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IN FOCUS

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Merchant Discount, Interchange, and Other Transaction Fees in the Retail Electronic Payment System

Recent policy discussions around faster payments, cryptocurrencies, and other financial innovations have highlighted some of the costs and fees associated with the retail payment system. In the past, Congress has passed legislation regulating some of the fees associated with certain electronic transactions (e.g., Section 1075 of P.L. 111-203, known as the "Durbin Amendment," discussed below). Further, the pandemic highlighted the impact of transaction costs on small businesses in an economic environment that took its toll on many retailers. This InFocus examines the range of transaction costs associated with various retail electronic payments and the fee structures for the two most common payment types: debit cards and credit cards.

Retail Electronic Payments Structure

Consumers and merchants can transfer money in a number of different ways. Cash, checks, and electronic transaction cards such as prepaid, debit, and credit cards are examples. The most popular payment types of electronic transaction devices for retail payments are debit and credit cards. According to the Federal Reserve's most recent payments study, in 2018 debit and credit cards accounted for 55% and 34% of noncash transactions, respectively. In addition, there has been a recent trend among some retailers toward going cashless, eliminating the costs associated with handling cash. Further, the pandemic has created new demand for contactless payments.

The payment choice a consumer makes determines the number of financial institutions involved and the range of costs borne by the consumer, the merchant, and their respective financial institutions.

There are a few key parties to be familiar with when discussing retail electronic card payments: (1) the consumer who makes a purchase; (2) the merchant that makes a sale; (3) the consumer's bank that issues the payment card, called the *issuing bank*; (4) the merchant's bank, called the *acquiring bank*; (5) the card or payment network that connects the issuing and acquiring banks; and (6) the payment processor that provides the infrastructure for a transaction, such as card readers.

To understand how these transactions are completed, consider how a consumer would use either a credit or a debit card at the point of sale (e.g., in a retail store.) To make a payment, a consumer typically swipes or inserts the card, though consumers can also tap or wave certain cards that have such capabilities. Additionally, consumers can use digital wallets such as Apple Pay or Google Pay to access their card information. The card swipe, insertion, tap, or wave is processed on a card reader. (Alternatively, card information can be processed over the phone or online in what is called a card-not-present transaction.)

The card reader sends a signal to the issuing bank to seek authorization for transfer of funds. Once it is authorized, the funds are transferred to the acquiring bank for deposit in the merchant's account.

Both debit and credit cards are processed over a network. The four major ones are provided by Visa, Mastercard, American Express, and Discover. The network facilitates the card transaction by providing the connection between the consumer's and merchant's banks.

While both debit and credit cards operate in similar ways, the primary exception is the way money is transferred out of the consumer's possession. In a debit transaction, the issuing bank is the consumer's bank, and the money leaves his or her checking account—in this way debit cards act more like checks—drawing down the balance. Conversely, in a credit transaction, the issuing bank is the bank that backs the consumer's credit, and the consumer will be billed for the amount transferred at a later date. The consumer then pays off the credit balance—in whole or in part, with interest on any unpaid balance thereafter—after the monthly statement is issued using whatever payment options the credit card company allows.

Transaction Fees

Credit and debit card transactions involve a set of fees typically paid by the merchant to the merchant's bank to the participants facilitating the transaction. While these fees are typically paid by the merchant, the merchant may be able to pass the cost indirectly to the consumer through higher prices, if market characteristics allow.

Merchant Discount Rate

Networks and processors provide the infrastructure necessary to facilitate the transfer of funds from the consumer's bank to the merchant's bank. For this service, the merchant agrees to pay a fee called the *merchant discount rate* (MDR) for each transaction. This fee is paid to the merchant's bank and then further split among the other market participants in the form of interchange fees, assessment fees, and payment processing fees, as described below. The MDR is typically around 1%-3% per transaction. For example, if a consumer pays $100 for a product and the MDR is 3%, the merchant would receive $97.

Interchange Fees

Interchange fees are paid to the consumer's bank and represent the largest share of the MDR. This fee is set by

the network and is paid to cover the costs of the consumer's bank associated with approving and handling the transaction and assuming the risk for any bad debt associated with the payment. The networks typically adjust interchange fee schedules semi-annually. They set these prices to attract issuing banks to their networks. Interchange fees are typically billed to merchant banks as one fee but actually represent several smaller fees rolled into one. Interchange fees vary based on the type of card used and whether the card is swiped, keyed in, or processed remotely. Fees are typically a percentage of the transaction plus a fixed amount. For example, a credit transaction may carry an interchange fee of 2.3% plus $0.10.

In 2011, the Federal Reserve issued Regulation II, implementing what is commonly known as the Durbin Amendment, which required the Fed to set debit interchange fees for large banks based on the cost of providing the services, capping debit card interchange fees at 0.05% plus $0.21 per transaction for large issuers. This was the first time transaction fees were required to be regulated. Credit card interchange is generally not covered by Regulation II.

As discussed in more detail in CRS Report R41913, *Regulation of Debit Interchange Fees*, by Darryl E. Getter, interchange fees are charged only in four-party networks such as Visa and Mastercard, where there is an issuing bank, an acquiring bank, a consumer, and a merchant. Alternatively, in three-party networks, such as American Express, the network provider's bank also acts as the issuer and acquirer.

Assessment Fees

A smaller portion of the MDR goes to the network. This is sometimes referred to as a card brand, network access, or brand usage fee. Typically this is a relatively small fee, around 0.1%-0.2% of a transaction, but markups can be added depending on the location of the consumer and merchant banks, the currency used, or other variables. For example, on a $100 credit card transaction, a network may charge a base assessment fee of 0.14% (14 cents) per transaction.

Processing Fees

The remaining amount of the MDR is paid to the payment processor, which accepts the card payment and sends the transaction to the payment network either through a physical card reader or an online payment gateway. Fee structures vary from per-transaction fees to flat service fees, and unlike the interchange and assessment fees over which merchants have little or no opportunity to negotiate, processing fees are often negotiated between the merchant and the service provider. There are a variety of pricing schemes among hundreds of processors. Commonly known payment processors include PayPal and Square, both of which charge standard processing fees ranging from 2.6% to 2.9% of the transaction plus $0.10-$0.30 per transaction. Alternatively, some processors charge flat rates for services (e.g., $50 per month) or comparatively lower transaction fees, around 0.35% per transaction.

Policy Considerations

One of the main policy considerations about electronic payments is the costs associated with each transaction. One specific concern is the impact these costs have on retailers, who bear the direct costs of most transaction fees. Some policymakers argue that regulating fees, as interchange fees have been, can alleviate some of the economic strain on small businesses and allow savings to be passed on to the consumer. However, opponents argue that regulating interchange fees is ineffective, as the merchant discount rate can be adjusted to compensate. Additionally, regulation can have unintended consequences such as reducing or eliminating card benefit programs, which consumers shop for when choosing a card.

Congress continues to debate the merits of regulating payment fees. For example, in 2017, the Financial Choice Act (H.R. 10, 115th Congress) originally included a provision to repeal the Durbin Amendment. More recently, policymakers have revisited a number of aspects of merchant fee issues. The pandemic has highlighted some of the pressure merchant fees place on retailers. In April 2021, retailers in North Dakota sued the Federal Reserve to challenge its debit card interchange rule, asserting that the Fed set the fee too high above costs.

Another issue is competition. In a market where retailers increasingly need to accept card payments, network pricing could incentivize issuing banks to direct payments to networks with the highest interchange rates. In May, the Federal Reserve issued a proposed rulemaking to clarify that debit card issuers cannot direct payments through a preferred network—preventing issuers and networks from colluding.

While the card networks have delayed updating fee schedules during the pandemic, with the growing popularity of credit cards, policymakers may also be interested in regulating fees associated with credit cards, perhaps in a way similar to debit interchange fees. (This was done in Europe in 2015.) One potential unintended consequence of such a policy could be the elimination of rewards programs, which are generally paid for with interchange fee revenue. However, it is not clear how costly or detrimental consumers would view this, because while rewards programs for U.S. debit cards and European debit and credit cards effectively disappeared after interchange regulation in those markets, card use nevertheless continued to increase.

Related CRS Products

CRS Legal Sidebar LSB10604, *North Dakota Merchants Sue Fed, Claiming Debit Card Swipe Fees Exceed Those Allowed by the Durbin Amendment to the Electronic Funds Transfer Act*, by M. Maureen Murphy

CRS Report R41913, *Regulation of Debit Interchange Fees*, by Darryl E. Getter

Andrew P. Scott, Analyst in Financial Economics

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