STATE ISSUE BRIEF

CALIFORNIA BANKERS ASSOCIATION

Interchange

Interchange fees, also known as "swipe fees," are critical to the financial ecosystem, supporting a range of consumer-friendly banking services. These fees, paid by retailers and restaurants for use of the payment systems for processing card transactions, help fund free and low-cost checking accounts, popular credit card rewards programs, and advancements in payment technology and fraud reduction efforts.

Long before financial institutions issued credit cards, merchants extended credit directly to their customers and maintained a ledger to track transactions and balances. Merchants were responsible for collecting payments and those retailers' incurred losses from unpaid accounts. Today, the responsibility for losses has shifted to banks and credit card issuers. Interchange fees are paid by merchants for the use of payment networks and these fees help cover the costs of secure payment networks, fraud prevention, and the convenience of electronic payments. For consumers, these fees indirectly fund several key banking services:

Low-Cost and Free Checking Accounts: Financial Institutions rely on interchange fee revenue to offer low-cost and free checking accounts. Interchange fees offset the cost to maintain these accounts, such as processing transactions, providing customer support, managing fraud risks, maintaining ATMs and online banking systems, and complying with regulatory requirements.

Credit Card Rewards: Popular rewards programs, such as cashback, travel points, and discounts, are largely funded by interchange fees. These programs offer tangible benefits to cardholders, allowing them to earn rewards on everyday purchases.

Innovation and Security: Interchange fees also support technological innovations like contactless payments and fraud protection, which improves convenience and security for consumers.

Highlights

- ***Interchange fees are essential to maintain safety and innovation of the payments system.***
- ***Revenue from interchange fees supports low-cost and free checking and credit card rewards programs.***
- ***Reductions in interchange fees benefit big-box retailers but do not result in reduced costs to consumers.***

Retailers' Argument vs. Consumer Reality

Retailers and restaurant groups have long argued that interchange fees raise their operating costs and claim that cutting these fees would lower prices for consumers. However, evidence does not support this argument. In countries like Australia and the EU, where interchange fees were capped, retailers did not pass on the savings to consumers. Instead, retailers retained the extra profits, while consumers experienced higher banking fees and reduced rewards.

Retail pricing is driven by market demand, not payment processing costs. Lower interchange fees do not compel merchants to lower prices, meaning consumers typically bear the costs through reduced banking benefits, not lower prices at stores.

Consumer Groups Weigh In

Consumer advocates recognize that interchange fees are crucial for maintaining free checking accounts, a vital service for millions of consumers. These fees provide a reliable revenue stream that enables banks to offer low-cost or no-cost checking accounts, especially for low- and moderate-income households. In a letter to the Pittsburg Courier on March 2024, Benjamin Chavis, chairman of the National Association for Equal Opportunity in Higher Education (NAFEO) and president and CEO of the National Newspaper Publishers Association (NNPA) wrote about the reduction of interchange fees mandated by the Federal Reserve in 2011 after the passage of the Dodd Frank Act. Said Chavis, "*Although large corporations benefited from not having to pay as much in swipe fees, this price control hit the small financial institutions that had to subsidize this giveaway for them hard. It gave many of them no choice but to reduce fee-free checking from 75 percent to 40 percent…While lowering the current cap on debit card swipe fees may appear like a reasonable measure to take in what has proven to be a lackluster economy for many merchants, my experiences — from coordinating youth activities with Rev. Martin Luther King to serving on the national board of directors for the NAACP — have underscored the importance of scrutinizing policies for their broader implications.*"

Financial Inclusion Progress in Jeopardy

Despite the decline of free checking following the 2011 reduction in interchange fees, significant progress has been made in recent years to bring low- and moderate-income consumers into the financial mainstream. The number of Bank On-certified accounts, which offer safe, affordable banking options, has increased from around 40 in 2019 to nearly 450 today, representing over 60 percent of the domestic deposit market; more than half (53 percent) of all US bank branches offer a Bank On-certified account. These accounts are now accessible to 95.5 percent of low- and moderate-income households. The FDIC recently reported a drop in the number of unbanked households to 4.5 percent nationally, and 4.3 percent in California- the lowest since the survey began, with millions of households gaining access to banking services.

Illinois Litigation

The 2024 Illinois Interchange Fee Prohibition Act (IFPA) prohibits issuers, acquirers, processors, and payment card networks from receiving or charging merchants any interchange fees on the tax or gratuity portions of electronic payment transactions. While restaurant groups in Illinois contended that eliminating interchange fees would allow tipped workers to retain a larger share of their earnings, no such benefit would be conferred to service workers in California. California Labor Code Section 351 already explicitly prohibits employers from deducting credit card processing fees from employees' tips. This statute mandates that when a patron includes a gratuity on a credit card payment, the employer must remit the full tip amount to the employee without any deductions for processing costs.

In December 2024 a federal judge issued a preliminary injunction against enforcing the IFPA for national banks and federal savings associations, citing conflicts with federal laws. The result of this decision is that the vast majority of interchange transactions are now exempt from the law, which was scheduled to take effect in July 2025.

####