The Costs of Payment Card Transactions: Interchange Fees and Merchant Discount Rates

With card payments there is often confusion between the meaning of the terms “Interchange Fees” and “Merchant Discount Rates”. These costs are applied to Visa, Mastercard, American Express and other credit, debit and prepaid card transactions.

Interchange Fees

These fees are paid by the transaction **Acquiring bank** to the card **Issuing bank;** they are inter-bank fees**.** Their purpose is to contribute to the Issuer’s costs in issuing cards and processing transactions.

The fees, or rather the interchange **rates**, are set by the card schemes, and will vary depending on the type of card and type of transaction. The fees may be capped by national or regional regulations. For example, in 2015 the EU set maximum rates of 0.3% for credit cards and 0.2% for debit cards. These rates are much lower than those used in previous years. Similar restrictions have been enacted in the US for US-issued debit cards. The effect of these lower rates reduces card issuers’ income significantly, and can make them more selective in choosing cardholders, less generous in providing benefits, and perhaps making issuers consider charging their cardholders monthly or annual fees.

Merchant Discount Rates (or Merchant Service Charge)

These fees are paid by the **Merchant/Retailer** to the **Acquiring bank** and are included in the contract (Merchant Service Agreement) between the two parties.

The rates will include interchange fee costs, which have traditionally made up the majority of the Merchant Discount Rate. The name “Merchant Discount Rate” is rather misleading, and the term “Merchant Service Charge” which is clearer, is also used.

The rates will vary considerably, based on the size and type of retailer, and reflecting the costs and risks involved. Major retailers will often own their own payment terminals, manage all transactions from their central computer hosts and that, together with the size of their business, will enable them to negotiate lower rates.   Merchant discount rates for e-commerce are typically higher due to additional costs related to higher risks.

The card schemes (Mastercard, Visa, etc.) are **not** involved in the setting of Merchant Discount Rates.

When acquiring banks pay lower Interchange Fees, they can afford to reduce Merchant Discount Rates, lowering Merchant/Retailer costs. This can, in theory, result in lower prices for all their customers.

Richard Johnstone has worked in the field of chip card payments for over 30 years, including 12 years at the Mastercard Chip Centre of Excellence. He currently presents a 3-day EMV Chip Card Training course for Barnes International, a provider of EMV card personalisation validation systems.