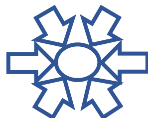

Financial Services Management

Debit-Card Interchange Fees

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https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-reg-ii-20231025.pdf

Impact Assessment

- Banks of all sizes but most especially mid-sized banks are likely to see significant reductions in debit-card interchange profitability.
- Competitive disparities between bank and nonbank issuers could increase.
- Consumer benefits would accrue if merchants pass on fee reductions in prices, product quality, and/or services as the Fed anticipates.
- Further reductions in low-cost transaction-account services are likely despite Fed expectations that the market has fully absorbed those evident after the 2011 fee cap and will not permit additional harm to vulnerable consumers.

Overview

As suggested when the Fed last year finalized controversial new debit-card routing requirements,[1] the central bank is now proposing a sharp reduction in the cap mandated on debit-card interchange fees under the Dodd-Frank Act's Durbin Amendment for debit-card issuers with over $10 billion in assets.[2] The Board premises this on significant drops in the costs associated with debit-card offerings, but its methodology from 2011 is largely unchanged and thus may not reflect current and prospective costs related to factors such as current and pending deposit-insurance, capital, liquidity, CRA, and open-banking standards that have sharply increased costs associated with bank funding sources and subsequent asset allocation since the methodology was first crafted on 2009 data.

Impact

The Board's current 21 cent base interchange fee along with related pricing was set in 2011 based on 2009 data after the law was first implemented.[3] Since then, the Fed has as noted changed routing requirements but left the cap as initially set. Now, based on its view that debit-card processing costs have sharply dropped, this proposal would reduce base fees by approximately thirty percent as well as drop the ad valorem fee and slightly raise the cap related to fraud. The board bases this proposal on its most recent study of

[1] See **INTERCHANGE11**, *Financial Services Management*, October 11, 2022.

[2] See **INTERCHANGE2**, *Financial Services Management*, January 4, 2011.

[3] See **INTERCHANGE7**, *Financial Services Management*, July 11, 2011.

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debit-card transactions showing what it finds to be a significant reduction in the cost of these transactions that the law requires be reflected in revised fee caps.

However, the new methodology is the same as the old methodology. While data-processing costs have surely dropped, the costs of holding deposit accounts have sharply increased due to factors such as higher interest rates and a raft of new rules. Inflation has also risen, making nominal costs comparisons still more problematic.

The NPR indicates that the Fed believes this new approach would recover 98.5 percent of actual costs, although the Board does not intend this approach to ensure that all covered issuers recoup all costs all the time even though the Fed recognizes that costs differ significantly for different issuers. In its 2009 survey, the board found base-component costs ranging from three to 66 cents per transaction along with significant discontinuities at various cost points. At the time, the Board decided that setting "reasonable and proportional" costs as required by the Durbin Amendment did not require consideration of high-cost issuers, a stand also reflected in the newly-proposed fee schedule. This approach is likely to prove problematic to smaller banks above the $10 billion threshold which have higher costs as well as to exempt small banks due to market forces not allowing them to charge higher fees despite this statutory exception. Importantly, the Board considered adopting tiered pricing to adapt to high-volume, low-cost issuers and low-volume, high-cost ones. It decided against this because it is deemed impractical from both the Fed and industry perspectives. Comment is not expressly sought on this point.

The proposal also does not address another issue that has arisen since the 2011 rule: "partnerships" between large fintechs and tech-platform companies with banks below the $10 billion threshold able to offer far lower interchange fees on debit cards and certain prepaid products due to processing efficiencies derived from high-volume transactions with the nonbanking entity that then sharply reduces its costs compared to other merchants. Opponents of this exemption argue that it violates the "reasonable and proportional" requirement, but the Fed does not address expanding coverage to indirect relationships between exempt banks and large nonbanks. As a result, co-branded debit cards could become a still larger market presence as fintechs and tech-platform companies expand their consumer-focused financial services.

The Durbin Amendment includes specific provisions requiring the Fed to conduct a cost-benefit analysis on these fees. The proposal's conclusions find that the most significant effect is to lower merchant debit-card fees with retailer competition "generally" ensuring that these cost savings are then passed on to consumers in terms of lower prices, better quality, or enhanced service (e.g., accepting debit cards for small transactions). The analysis disputes the impact lower fees would have on exempt issuers and acknowledges that covered issuers might alter other account fees to make up for lost income although it also notes ways covered issuers could offset lost income (e.g., via lower operational costs, smaller rewards). The Board also suggests that, despite the demonstrable costs to lower-balance transaction-account holders following the initial interchange-fee cap, the market may now not permit significant product-offering or cost changes that adversely affect debit-card or other bank-product customers. The Board also finds no evidence that prior fee caps led issuers to discontinue debit-card offerings. However, many of these conclusions are based on net effects that do not differentiate interchange-fee implications by income or wealth distribution or by the size of affected banking organizations.

What's Next

The FRB proposed this revised fee on a 6-1 vote on October 25; comments are due ninety days after the proposal is published in the *Federal Register*. Fees set in the final rule would govern from its effective date until June 30, 2025. At that point, fees would be adjusted based on the new approach to cost surveys described below.

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The Supreme Court is set to hear a case later this year challenging the Fed's overall debit card interchange fee approach. Given that much of it is reflected in this proposal despite lower fees, a victory for the plaintiffs could throw this approach into doubt. Legislation is also pending to curb interchange fees on credit cards.[4] Its sponsors are pressing hard to enact it in this Congress. Should they do so, then the structural issues outlined above related to debit cards would prove still more challenging to banks of all sizes but those with tech "partners." Should the legislation not pass, banks could seek to adjust for lost debit-card revenue by curtailing offerings and pressing account-holders instead to rely on credit cards. This could increase household debt burdens as well as create obstacles to efficient, low-cost payment for households unable to get cost-effective credit cards.

Analysis

A. Fees

Under the proposal, the base component would decrease from 21 cents to 14.4 cents, a sharp decrease but well above the nine-cent cap recommended by merchant groups. The ad valorem component would decrease from five basis points (multiplied by the value of the transaction) to four basis points (multiplied by the value of the transaction) and the fraud-prevention adjustment would increase from one cent to 1.3 cents.

B. Adjustments

The interchange fee cap would henceforth be adjusted every other odd year to better ensure that the caps reflect the law's requirement for fees set in a "reasonable and proportional" way based on actual, allowable cost. No changes in the Board's current base-cost and *ad valorem* calculation methodology are proposed, but the Board does propose modest changes to the fraud adjustment and indicates that it might turn to this in a future proposal. Otherwise, future changes to permissible fees would not be released for public comment.

C. Request for Comment

Issues on which comment is sought include:

- the two-year evaluation process, with the Board again stipulating it is not seeking views on its allowable-cost methodology, but views are solicited on the ad valorem and fraud adjustment methodologies;
- an alternative cost-recovery target;
- reporting and data-quality problems with the current cost surveys;
- the need for data-survey record retention requirements;
- implementation timing; and
- the quality of the Board's economic-impact analysis.

[4] See **INTERCHANGE10**, *Financial Services Management*, August 11, 2022.

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