Networks, Merchants, And the Tortured Story of Interchange by Fiat

By Eric Grover

Digital Transactions

June 1, 2024

Market pricing is preferable to legal settlements, which in turn are preferable to government regulation. Will the payments business ever learn that lesson?

Many in the payments industry breathed a sigh of relief at Mastercard's and Visa's announcement in March of their landmark settlement of a longstanding antitrust suit over credit-card interchange and network-acceptance rules.

Not everyone is happy, however. Mastercard and Visa want to be free to set interchange prices and network rules to maximize total value for cardholders, merchants, and banks. Merchants would like payments to be free and to generate incremental sales. But it's in the nature of settlements that neither party gets everything it wants.

At trial, either party might have achieved total victory. But each would have risked a catastrophic outcome, and merchants' attorneys would have had a deferred or no payday. Indeed, there is one clear winner in this litigation: the attorneys, who stand to make up to $170 million from the case, are licking their chops at the settlement.

If the settlement is approved by Judge Margo Brodie in the U.S. District Court for Eastern New York, it will have a momentous impact on credit-card acceptance fees and merchants’ ability to influence tender type. It will not, however, end the forever war over payment-industry fees, a war being waged on multiple fronts, by litigation, legislation, and regulatory diktats, at the state and federal levels in the U.S., and abroad.

Interchange fees are used by two-sided payment networks to balance participation on both sides of the network and thereby maximize total value. They fund fee-free accounts, a smorgasbord of cardholder benefits and rewards, and issuer innovation.

A Billion-Dollar Transfer

In the settlement, Mastercard and Visa committed to reduce interchange fees by roughly $30 billion over five years. Every published interchange rate would be decreased by at least 4 basis points, and average interchange by at least 7 basis points.

The massive settlement would transfer billions of dollars from cardholders and credit card issuers to large merchants, two-stage digital wallets like PayPal, and merchant acquirers serving small merchants.

Interchange rates for large merchants would be reduced more than the average, and these sellers will reap the entire windfall immediately. Reductions for smaller merchants will be less.

Merchant acquirers will enjoy a bonanza by retaining interchange cuts. Digital-wallet-anchored payment networks like PayPal will benefit from lower funding costs, which they are unlikely to pass on through any reduction in their take rate.

Lower interchange will put a damper on competition among credit card issuers over rewards that many U.S. consumers take for granted. Caps will also make it nearly impossible for Mastercard and Visa to use interchange to woo new issuers and win greater payments share from existing issuers.

Besides all this, the settlement prohibits Mastercard and Visa from boosting issuer compensation with synthetic interchange by increasing acquirer fees and making net issuer fees negative.

To prevent payments networks from circumventing interchange price controls, synthetic interchange is banned for debit in the U.S. by the Durbin Amendment and in the European Union for credit and debit.

Mastercard's and Visa's fettered interchange could offer an opening to a combined Capital One and Discover, on top of disrupting Durbin's straitjacketed debit market.

If Discover cardholders are fueled by compelling rewards, if enough of them strongly prefer Discover, and if there are more of them and their spend increases, America's long-struggling number-four credit-card network could hike interchange.

Higher interchange would enable Discover to enrich its rewards, incenting greater use, and, critically, improving its prospects of persuading major U.S. credit-card issuers to offer Discover in addition to Visa, Mastercard, and American Express. In a similar vein, the premium-interchange AmEx network will become more attractive to U.S. banks.

Consumers Trump Sellers

Whoever in the payments value chain can shift payments share captures richer economics. The payments industry defends interchange fees as a means of recouping issuer costs. That's a utility model. The primary reason, however, that interchange flows from merchants to issuers—and then, to a large extent, on to cardholders in fee-free products, benefits, and rewards—is that consumers' payments preferences trump those of merchants.

This is why it's a penny-wise, pound-foolish strategy for retailers to aggressively push consumers to pay with cheaper payments products. This also means that, while payments networks must adequately serve merchants to increase payment-network volume and share, it's more important for them to persuade financial institutions to issue their payments products and to incent cardholders to use them.

The proposed settlement attempts to address this asymmetry by giving merchants a greater ability to influence payments mix and, consequently, acceptance fees. It would permit surcharging up to 3% for interchange

and network fees, whichever is higher, if competing payment networks such as American Express and Discover are comparably surcharged, or, if they aren't, up to 1%.

American Express's rules prohibit surcharging unless all other cards are comparably surcharged. It would be good for Mastercard, Visa, Discover, credit card issuers, and cardholders if AmEx sticks to its guns.

Consumers don't like surcharges. They don't like paying to pay. Discounts are a more palatable means of encouraging consumers to use different tender types.

The settlement invites merchants to negotiate deals with issuers, under which they would offer discounts to consumers paying with particular issuers' cards. Today, Costco enjoys the lowest credit card acceptance fees of any merchant in America because it gives 100% of its credit card volume to Visa.

If a large merchant—say Amazon—provided discounts to consumers paying with cards from a particular issuer and network, and thereby steered more payment volume to them, it would enjoy better terms.

Consenting Parties

The proposed settlement authorizes merchants to band together to collectively bargain with Mastercard and Visa. This provision is reminiscent of Sen. Richard Durbin's Credit Card Fair Fee Act of 2008, which envisioned

merchants, under government supervision, collectively negotiating fees with the payments industry.

Under this initial attempt by Durbin to make the payment industry a public utility and gut its economics, if merchants and the payments industry were unable to find accord, government “payment system judges” would determine the merchant-discount fee that would obtain in a perfectly competitive market. This they would set as the price ceiling.

Merchants don’t have a great track record of successful collaboration. Notably, their grand payments coalition, Merchant Customer Exchange, launched in 2012 with great fanfare, failed soon afterward.

Prices and practices set in the market by mutually consenting parties best dynamically allocate resources to maximize total value. Prices and practices established by agreement to settle a lawsuit are unfortunate, but still preferable to prices and practices imposed by politicians and regulators.

By lawsuits, legislation, and regulatory diktats, payment networks’ freedom to compete continues to be whittled away.

—Eric Grover is principal at Intrepid Ventures.