Regulation II

A proposal that would make checking accounts more expensive by cutting debit revenue by a third

On October 25, the Federal Reserve Board (the "Fed") issued a rulemaking that would lower the maximum amount of interchange revenue that most debit card issuers can earn (the "Fee Cap"). This would be the first adjustment of the Fee Cap since it was introduced by a 2011 Fed rulemaking.

The "Durbin Amendment" to the Dodd Frank Act requires the Fed to ensure that debit interchange fees are "reasonable and proportional" to debit issuer costs relating to debit transactions.[1]

In 2011-2012, the Fed issued Regulation II, setting a Fee Cap that is the sum of:	The Fed now proposes[2] to lower the Fee Cap to:
• 21 cents (the "base component"); • 5.0 basis points multipled by the value of the transaction (the "ad valorem component"); and • 1.0 cent, for issuers that meet certain fraud-prevention standards (the "fraud-prevention adjustment").	• 14.4 cents for the base component; • 4.0 basis points for the ad valorem component; and • 1.3 cents for the fraud-prevention adjustment. The Fed also proposed to amend Regulation II, so that it would automatically update the fee cap, without public comment, every other year going forward based on data it collects from industry.

Under the proposal, all issuers would still be subject to dual-routing requirements. The Fee-Cap would apply to issuers of $10 billion in assets or more. [3] Three-party issuers would not be subject to the Fee Cap.

Policymakers immediately raised questions about the impact on low-income consumers and small banks and conflicts of interest.

In her dissent, Fed Governor Michelle Bowman expressed concern that the cumulative effect of current regulatory proposals, like higher capital requirements, could impact access to banking services for low-income consumers and pose "ongoing risks to the health of certain financial institutions and the overall U.S. banking system." For example, banks have relied on interchange revenue in reducing overdraft fees and expanding access to free checking. If the Fed reduced issuer interchange revenue by one-third, banks would face material obstacles in their efforts to offset the regulatory, anti-fraud, and operating costs involved with extending banking services to low-balance consumers. She also highlighted that nearly one-third of bank issuers would not be able to even recover their costs, much less grow business, under the Fed's "reasonable and proportional" Fee Cap. Prior to the proposal's release, Rep. Luetkemeyer (R-MO) and Rep. Barr (R-KY) raised similar concerns and also cautioned the Fed about potential conflcits of interest, given that the Fed competes with debit networks with its own FedNow payments network.[4]

[1] 15 U.S.C. 1693o-2.

[2] Federal Reserve Board, 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.

[3] 12 CFR § 235.5(a).

[4] See attached.

Reputable academics agree the Durbin Amendment hurt low-income consumers.

After reviewing relevant research and extensive interviews with market participants, the Government Accountabilty Office ("GAO") concluded in February 2022 that "debit card interchange fee regulations increased the cost of checking accounts."[5] As the GAO noted, Federal Reserve economists in 2017 reviewed the impact of the Durbin Amendment and found that it resulted in banks "decreasing the availabilty of free accounts, raising monthly fees, and increasing minimum balance requirements." The Fed researchers found that two-thirds of non-interest checking accounts offered by impacted banks would have otherwise been free.[6] Further, the researchers found that even "Durbin-exempt" banks also raised prices, reducing the availability of free checking accounts by over 15%. (Remarkably, some of those same Fed researchers are listed as co-authors of the Fed's Proposal.) Separate Fed research has shown that, after the Durbin Amendment, smaller issuers' interchange fees fell by nearly 31% in inflation-adjusted dollars from 2011 to 2021.

Retailers have claimed that that they pass savings from interchange reductions back to consumers in the form of lower prices. But the primary study they cite contains no actual data from debit transactions about pass-through effects. Instead, the author assumed a savings-pass-through-rate from transactions that occurred before the passage of the Durbin Amendment and involving a limited set of retailers and promotions.[7] In contrast, before serving as Deputy Assistant Secretary for Economic Policy and Counselor to Treasury Secretary Janet Yellen, Professor Natasha Sarin conducted a robust "difference in differences" analysis and was conclusive that "we find little evidence of across-the-board consumer savings. Our analysis suggests that consumers are not helped by this interchange regulation."[8] Likewise, the Federal Reserve Bank of Richmond surveyed merchants after the Durbin Amendment was enacted.[9] Only 1.2% of merchants reported reducing prices. In contrast, 21.6% of merchants actually reported having increased prices on their consumers.

Interchange grows value for merchants, consumers, and banks alike.

As the Fed itself has explained and the Supreme Court has validated, payment cards are "two-sided markets."[10] This means that the value of payment cards are only realized if two different groups of users agree to use the product: merchants and consumers, via their issuers. Establishing and maintaining payment card networks, however, requires up-front investments by the issuer. In contrast, most of the economic surplus goes to merchants, after networks are operational (e.g., increased sales; lowered costs, including costs and losses from handling cash). As Federal Reserve researchers demonstated, interchange "transfers surplus from one side of the market to the other in order to internalize the external effect that one party has on the other."

What's next?

Comments on the proposed rule will be due 90 days upon publication of the proposed rule in the Federal Register (which may occur in mid-November or later). Fed Governors will next be testifying in mid-November.

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[5] GAO, Regulators Have Taken Actions to Increase Access, but Measurement of Actions' Effectiveness Could Be Improved (Feb. 2022) https://www.gao.gov/assets/gao-22-104468.pdf.

[6] See, e.g., Mark D. Manuszak and Krzysztof Wozniak, The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation (2017), https://www.federalreserve.gov/econres/feds/files/2017074pap.pdf.

[7] Robert Shapiro, The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees (Dec. 2014) (citing research on grocery and drug pass-through savings of limited-time promotions of 0.69, calculated prior to the enactment of the Durbin Amendment) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2541728.

[8] Vladimir Mukharlyamov and Natasha Sarin, The Impact of the Durbin Amendment on Banks, Merchants, and Consumers (2019), https://scholarship.law.upenn.edu/faculty_scholarship/2046/.

[9] Zhu Wang, Scarlett Schwartz, and Neil Mitchell, The Impact of the Durbin Amendment on Merchants: A Survey Study (2014), https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_quarterly/2014/q3/pdf/wang.pdf.

[10] Prager, Manuszak, Kiser, & Borzekowski, Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues (2009), https://www.federalreserve.gov/pubs/feds/2009/200923/200923pap.pdf (see Table 1); Ohio v. Am. Ex. (June. 25, 2018), https://www.supremecourt.gov/opinions/17pdf/16-1454_5h26.pdf.

October 24, 2023

The Honorable Jerome Powell
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: *Federal Reserve Board Plan to Revise Regulation II Debit Card Price Caps*

Dear Chair Powell:

We are deeply concerned by the Federal Reserve Board of Governors' recent announcement that it will meet on October 25, 2023 in Washington to propose revisions to the debit card regulations impacting the debit cards of hundreds of millions of Americans. It is our understanding that the Federal Reserve is currently under litigation intended to force it to revisit this very question and that the U.S. Supreme Court recently granted the litigants' *cert* petition.

We urge the Federal Reserve to postpone this meeting and to defer making any potential proposals on Regulation II due to a current lack of adequate data to support policymaking, as well as the foreseeable negative impact on checking account customers at banks and credit unions.

The Federal Reserve recently mandated additional debit routing requirements whose effects on financial institutions and on competition are emerging now; however, all anecdotal evidence is that the routing rule is reducing net interchange paid to issuers in ways that are directly relevant to evaluating the covered issuer cap. Some of these impacts relate to issuer fraud mitigation and costs, but these are not accurately measured by current data collections, severely distorting and degrading their usefulness. The Federal Reserve should gather that cost data on dual routing to obtain an accurate representation of issuer costs before proposing any changes to Regulation II.

In addition to our concerns about the policy direction that the Federal Reserve is taking, the process being undertaken by the Board raises significant governance issues. The Sunshine Act notice published by the Federal Reserve states that the public will only release the materials for next Wednesday's meeting 20 minutes before it begins. This is clearly unacceptable. Government in the sunlight requires that, wherever possible, the proposed actions of our government and its instruments like the central bank are made available to the public and press in advance of deliberations.

One reason for our letter is to respectfully remind you that the policy independence of the Federal Reserve extends only to certain matters of monetary policy which do not include payment system policy. On payments, the Federal Reserve is permitted to compete with the private sector in the market and make a profit, under strict conditions set by Congress. In fact, the Federal Reserve recently entered into direct competition with bank and credit union debit cards by launching *FedNow*.

During the launch of this competitor, the Federal Reserve initiated a rulemaking to impose costly operational mandates on debit card issuers and now you are apparently considering further regulations on your competitors by tightening price caps on their debit payments products. The timing and intensity of your agency's actions against competitors raises additional fundamental questions because your competitors are regulated entities – regulated by you.

Finally, litigation on the debit card rules is now pending at the nation's highest court. The appearance of a defendant federal agency changing course to benefit plaintiffs while the government expends resources to defend its prior votes is one that requires explanation. We cannot help but notice that this proposal is taking place within weeks of the Supreme Court granting merchants *cert*, creating the appearance of surrendering the agency's position administratively. The intersection of your policymaking with the federal judiciary's consideration of administrative law issues applicable across the government places these matters squarely within the oversight duties of Congress.

This unusual turn of events naturally demands that Congress monitor closely any conflicts of commercial interest between the Federal Reserve's for-profit payments businesses and its regulatory actions on regulated entities, as well as to gain a detailed understanding of the motivations and processes of Federal Reserve stakeholders in making any proposal.

We are requesting that you provide the October 25, 2023 Federal Reserve Board materials (whether draft or final) to our staff by COB Tuesday, October 24, 2023. In addition to using this material for oversight, we will share it with our constituents who have asked us to intervene on their behalf to obtain this information and protect their right to participate in the policymaking of their government's central bank. Should you be unable to provide this information to us within the timeline referenced above, we respectfully request that you postpone this meeting.

Further, we ask that you provide the following information, that we trust you have available based upon the breadth of the debit card policymaking the Federal Reserve is undertaking:

- The Federal Reserve's estimates of the cost of Regulation II to persons currently serving, retired from, or on reserve status with the United States military, inclusive of higher checking account fees, more frequent application of these fees because of higher or more common minimum balances, lost debit card rewards, and any other relevant costs;
- The Federal Reserve's estimates of the cost of the new debit card routing rule on banks and credit unions below $10 billion in assets and between $10 billion and $50 billion;
- The change in fraud liability for banks and credit unions of those sizes based on changed routing and transaction types processed under the regulation, and an estimate of the net interchange impact (a key metric if the Regulation II rate caps are under discussion);
- A listing of all merchants and merchant groups that the Federal Reserve met with in the one year proceeding the routing rule's proposal and one year proceeding the upcoming meeting on proposed debit rate cap provisions; and
- Copies of all correspondence between the Federal Reserve and other prudential regulators on the safety and soundness implications of the proposed debit rate cap revisions.

Thank you for your attention to this matter.

Sincerely,

Blaine Luetkemeyer
Chairman of the Subcommittee on
National Security, Illicit Finance,
and International Financial Institutions

Andy Barr
Chairman of the Subcommittee on
Financial Institutions and
Monetary Policy