

Fed's New Swipe At Debit Fees Stirs Up Dilemma For Banks

By **Kristen Larson** (December 19, 2023)

Financial services trade associations are urging the Federal Reserve Board of Governors to reject proposed rule changes that would reduce the cap on debit card interchange fees charged or received by card issuers and payment networks.

In support of their position, the associations point to what happened when the Fed capped debit transaction costs in 2011, pursuant to Regulation II under the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act.



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"The last time the Federal Reserve placed a cap on debit transaction costs, two things happened: The availability of free checking accounts declined and merchants pocketed the difference in cost," a group of three associations wrote in a statement urging the Fed to reject the proposal.

The board is accepting comments until Feb. 12 on its notice of proposed rulemaking to amend Regulation II to lower the maximum interchange fee a large debit card issuer can receive for a debit card transaction.

Notably, the rule would also establish a regular process for updating the maximum amount every other year going forward. If adopted, the proposed rule would become effective at least 60 days after the final rule is published in the Federal Register.

Financial services providers and card issuers have asserted that the proposed rule is based on stale and faulty data in reports to the board, ignores their increased digital security costs, and can be expected to only benefit merchants, not consumers. These concerns are expected to be raised in comment submissions to the board.

The Proposal's Stark Reality for Consumers

The Durbin Amendment required promulgation of the debit card interchange fee rule under Regulation II, and reduced the debit card interchange fee from an average of 44 cents to 21 cents, plus 5 basis points multiplied by the transaction amount, plus a 1-cent fraud prevention adjustment.

Large merchants claimed that savings would be passed on to consumers. Despite a lack of evidence over the past 12 years, the board's staff continues to tout that interchange reduction will benefit consumers because large merchants will pass along price reductions.

The stark reality from the Durbin Amendment is that consumers lost their debit card reward programs and free checking accounts without realizing any price savings from merchants.

Regulated interchange also had the unintended consequence of limiting pricing flexibility for smaller merchants, which had allowed them to retain more profits and compete with larger merchants. Another unintended result was limiting the ability of noncovered issuers to charge higher interchange.

Under the proposal, the base component would decrease from 21 cents to 14.4 cents, the ad valorem component would decrease from 5 basis points (multiplied by the value of the transaction) to 4 basis points (multiplied by the value of the transaction), and the fraud-prevention adjustment would increase from 1 cent to 1.3 cents for regulated transactions.

More significantly, the proposed revisions seek to codify automatically updating the interchange fee cap every two years based on the most recent data in the covered issuers' reports to the board.

Board staff believes that directly linking the interchange fee cap to the data from the board's biennial survey of covered issuers should ensure that any regulated interchange fees will be reasonable and proportional to the cost incurred by the issuer, as required by the Durbin Amendment.

Board staff indicated that the average per-transaction authorization, clearing and settlement costs, excluding issuer fraud losses, among covered issuers declined by nearly 50% from 7.7 cents in 2009 to 3.9 cents in 2021 and that merchants absorbed 47% of fraud losses, issuers absorbed 33.5% of fraud losses, and cardholders absorbed the remainder.

For example, the interchange fee cap on a \$50 debit card transaction would decline from 24.5 cents under the current rule to 17.7 cents under the proposed rule, which is a 28% reduction. The proposal relies on stale 2021 data to determine issuers' costs until July 2025.

"Failed Policy"

In a statement issued Oct. 26, the Consumer Bankers Association, the Bank Policy Institute, and The Clearing House said that "attempting to revisit the failed policy in a world where technology and fraud prevention costs are even higher will exacerbate these problems and further harm consumers."

The statement highlighted the four realities of Regulation II: (1) Merchants did not decrease prices; (2) customers have experienced decreased access to free checking accounts; (3) fraud costs have risen; and (4) noncovered issuers, as well as covered issuers, were adversely affected by the interchange fee caps.

The American Bankers Association also issued a statement expressing its disappointment with the board's proposed revisions, stating: "If enacted, this government price cap would result in reduced fraud protection and reduced access to debit cards, which no one should want, including merchants. Even more troubling is the idea that the Fed wants to automate this misguided process and policy and repeat it every two years."

Better Payment Methods

Clearly, payment technology has come a long way since 2011. Interchange fees are the cost of convenient and immediate payments merchants receive for their products and services.

Should the proposed rule be adopted, we can expect the debit card interchange fee reductions to crimp consumer access to banking products and services.

Amid efforts to curb other deposit account fees as well, banks may limit debit card offerings and increase monthly maintenance fees on checking accounts and eliminate free checking accounts.

This evolution would shift consumer payments from debit cards to credit cards, checks or cash. Check and cash payment transactions take significantly longer than a card tap, insert or swipe, and increase merchants' fraud risk.

Merchants should want to avoid reverting to the cumbersome process of accepting paper checks for purchases and converting them to electronic checks to determine whether funds are available. No restaurateurs want to revert to chasing customers for another form of payment after the check converter reveals the check would bounce. No one wants to go back to cash on delivery for mailed orders.

If consumers shift to credit card payments, with credit card interchange currently unregulated, for now merchants will pay more to process these transactions. This summer, Sen. Dick Durbin, D-Ill., the namesake of the Durbin Amendment, and Rep. Lance Gooden, R-Texas, introduced identical bipartisan bills in the Senate and House, titled the Credit Card Competition Act of 2023.

The legislation would regulate interchange fees on credit cards by requiring certain credit card issuers with over \$100 billion in assets to enable at least two credit card networks on their credit cards, with at least one being a network other than Visa and MasterCard.

The current version of the bill would not apply to networks that are the card issuers, such as cards issued by American Express and Discover. The bill has failed to gain any traction in Congress.

The Biden Administration's "Junk Fee" Agenda

On the surface, the proposed interchange fee reductions appear to further the Biden administration's ongoing efforts to target so-called junk fees, including bank fees allowable under existing law.

The junk fee initiative has targeted several other deposit account fees, including for overdrafts, nonsufficient funds, minimum balances, return items, stop payments, check images, paper statements, card replacements, out-of-network ATM transactions, foreign transactions, wire transfers, account closures, inactivity, and fraud investigations.

Another factor that may have prompted the proposed interchange fee revisions is a lawsuit against the board, *Corner Post Inc. v. Board of Governors of the Federal Reserve System*, currently pending before the U.S. Supreme Court.

In it, *Corner Post*, a small consumer finance business, seeks to invalidate Regulation II's standard for reasonable and proportional interchange fees. The plaintiff argues that the Durbin Amendment requires a case-by-case approach to determine whether an interchange fee is reasonable and proportional, not a single standard as the board adopted.

After the case was dismissed by the district court as time-barred and the dismissal was affirmed by the U.S. Court of Appeals for the Eighth Circuit, the Supreme Court granted *Corner Post's* petition for certiorari.

The question the Supreme Court will decide is when a right of action first accrues for an Administrative Procedure Act challenge to a final rule issued by a federal agency — when the final rule is issued or when the rule first causes injury. As a result, the Supreme Court's decision will address only whether the plaintiff's lawsuit is timely and not the merits of the challenge to Regulation II.

Conclusion

As of mid-December, the board has received more than 1,450 comment letters about the proposal, from individuals and organizations, and more have the opportunity to weigh in before the comment period closes in February.[1]

Financial services trade associations and other stakeholders are lining up and taking sides. Clearly, the proposed changes have generated controversy and feedback the board will need to consider before it votes.

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[1] https://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R-1818&doc_ver=1/.