New Debit-Interchange Rates Could Hurt ISOs

ISO & Agent Weekly | Wednesday, July 14, 2010

By Kate Fitzgerald

ISO&AGENT WEEKLY

New debit card interchange rules that are likely to go into effect next year if the Senate passes the financial services reform bill could take a bite out of ISOs' profit margins, observers say.

“The debit-interchange amendment will most likely have far-reaching implications for ISOs and acquirers,” says Steve Mott, a principal at BetterBuyDesign, a Stamford, Conn.-based payment consultancy.

If debit-interchange fees decline after the Federal Reserve Board sets new “reasonable and proportional” rates based on their actual cost, ISOs likely would see a decline in the portion of the discount rate acquirers pay them. But it is too soon to forecast how steep the cuts would be or what effect they might have on the ISO business model, Mott says.

Some analysts speculate regulators could cut interchange from 25% to 75% of current levels. The National Retail Federation, a Washington, D.C.-based retail trade group, says debit interchange costs merchants some $20 billion annually.

The Federal Reserve would have nine months after the financial-reform bill passes to set new debit-interchange rates, and the rules would become effective 12 months after the bill is signed into law.

The Electronic Transactions Association lobbied against the debit-interchange amendment, sending a letter last month to members of the congressional conference negotiating provisions of the bill. The letter said ISOs' business models often depend on a portion of fees merchants pay acquirers. “If interchange fees are capped, they are in the undesirable position of experiencing the greatest reduction in income. Quite simply, this can translate into ISOs and other small businesses in the payments chain having to downsize, lay people off or possibly go out of business,” the Washington, D.C.-based ETA said.

One From Another

Several players are excluded from the new debit-interchange rules, and some observers say this could pose considerable challenges for merchants and processors.

Institutions with less than $10 billion in assets would not have to abide by the new debit-interchange rules. Also excluded are governments delivering benefits through debit cards and issuers of reloadable prepaid cards

The legislation does not specify how merchants would differentiate among these players at the point of sale, and there is debate about the potential complexity the excluded groups pose for merchants and processors.

“Presently, we don't know of any system that automatically sorts transactions at the point of sale by the size of the institution," Mary Bennett, the ETA's director of government and industry relations, tells *ISO&Agent Weekly*. "This law is going to cause a lot of headaches, and it may result in greater costs to ISOs and processors to sort out different types of debit transactions."

Though merchants generally applaud the arrival of debit-interchange regulations, at least one merchant-processor consultant is skeptical about the long-term benefits for merchants and processors.

"The term 'interchange' is used pretty loosely in the industry, and not only does it vary a lot, but there are a lot of other fees built into interchange that are not affected by legislation," Robert Livingstone, president of IdealCost.com, a West Palm Beach, Fla.-based merchant-processor consulting firm. "Banks set interchange fees, but those are passed on to merchants through a complicated chain, which includes a general processing fee that's built into merchants' payment-acceptance costs. We assume the actual debit-interchange piece will be lower, but it doesn't mean overall costs will be substantially lower."

Merchants may be faced with diverse additional costs in accommodating the exempted debit cards. "Merchants may have to invest in new tools not yet on the horizon that would let them know which cards offer higher or lower transactions. And they may end up spending considerable time, especially smaller merchants, trying to find out which card is cheapest to accept, taking time away from sales and service," IdealCost.com's Livingstone contends.

New Way Of Thinking

Although merchants have not yet assessed all the potential implications of debit-interchange regulation, most do not foresee complications. "This is the start of a new way of thinking for the financial community," says Jeff Lenard, a spokesperson for the Washington, D.C.-based National Association of Convenience Stores.

"For the first time, there is going to be some consideration for the actual cost of interchange and fair competition between debit networks. This may force banks to have to fight for customers with better deals," he says.

Sonja Hubbard, CEO of E-Z Mart Food Stores Inc., a 300-unit convenience store chain based in Texarkana, Texas, says she does not anticipate difficulties at the point of sale in handling debit cards from different-size issuers.

"The exemptions won't cause hassles," Hubbard says. "All cards will be treated the same way. While some will cost the retailer, and ultimately consumers, more, that won't make any difference as to how things happen at the point of sale."

Merchants likely "won't know which cards cost more," and the incentives they offer to steer customers to lower-cost payment forms "will be applied in an even-handed way," she says.

Excerpted from a longer article appearing in the July/August issue of ISO&Agent *magazine*.