Will interchange provide the driver for disruptive payments innovation?

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Many start-up payment providers have emerged recently with an eye on competing with traditional credit and debit card networks by undercutting interchange fees. Will the ongoing public debate concerning interchange fees help drive their success?

The use of both debit and credit cards has been rising rapidly in the United States in recent years as an electronic alternative to paper checks and cash. However, recent credit card legislation as well as an ongoing debate concerning interchange fees could influence the direction of that growth.

In simplified terms, interchange fees represent the costs paid by merchants to their banks for processing card transactions. The card-issuing bank may also use revenue earned from interchange fees to fund loyalty rewards to attract customers. Recently merchants have contended that the interchange costs they pay for card transactions have become excessively high. Given the universal acceptance of the major card networks, merchants contend they have few meaningful alternatives for consumers to transact payments, especially at the point of sale. On the other hand, card companies indicate that interchange fees are fair compensation for providing a valuable service to merchants.

So how do card issuers earn revenue on cards? This example shows a breakdown of issuer revenue in 2004. In this example, interchange represents 18 percent of the card issuer’s total revenue.
Various trends and policy debates regarding interchange fees and card revenue sources appear to be a factor in the development of innovative point of sale payment methods that seek to compete directly against card networks.

**Growth in card use has increased payment processing costs for merchants**
The Federal Reserve Board published a staff research paper in May 2009 titled *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues*. This report considers the economics underlying interchange fees and the background for understanding the interchange fee debate. Merchants argue that recent increases in fee rates, along with transaction volume growth, have increased their card acceptance costs substantially.

According to this report, an argument in favor of interchange fees is that they support the universal acceptance of cards through the strength and efficiency of the card networks. The standard fee, set by the card networks, is established in a way that balances merchant costs with the economic benefits merchants realize through the value of the network. Further, consumer adoption is driven partly by consumer protections associated with the use of cards. Overall, merchants who accept cards may realize increased sales, particularly for large value transactions relying upon credit.

**Another factor: The impact of credit card legislation**
Recently passed credit card legislation limits or prohibits certain fee and interest charges imposed on credit cards. As a result, some expect card issuers to limit or even to eliminate loyalty reward programs and raise interest rates and fees for more creditworthy card holders. While it remains to be seen, these kinds of effects could alter the economics of card networks, potentially opening up avenues for new competition.

**Will these developments create opportunities for innovators of payment alternatives at the point of sale?**
Companies such as Revolution Money and Tempo, among others, are working to establish independent point-of-sale payment systems from the established card networks with alternative transaction pricing models. Both companies are offering cards (Revolution issues credit and Tempo “decoupled” ACH debit) that compete partly by bypassing the interchange fees of the major card networks. In addition, successful online payments providers like Paypal and others are reportedly looking to compete at the merchant locale as well. In all these examples, competitors will face the classic "network effect" problem in that success requires adoption by both consumers and merchants. The success of these business models at the point of sale remains to be seen and may depend on those very merchants that complain about the current interchange system.

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