Fact Sheet

Interchange and the Payments Industry

Every business establishes a price for the goods and services it provides, and the electronic payments business is no exception. As one element of the cost of acceptance, interchange is a small fee in relation to the enormous value merchants receive for accepting MasterCard payment cards.

For almost 40 years, MasterCard has established default interchange fees that have proven to be the most efficient way to balance costs in the system and promote a strong, competitive payments industry that benefits cardholders, merchants and financial institutions. Today, some 25,000 financial institutions provide the cards and services that allow hundreds of millions of consumers and 25 million merchants around the world to benefit from the convenience and security of electronic payments.

What is Interchange?

Interchange is established to incent banks to issue payment cards and merchants to accept those cards. It is a small fee paid by a merchant's bank (also known as the acquiring bank) to the cardholder's bank (the issuing bank) and serves to compensate the issuing bank for a portion of the risks and costs it incurs to maintain cardholder accounts. These costs include finance costs for the interest-free period between the time a consumer makes a purchase and pays his/her bill, credit losses, fraud protection and processing costs.

By shifting some of the cost of the payment system from issuers and their cardholders to acquirers and their merchants, a system operator like MasterCard can encourage greater utilization of its cards. Often referred to as "balancing the system" this makes the system more efficient and valuable to cardholders and merchants.

When a purchase is made with a payment card, the acquiring bank pays the issuing bank an interchange fee to help offset a portion of these costs. The acquiring bank eventually collects this fee from the merchant as a component of the merchant discount fee.

Merchant Discount Fee

The merchant discount fee is generally a small percentage of the price of the goods or services the merchant pays its bank when a payment card is used. The merchant discount fee is negotiated between the merchant and its bank. MasterCard is not a party to this contract nor does it have a role in the negotiation between the merchant and its bank.

The Four-Party System

MasterCard operates a "four-party payment system" that processes transactions and routes information between cardholders' and merchants' financial institutions in fractions of a second. This system, enabled by interchange, allows hundreds of

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millions of cardholders and 25 million merchants around the world to benefit from the convenience and security of electronic payments. The MasterCard network links together the four parties involved in each transaction (hence the name "four-party system") as described below:

- The cardholder's issuing bank markets and issues MasterCard payment cards to consumers and extends credit to cardholders from the time a purchase is made until payment is due. Broad issuance of MasterCard cards benefits merchants through increased sales.
- The cardholder uses a MasterCard payment card to purchase goods and services at more than 25 million acceptance locations around the world.
- The merchant accepts MasterCard payment cards in exchange for goods and services and receives guaranteed payment as well as increased sales.
- The acquiring bank contracts with merchants and provides them with MasterCard acceptance and processing services. Cardholders benefit from widespread acceptance, giving them more places to shop conveniently and safely.

Three-party systems, like American Express, charge merchants discount fees which are often higher than the cost of accepting MasterCard cards. Because three-party system operators act as both issuer and acquirer, they do not have to establish interchange fees because they can balance their systems through internal accounting transfers. They can use funds collected directly from merchants to cover some of the costs on the issuing side of their businesses.

How Interchange Rates Are Established
By balancing the costs, risks and rewards within the four-party system, interchange promotes a strong, competitive and efficient payments industry. In the absence of interchange, this system could not exist. MasterCard establishes default interchange rates to provide incentives to merchants to accept cards and to card issuers to provide innovative card products that meet consumer demand. These rates apply in the absence of a bi-lateral fee agreement between an issuing and an acquiring bank. Importantly, while MasterCard sets default interchange fees to enable efficient interaction among thousands of financial institutions, it receives no revenue from those fees.

Setting interchange requires a careful balance. If interchange rates are set too high, merchants' desire and demand for accepting MasterCard cards will drop. If interchange rates are set too low, card issuers' willingness to continue to create innovative products and issue cards will drop, and as a result so will consumer demand for, and use of, cards.

MasterCard periodically reviews interchange rates to ensure the rates continue to maximize the benefits of the MasterCard system for merchants, financial institutions and cardholders. MasterCard has more than 100 different interchange rates that recognize differences between card programs and that incent new acceptance categories, like fast food or taxicabs. In addition, MasterCard incents the use of new payment system technologies, for example, by offering reduced rates for online merchants who implement Secure Code to protect cardholder data.

Interchange Transparency and Merchant Communication
MasterCard is leading the industry in bringing transparency to the interchange system. MasterCard posts all of its U.S. interchange rates and operating rules that apply to merchants on its merchant Web site, www.mastercardmerchant.com, along with comprehensive information to help merchants understand the rates and how they apply. These steps are intended to help foster an ongoing dialogue with merchants, acquirers and others about interchange rates and disclosure.

MasterCard also has established the MasterCard Merchant Advisory Group which meets regularly to give merchants a forum to share with MasterCard what they need to engage in the payments system in the most efficient and beneficial manner possible.

Merchants Benefit from Interchange
Payment cards help merchants operate more successfully. Electronic payment transactions are faster at checkout and merchants who comply with issuers' security guidelines are guaranteed to receive payment for these transactions. With less cash on hand, merchants are less vulnerable to theft and can provide safer workplaces for their employees. Electronic payments also save time and money by easing payment reconciliation.

Accepting payment cards provides merchants with incredible benefits at a fair price. The benefits to merchants of accepting MasterCard are significant and include increased sales, as more people are attracted to stores that accept their card of choice; management of lending losses, fraud and the costs of complying with regulations. Interchange enables merchants to participate in a payment system that is far more cost-effective for them than issuing their own proprietary card or some other form of credit.

Consumers Benefit from Interchange
Interchange helps foster choice, innovation and security – all vitally important to today's consumer. By providing incentives for card issuers, interchange encourages banks to innovate and develop new payment options, broaden the range of card programs available to consumers and invest in cutting-edge security and fraud prevention measures. Interchange helps to spur new types of card programs to meet different consumer needs and a wide variety of payment card reward and incentive programs that help people get more out of every dollar they spend. Moreover, these programs incent card usage, which ultimately benefits merchants.

Interchange Promotes a Competitive Payments Industry
For almost 40 years, the default interchange rates MasterCard has established have proven to be the most efficient way to balance costs in the system and promote a strong, competitive payments industry.

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Moreover, the courts and regulators in the U.S. have found interchange to be legal, efficient and an essential component to the operation of a payment system like MasterCard. Some countries have rejected a free-market approach toward interchange and have regulated interchange levels. In those countries, including Australia, where the level of interchange has been reduced as a result of regulatory intervention, cardholders have seen their fees rise and their card benefits reduced.

In essence, interchange promotes competition and more cards in circulation, thus benefiting every participant in the system – cardholders, merchants and financial institutions.

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Contacts:
Sharon Gamsin. 1-914-249-5622, sgamsin@mastercard.com

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