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Regulation of Debit Interchange Fees

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Summary

Although the United States has seen continued growth of noncash or electronic payments, debit card transactions outpaced credit card transactions and other forms of payments in 2009. When a consumer uses a debit card in a transaction, the merchant pays a “swipe” fee, which is also known as the interchange fee. The interchange fee is paid to the card-issuing bank (the consumer’s bank that issued the debit card), and the fee covers the bank’s costs to facilitate the transaction. Section 1075 of the Dodd Frank Act (15 U.S.C. 920), also known as the Durbin Amendment, authorizes the Federal Reserve Board to prescribe regulations to ensure that the amount of any interchange transaction fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer.

The Federal Reserve may consider the authorization, clearance, and settlement costs of each transaction when it sets the interchange fee. The Durbin Amendment allows the interchange fee to be adjusted for costs incurred by debit card issuers to prevent fraud, but the Federal Reserve is prohibited from considering other costs associated with the transaction. Debit card issuers with less than \$10 billion in assets would be exempt from the regulation, which means that smaller financial institutions may receive a larger interchange fee than larger issuers. The legislation also prohibits network providers (e.g., Visa and MasterCard) and debit card issuers from imposing restrictions that would override a merchant’s choice of the network provider through which to route transactions.

On June 29, 2011, the Federal Reserve issued a final rule to implement the Durbin Amendment, which includes a cap on the interchange fee for large issuers. The rule went into effect on October 1, 2011. Merchants that currently pay fees above the regulated interchange fee would likely benefit from the Durbin Amendment; large debit card issuers that would lose revenue under the regulated cap would be opposed. Many small debit card issuers that are exempt from the rule, however, are also opposed to the Durbin Amendment given concerns that a two-tiered interchange pricing system may not be sustainable over time. On September 9, 2016, legislation was introduced in the 114th Congress, H.R. 5983, the Financial CHOICE Act of 2016, which would repeal the Durbin Amendment. Specifically, Section 335 of the Financial CHOICE Act would repeal Section 1075 of the Consumer Financial Protection Act of 2010. On September 13, 2016, H.R. 5983 was ordered to be reported by the House Financial Services Committee.

This report begins with a description of the debit payments process and network pricing. Possible effects of the Durbin Amendment on the banking system are then discussed in light of comments by Federal Reserve Board Chairman Ben Bernanke. Given that banks have increasingly relied upon non-interest or fee income during the past two decades, the decline in overall bank operating income may be material; smaller banks may be disproportionately affected because a large share of their fee income is generated through checking and savings deposits-related services. Technological developments by network providers, however, could reduce the revenues generated from this line of business for large and small banks even in the absence of the Durbin Amendment.

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Introduction

The United States has seen continued growth of noncash or electronic payments even though debit card transactions outpaced credit card transactions and other forms of payments in 2009.¹ When a consumer uses a debit card in a transaction, the merchant pays a “swipe” fee, also known as the interchange fee. The interchange fee is paid to the consumer’s bank that issued the debit card, and the fee covers the bank’s costs to facilitate the transaction. Section 1075 of the Dodd-Frank Act (15 U.S.C. 920),² known as the Durbin Amendment, authorizes the Federal Reserve Board to mandate regulations to ensure that any interchange transaction fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer.

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This report begins with a description of the debit payments process and network pricing. It then discusses the possible effects of the Durbin Amendment on the banking system in light of comments by Federal Reserve Board Chairman Ben Bernanke.⁶ Given that banks have

¹ Debit cards were used in 35% of noncash payments in 2009, while checks and credit cards were used 22% and 20%, respectively. See *The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006-2009* at http://www.frb-services.org/files/communications/pdf/press/2010_payments_study.pdf.

² P.L. 111-203, the Dodd-Frank Wall Street Reform and Consumer Protection Act.

³ The legislation does not regulate the interchange fees associated with reloadable prepayment cards or debit cards provided pursuant to a federal, state, or local government administered program.

⁴ See <http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm> and <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110629b1.pdf>.

⁵ See National Retail Foundation website at <http://www.nrf.com/>. Smaller retailers may potentially benefit more than large retailers from the Durbin Amendment. Because of the large volume of transactions, some large merchants may be able to negotiate interchange fees below the proposed regulatory cap discussed in the next section. Consequently, some merchants could see their interchange fees increase, up to the rate cap.

⁶ See [http://www.bloomberg.com/news/2011-05-12/bernanke-says-lawmakers-should-be-concerned-about-swipe-\(continued...\)](http://www.bloomberg.com/news/2011-05-12/bernanke-says-lawmakers-should-be-concerned-about-swipe-(continued...))

increasingly relied upon non-interest or fee income during the past two decades, the decline in overall bank operating income may be material; smaller banks may be disproportionately affected because a large share of their fee income is generated by providing services related to checking and savings deposits.⁷ Technological developments by network providers, however, could reduce the revenues generated from this line of business for both large and small banks even in absence of the Durbin Amendment.⁸

How Network Pricing Works

Network providers, such as MasterCard and Visa, facilitate the interactions of four parties under a business model referred to as a “four-party system,” consisting of the cardholder, the merchant, the acquirer, and the issuer. (See **Figure 1** below, which illustrates the payment distribution.) When a debit card is used in a transaction, the merchant pays a fee that is collected by the merchant’s bank (the acquirer). For example, a debit cardholder makes a \$100 purchase, the merchant retains \$98.57 and pays \$1.43 (merchant discount fee) to process the transaction. The \$1.43 is distributed among the acquirer, the cardholder’s bank (the issuer) that issues the debit card, and the network provider that links the acquirer and issuer. The network provider retains 10 cents, the acquirer keeps 30 cents, and the issuer is paid \$1.03.⁹ The \$1.03 paid to the issuer is known as the interchange reimbursement or “swipe” fee. This fee may cover some or all of the costs to process the debit card transaction (authorization, clearing, and settlement); fraud prevention and investigation; and other fees, such as customer service, billing and collections, compliance, network connectivity fees, and network servicing fees.

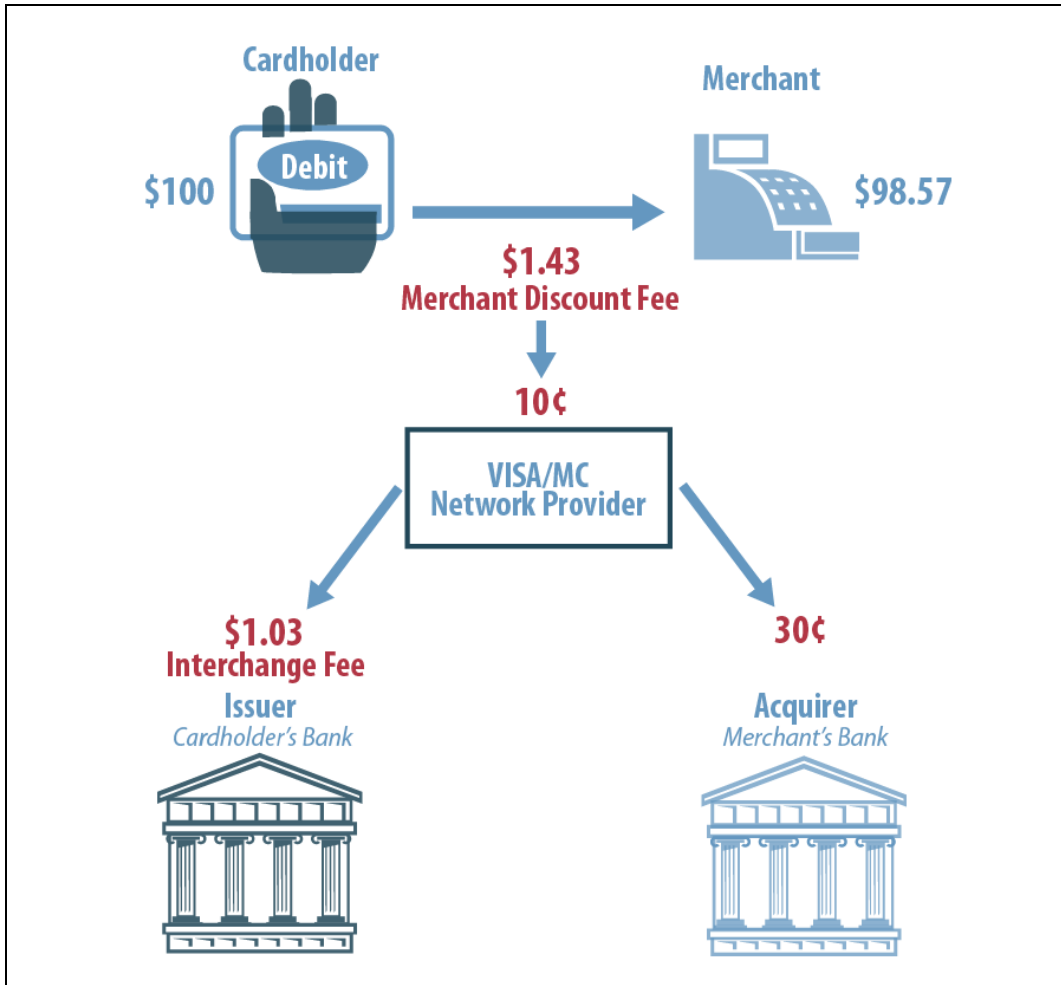
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⁷ Robert DeYoung and Tara Rice, “How Do Banks Make Money? The Fallacies of Fee Income,” *Economic Perspectives*, Fourth Quarter 2004 at http://www.chicagofed.org/digital_assets/publications/economic_perspectives/2004/ep_4qtr2004_part3_DeYoung_Rice.pdf.

⁸ In addition, small banks (or banks with less than \$10 billion in assets) have seen declines in both numbers and asset share; thus, a substantial market transformation or consolidation of these institutions is expected to occur. See <http://www.americanbanker.com/bankthink/operating-revenue-community-banks-1038365-1.html>.

⁹ A debit card transaction has a lower interchange fee relative to a credit card transaction. Credit card authorizations essentially become loans made by issuers that carry default risk. This translates into higher interchange fees for these transactions.

Figure I. Four-Party Network



Source: The Congressional Research Service (CRS).

Network providers enter into contractual arrangements with issuers and acquirers rather than deal directly with merchants and customers. *Network providers set the interchange fees* to encourage greater issuance of payment cards by issuers, which in turn generates more transactions over their networks. Issuers may choose to rebate some of their interchange fee profits to cardholders in the form of reward points, which may entice greater debit card use. Consequently, some financial institutions may have greater ability to negotiate interchange fees with the network providers, especially if they have a large number of customers who frequently use debit cards. Nevertheless, network providers ultimately set interchange fees paid to issuers.

In addition to setting the interchange fees, network providers have association rules that merchants must follow. For example, *no surcharge* rules forbid merchants to levy surcharges when cardholders use debit cards, which prevents merchants from passing any of the merchant discount fees directly to cardholders. The *honor-all-cards* rules require merchants to take any cards that bear the network association's brand name, which means merchants cannot turn away credit or signature debit cards that may have higher merchant discount fees if the association's name appears on the card. Moreover, merchants are prohibited from offering discounts for the use of particular types of cards, which is known as the *non-differentiation* rule. Merchants are also required to accept these cards at all of their outlets, which is referred to as the *all-outlets* rule.

Hence, association rules prevent merchants from passing on to customers the costs to use cards and thereby discourage card use. The ability of merchants to pass such costs on indirectly to customers, therefore, would vary from product to product.¹⁰

Implementation of the Durbin Amendment

After conducting a survey to obtain transaction cost information,¹¹ the Federal Reserve issued a rule that caps the interchange fee received by large issuers (with \$10 billion or more in assets) to 21 cents plus 0.05% of the transaction. The Federal Reserve also allows for a 1 cent adjustment if the issuer implements fraud-prevention standards that satisfy the requirements set out in an interim final rule.¹² The final rule would also require every issuer regardless of size to link with at least two unaffiliated network providers, and thus it would allow merchants to choose the network provider with the lowest fees to process their debit card transactions.¹³ Mandatory compliance dates for network providers and issuers are October 1, 2011, and April 1, 2012, respectively.

Decline in Interchange Fee Revenue for Issuers

The final rule does not regulate the interchange fee that a network provider may charge; it only restricts the amount of interchange fee revenue that large-issuing banks may receive. This could theoretically result in a two-tiered interchange fee system in which small banks would receive higher interchange fee revenue from network providers.¹⁴ The sustainability of a two-tiered interchange pricing system, however, is questionable.¹⁵ The ability to charge different prices for the same service usually occurs when the *supplier* of the service can segment its customers into

¹⁰ Merchants may be able to pass more of the interchange fee costs to customers on products with fewer substitutes, which may face less competition in the marketplace, but not on highly competitive products.

¹¹ See <http://www.federalreserve.gov/newsevents/press/bcreg/20101216a.htm> and <http://edocket.access.gpo.gov/2010/pdf/2010-32061.pdf>. The Federal Reserve reported an *average interchange fee* of 44 cents per transaction and a *median total processing cost* of 11.9 cents per transaction for all debit transactions in the proposed rule. On December 16, 2010, the Federal Reserve proposed a cap of 12 cents per transaction, which only considered authorization, clearing, and settlement costs. Fraud prevention expense had not been incorporated in the proposed rule.

¹² See <http://www.federalreserve.gov/newsevents/press/bcreg/20110629a.htm> and <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110629b1.pdf>. For example, suppose a customer makes a \$38 purchase, which is the average debit card transaction in 2009 reported by the Federal Reserve. Under the rule, the interchange fee received by the bank would be 21 cents plus 0.05% (approximately 2 cents) for a total of 23 cents. If the bank's fraud protection measures are deemed sufficient by regulators, the bank may receive an additional 1 cent for a total of 24 cents. The equivalent interchange fee for a \$100 transaction would be 27 cents, or 21 cents plus 0.05% (5 cents) and 1 additional cent. The interim final rule concerning the fraud-prevention standards may be found at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110629a1.pdf>.

¹³ The effective date for the network exclusivity prohibition is April 1, 2012. Issuers of certain health-related prepaid cards have a delayed effective date of April 1, 2013, or later in certain circumstances.

¹⁴ The Government Accountability Office (GAO) evaluated various options for reducing interchange fees that were similar to those taken by other countries, but a two-tiered pricing structure that varies by issuer size was not considered. See Testimony of Alicia Puente Cackley, GAO's director of Financial Markets and Community Investment, before U.S. Congress, Senate Committee on Appropriations, Subcommittee on Financial Services and General Government, 111th Cong., 2nd sess., June 16, 2010 at <http://www.gao.gov/products/GAO-10-821T>; and GAO, *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants But Options for Reducing Fees Pose Challenges*, GAO-10-45, November 2009, <http://www.gao.gov/new.items/d1045.pdf>.

¹⁵ See Testimony of Governor Sarah Bloom Raskin before U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *Interchange Fees*, 112th Cong., 1st sess., February 17, 2011 at <http://www.federalreserve.gov/newsevents/testimony/raskin20110217a.htm>.

different categories. In this situation, however, the suppliers of the service (issuers) would be segmented into groups rather than the customers (merchants). Although some network providers have agreed to implement a two-tiered interchange pricing system,¹⁶ they may still find that competition for transactions over their networks would be difficult to sustain over time, especially in light of the next regulatory component of the Durbin Amendment.

The final rule would also give merchants greater ability to route transactions to network providers. Because merchants would have more choice over the processing of debit transactions, the increased competition may lead to a disappearance of the two-tiered interchange system over time and result in lower interchange revenue for smaller issuers.¹⁷ If smaller issuers (e.g., community banks and credit unions) represent only 20% of debit transaction volume, then network providers, who would be in competition for the routing of merchant transactions, may be more inclined to respond to merchant pressures for lower interchange fees rather than to pressures by smaller issuers for higher fees.¹⁸ Consequently, interchange profits for small issuers might still decline over time, and losses could be material if their processing costs are higher relative to those of large issuers.¹⁹

The Three-Party System

The American Express model is a three-party system that consists of the cardholder, the merchant, and the network provider, who serves as both the acquirer and issuer; the three-party system is illustrated in **Figure 2** below. American Express enters directly into contractual arrangements with merchants and customers; in this arrangement, American Express is the network provider, the acquirer, and the issuer.

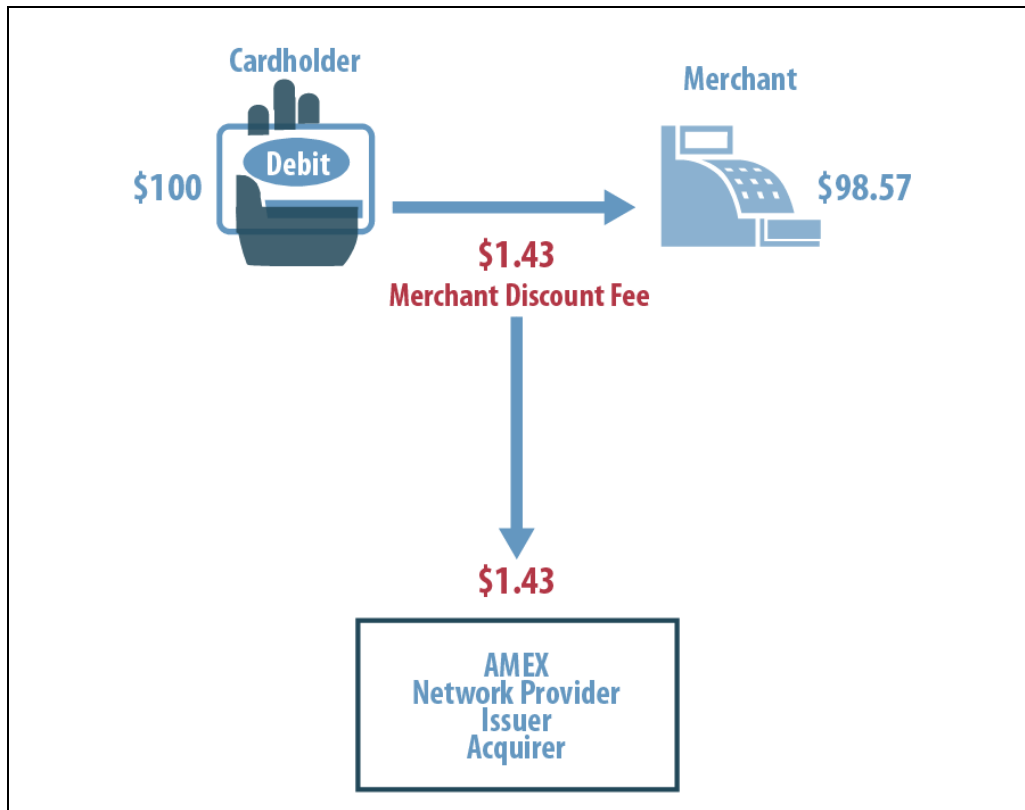
¹⁶ According to Electronic Banking Options, which is a merchant account industry blog, Visa, Star, Pulse, Shazam, and CU-4, which process an estimated 80% of PIN debit-card transactions, have all committed to a two-tier interchange system. See announcement at <http://electronicbankingoptions.com/2011/03/04/a-two-tiered-interchange-system>.

¹⁷ Interchange fees in other countries fell after the elimination of rules, which were imposed by four-party network providers, were found to be anti-competitive and in violation of anti-trust laws in those countries. See James M. Lyon, *The Interchange Fee Debate: Issues and Economics*, Federal Reserve Bank of Minneapolis, Banking and Policy Issues Magazine, June 2006, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3235; and Stuart E. Weiner and Julian Wright, "Interchange Fees in Various Countries: Developments and Determinants," *Review of Network Economics*, vol. 4, no. 4 (December 2005) at <http://www.newyorkfed.org/research/conference/2005/antitrust/WeinerWright.pdf> and http://profile.nus.edu.sg/fass/ecs/jkdw/weiner_RNE_dec05.pdf.

¹⁸ According to the American Bankers Association, large issuers process approximately 80% of debit card transactions. See http://www.federalreserve.gov/newsevents/files/ABA_comment_letter_20101213.pdf, page 2.

¹⁹ The Federal Reserve survey of debit card issuers only included the issuers that would be affected by the legislation. (See http://www.federalreserve.gov/newsevents/files/merchant_acquirer_survey_20100920.pdf.) Given the larger volume of transactions, the cost per transaction for larger issuers might be lower than that of small issuers. The interchange fee cap set by the Federal Reserve, therefore, reflects the median processing cost of only large as opposed to all U.S. debit card issuers. For remarks on the impact of the two-tiered interchange system from trade associations that represent smaller issuers, which would consist of community banks and credit unions, see <http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=83508> and <http://www.cuna.org/newsnow/11/wash032411-4.html>.

Figure 2. Three-Party Network



Source: CRS.

After the Reserve Bank of Australia eliminated no-surcharge rules and lowered the interchange fees collected in the four-party system, MasterCard Worldwide reports that three of the four largest payment card issuers in Australia restructured themselves to resemble a three-party system.²⁰ Some firms in the United States, therefore, might also consider restructuring their business models to bypass the impending regulation. For example, given that American Express links directly to the merchant and the customer, there is no explicit interchange fee paid to a customer's bank. This feature limits regulators' ability to enforce the interchange fee restrictions on firms that operate under a three-party system business model.²¹ Given that the fees charged by the merchants' bank are not restricted by the Dodd-Frank Act, the Federal Reserve acknowledges that there are "practical difficulties in limiting the amount of a merchant discount charged in a three-party network." The Federal Reserve, therefore, requested comments on the appropriate way to treat three-party networks and apply the routing provisions under a three-party system.²²

²⁰ See <http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-conclusions.pdf> and <http://www.rba.gov.au/media-releases/2008/mr-08-28.html>. In MasterCard Worldwide's assessment, the Australian payments system has become more expensive for payment cardholders, and there is little evidence of retail price reductions by merchants (See <http://www.masterintelligence.com/upload/169/113/MC53-Interchange-FNL-S.pdf>).

²¹ See comments made by American Express at http://www.federalreserve.gov/SECRS/2011/March/20110303/R-1404/R-1404_022211_67230_584162046602_1.pdf.

²² See the Federal Reserve Board's proposed rule on interchange fees on page 81727 at <http://edocket.access.gpo.gov/2010/pdf/2010-32061.pdf>.

Even in the absence of the interchange fee caps, technological innovations in the electronic funds transfer network industry arguably may eventually result in an industry restructuring such that issuers in a four-party system would experience declines in interchange revenue. For example, technology now exists that would allow consumers to submit payments directly to other consumers or small businesses by using the recipient's email.²³ A new payment service that would allow people to use a payment card to send money directly to another personal payment card has been announced, which would bypass the need for banks to process numerous financial transactions.²⁴ Such developments might allow network providers that currently use a four-party system to restructure themselves to link directly to merchants and customers, and therefore routing through a merchant bank and a customer bank would not be necessary to complete the transaction. Hence, interchange fee revenues for four-party issuers may already be vulnerable to innovation and technological change.

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²³ See <http://www.pymnts.com/nyce-and-cashedge-join-forces-to-bring-real-time-person-to-person-payments-to-financial-institutions-20110203006568/?hpb>.

²⁴ See <http://www.blackweb20.com/2011/03/17/visa-announces-new-payment-service-takes-on-paypal/>.

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