White Paper

The Durbin Amendment and the Payments Value Chain
A Current Look

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Executive Summary

The financial crisis of 2008-2009 produced a widespread call for changes in the financial regulatory system. As a result, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") was signed into law on July 21, 2010. The Act represents a significant change in the American financial regulatory environment affecting all Federal financial regulatory agencies and affecting almost every aspect of the nation's financial services industry. Section 1075 of this Act amends the Electronic Funds Transfer Act (EFTA) by adding Section 920, also known as the Durbin Amendment ("Durbin"), which encompasses the debit interchange transaction fees and rules for payment card transactions. The intent of Durbin was to transfer wealth from the Issuing banks to the merchants with the hope that it will result in lower prices for consumers through lower fees to merchants. This paper seeks to clarify issues and discuss the affects on the industry as a whole.

Introduction

The Durbin Amendment, a last-minute add-on to the Dodd-Frank Act, lowers debit "interchange fees," the payments that support the administrative and anti-fraud expenses paid by merchants. Acceptance of a debit card transaction provides the retailer with protection not received when accepting a check, because if a check bounces, the responsibility is on the merchant to collect. But, if a debit card transaction is rejected after the settlement, the issuer of the card typically must cover the transaction amount.

The Durbin Amendment has sparked furious debate. The Amendment was challenged both in Congress, albeit after the amendment was passed, and by the payments industry. Some challengers voiced that the amendment was too lenient while others stated the amendment did not go far enough. The active debate did impact the direction of the final regulation, resulting in more favorable rules to the financial industry than originally proposed. The Federal Reserve Board (FRB) ruled debit interchange fees would be capped at $0.21 cents plus up to an additional 5 basis points Ad Valorem fee of the transaction to cover losses due to fraud (based on the median per-transaction fraud losses reported to the Board by issuers) and an additional $0.01 for fraud prevention. Additional final rules resulting from the amendment include that issuers must ensure that each debit card can be processed on at least two unaffiliated networks. Issuers must comply with what is known as non-exclusivity by April 1, 2012. Finally the choice of which network a transaction will route to was shifted from an issuer-defined choice to a merchant choice. Networks were required to support merchant routing effective October 2011.

The provisions that are already in place include:

- Merchants can impose a $10 minimum on credit card transactions (this number can be adjusted by the FRB as they determine a change should be made). Previously, Visa and MasterCard's operating rules banned this limitation and required this disclosure appear in merchant agreements.
- Merchants are allowed to give discounts to those who pay with cash or debit cards. Previously, Visa and MasterCard permitted discounts for cash payments.

Issuing banks and credit unions are in opposition to the Amendment. Issuing banks typically take in about 1.3% of every dollar spent on a debit card, as a fee from the merchant. This amounts to approximately $3 billion a year of very high profit margin revenue for one of the largest banks based in the U.S., for example, a number which looks to decline by approximately 80% unless applicable government entities intervene.

The final regulations apply to banks with over $10 billion in assets. These banks are to receive debit card swipe fees that are "reasonable and proportional to the actual cost" of processing the transaction. Banks under the $10 billion threshold are still bound by the merchant routing and network exclusivity rules.

Historical Perspective/Regulatory Timeline

Some key milestone past and future dates in relation to the Amendment include:

- **May 13, 2010:** Durbin Amendment approved by the U.S. Senate.
- **July 21, 2010:** Wall Street Reform Act signed into law.
- **September 13, 2010:** FRB issues surveys to networks, issuers and acquirers to learn about the debit market, and are given one month to complete surveys.
- **December 16, 2010:** FRB releases draft rules required by the Durbin Amendment, with public comments requested over the next two months.
- **March 30, 2011:** The FRB announced it will not make the April 21 date to publish final rules but expect to keep the July 21 effective date in place.
- **July 21, 2011:** Mandated effective date for interchange rules, and mandated publication date for network rules.
- **October 1, 2011:** Effective date for interchange and merchant routing support.
- **April 1, 2012:** Effective date for the network exclusivity prohibition.
- **April 1, 2013:** Effective date for non-reloadable and reloadable general-use prepaid cards.

Current State

Advocates of the Amendment contend that merchant interchange fees have soared relative to transaction processing costs. The interchange market is fundamentally uncompetitive — Visa and MasterCard effectively set the interchange fees for all merchants. Merchants can choose not to accept Visa and MasterCard, but this is not practical for most. The FRB goal, under the Durbin Amendment, for reducing prices is twofold — first, to shift the competitive landscape and equalize the drivers, and second, a limit to fees in order to correct the open market "failure." The Durbin Amendment called for guidance on setting interchange; setting an actual price was not part of the legislation, but was the direction taken by the FRB.

Swipe fees in the U.S. are, overall, uncompetitive when compared to European countries, where anti-trust regulation limited what the card brands can charge. U.S. debit interchange fees are higher than the European Union's average but not flagrantly so; the true effect of unregulated pricing is seen in the interchange fees charged on credit card transactions, where the U.S. is by far the highest. Most notably, the fees on some premium credit cards deviated greatly from the rest of the industry in conjunction with the 2007 IPO's of both Visa and MasterCard — likely because of pressure to create profits for public shareholders.

Because of the difficulty distinguishing prices for goods based on the method of payment, merchants generally factor the interchange fees into the prices of goods or services, or absorb the cost themselves. So, whether a consumer pays with cash, debit, credit or rewards credit, he will see the same price (one exception is in gas prices, where the limited number of products offered allows for price differentiation). However, merchant interchange fees for credit cards — rewards credit cards in particular — are significantly steeper than debit card fees.

One feature of monopoly pricing is that the card network can, as much as they are able, set different prices to maximize investment and acceptance in premier or value-add products. It should be noted that merchant funding of rewards cards or their acceptance in general of a particular card at their establishment contributes to the on-going evolution of those interchange rates. Historically, merchants do not differentiate acceptance at a product level, even though they may at a network level. An example is a Visa Signature Preferred rewards card returns a 2.5% interchange fee at an establishment, while a Visa Classic transaction may cost another merchant only 1.15% (because Visa wouldn't want to risk, say, Walmart walking away). By comparison, in France, a credit card with an embedded security chip costs all merchants 0.22% of the transaction plus 10 Euro cents, while the least secure (and thus most expensive to cover) method of payment costs 0.3% plus 10 Euro cents (there is virtually no difference by way of fees with Visa versus MasterCard). The particulars of pricing, and the emphasis on the lucrative reward credit cards, speak to inconsistencies of the market.

The Effects of the Regulations

In response to evolving regulations, banks threaten tighter credit rules, higher fees and steeper interest rates. Some have also threatened per-transaction spending caps on debit cards, at $50 or $100, rendering debit effectively useless in paying for groceries, restaurants, or plane tickets, and driving customers toward more lucrative credit cards.

Additionally, Bank of America recently announced it would begin charging a $5 per month fee for its debit card holders. In response to their customers' feedback, Bank of America has decided to pull the plug on the fees. Wells Fargo and Chase have also decided to discontinue geographic market testing of a $3 debit card use fee. This is no doubt in response to strong customer discontent, with many bank customers switching to small banks and credit unions, where so far the interchange limitations don't apply if their assets held are under $10 billion. Also a driver in the recent dropping of the debit card use fee is a call for a "Bank Transfer Day" encouraging consumers to close the accounts they have with banks charging debit fees.

An example of changes in dynamics to debit transaction economics with the new regulations in effect and its negative effects on consumers follows. It should be noted that most merchants will see substantial debit fee savings for transaction amounts of $100 and may have little incentive to pass on savings to consumers. This is true particularly of small merchants, given the current economic climate.

Pre-Durbin:

- A consumer buys a $100 product from a merchant using a signature debit card issued by a large national bank.
- The merchant's expense for accepting that transaction is $2.00 total in fees.
- The consumer uses their debit card free of charge from their issuing bank.

Post-Durbin:

- A consumer buys a $100 product from a merchant using a signature debit card issued by a large national bank.
- The merchant's expense for accepting that transaction is $1.12 total in fees. The merchant saved $0.88 due to Durbin and has limited incentive to pass on its savings to consumers.
- The consumer's issuing bank makes up the lost revenue by charging new debit usage fees to its customers.
- Customer still pays $100 for same product while now also paying new bank fees.

Not-for-profit credit unions are also strongly opposed to the Amendment — for much the same reason as banks — they fear that they will have to cut services or increase fees in response to an increased bottom line. Some feel credit unions may have more substance to their claims than for-profit banks.

Although the regulations make an exception for small institutions, this exemption may only benefit them in the short-term and most likely will not impact them positively in the long-term. As overall market pricing dynamics adjust the notion that non-regulated rates will remain status quo is unlikely. The unintended consequence will be that these unregulated tiers will come down and the gap between regulated and unregulated interchange will compress, leaving the smaller institutions will similar revenue reductions.

Card Issuer Rules

It is important that the landscape be reviewed in total. Durbin is not the first or only regulation to significantly impact financial institutions. The CARD Act of 2009 was passed to provide additional protection to consumers and impacted nearly every aspect of an issuer's business. The final clarifications were just recently implemented. Many issuers reacted to CARD with tighter underwriting policies and lower credit lines. Before the dust has completely settled, the issuers are faced with a deep cut to their interchange revenues.

That being said, financial institutions need to balance the best interest of their consumers with the best interest of their merchant customers, including small businesses.

Summary

The effects of the regulations are still playing themselves out. The FRB has said it is unclear whether consumers will benefit or be hurt by debit interchange regulation. There are a couple of possible scenarios that may occur. Due to the interchange rate cap, bank revenue from debit transactions is estimated to fall by as much as 40 percent. As a result, consumers may see the end to debit rewards programs, increased minimum balance requirements, or new fees on checking accounts.

While the possibility of facing lower transaction costs, merchants could (but may not) pass those savings on to the consumer. The consumer may see the savings in an overall reduction in prices or discounts on specific cash/pin-debit transactions.

As always, the payments market will rise to the occasion and find opportunity for growth. For now, it is a competitive market. Network players vie for merchant volume and issuer choice. Acquirers and ISO's creatively market the potential to pass savings to the merchants as a way to entice merchants into their portfolio. Acquirers also look for the right balance between attracting merchants and providing themselves an opportunity to enjoy, even temporarily, interchange expense reduction.

The regulatory effectiveness and true financial impact on industry stakeholders, merchants and consumers in a post-Durbin world will continue to be debated. Now that the electronic payments regulatory door is open, what will be next? Prepaid? Credit interchange? There is no doubt there will be continued focus on this market and that further change is inevitable.

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