

Interchange Fee : Revenue generating area for card issuing banks

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February 6, 2017

Card based transactions have grown leaps and bounds as the customers find it easy to purchase using the plastic money rather than carrying cash in their wallets. With the advancement in technology and banks offering variety of cards to the customers, we often think that how does bank earn when they issue credit cards/debit cards to customers.

In India, Credit card issuances have recorded an impressive growth of 16 per cent year on year to 24.5 million in the financial year ended March 31, 2016 as banks added 3.4 million cards to the system. Card spends too registered a 26.7-per cent growth in FY16.

When it comes to credit card networks, almost everyone knows Visa, MasterCard, and American Express. to attract customers

- Visa: Visa had 2.452 billion debit and credit cards in circulation in the 12-month period ended September 30, 2015 and processed \$7.354 trillion in total volume.
- MasterCard: In the nine-month period ended September 30, 2016, MasterCard had issued 1.631 billion cards in its credit, debit, and charge program and had processed \$3.591 trillion in gross dollar volume.
- American Express: The company had issued 117.8 million cards and processed \$1.04 trillion in card billed business in 2015.

When the banks issue cards, they earn revenue which is termed as “Interchange fee”. While there are other fees that merchants pay for the privilege of making sales via credit and debit card, interchange fees are by far the largest, **representing 70% to 90% of the total fees paid to banks by merchants**

- This term is used in the payment card industry to describe a fee paid between banks for the acceptance of card based transactions.
- Usually it is a fee that a merchant's bank (the "acquiring bank") pays a customer's bank (the "issuing bank"); however there are instances where the interchange fee is paid from the issuer to acquirer, often called reverse interchange.

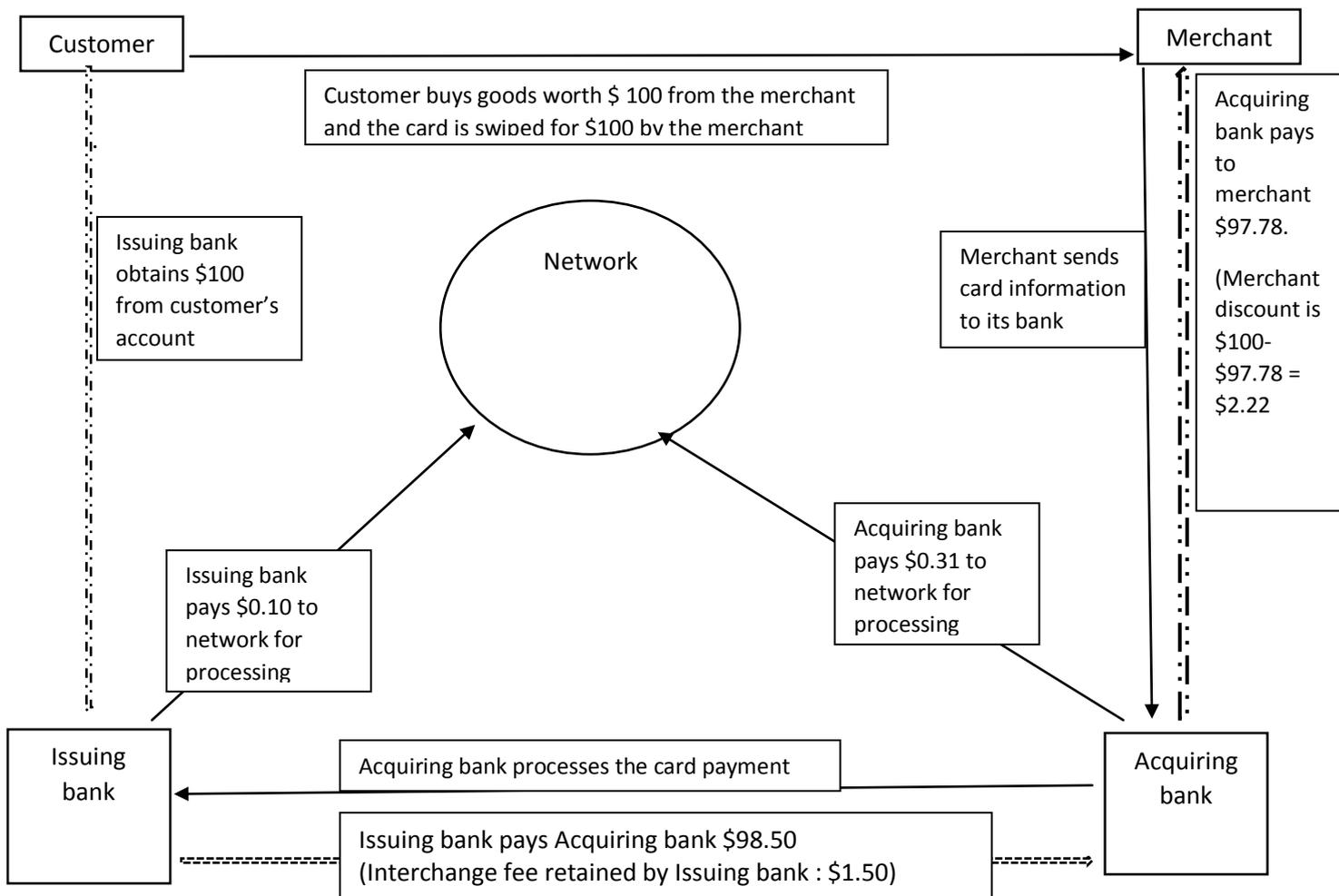
Before we move ahead to understand how the bank earns Interchange Fee, we need to know the **parties involved in the transaction:**

- Cardholder: An individual who holds the credit card/ A person to whom a card has been issued.
- Issuing Bank: The bank that issues a card to the customer. E.g. Standard Chartered Bank, HDFC, ICICI etc.,
- Merchant: Sellers of goods, services, and/or other information who accept credit cards as payment for these items. They have signed a merchant agreement to honor credit cards and display the service mark (logo). E.g. Walmart, Shopper’s Stop etc.
- Acquiring Bank/Merchant Bank: A bank that contracts with merchants to accept, process, and settle credit card transactions. The acquiring bank is the entity that maintains the merchant relationships and collects cardholder transaction data from those merchants
- Associations/Network: : Networks set & enforce operating rules governing how network participants (Issuing Bank, Acquiring Bank & Merchants interacts). The organizations (VISA and MasterCard) provide rules, advertising, and settlement services.

How is interchange fee earned by a bank:

- a. In a credit card or debit card transaction, the issuing bank in a payment transaction deducts the interchange fee from the amount it pays the acquiring bank that handles a credit or debit card transaction for a merchant.
- b. The acquiring bank then pays the merchant the amount of the transaction minus both the interchange fee and an additional, usually smaller, fee for the acquiring bank which is often referred to as a discount rate, an add-on rate. [For cash withdrawal transactions at ATMs, however, the fees are paid by the card-issuing bank to the acquiring bank (for the maintenance of the machine)]
- c. The interchange fee is typically set by the Associations/Networks and are the largest component of the various fees that most merchants pay for the privilege of accepting credit cards, representing 70% to 90% of these fees by some estimates, although larger merchants typically pay less as a percentage.

Diagrammatic representation:



- Issuing bank earns: $\$1.50 - \$0.10 = \$1.40$
 - Interchange fee earned by Issuing bank: $\$1.50$
 - It is normally extracted from the merchant discount by the acquiring bank and paid to the separate issuing bank to compensate it between the time of settlement with the acquiring bank and the time of recouping value (payment) from the cardholder.
 - Fees paid by one bank to another to cover handling costs and credit risk in a card transaction. Also, referred to as the interchange rate, it is usually a percentage of the transaction amount and is derived from a formula that takes into account authorization costs, fraud and credit losses, and the average bank cost of funds.
- Acquiring bank earns: $\$0.72 - \$0.31 = \$0.41$
 [(Acquiring bank charges a processing fee of $\$0.72$ and deposits $\$97.78$ in the merchant's account ($\$98.50 - \$97.78 = \$0.72$)),
- Merchant discount: $\$2.22$
 This discount fee, as a percent of sales volume, an acquirer charges a merchant for processing sales transactions. This is also referred to as the merchant discount

How the interchange rates are established: Interchange rates are established at differing levels for a variety of reasons.

- A premium credit card that offers rewards generally will have a higher interchange rate than do standard cards.
- Transactions made with credit cards generally have higher rates than those with signature debit cards, whose rates are in turn typically higher than PIN debit card transactions.
 - Signature Debit:
 - i) A signature debit transaction is where a customer uses debit card to pay for a product or service without entering her personal identification number (PIN) into a PIN pad.
 - ii) Instead, the user completes the transaction by signing the sales receipt as if the user used a credit card to make the purchase.
 - iii) Since a customer does not enter her PIN number, a signature debit transaction is routed to the bank via Visa or MasterCard's computer network instead of the PIN debit network, making the transaction subject to Visa and MasterCard interchange fees instead of the PIN debit network fees.
 - iv) Signature debit transactions are often referred to as an *offline debit transaction* because a PIN debit network does not play a role in processing the transaction.
 - v) Debit Interchange : A business pays an interchange fee to a customer's issuing bank each time it processes a signature debit transaction through Visa or MasterCard's network.
 - vi) The amount of the interchange fee varies depending on the size of the bank that issued the customer's card, the amount of the transaction. Card-present (swiped) debit interchange fees differ on a per-transaction basis depending on the size of a transaction. Transactions that are less than $\$15$ are classified as small ticket, whereas transactions that are $\$15$ or more are classified simply as retail debit..

➤ PIN Debit

- i) A PIN debit transaction is one where a customer pays for product or service by entering her personal identification number (PIN) into a PIN pad to complete a transaction. In the case of a PIN debit transaction, the customer does not sign the sales receipt.
- ii) Information for a PIN debit transaction is routed from the merchant to the customer's bank by a PIN debit network, therefore subjecting the transaction to the debit network's fees.
- iii) PIN debit transactions are often referred to as an *online debit transaction* because a PIN debit network handles the routing of transaction information instead of Visa or MasterCard.
- iv) PIN Debit Network Transaction Fees : Debit networks such as NYCE, STAR and ACCEL maintain computer networks to route transaction information among businesses and banks. A debit network charges an interchange fee and a switch fee to route transaction information over its network.

- Sales that are not conducted in person (also known as card-not-present transactions) such as by phone or on the Internet, generally are subject to higher interchange rates, than are transactions on cards presented in person. This is due to the increasing risk and rates of fraudulent transactions.
- Interchange fees are not static: Based on the costs of moving money, the time value of money in terms of current interest rates, and the relative risk involved, credit card companies set and regularly adjust their interchange rates.
- Visa and MasterCard, for example, change rates twice a year, in April and October. .

How interchange fees are calculated: Interchange fees are determined by a large number of complex variables. To simplify the cost for merchants, credit card companies compute interchange into flat rate plus a percentage of the sales total (including taxes).

Transactional factors affecting interchange

- **Card type:** Debit cards with PINs have lower rates than credit cards due to lower risk, and each credit card company will charge a different rate. Rewards cards pay for the perks given to card holders by charging higher interchange rates to businesses. The perks may, however, induce consumers to purchase more.
- **Business size and industry:** Rates can vary by business type — supermarkets, for example, pay more than do gas stations. Additionally, larger merchants often have lower rates because they have enough "clout" to successfully negotiate with banks/credit card companies.
- **Transaction type:** POS (point-of-sale) transactions are less risky than CNP (card-not-present) since the chip can be scanned, a signature taken or a PIN entered. Both MOTO (mail-order-telephone-order) and online orders are classed as CNP and charged a higher interchange rate.