Frequently Asked Questions About Interchange Fees and Credit Card Payment Systems

As Georgia and other states consider legislative action to adjust or eliminate sales taxes on credit card fees and other changes to the card payment process, we've compiled answers to some frequently asked questions on the topic. In light of past proposals seeking government intervention into what is often referred to as the interchange process, it is important to highlight the risks that would come with such action.

1. Who receives what in the interchange process? Asked a different way, what do merchants receive from the interchange fee? What do banks receive? What do processors receive? What do consumers receive?

When a customer and merchant engage in a sale of goods or services in a four-party payment transaction, the customer pays the sale price to an issuing bank and receives benefits like extended warranties, purchase-protection insurance and rewards. Credit card networks, such as Visa and Mastercard, transmit data to the issuing bank, which either authorizes or declines the transaction. Networks also search data for signs of fraud based on pattern recognition and set compliance standards and the interchange fees that merchants pay per transaction. A credit card issuer – which is most commonly the customer's bank (the issuing bank) or a credit union – pays the merchant's bank (the acquiring bank) the transaction's sale price minus the interchange fee. Merchants receive the sales price minus a merchant discount rate from the acquirer.

The fees associated with credit card transactions help to facilitate a globally connected network that allows consumers to make purchases almost anywhere in the world. A disruption to that system would have negative effects on more than just convenience, too. It would weaken card issuers' ability to protect consumer purchases and personal information. It would also, according to a recent study,[1] lead to decreases in economic activity and a net reduction in business activity and profitability. Furthermore, additional costs in transactions would result in fewer rewards for card usage and reduced purchasing power for consumers. The overall result would be greater burdens and fewer benefits for all stakeholders across a global system of transactions.

2. Why can't credit card companies and other financial transaction processors just make the change to separate sales tax from the cost of an item if they already regularly update their systems?

A change like this would disrupt credit card companies' global systems and impose greater burdens on processors and consumers alike. These disruptions could include customers having to make two separate purchases at a time – the purchase itself and another card swipe, or perhaps cash transaction, to cover a sales tax – and would limit banks' abilities to cover operating costs

[1] https://laweconcenter.org/resources/state-regulation-of-interchange-fees/

and protect against fraud. Naturally, these costs would be passed on to consumers. It would also require merchants and processors to collect more information from cardholders, leading to privacy concerns. Furthermore, there is potential for legal challenges. For example, earlier this year, the Office of the Comptroller of the Currency, an independent bureau of the U.S. Department of the Treasury, filed an amicus brief supporting a lawsuit that looks to block Illinois' Interchange Fee Prohibition Act. Illinois is the only state government that has moved to impose restrictions on interchange fees, and although that legislation will not go into effect until 2025, researchers and economists have noted the likelihood of potential market disruptions and negative effects on stakeholders. Beyond operational problems between transaction parties, there would likely be a drop in card usage, which would lead to reduced revenue for merchants, as well as for banks and credit unions. Smaller enterprises would be disproportionately affected because they are not as well suited to distribute costs. Consumers would also receive fewer rewards and other benefits to credit card usage.

3. Is there a way to bifurcate risk between the bank and the merchant?

The card network system of exchange helps to mitigate risk and balance advantages between banks and merchants. However, consumers – and their bank accounts – and retailers are not the only parties in these transactions. For example, the acquiring bank is the bank on the merchant's end of the transaction, and the issuing bank is the cardholder or consumer's bank. Merchant fees in a three-party network – a transaction between a merchant, consumer and the acquiring bank or payment processor – and interchange fees in a four-party network – a transaction between a merchant, consumer, acquiring bank or processor and an additional issuing bank – are set at default multilateral levels that balance competing interests. While optimal fees in these transactions cannot be objectively determined, they are set to find a balance of pricing that optimizes matches between cardholders and merchants. Balancing prices leads to system optimization over time, benefitting cardholders with rewards and other card perks and merchants via increased sales as a result of the efficiencies of electronic transactions, the ability to spend money not in one's wallet and the deferred payment function of credit cards.

4. On a $100 sale at a retailer, assuming sales tax is 7 percent, what are the different layers of risk for the merchant, issuer, bank, and government? Does the government hold the least amount of risk?

In cases of fraudulent credit card purchases, banks and merchants typically bear the greatest burden. The issuing bank or the merchant will assume liability and reimburse virtually all charges that were not authorized by the cardholder. The issuer would also shoulder the expense of issuing new credit cards. Liability between the merchant and issuer is circumstantial, but typically, if a purchase is made with a physical credit card, the issuing bank is liable. Merchants incur liability when they fail to comply with network-mandated authorization requirements and are more commonly found liable when a transaction is made without a physical card. Repeated instances of fraud may also lead to a merchant's account being terminated by its payment processor. The acquiring bank is not responsible for reimbursement, but may absorb chargeback costs if the merchant is unable to pay. Acquirers may also face penalties if the merchants they serve exhibit high rates of fraud. All these parties must deal with the operational costs associated with dealing with fraud. So, in the purchase in question, the issuing bank is most likely to reimburse the cardholder $107 if the merchant has met authorization requirements. The government carries the least risk, as they have little involvement in these processes and would likely not be required to pay back the $7 in taxes.

5. Why should the government not interfere in the interchange process?

Any government action limiting or prohibiting issuing banks from retaining interchange fees on taxes would create harmful market distortions to several parties involved in relevant transactions. Consumer benefit from credit card usage would decrease, as issuing banks would offset revenue loss by reducing card rewards. Interference in the interchange process would reduce business activity and profitability, including a reduction in card usage. This would result in lower revenue for merchants with a disproportionate impact on small and medium-sized merchants as opposed to large, "big-box" merchants. Banks and credit unions would also see revenues drop, particularly affecting smaller local banks disproportionately. Finally, reduced economic activity in this context would also lower revenue for state and local governments, and the costs of enforcing sales taxes would increase as well. However, the state should regularly examine the vendor compensation package offered to retailers – currently, 3% of the first $3,000 of taxes collected and 0.5% of any amount collected over $3,000 – to ensure it is keeping up with the rate of inflation and to account for any additional costs accrued through the interchange process as technology and consumer use continues to evolve.