SEPTEMBER 2022

ISSUE BRIEF

Interchange

BACKGROUND

The Durbin Amendment, offered by Senator Dick Durbin (D-IL), was enacted in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The amendment established an artificial price cap, determined by the Federal Reserve, on the interchange fees merchants paid for the system that gives them the convenience of accepting debit cards. It also established new network routing requirements for debit cards.

While the interchange fee caps receive more attention, the Durbin Amendment's network routing provision also functions as a backdoor price control. Like the fee caps, the routing provision is an example of government interference in a well-functioning market, which leads to price distortions that benefit the largest retailers at the expense of community banks, credit unions, and other financial institutions. More importantly, it ultimately hurts consumers and restricts innovation, and is another clear example why the Durbin Amendment must be repealed.

Prior to 2010, credit unions had the freedom to choose which payment networks they wanted on their debit cards. Credit unions could select among competing networks based on the various features they offered, including security, reliability, and other consumer benefits. Credit unions exercised their choice based on what served their members best, and members selected cards based in part on these network features. Importantly, members could be confident that their network choice would be honored by merchants at the checkout counter.

But under the Durbin Amendment, all U.S. debit cards are required to participate in multiple unaffiliated networks. Retailers—not consumers—now dictate which network is used. These routing and exclusivity provisions have harmed consumers, who can no longer choose a debit network that reflects their preferences on payment speed, reliability, and security. Instead, merchants can re-route debit transactions to the lowest-cost network, regardless of its commitment to security. This means consumers may lose access to certain features associated with a debit network, including zero-liability protection or text message alerts. Retailers may save a few pennies on each transaction, but consumers are more exposed to fraud risk while networks have less incentive to invest in innovative data security measures.

Further, many credit unions were told that the Durbin Amendment would not impact their interchange rates because they are exempt from the price controls that apply to institutions with more than $10 billion in assets. In reality, these so-called “exempt” credit unions have seen a steady erosion of interchange income since 2010 according to Federal Reserve and NAFCU studies. A key reason for this decline is the network routing requirement, which applies to all financial institutions regardless of asset size.

RECENT DEVELOPMENTS

On July 28, 2022, Senators Dick Durbin (D-IL) and Roger Marshall (R-KS) introduced S. 4674, the Credit Card Competition Act of 2022 (CCCA), legislation that would extend the Durbin Amendment’s debit interchange network routing requirements to also cover credit cards. However, credit cards from institutions with under $100 billion in assets would be exempt from this new requirement. While the legislation was referred to the Senate Banking Committee, it could emerge at any time as an amendment on the Senate floor. A House version of the legislation has not been introduced as of yet, but retailers have been seeking the introduction of a House companion.

CREDIT UNION CONCERNS

As credit unions’ experience with the original Durbin Amendment has proven, even a high asset threshold “exemption” offers no protection to smaller financial institutions. Credit unions of all sizes and their 131 million member-owners would suffer significant negative impacts if this legislation were enacted.

As noted above, the Durbin Amendment contained a provision that was supposed to exempt institutions under $10 billion in assets from the new debit price caps. However, studies have shown that “exempted” institutions actually have seen their per-transaction interchange income decline by more than 10 percent in real terms. This loss is particularly harmful for community financial institutions with lower transaction volumes—the kind of credit unions and banks that operate in rural and underserved communities—because they face drastically higher per-transaction costs for settling electronic payments.[1] For larger financial institutions that are

[1] Electronic Payments Coalition. “What Exemption? Community Banks and Credit Unions Lose Under the Durbin Amendment” (June 24, 2021). https://electronicpaymentscoalition.org/resources/what-exemption-community-banks-and-credit-unions-lose-under-the-durbin-amendment-2/.

governed by the Federal Reserve's Regulation II (which implemented the Durbin Amendment) the fixed component of the debit interchange fee cap has not once been adjusted for inflation since it was set in 2011. Importantly, credit unions face statutory limitations that make it difficult to compensate for this decline in revenue through offering additional products or making alternative investments.

Consumers have also directly felt negative impacts from the Durbin Amendment. First, the Durbin Amendment led to a significant reduction in the number of debit card rewards programs, with 30 percent of cardholders losing debit rewards two years after enactment.[2] Second, the availability of free checking accounts suffered a major decline as an immediate result of Regulation II. According to research from the Federal Reserve, the implementation of Regulation II caused the proportion of no-monthly-fee checking accounts to drop to 30 percent from an expected level of 65 percent without the interchange fee cap. Even financial institutions meant to be exempt from the Durbin Amendment suffered from the "spillover effects" of regulation as market pressures caused a policy targeted to large institutions to instead affect the broader industry as a whole.[3] A survey of industry stakeholders and review of academic literature conducted by the Government Accountability Office also found a causal relationship between the Durbin Amendment and a decrease in free checking accounts. The Durbin Amendment was among the five laws most cited as impacting the availability of free checking and an academic study found that banks offset lost interchange fee revenue with higher fees on checking accounts.[4] Clearly, enacting similar changes to the credit card interchange market risks redoubling these negative consequences for consumers, and market forces would lead to routing requirements for large financial institutions functioning as a backdoor price cap for community credit unions and banks.

RETAILERS DISTORTING REALITY

When they argued for the original Durbin Amendment, retailer groups frequently claimed those restrictions would lead to cost savings for consumers and small

[2] Electronic Payments Coalition. "Out of Balance: How the Durbin Amendment has Failed to Meet Its Promise" (May 2022). https://2oynji41vtot1y4f8s1gnb8a-wpengine.netdna-ssl.com/wp-content/uploads/2022/05/EPC.DurbinStudiesPaper.pdf.
[3] Manuszak, Mark D. and Krzysztof Wozniak. "The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation," (2017). Finance and Economics Discussion Series 2017-074, Board of Governors of the Federal Reserve System. https://doi.org/10.17016/FEDS.2017.074.
[4] Government Accountability Office. "Banking Services: Regulators Have Taken Actions to Increase Access, but Measurement of Actions' Effectiveness Could Be Improved" (February 2022). https://www.gao.gov/assets/gao-22-104468.pdf.

businesses and greater choice and reliability in payment networks. Unfortunately, these promises did not come true. Research from the Federal Reserve Bank of Richmond found that rather than cut prices in response to lower debit interchange costs, merchants had "asymmetric reactions" as 98.8 percent did not decrease prices and 21.6 percent even implemented price increases.[5] Among businesses, big box retailers clearly saw greater benefits from the Durbin Amendment's price caps than small businesses, many of which were harmed by government distortion of the market price for interchange fees.[6] The Durbin Amendment's routing provisions also had a harmful effect on financial institutions and consumers. The incidence of fraudulent debit transactions has more than doubled since the Durbin Amendment was enacted and allowed retailers to process transactions over less secure networks.[7] Consumers who had chosen a debit card based on the network's reputation for payment security had their choice invalidated, and the cost of remediating consumers in response to the increasing volume of fraudulent transactions continues to fall on financial institutions. Extending similar requirements to credit cards would also allow retailers to choose alternative payment networks that do not provide consumers with the rewards they expect based on their choice of credit card.

In fact, electronic payments offer benefits to retailers that far outweigh the costs of interchange fees. An independent survey of small merchants found that a majority recognize the value of electronic payments and are satisfied with their interchange costs, and that merchants even prefer credit cards to debit cards despite the higher interchange fees associated with credit card payments.[8] Increasingly businesses are attempting to refuse to accept cash payments at all, deciding that the costs of handling cash, though they are not itemized in the manner of interchange fees, greatly exceed the costs of accepting electronic payments. This trend has been so strong that major municipal governments have felt the need to restrain it with legislative

[5] Wang, Zhu, Scarlett Schwartz, and Neil Mitchell. "The Impact of the Durbin Amendment on Merchants: A Survey Study" (2014). Economic Quarterly, Issue 3Q, pp. 183-208. https://ssrn.com/abstract=2655978.
[6] Zywicki, Todd J., Geoffery A. Manne, and Julian Morris. "Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses" (April 25, 2017). International Center for Law and Economics. http://laweconcenter.org/images/articles/icle-durbin_update_2017_final.pdf.
[7] Federal Reserve. "2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions" (May 2021). https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2019.pdf.
[8] Javelin Strategy & Research. "Small Merchants on Interchange: Value More Important than Cost" (March 2017). https://electronicpaymentscoalition.org/resources/report-small-merchants-on-interchange-value-more-important-than-cost-2/.

interventions of their own.[9] While contactless payment methods offered obvious health and safety benefits to merchants and their employees, as well as to consumers, during the height of the COVID-19 pandemic, merchants also realize the more general economic benefits they stand to capture from the increasing growth of electronic payments.[10] Executives from companies like Kroger, Macy's, Chipotle, and NCR are all on the record recognizing the value of electronic payments in lower costs, higher transaction values, and increased customer convenience.[11]

In total, debit card issuers lost more than $100 billion in revenue from 2012 through August 2021 as a result of the Durbin Amendment.[12] As retailer groups and their allies in Congress work together to try to impose new routing requirements for credit card transactions, even small financial institutions exempt from the proposed changes are at risk of further revenue losses.

Credit union leaders understand the significant threat this legislation poses, including what lost revenue actually means for the ability to serve credit union members.

For example, Thomas Domingue, President and CEO of Labor Credit Union in Washington, DC, said:

> *This legislation will have a significant detrimental impact on our ability to continue providing services to underserved areas and groups within our membership. A reduction in our interchange iincome, which this legislation will result in, has a compounding impact. Every $0.10 reduction in interchange income results in $1 being removed from our ability to lend to those in need, or to provide critical services such as checking accounts for free.*

[9] New York Times. "New York City Stores Must Accept Cash, Council Says" (January 23, 2020). https://www.nytimes.com/2020/01/23/nyregion/nyc-cashless-ban.html; Washington Post. "D.C. Council votes to outlaw cashless stores, allow some prisoners to seek early release" (December 1, 2020). https://www.washingtonpost.com/local/dc-politics/dc-council-december-votes/2020/12/01/aafa3e72-334d-11eb-a997-1f4c53d2a747_story.html.

[10] CNBC. "Digital payments soared during the pandemic and are here to stay" (August 17, 2021). https://www.cnbc.com/2021/08/17/digital-payments-soared-during-the-pandemic-and-are-here-to-stay.html.

[11] Electronic Payments Coalition. "The Value of Electronic Payments: Merchants in Their Own Words" (April 4, 2022). https://electronicpaymentscoalition.org/resources/the-value-of-electronic-payments-merchants-in-their-own-words/.

[12] Electronic Payments Coalition. "The Cost of the Durbin Amendment" (August 9, 2021). https://electronicpaymentscoalition.org/resources/the-cost-of-the-durbin-amendment/.

NAFCU OPPOSITION AND ASK

The Credit Card Competition Act (CCCA), S. 4674, represents an unwarranted and heavy-handed government intrusion into the credit card payment market that would hurt credit unions and consumers alike, while allowing the largest retailers to pocket significant cost savings. It is nothing more than a “big box bailout” for the nation’s largest retailers under the guise of a competition bill. The CCCA’s asset threshold exemption would not protect smaller institutions such as credit unions. History has already taught us that the market pressures of the new credit card routing requirements would affect smaller institutions in the same way that the Durbin Amendment led to a loss of interchange revenue even for the below-threshold financial institutions it claimed to exempt. Consumers would see higher account fees and a continued decline in the availability of free checking accounts. Many would lose access to credit card rewards. Furthermore, there is nothing in this legislation guaranteeing that retailers would actually lower consumer prices in line with their own lower payment costs.

NAFCU urges lawmakers to reject and oppose this misguided legislation.