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## Hidden Credit Card Fees Interchange Fees Cost Consumers Billions Each Year

Every year American consumers pay billions in credit card late fees, over-the-limit fees, annual fees and balance-transfer fees, sometimes without warning, but at least they are informed. Consumers are not informed about the most costly credit card fee by far — so-called “interchange” — hidden in the price of every plastic transaction. In 2005, interchange fees exceeded the combined total of all these known charges, costing \$30.7 billion (see Figure 1).

Interchange fees are set in secret by Visa, MasterCard and the banks that issue their cards. The card companies “compete” by increasing the fees — today, averaging about 2 percent of each plastic payment — to induce banks to issue their cards. Also driving up the cost are the campaigns to convince consumers to use so-called “rewards” cards, which charge interchange rates in the 2-3 percent range.

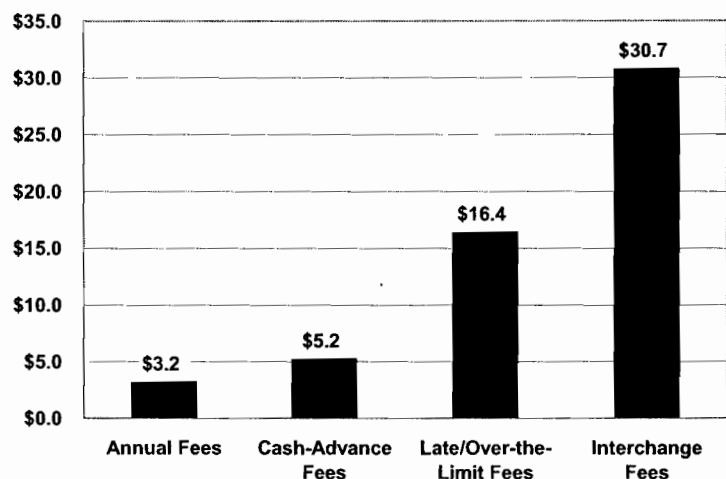
Retailers initially incur the interchange fees, which banks extract from the price of each plastic transaction. As the fees increase and card use explodes, the costs must be passed along to consumers in the form of higher prices for all products. In fact, all consumers pay — even those who do not use plastic — because they all pay the same prices for products. The average household paid more than more than \$280 in hidden interchange fees in 2005.<sup>1</sup>

Hit hardest are low-income families. Families who pay by cash or check, in fact, subsidize rewards programs that only the richest consumers can afford.

Interchange rates far exceed actual transaction costs. In fact, a small portion of the interchange fee covers the transaction processing cost. A bank industry consulting firm estimated that 13 percent of the interchange fee covers processing costs, while 44 percent pays for rewards programs; the balance

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**Figure 1. Cost of the Largest Credit Card Fees in 2005 (billions)**



Sources: *The Nilson Report, Cards & Payments*, R.K. Hammer Investment Bankers, Merchants Payments Coalition

<sup>1</sup> Based on U.S. Census Bureau data showing there were 109 million U.S. households in 2005. Figure is derived by dividing \$30.7 billion by 109 million.

The Food Marketing Institute (FMI) is a nonprofit association conducting programs in research, education, industry relations and public affairs on behalf of its 1,500 members including their subsidiaries — food retailers and wholesalers — in the United States and around the world. FMI's U.S. members operate approximately 26,000 retail food stores with a combined annual sales volume of \$340 billion — three-quarters of all retail food store sales in the United States. FMI's retail membership is composed of large multi-store chains, small regional firms and independent supermarkets. Its international membership includes 200 members from 50 countries.



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covers marketing, advertising, network servicing, profits and other expenses (see Figure 2).

This breakdown explains why interchange fees are not declining despite dramatic decreases in the cost of computer communications. The U.S. leads the world in productivity and efficient use of technology, yet American consumers pay the highest interchange rates among industrialized nations. Americans are not receiving the benefits of economies of scale, innovation and competition, along with continuing low inflation and interest rates. Card companies and banks ignore these benefits when fixing the fees.

Investigations in Australia, the United Kingdom (UK),

European Union (EU) and elsewhere are documenting the disconnect between the fees and actual transaction costs. Australia responded by capping the credit card rate at 0.50 percent — less than one-third the average rate in America. The EU is capping Visa rates on cross-border transactions at an average of 0.70 percent. European Commissioner for Competition Policy Neelie Kroes called upon Visa and MasterCard to reduce their “outrageous” credit and debit card fees, issuing an interim report in an ongoing investigation on April 12, 2006. The report stated that interchange fees are increasing consumer prices by up to 2.5 percent and are “equivalent to a tax on consumption.”

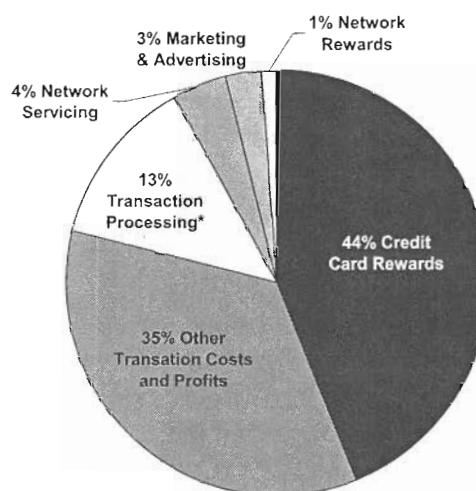
### Background

In 2003, how U.S. consumers pay for goods and services crossed a historic milestone as electronic payments exceeded check payments for the first time.<sup>2</sup> This milestone signals that plastic is becoming the predominant currency of commerce. Although cash and checks are not likely to disappear soon, the former is now relegated to small transactions while check use is steadily declining.

Most card transactions today are one of three types:<sup>3</sup>

**Credit** — The customer’s card account is queried to verify it exists. The retailer is assessed a fee based on the percentage of the transaction. About one-quarter of that fee covers the processing costs of the retailer’s

Figure 2. The Estimated Components of Interchange Fees



\*Combines 9% for bank processing and 4% for network processing.

Source: *A New Business Model for Card Payments*, Diamond Management & Technology Consultants, 2006.

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*— Neelie Kroes, European Commissioner for Competition Policy*

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<sup>2</sup> Federal Reserve System, *The 2004 Federal Reserve Payments Study — Analysis of Noncash Payments Trends in the United States: 2000-2003*.

<sup>3</sup> In other electronic payments, consumers use automated clearing house (ACH) cards issued by retailers; the bank processing costs are minimal. Consumers now redeem most Food Stamps with electronic benefit transfer (EBT) cards; in some states, they can use EBT cards to buy products under the Women, Infants, and Children program.

bank. The balance constitutes the so-called interchange fee, which goes to the bank that issued the card. The customer receives a statement at the end of the month and pays the full amount or part of the unpaid balance.

**Signature/Offline Debit** — The customer’s account is queried to verify the purchase can be covered. The transaction is held offline, and then transferred from the customer’s bank account to the retailer’s within two business days. The retailer is assessed an interchange fee from \$0.35 for a supermarket transaction to about 2 percent for other merchants.

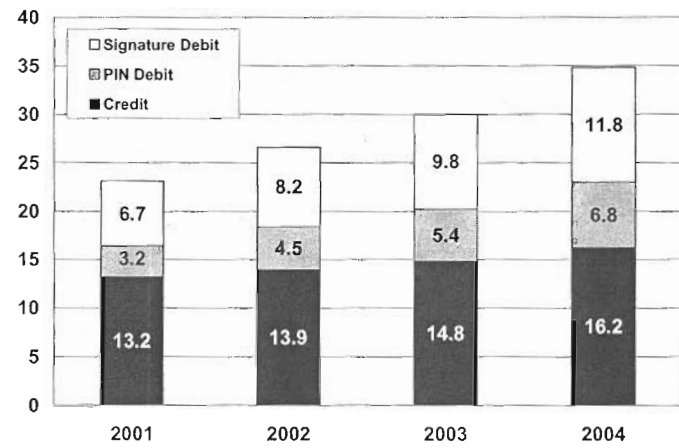
**PIN/Online Debit** — Funds are withdrawn instantly from a checking account after the customer enters a personal identification number or PIN. The retailer is assessed a \$0.17-\$0.50 fee. Some banks charge customers a fee as well, from \$0.10 to \$2.00.<sup>4</sup> This fee appears on the customer’s bank statement as a bank or convenience fee, or the retailer is listed as the payee even though the retailer neither assessed nor received the fee.

As a condition of accepting credit and debit cards, retailers are not permitted to assess a surcharge to reveal or recover the interchange fees on transactions. This restriction is part of the card rules that retailers must adhere to. The rules run more than a thousand pages, governing every detail of electronic transactions. For many years, retailers were not even allowed to see much less obtain a copy of these mammoth regulations. The card companies regard them as proprietary secrets. In 2006, under pressure from Congress and merchants, Visa and MasterCard posted excerpts of the rules on their websites. Visa now allows retailers to view the full set of rules only if they sign a non-disclosure agreement.<sup>5</sup>

At a February 15, 2006, hearing, the House Energy and Commerce Subcommittee on Trade and Consumer Protection asked the card companies to turn over their full set of rules. The Senate Judiciary Committee made the same request at a July 19 hearing. As of mid-January 2007, Visa and MasterCard have defied these congressional requests.

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**Figure 3. Number of Card Payments at the Checkout (billions)**



<b>Total</b>	23.1	26.6	30.0	34.8
<b>Yearly Growth</b>		15.2%	12.8%	16.0%
<b>Signature Debit</b>		22.4%	19.5%	20.4%
<b>PIN Debit</b>		40.6%	20.0%	25.9%
<b>Credit Card</b>		5.3%	6.5%	9.5%

Note: 2004 data are a projection.

Source: Federal Reserve System, *Report to the Congress on the Disclosure of Point-of-Sale Debit Fees*, November 2004

<sup>4</sup> Federal Reserve System, *Report to the Congress on the Disclosure of Point-of-Sale Debit Fees*, November 2004, p. 17.

<sup>5</sup> Visit [http://www.mastercardmerchant.com/accept\\_mastercard/merchant\\_rules.html](http://www.mastercardmerchant.com/accept_mastercard/merchant_rules.html) to view MasterCard’s *Merchant Rules Manual*. Excerpts of Visa’s rules are posted at [www.usa.visa.com/download/business/accepting\\_visa/ops\\_risk\\_management/rules\\_for\\_visa\\_a\\_merchants.pdf?it=r4%2Fbusiness%2Faccepting\\_visa%2Fnew\\_acceptance%2Fmerchant\\_responsibility%2Ehtml](http://www.usa.visa.com/download/business/accepting_visa/ops_risk_management/rules_for_visa_a_merchants.pdf?it=r4%2Fbusiness%2Faccepting_visa%2Fnew_acceptance%2Fmerchant_responsibility%2Ehtml) | [Rules%20for%20Visa%20Merchants&it=r4%2Fbusiness%2Faccepting\\_visa%2Fnew\\_acceptance%2Fmerchant\\_responsibility%2Ehtml](http://www.usa.visa.com/download/business/accepting_visa/ops_risk_management/rules_for_visa_a_merchants.pdf?it=r4%2Fbusiness%2Faccepting_visa%2Fnew_acceptance%2Fmerchant_responsibility%2Ehtml) | [Rules%20for%20Visa%20Merchants](http://www.usa.visa.com/download/business/accepting_visa/ops_risk_management/rules_for_visa_a_merchants.pdf?it=r4%2Fbusiness%2Faccepting_visa%2Fnew_acceptance%2Fmerchant_responsibility%2Ehtml).

### The Questionable Basis for Interchange Fees

The volume of electronic transactions has increased dramatically in recent years (see Figure 3). Since 2001, debit card use has surged by more than 20 percent a year. Economies of scale, competition, plummeting computer costs, low interest rates and inflation, however, are not driving down payment fees. In fact, the fees on average doubled over the past 10 years. Banks and card companies acknowledge the fees are not based solely on communications costs. Many of the expenses they cover do not provide clear benefits to consumers or retailers.

The fees help subsidize the marketing to entice consumers to use more cards, to use them more frequently and to charge more goods and services. The inducements include reward points and rebates and no annual card fees. Retailers counter that consumers have a fixed amount of disposable income. Increased purchases at some outlets are offset by decreases elsewhere. As plastic becomes the predominant form of payment, net increases reflect inflation. In the supermarket industry, the weekly family grocery bill has changed little over the past five years, and, when adjusted for inflation, has declined.<sup>6</sup>

Furthermore, with cards and card offers proliferating, this hypermarketing is unnecessary. In 2005, U.S. consumers received 6.08 billion mail solicitations for credit cards alone, after receiving 5.23 billion the previous year.<sup>7</sup> Visa explains why people are deluged with card solicitations: 10 mailings are now required to sign up new customers — up from two mailings when cards were less widely held.<sup>8</sup> One can reasonably ask if such marketing is needed, especially when people today carry an average of 4.8 credit cards.<sup>9</sup>

Whether or not one agrees with the card marketing frenzy, retailers and consumers should not help subsidize it with interchange fees. And customers who pay by cash or check — payments that are not subject to large processing costs — should not help underwrite these card campaigns as well by paying the higher retail prices needed to cover the interchange costs.

The fees are said to cover the risk of fraud. Most of the debit fraud losses result from easily forged signatures on cards that are not PIN-protected. Yet banks and card companies are inducing customers to use the less-secure signature debit cards, no doubt because these payments generate higher interchange fees. At the same time, they are increasing PIN-debit fees for retailers and starting to charge consumers even though these payments cost the least and are password-protected from fraud. Retailers and consumers benefit most from the lower-cost and more secure PIN-debit cards. They should not help subsidize less secure and more costly signature debit card payments — which, if current trends continue, will soon account for twice as many PIN-debit transactions.

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<sup>6</sup> FMI, *Trends in the United States: Consumer Attitudes and the Supermarket, 2004*, p. 53, *U.S. Grocery Shopping Trends, 2005*, p. 31, *U.S. Grocery Shopping Trends, 2006*, p. 81.

<sup>7</sup> Synovate, April 27, 2006.

<sup>8</sup> "Visa Charges Ahead," *Time* magazine, March 14, 2005, p. A6.

<sup>9</sup> Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions*, June 2004, p. 4.

Another rationale for the fees is to cover the losses from consumers who cannot make their card payments. Customers and retailers should not help cover the losses to overextended consumers who succumb to the aggressive marketing and default on their card payments. The banks or card companies decide whether to accept a card application. Retailers and consumers should not subsidize issuing a card to bad credit risks. Most outrageous is a recent marketing campaign targeting consumers who had just filed for bankruptcy.

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On a pure cost basis, it is difficult to justify any fee for a PIN-secured transaction. The funds are guaranteed to be there and are withdrawn instantly. The transmission costs are negligible since the transactions are routed through preexisting networks, in most cases those used for ATM withdrawals.

Interchange fees also cover the so-called interest-free period — up to a month for credit cards and within two days for signature debit transactions. The interest-free periods are negligible for signature cards and non-existent for PIN-debit ones. With credit cards, financial institutions earn significant interest from consumers who choose to make monthly payments rather than clear their account balance. Nearly half of all consumers (44 percent) do not pay off their card balances each month, generating billions of interest income for banks and card companies.<sup>10</sup> Once again, consumers and retailers should not supplement this ample source of income with interchange fees.

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Most telling is the fact U.S. consumers and retailers pay the highest credit card interchange fees in the world with rates averaging more than 1.70 percent, according to TransAction Resources, an international expert in the field.

### Conclusion

The movement toward a plastic marketplace presents opportunities to reduce costs and fraud and to offer consumers ample convenient payment options. As with the shift from a cash- to a largely check-based economy years ago, preserving the public trust in the new electronic payments system is paramount. Exploiting change of this magnitude for financial gain undermines that trust. When this occurs, public institutions must intervene.

From Australia to the U.S. to Europe, the current interchange fee system is not based on easily measurable costs. Proponents of the system argue that costs are less important than having a fee structure that maximizes card use. This argument may have applied years ago when card use was in its infancy. Now that plastic has become the predominant currency of commerce, there is no need to stimulate more use of plastic. In addition, by driving up the costs of goods and services, the current fee system abuses low-income consumers who depend on every dollar to survive. And it is ill-suited for a world economy in which billions of transactions are made monthly as trillions of dollars, yen and euro change hands.

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<sup>10</sup> March 2005 survey of 800 households by Cambridge Consumer Credit. This figure includes 11 percent of households that made no monthly payments at all.