The Credit-Card Fees Merchants Hate, Banks Love and Consumers Pay; Growing and largely hidden interchange economy creates 'a giant reverse Robin Hood'

Andriotis, AnnaMaria; Torry, Harriet.**Wall Street Journal (Online); New York, N.Y.** [New York, N.Y] 21 June 2020.

In Silver Spring, a Maryland suburb of Washington, D.C., cash is becoming a rarity as consumers increasingly rely on credit cards, apps and online purchases during the pandemic.

For Bump 'n Grind, an independent coffee and vinyl record shop, that is a growing burden. The shop, which roasts its own coffee beans, spent less on green beans last year ($12,827) than on the card-processing fees ($18,645) it pays to the financial institutions that enable cashless payments.

"That's depressing," said owner David Fogel. "All you know is at the end of the month they're pulling out X thousands of dollars."

Mr. Fogel closed his store for nearly two months during the coronavirus pandemic while continuing to roast and deliver beans. The coffee shop is now open for takeout. Depending on whether he can renegotiate his rent, Mr. Fogel said he may shut his store to focus on wholesale coffee beans.

The store is a microcosm of tensions sparked by the growing and largely hidden interchange economy: the stream of fees merchants pay to banks. The fees help drive the payments system. Merchants hate them; banks love them.

In the middle are consumers. The fees push up prices for everyone. They also fund a growing array of cardholder rewards—which flow largely to affluent customers.

When you buy something with a credit card, the merchant often remits around 2% of the price to the bank that issued it. The fee can be higher, at times around 3%, on more generous reward cards. The bank returns some of these "interchange fees" (also called swipe fees) to the cardholder in the form of rewards, including cash back, points or airline miles. (Separate, smaller fees are paid to the payment networks, such as Visa Inc. and Mastercard Inc., and to the financial institution that helps process the transactions.)

Because retailers' profit margins are slim, they pass some of the fees to customers through higher prices, according to the National Retail Federation.

Customers typically pay the same price whether they use cash or a card. Economists say this equates to a transfer from users of cash to users of cards. How much? On average a cash-using household pays $149 a year and a card-using household receives $1,133, according to a 2010 study from the Federal Reserve Bank of Boston .

The discount to customers who often make hundreds of thousands of dollars a year "is a giant reverse Robin Hood moving billions of dollars a year," said Aaron Klein, a fellow at the Brookings Institution specializing in the financial industry.

Americans made 67% more credit-card payments in 2018 than in 2012. PHOTO: Melissa Lyttle for The Wall Street Journal

The card industry disagrees. "Americans of all income levels responsibly use and receive great value from their cards and rewards programs," said Jeff Tassey, board chairman of the Electronic Payments Coalition, which represents financial institutions and card networks. "Bigger spenders will receive proportionately more rewards, which tend to be proportional to spending—how else would you do it?"

Most U.S. households that have credit cards have a rewards card, even those earning less than $20,000 a year, according to Greg Weed, director of card-performance research at Phoenix Marketing International, which tracks the credit-card market.

Merchants paid issuers $53.6 billion in Visa and Mastercard credit-card interchange fees in 2019, more than double what they paid in 2012, according to the Nilson Report, a trade publication. The growth reflects two things. First, credit-card use rose in recent years: Americans made 67% more credit-card payments in 2018 than in 2012, according to the Federal Reserve . Second, banks rolled out more cards with higher interchange fees to pay more rewards.

To help pay for rewards, banks also are charging higher rates. Average annual percentage rates for credit cards have risen more for those with the lowest credit scores: by about 4.2 percentage points since 2010, according to WalletHub.com, a consumer-finance website, compared with about 1.3 points for those with the highest credit scores.

Low-income consumers who have credit cards often find the costs they incur for carrying balances outweigh rewards. Tanya Villani of Bedford, Va., relies on credit cards to help pay for groceries, gasoline, car insurance and medical costs when her disability income of roughly $1,000 runs out every month. In January she was approved for a rewards card, a QuicksilverOne card from Capital One Financial Corp., which has a $300 spending limit. She currently owes around $300 and is paying interest of about 25%.

"I needed some kind of buffer for my income," she said, "to last me to the end of the month."

Tanya Villani relies on credit cards when her disability income of roughly $1,000 runs out every month. 'I needed some kind of buffer for my income to last me to the end of the month,' she said. PHOTO: STEPHANIE KLEIN-DAVIS for The Wall Street Journal

Merchants, who have battled card companies over interchange fees for decades, are using the impact on low-income consumers to help make their case.

Card networks bar merchants from accepting some but not all of their credit cards. A merchant who accepts Visa credit cards can't turn down premium cards such as JPMorgan Chase & Co.'s Sapphire Reserve, which are often carried by wealthier Americans and have higher interchange fees. Roughly 63 merchants, including Amazon.com Inc., Lowe's Cos., Gap Inc. and Starbucks Corp. are suing Visa, Mastercard and card-issuing banks, alleging they collude to avoid competing over interchange fees. The merchants allege card fees are a hidden tax, including on lower-income consumers who are more likely to pay with cash.

Merchants want the freedom to select which cards they accept and to negotiate interchange fees directly with card-issuing banks rather than Visa and Mastercard.

Card companies say this would confuse consumers. They say interchange fees help cover costs such as fraud, innovation, reissuing cards with updated features and charge-offs (losses on unpaid cardholder bills). They add that cards help avoid cash-related costs including theft.

Large merchants fare better in the interchange economy than small. Costco Wholesale Corp. switched its co-branded cards in the U.S. from American Express Co. to Visa in part because Visa lowered Costco's interchange fees on all Visa-branded credit cards close to zero, according to people familiar with the matter.

Few small businesses have that negotiating power. Visa and Mastercard planned to increase interchange fees for many merchants beginning in July, and the changes in some cases would have been the hardest on small businesses, The Wall Street Journal reported. Visa and Mastercard have since said they delayed those changes until next year.

Some merchants bypass cards entirely, but that has become harder during the coronavirus pandemic.

Until it hit, Mississippi Records in Portland, Ore., only accepted cash, and credit-card fees were a big reason why, said owner Eric Isaacson.

The closure of his physical store from mid-March to June, and an 80% drop in revenue, meant that for the first time in his 17 years in business, Mr. Isaacson set up an online store and got a Square Inc. contactless card reader.

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"It's breaking my heart, but I'm doing it, people are so freaked out about money being dirty," he said.

Mr. Isaacson reopened the store June 13, with only two people allowed inside at a time, wearing masks. The store now accepts both cash and cards, although Mr. Isaacson said he hopes to get rid of card payments at some time in the future.

Card executives say the pandemic shows how cards provide value to consumers and merchants.

Governments in many developed countries, including Australia and much of Europe, have capped credit-card interchange fees. The U.S. only has caps on debit-card fees.

To lower interchange fees, merchants are looking for a way around card networks.

Bump 'n Grind owner David Fogel said that last year he spent more on card fees than he did on green coffee beans. PHOTO: Melissa Lyttle for The Wall Street Journal

Large retailers, including Walmart Inc. and Target Corp., urged the Fed to develop a real-time payments system as an alternative to card networks.

Separately, more merchants, led by gas stations and supermarkets, are pursuing their own payment apps and other options that lower the stores' fees.

"Banks have no incentive to curtail [credit-card spending], because they make money on it, obviously airlines make money and merchants make money…so they don't have an incentive to prevent people from using credit cards," said Joanna Stavins, an economist at the Boston Fed and a co-author of the 2010 study.

https://www.wsj.com/articles/the-credit-card-fees-merchants-hate-banks-love-and-consumers-pay-11592731800