

Merchant Service Fees for Credit Cards

The Reserve Bank's reforms to credit card schemes came into effect over 2003 and early 2004. One of the key elements of the reforms was the lowering of the fee paid by a merchant's bank to a cardholder's bank whenever a credit card purchase is made – the so-called interchange fee. Effective end October 2003, the Bankcard, MasterCard and Visa credit card schemes have been required to set this fee in conformity with a benchmark based on the costs incurred by banks issuing credit cards.

At the time the reforms were implemented there was a strong expectation that competition between banks for merchants' business would see the fall in interchange fees flow through into a fall in fees (known as merchant service fees) that banks charge merchants for providing credit card facilities. To monitor whether this has been occurring, the Reserve Bank has been collecting data on the revenue earned by financial institutions from these merchant service fees.

This article reports the Bank's initial findings. The data show that the average merchant service fee charged by banks in the Bankcard, MasterCard and Visa credit card schemes has fallen by 35 basis points since the reforms to credit cards, indicating that most of the fall in interchange fees has been passed on to merchants. A more comprehensive assessment of the reforms will be included in the Payments System

Board's *Annual Report* due to be released later this year.

Interchange Fees

Card schemes have a range of interchange fees depending on the type of transaction. Prior to the reforms, in the Bankcard, MasterCard and Visa schemes a fee of 0.8 per cent of the transaction value applied when the card was swiped for electronic processing and the transaction was authorised by the customer's signature (the electronic rate), and 1.2 per cent for all other transactions (the standard rate). The electronic rate was introduced to encourage merchants and their banks to switch from paper to electronic processing.

The interchange fees applicable since the reforms are different for each scheme and are shown in Table 1.

Bankcard now applies a single rate. MasterCard and Visa still have a separate rate for electronic transactions and apply a 'standard' rate to those that are either manually processed or are not verified by the cardholder's signature, for example, transactions over the telephone or Internet. MasterCard and Visa also apply a commercial rate for corporate and purchasing cards, and

Table 1: Interchange Fees
Per cent of transaction value

Pre-reform		Post-reform		
		Bankcard	MasterCard	Visa
Standard	1.20	0.49	0.62	0.60
Electronic	0.80	0.49	0.46	0.44

Sources: RBA and schemes' websites

Visa applies a separate rate for recurring debits to credit cards such as mobile phone accounts.

Data collected by the Reserve Bank in 2000 showed that the weighted-average interchange fee in 1999 was 0.95 per cent. Data on the average interchange fees paid are not available between 1999 and 2003, but following the reforms and the introduction of the fees shown in Table 1, the weighted average has fallen to a little below 0.55 per cent. When the reforms were introduced, American Express and Diners Club were almost exclusively three-party schemes where the scheme dealt with both the merchant and cardholder and thus there was no interchange fee.

Merchant Service Fees

When the Reserve Bank collected data on merchant service fees on a one-off basis in 2000, it found that the average fee in the Bankcard, MasterCard and Visa schemes for 1999 was around 1.8 per cent of the transaction value. This suggested a margin between merchant service and interchange fees higher than in a number of comparable countries for which data were available.

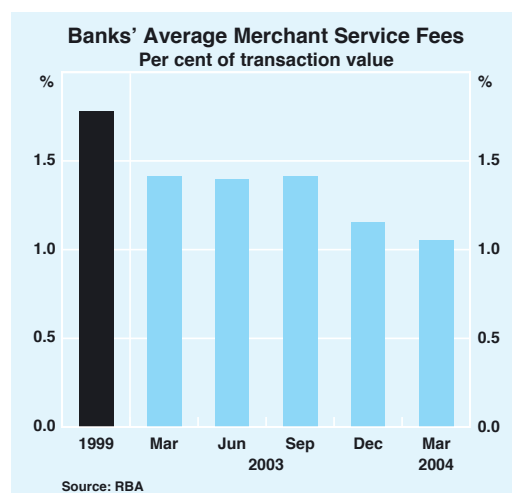
In March 2003, the Reserve Bank commenced a quarterly survey to monitor the effect of the reforms to credit card schemes. Data are provided by nine financial institutions (including American Express and Diners Club) that provide credit/charge card facilities to merchants. These institutions account for almost all of the value of credit/charge card transactions in Australia.

Data are collected on total income from per transaction fees as well as income from other fees (e.g. terminal rental fees). Combining this information with data on the value of transactions allows calculation of average merchant service fees.

The survey shows that by March 2003, the average merchant service fee for Bankcard, MasterCard and Visa had fallen to 1.4 per cent of the transaction value. To some extent this fall reflected the intensification of competition between 1999 and 2003 for merchants' business, partly in response to the increased focus over this period on merchants' costs of accepting credit cards.

Since March 2003, the average merchant service fee has fallen by a further 0.35 of a percentage point to around 1.05 per cent (Graph 1). This brings the cumulative decline since 1999 to around $\frac{3}{4}$ of a percentage point, which represents a fall of more than

Graph 1



40 per cent in the average merchant service fee.

The most recent decline in fees took place after the lower interchange fees became effective at end October 2003. The data for the December quarter – which includes only two months in which the lower interchange fees applied – are consistent with the bulk of this reduction having come into effect with little delay. In total, the decline in merchant service fees since October 2003 amounts to an annual saving of around \$430 million for Australian merchants based on recent transaction volumes. Given the competitive nature of Australian retailing, it is expected that this saving will be passed through to consumers in the form of lower prices than would otherwise have been the case.

It is clear from the Reserve Bank's ongoing discussions with merchants that the new regulatory arrangements for credit cards have prompted a good deal of competition. Merchants have reported substantial unilateral offers of fee reductions from their banks and many have found that they could do even better by shopping around. In some sectors, retail industry organisations have negotiated substantial reductions on behalf of their members, while in others, brokers have assisted small business to find the best deals. Many large merchants were previously paying merchant fees close to the average interchange fee, while small merchants generally paid much higher rates.¹ The Bank's enquiries suggest that both large and small merchants have benefited, but because there was more scope for reducing small merchants' merchant service fees, those who have searched out opportunities appear to have done relatively well.

One concern that has been expressed is that banks are seeking to recoup some of the lost revenue from merchant service fees by raising other charges to merchants such as terminal fees, charges for paper and fees for transactions that are charged back. While there has been some increase in these charges, the

Table 2: Other Income Earned by Banks from Merchants Accepting Credit Cards

Per cent of transaction value

2003	March	0.05
	June	0.05
	September	0.05
	December	0.04
2004	March	0.06

Source: RBA

increase has been substantially outweighed by the reduction in merchant service fees (Table 2).

Overall, the 35 basis point reduction in merchant service fees since the reforms came into effect is consistent with the reduction in the interchange fee for electronic transactions, although it is smaller than the reduction in the 'standard' interchange fee. This suggests that while the lower interchange fees have largely been passed through into lower merchant service fees, there remains scope for further reductions. One reason sometimes advanced to explain why full pass-through is unlikely is the existence of transactions where the cardholder's bank and the merchant's bank are the same (so-called 'on-us' transactions). For these transactions, no interchange fees are paid and hence the merchant's bank has not obtained a saving from lower interchange fees. However, this argument is inconsistent with the fact that merchants are charged the same fee regardless of which bank issued their customer's card. Given the more competitive conditions that currently exist, a further small decline in merchant service fees might be expected.

Three-party Schemes

The three-party schemes are not subject to the Reserve Bank's standard on interchange

1. Reserve Bank of Australia, *Reform of Credit Card Schemes in Australia, IV Final Reforms and Regulation Impact Statement*, August 2002, p 6.

fees. They do, however, compete with the Bankcard, MasterCard and Visa schemes for merchant business and thus their merchant service fees are expected to be affected by changes in interchange fees flowing from the Reserve Bank's reforms.

In 2001, a survey by the Australian Retailers Association indicated that the average merchant service fee charged by the three-party schemes was 2.9 per cent.² The Reserve Bank's new data collection suggests that by March 2003, this figure had fallen by an amount broadly similar to the fall in the merchant service fee over the same period in the credit card schemes. Since then, however, the average merchant service fee for the three-party schemes has fallen by less than 10 basis points, considerably less than the fall in the credit card schemes. Confidentiality provisions of the *Reserve Bank Act 1959* prevent the publication of more precise data, given that there are only two significant three-party schemes (American Express and Diners Club).

There are a number of possible explanations for the relatively small decline in the average merchant service fees of the three-party schemes. One is that the schemes hold sufficient bargaining power to secure an increased margin over the fees charged by banks for accepting Bankcard, MasterCard and Visa cards. Another is that the contracts between merchants and American Express and Diners Club have a relatively long duration, with many not yet having been renegotiated. A third is the relative importance of the three-party schemes in the parts of the

travel and entertainment sector which have a relatively high expenditure on cards issued overseas. Interchange fees on MasterCard and Visa cards issued overseas have not fallen and so merchants in that sector have not benefited as much from the fall in domestic credit card interchange fees.

Notwithstanding these factors, a further decline in these merchant service fees should be expected. The competitive forces that are important in delivering this outcome are likely to work more quickly the more prepared are merchants to decline acceptance of these cards based on their high cost or to charge customers directly for this cost.

Conclusion

Merchant service fees charged by banks in the Bankcard, MasterCard and Visa credit card schemes have fallen by 35 basis points, or \$430 million at an annual rate, since the reforms to credit card interchange fees. Most of the fall in interchange fees appears to have been passed on, although a further modest fall in merchant service fees might be expected. Merchant service fees for American Express and Diners Club have fallen by less than 10 basis points, widening the premium merchants pay to accept those cards. The Reserve Bank will be monitoring closely the outcome of competitive pressures in that sector of the market. ✎

2. Australian Retailers Association, *Credit Card Schemes in Australia*, Submission to the Reserve Bank of Australia, July 2001, p 20.