Treasury Report on Credit and Debit Card Interchange and Other Fees
June 2010

Background

The Fiscal Year 2010 Consolidated Appropriations Act Conference Report directs the Financial Management Service (FMS) to report back to the House and Senate Appropriations Committees on the Federal government's payment of interchange and other fees on credit and debit card transactions. Specifically, FMS was directed to identify potential costs savings and other benefits to the Federal government if FMS were able to effectively negotiate (1) changes in the rates and fees assessed by card networks, and (2) modifications to the rules and regulations of the card networks which restrict the Federal government's ability to determine the types of card payments it accepts and the methods by which its transactions are processed.

This report provides Treasury's response to the Congressional requirement.

Current Operations

The Federal government is among the largest public sector merchants. Treasury[1] supports over 4,350 Federal agency locations currently accepting credit and debit cards from citizens, businesses, and other governmental entities to pay for goods, services, fees, and fines, among other items. In Fiscal Year 2009, Federal agencies accepted over 80 million credit and debit card transactions totaling $8.6 billion. Interchange and other fees associated with these transactions cost the Federal government over $116 million, making credit and debit cards Treasury's most expensive collection mechanism.

Card holders transact more frequently using debit products than credit products. Over 60% of total card transactions in Fiscal Year 2009 were placed on a debit card, with PIN debits accounting for the majority of the transactions. However, credit products accounted for nearly 60% of total dollar volume, indicating that larger transactions are more frequently conducted using credit. Treasury's effective interchange rate for credit transactions is more than four times the effective interchange rate for debit transactions, and interchange associated with credit transactions accounts for 85% of total interchange.

Treasury does benefit from favorable interchange rates offered to government merchants in some instances, such as rates that apply regardless of how a transaction is tendered (e.g., card present versus card not present) or the type of card used (e.g., rewards versus non-rewards). However, these favorable rates are applied neither consistently across all transactions nor equitably across the payment networks. Moreover, payment networks frequently change rates and can unilaterally raise fees.

[1] Treasury data analysis and approach does not include the United States Postal Service, convenience fees charged by third parties for payments to the Internal Revenue Service for business and individual taxes, and Non-appropriated Fund Instrumentalities that manage their collections outside of Treasury. Only Federal agencies processing with FMS's card acquirer are included.

Negotiating Strategy

Treasury believes that any strategy to negotiate reductions in the Federal government's interchange costs must be achieved within the current card processing infrastructure, without substantive changes to systems and work flows. To achieve this goal, Treasury would negotiate for terms that are operationally straightforward for issuers, acquirers, and card networks to implement, and that do not make Federal government transactions an exception process for the global industry.

In addition, Treasury would distinguish between the fees charged by the card networks and the fees paid to acquiring banks and payment processors for strictly operational services. The terms must ensure realistic compensation for the latter parties, so that acquiring banks are willing to compete for the Federal government's business.

The agreements negotiated by Treasury should also recognize the Federal government's unique business model in delivering essential public services to all citizens, and in acting as a not for profit entity with the lowest risk profile. This acknowledgment would help Treasury negotiate terms in better alignment with its primary responsibility as steward of taxpayer funds.

Finally, Treasury would negotiate to reduce the multiplicity of rates and fee categories for card transactions, and to moderate the card networks' ability to unilaterally raise fees. The complex structure of card network fees makes it difficult to route and process credit card transactions, in particular, at the lowest possible cost.

Approach

Ideally, to negotiate the best terms for the taxpayer, Treasury would have independent authority to restrict or opt out of accepting cards for particular transactions or types of transactions, without threat of penalty from a card network, if processing the transactions would not be in the public interest due to excessive cost. This simple capability would allow Treasury to negotiate card acquiring agreements with a bank and with the card networks on relatively equal terms, but without imposing direct costs or service requirements on a card network or its members.

Of course, the desired outcome would not be to reject card transactions, but rather to cost effectively process all card transactions that may be convenient for any citizen or business interacting with their government. Having the option to restrict or opt out of certain transactions based on cost would put Treasury in an equitable position to negotiate fair terms on behalf of the taxpayer and to achieve the outcomes discussed below.

Outcomes

Treasury believes that significant cost savings could be achieved if it were able to negotiate the following terms. First, Treasury would negotiate for one interchange rate that the government would pay to all networks for all credit transactions, and a separate single interchange rate the government would pay to all networks for all debit transactions. The rates would apply

regardless of how a transaction is tendered (e.g., card present versus card not present), the type of card used (e.g., rewards versus non-rewards), or the type of Federal collection (e.g., sale of goods, loan repayment, fine, etc.). For all credit transactions, Treasury would seek to negotiate a maximum rate that would be a fixed percentage of transaction dollars. For all debit transactions, Treasury would seek a maximum rate that would be the same for PIN and signature debit, and would be a fixed fee per transaction. These general rates would displace the current complex of rate categories applied to Federal agency transactions.

Second, Treasury would seek the ability to establish a maximum transaction amount, or other threshold, above which an individual credit card transaction would not be allowed. Above a certain dollar amount, credit cards are simply not an appropriate payment mechanism under most Federal programs, especially when the Treasury can process the transaction at considerably less expense with any other paper or electronic payment mechanism.

Third, Treasury would negotiate for reasonable limits on the card networks' unilateral right to raise or institute new fees. Such reasonable limits are important not only for reasons of equity, but also to ensure that reductions in the Federal government's interchange costs are not offset by unilateral increases in other mandatory card network fees.

Fourth, Treasury would pursue the right to establish and collect a processing fee from an individual card holder to defray the Treasury's cost of processing a particular transaction. Such a fee would not be used in most cases, but might be charged, as an example, in those cases where the cost of a unique transaction should be reasonably born by the individual card holder receiving some special benefit from the transaction and not by the general taxpayer. The amount of the fee would be limited to the cost to the Treasury imposed by a card network for the transaction, and would be deposited into the Treasury as a miscellaneous receipt.

Estimated Cost Savings and Other Benefits

If Treasury could negotiate a flat fee per transaction for all PIN and signature debit transactions, the estimated annual savings would range from $4.8 million to $5.0 million, or 28% to 29% of total debit interchange. This estimate is based on Fiscal Year 2009 debit sales of $3.7 billion and interchange costs of $16.9 million, and assumes that the average cost per debit transaction declines by $0.10. Additional savings could be realized if the upward trend in debit card usage continues.

If Treasury could negotiate a flat rate based on a percentage of dollars for all credit transactions, the estimated annual savings would range from $25.5 million to $28.4 million, or 27% to 30% of total credit interchange. This estimate is based on Fiscal Year 2009 credit sales of $4.9 billion and interchange costs of $94.2 million, and assumes that the average cost per credit transaction declines by a range of $0.84 to $0.93.

If Treasury established a maximum amount of $9,999.99 for an individual transaction, the estimated annual savings would range from $5.4 million to $8.8 million, or 5% to 8% of total interchange. This estimate is based on Fiscal Year 2009 data of 18,000 transactions for $10,000 or more, representing $442 million in total collections and $8.8 million in interchange costs.

This maximum would eliminate transactions costing on average $492 and would reduce the overall unit cost per transaction by up to $0.11 potentially. This savings estimate excludes the costs of directing payers to use an alternative payment mechanism for large dollar transactions and the cost of the alternative mechanisms. In addition, in some cases card holders could split large dollar transactions into multiple smaller transactions, thereby reducing the estimated savings.

These savings estimates are presented as ranges for a variety of reasons, including that implementation of one change may affect the savings potential of another change. For example, implementing the maximum transaction amount in conjunction with a lower overall credit interchange rate would affect the total savings that could be achieved by lowering the credit interchange rate alone, since enforcing a maximum transaction amount would change the base of dollars processed through credit transactions.

In addition to tangible cost savings, the Federal government would realize other operational benefits if Treasury could implement all or part of the strategy discussed above. For example, the resources Treasury expends on interchange management, expense forecasting, and various accounting and reconciliation activities could be redirected to other activities.

Overall Savings

Treasury estimates annual cost savings in the range of $0.45 to $0.49 per transaction if Treasury were able to negotiate the changes in rates and the transaction processing flexibilities discussed above. This savings equates to $36 million to $39 million in reduced annual interchange fees based on Fiscal Year 2009 transaction volumes, dependent on the Treasury's ability to secure the target rates and other outcomes.