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Interchange: Trends and Opportunities

Introduction

Some years ago I recall talking to a new recruit in the accounting department of what was then a combined issuing/acquiring cards centre. He said to me that the thing that was confusing him most in making General Ledger entries was that interchange is a revenue or an expense depending on whether you are making the entry for the acquirer or the issuer.

This seems like a very niave and basic observation but the flow of funds from acquirer to issuer for retail purchases has been a central dynamic of the credit card business since it's inception. Of late, it has become one of the hottest topics of discussion amongst card industry players (including merchants) and financial regulators.

Increased Regulatory Pressure

As I write, the influence of regulatory and govermental bodies is exerting pressure on interchange regimes globally. Australia continues a process of interchange rate reductions which has been on-going since the Reserve Bank of Australia intervened in 2003. New Zealand regulators are heading in the same direction following a recent lawsuit there. The Office of Fair Trade in the UK, the European Commission and the competition authorities under the direction of EU Commissioners Nellie Kroes and Charlie McCreevy are exerting similar downward pressure on interchange rates across Europe (SEPA).

In the US, a combination of business (particularly Merchant Pressure groups) and political forces are drawing attention to what are perceived as excessive interchange charges. This is despite technological advancements which these groups suggest should drive rates down. Reference to Visa or Mastercard Interchange fee data published on their websites does indicate a very considerable disparity between European Economic Area (EAA) and US rates. For example the Visa Electronic Data Capture (non chip and PIN) fee rate for the EEA region is 0.75% . The corresponding Visa EIRF rate for the US is 2.30% plus10 US cents. Comparisons for Mastercard products between EEA and the US also show a considerable difference with rates of 0.95% (EEA enhanced electronic) versus a US rate of 1.90% for consumer credit card transactions with electronic authorisation.

Winners and lossers

Looking at Global trends outside the US therefore, one might conclude that it's all good news for acquirers and bad news for issuers. Well, as always, it's not quite as simple as that.

Outside of the US, one of the drivers for falling interchange rates aside from pressure from regulators has been the introduction of EMV (Chip and PIN). The Card Present Chip and PIN rate across Europe for Visa is now 0.55%, some 20 basis points less than the EDC rate.Whilst the introduction of Chip and PIN has imposed costs on both issuers and acquirers the main beneficiaries of what it has delivered (substantial reductions in Card Present Fraud) have been card issuers. On the other side, acquirers have had to carry out major POS and host systems upgrades and in many cases have had to share the interchange rate reductions with their merchants, with little or no apparent payback for their investment. Now that Chip and PIN mandates are in place for all card scheme regions, apart from the US, similar cost and revenue dynamics can be expected globally.

How can Acquirers and Merchants control Interchange Costs

Aside from whatever limited influence acquirers and merchants can exert over the regulators and card schemes, they need to pay close attention to the quality of the systems used for card processing and the quality of the data these systems produce. Card processing solutions (either POS or Acquirer Host systems) can, through one or more of the following factors cause transactions to downgrade to less favourable interchange rates.

- Use of old data deficient messaging protocols
- Intermittently faulty equipment
- Staff poorly trained in the correct use of POS devices
- Acquirer Host based data enrichment processes which are not optimised
- Late presentment of transactions to clearing
- Faulty POS system's logic which clears transactions under a card type which attracts less favourable rates of interchange
- Deficient Acquirer Host interchange qualification processes
- Failure to use non-mandatory industry standards particularly for eCommerce and Card Not Present solutions
- Use of ISOs who do not support latest industry standards for eCommerce

If, for example, a credit card transaction achieves Standard US Interchange versus a CPS retail rate (Card Present), the impact on interchange on every million dollars of credit card turnover would be as much as $10,500. Similar situations can occur on consumer debit transactions. This cost is borne either by the acquirer or the merchant depending on the nature of the merchant contract.

Similarly in the Card-Not-Present (ecommerce) sector there are significant gains to be made if 3DSecure and UCAF are employed.

Larger merchants should also pay particular attention to the Card Schemes position with regard to **PCI Compliance.** Recently Visa announced a proposal to link tiered interchange to PCI compliance – if you are not compliant you don't qualify.

How can Issuers arrest Revenue Erosion

It's clear, outside the US, that the trend towards lower interchange is unstoppable and that issuers will have to accept this and find other revenue opportunities. Some concerns have been expressed that as their interchange revenue erodes further, card issuers will be left with no choice but to impose additional fees and charges on cardholders. That said, given the vigilance of regulators and the power of consumer groups, banks thinking of this as a source of revenue would be advised to proceed with caution. Beyond this approach there are measures issuers can take to limit revenue loss and create other opportunities from the new environment:

- Where the Chip and PIN investment has been made or is imminent, leverage the investment by using the potential of the Chip to sell value add products – loyalty and prepaid.
- Use the power of the Chip to store cardholder risk parameters so that the card does not have to go on-line every time it is used to transact. This has the affect of reducing network traffic and loads on authorisation systems all of which result in reduced cost.
- Carefully monitor interchange income to ensure it is optimal. As discussed earlier the manner in which transactions are prepared and cleared to schemes can affect what the acquirer is charged by the scheme and ultimately what the scheme pays to the Issuer.

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