC) [report](#), prior to 2011, merchants would pay lower interchange rates for PIN debit card transactions (approximately .58% of the purchase price) than they would for signature debit card transaction (approximately 1.53% of the purchase price). The Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (§ 1075) required the Federal Reserve to impose debit card interchange transaction fee standards that were “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” In response, the Federal Reserve issued Regulation II (Debit Card Interchange Fees and Routing) which established such standards, effective October 1, 2011.

The rule limits debit card issuers to charging 21 cents plus .05% of the purchase price per debit card transaction. The rule also allows eligible issuers to charge an additional one cent per transaction to cover fraud prevention costs. According to the [Federal Reserve](#), “[w]hen combined with the maximum permissible interchange fee under the interchange fee standards, a covered issuer eligible for the fraud-prevention adjustment could receive an interchange fee of up to approximately 24 cents for the average debit card transaction, which is valued at \$38.” The rule exempts financial institutions with less than \$10 billion in assets from the debit interchange fee limits.

According to the [Federal Reserve](#), the average interchange fee per transaction for all debit card issuers in 2009 was 43 cents. Data collected from the fourth quarter of 2011 indicated that the average interchange fee received by non-exempt issuers declines 45% from the 2009 level to 24 cents. The data also indicated that exempt issuers continued to collect an average interchange fee of 43 cents.

A small portion of the merchant discount fee also covers network use fees. Regulation II requires issuing banks and payment networks to allow merchants to choose between two or more competing payment networks for debit card processing. (Prior to Regulation II, the merchant's bank would select the processing network.) This requirement is intended to increase competition between payment networks, which could result in lower network use fees.

## **HYPERLINKS**

Board of Governors of the Federal Reserve System (Federal Reserve), *Press Release*, June 20, 2011, <http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm>.

Federal Reserve, *Average Debit Card Interchange Fee by Payment Network*, August 10, 2012, <http://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm>.

MasterCard, *MasterCard Worldwide and Interregional Interchange Rates*, October 2012, [http://www.mastercard.com/us/merchant/pdf/MasterCard\\_Interchange\\_Rates\\_and\\_Criteria.pdf](http://www.mastercard.com/us/merchant/pdf/MasterCard_Interchange_Rates_and_Criteria.pdf)

Sandwith, M. Pierce, "Debit Card Interchange Fees and the Durbin Amendment's Small Bank Exemption," *North Carolina Banking Institute*, February 19, 2012, <http://www.law.unc.edu/documents/journals/articles/1073.pdf>.

Shy, Oz, *Who Gains and Who Loses from the 2011 Debit Card Interchange Fee Reform?* Consumer Payments Research Center, June 19, 2012, <http://www.bostonfed.org/economic/ppdp/2012/ppdp1206.pdf>

United States Government Accountability Office, *Credit Cards: Rising Interchange Fees Have Increased Cost for Merchants, but Options for Reducing Fees Pose Challenges*, November 2009, <http://www.gao.gov/assets/300/298664.pdf>.

Visa, *Interchange Brochure*, <http://usa.visa.com/download/merchants/interchange-brochure.pdf>

KD:ts