Consumer Finance Monitor (Season 7, Episode 4): Understanding the Federal Reserve Board Proposal to Lower Interchange Fee Cap for Debit Card Transactions

Speakers: Alan Kaplinsky and Zarik Khan

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm, and I'm your host, Alan Kaplinsky, the former practice group leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr. And I'll be moderating today's program. For those of you who want even more information, don't forget about our blog, which also goes by the name of Consumer Finance Monitor. We've posted the blog since July 1st, 2011 when the CFPB became operational. So there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com.

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And this is a little bit different than the usual topics that we talk about, because it's something that is not directly impacting consumers, but indirectly impacting consumers. And what I'm referring to are interchange fees that are charged by debit card issuers. And it's an interchange fee essentially means it's revenue that is generated by a debit card issuer every time a customer uses his or her debit card at a merchant. A portion of that merchant discount, the profit that the merchant makes on the transaction, a part of that goes back to the debit card issuer. Well, this became a very controversial subject back in 2010, when the Dodd-Frank Act became law and Senator Richard Durbin, a senator who often seems to align himself with retailers and merchants, decided that interchange fees were too high and that was hurting consumers, not that it was hurting merchants, but he framed the argument as something that was anti-consumer. And he put an amendment which is referred to, and we'll refer to it as Durbin I, because now he's back at it again. And a little later in our show we'll talk about Durbin II.

But in Durbin I, he puts something in the Dodd-Frank Act, which required the Federal Reserve Board to promulgate a regulation applicable to banks having more than 10 billion in assets, which would establish the maximum debit card interchange fees that are, and this is the language from the statute, reasonable and proportional to the actual cost unquote of processing the transaction. On June 29th, 2011 little more, almost a year after the enactment of Dodd-Frank, the Federal Reserve Board issued Regulation II, which provides that the maximum interchange fee an issuer can receive from a single debit card transaction is 21 cents plus five basis points multiplied by the dollar amount of the transaction. And also the rule allowed issuers to raise their interchange fees by as much as one penny if they implement certain fraud prevention measures. Okay, very controversial regulation when it got promulgated. The merchants generally liked it, although one merchant has brought a lawsuit against the Federal Reserve Board, which I will mention in a moment, but they generally liked it.

The industry of course did not like it. The banking industry that issues debit cards, because it put a big dent in the revenue that they generate, and as a result is our guest will tell us today they've had to become less profitable issuing debit cards, but they've had to try to pass along the loss of that revenue to customers of the banks in other ways. So that's bad enough. But now we have what's called a, let's call it proposed amendments to Regulation II. That happened at an open meeting of the Federal Reserve Board on October 25th. And at that meeting there was a study presented by the staff showing that the costs of two debit card issuers' transaction costs had declined significantly since they promulgated the regulation back in 2011. And there is now a proposal on the books to slash the debit card interchange fees even more.

And that is what we're going to be diving into today. Let me just mention, because I promised I would, this litigation that got filed a few years ago by a retailer called Corner Post. They were a merchant, they sued the Federal Reserve Board about three years ago, claiming that it didn't have the right to establish a standard uniform interchange fee, that the Durbin amendment to Dodd-Frank requires a case-by-case determination of each debit card issuers' transaction costs. And what they did by creating this uniform standard is that it was contrary to what Congress had told them to do. That litigation has been hung up on what I'll call procedural issue. The issue is whether the statute of limitations under the Administrative Procedures Act, which is a six-year statute of limitations for challenging a regulation issued by a federal agency, does it run from when that regulation got finalized, which was back in 2011? And if so, there's a lawsuit that can be filed. The lawsuit is barred by the statute of limitations, or does it run from when the merchant was injured?

In this case, the merchant was a new business that started only three years ago. So if the determination is made that the statute of limitations runs when the injury occurred, then it can be challenge. It's within the six years. That issue now is pending before the U.S. Supreme Court. Once this Regulation II gets finalized, as I'm quite sure it will be at some point, then I would think Corner Post or some other merchant will sue the Federal Reserve Board again, and then there won't be a statute of limitations issue. And at that point, the courts are going to determine something, which I think is even more frightening than what they already have done or what they're proposing to do, namely require each debit card issuer to determine what the appropriate interchange fee can be, or to put it differently, they're going to have to determine their transaction costs. And the interchange fee has to be reasonable and proportionate to that, and who the heck knows what those words reasonable and proportionate mean.

Anyway, I'm going to end my monologue right now, because I want to really delve into this with our guest, Zarik Khan, who is no stranger to our show. He was a guest on our October 19th episode called Understanding the Credit Card Competition Act, also known as Durbin II, which we'll mention a little bit toward the end. But as I said, Senator Durbin's at it again, at the behest of the merchants, he wants to create, in my view, more havoc with how credit cards, how interchange fees on credit cards can be assessed. So let me tell you a little bit about Zarik. He's the founder of Finsolute Advisors, an independent consulting organization focused on providing audit and compliance expertise in the financial services space. Prior to that, he spent over 15 years as an internal auditor working in various companies, including Google and Discover Financial Services. At Google, had responsibility for auditing the company's payments business, including assessing AML-related compliance for their various numerous payment licenses.

And in his almost nine years of Discover, he was responsible for auditing the entire card-issuing business, including assessing regulatory compliance risks, spending time with various banking regulators and participating in their examinations. To put it briefly, Zarik is an expert in the payments industry, not a lawyer, but an expert in the business side of payments. He also writes a weekly newsletter, which I've subscribed to ever since I found out about it, called FinTech Compliance Chronicles. You want to make sure you subscribe to that newsletter. He has a CPA, a CAMS, a CFE, a CRCM, and an MBA. Yes, he is very well-educated. So Zarik, a very warm welcome to you and I first of all, apologize to you for my monologue at the beginning, but I really wanted people to understand sort of what this thing is all about, because the subject, I think to the average consumer and maybe even to some banking lawyers is a little bit obscure. But welcome.

Zarik Khan:

Well, no, thanks, Alan. Great to be back. And I think that monologue was appropriate. And as you were talking about Senator Durbin, I couldn't help but chuckle thinking about how prior to this, I used to live in Illinois, so he was very prominent in my day-to-day life when I used to live there. So yeah, no, I'm really happy to be here.

Alan Kaplinsky:

It's a pleasure. And I want to kick us off as you did the last time you were on our show. Can you help us understand or give us a refresher on the concept of debit interchange? I mean, I referred to it in very, very broad terms in my introduction, who the players are, who takes funds from who, sort of how does it all fit together?

Zarik Khan:

So maybe I'll take a step back and just frame where debit fits in relative to other forms of payment. And then we can talk about where interchange also plays in. So debit is actually, I think as of last year, according to Kiplinger's Personal Finance, it's actually the largest form of non-cash payment in the U.S.. And actually according to S&P Global, they did a research study last year as well, and it's actually recently surpassed credit cards as the preferred method of payment for consumers, and it's interesting, because it used to be the other way around where around 56% used to prefer credit, and around 40% used to prefer debit. And so, it's now flipped where 56% prefer debit and around 40% prefer credit. So the rise of debit is the preferred payment option is really happening very quickly. So that kind of sets the stage of how much consumers depend on this form of payment.

And that's driven by a lot of the trends from pandemic where cash is becoming less and less of a mechanism which consumers use to pay. So just setting the stage of where debit fits and other forms of payment. Just going through the players, and if you listened to our previous podcasts, you may have heard me talk about this before, but there's a manic model which refers to the various players that are involved in not only credit transactions, but also in this case debit transactions. So M is for the merchant, and that's going to be a merchant that isn't just taking cash, it has to be a merchant that will take debit, potentially credit as well. And this is a merchant that the consumer, which is at the end of the acronym of the MANIC, is going to be transactional. And then A just as with in the credit card scenario, is the acquiring banks.

So sometimes they're called merchant banks, they have different merchants in their portfolio. They're providing the tools to the merchants like the software. They work with processors to provide the POS tools, but they're the ones who are going to take the funds from the debit card transaction, then they'll be depositing it in those merchant accounts. And then as I mentioned before, they're providing those POS terminals. They're also working with third parties for all sorts of payment processing, including organizations like PayPal, Stripe, et cetera. Then moving to the end, I think many folks are familiar with these, well-known names, the payment network, which we've got Visa, MasterCard, Discover, Amex. Interestingly, in the case of debit, some of those players are still involved, but they have different names for their debit network. On the credit side, you've heard of them, right? Visa, MasterCard, Amex, Discover. But on the debit side, Visa's Debit Network for example, is called Interlink.

Discover's network is called Pulse, and then MasterCard Network is called Cirrus. There's a whole host of other networks that fall under the umbrella of some of these networks as well. But those are the three that I think are the most prominent when we're talking about debit networks. So essentially when we're talking about the network, they're the rails on which the transactions are right upon and they drive a lot of the transactions. And so, the networks themselves will actually make their profit by actually clawing back some of the interchange fees that they actually set the parameters for that the issuing bank would then start to the various merchants via the acquirers actually. So network is actually the one that sets that specific interchange fee, which is actually being regulated, but the issuing bank is the one that actually charges it via the acquirers onto the merchant.

So then moving to the issuing bank themselves, right? Example of those could be Chase, Bank of America, even Credit Union, anyone who's issuing the card, which in this case is a debit card. So they're the ones who give that debit card, send that debit card to the consumers. They're the ones who are providing the deposit accounts in this case. And they're also the ones who have the card agreement. And so, as we said before, they're the ones who are charging that interchange fee, the merchant, and then small percentage of whatever they charge for the fee, they'll pay that back to the network almost as a rent payment for allowing them to use the network's rail. So another thing to just note as we're talking about the players, we've talked a little bit about the interchange fee is some of the other fees that come into play here, right? We're talking about debit.

So there's the overdraft fees, which these issuers are going to levy, if consumers have opted in to sometimes overdraft agreements where they say, yeah, we'll opt into fees. You might wonder, well, why would they opt into having fees levied on the overdraft fees? Well, the reason is that at least the consumer can complete transactions if they run out of funds in their account. But if they don't opt in, you'd think, well, that's better, they're not getting card fees. But in fact, those debit transactions will be declined, and then of course, they won't be able to purchase whatever they're intending purchase. Then the final piece actually in the MANIC acronym is the consumer. So that's the part so instead of getting the card from their issuing bank, that's the person who's going to be presenting card to the merchant, and they're the folks who are going to have the money come out from their account.

So those are the various players involved. We touched a little bit on who levies the interchange fee, who sets it, how it comes into play on the merchant, on the issuers, even how the networks are involved. And so when you think about transaction, how it goes through, I think these are some of the names you're going to hear as we proceed further in this conversation. So very similar to the model in credit, except with slightly different instruments in this case, debit card, and then what is the rails on which these transactions are being routed, which in this case is a debit network instead of the credit network.

Alan Kaplinsky:

Yeah, thank you. I think that's really helpful, very educational Zarik. The one thing that surprises me, and it always has surprised me, why people would choose to use a debit card instead of a credit card, assuming they have a credit card, because with a credit card, there isn't an immediate deduction from your bank account. You've got a float that you can take advantage of. You don't have to pay and generally pay any interest if you pay off your credit card bill each month, and by the time it gets billed to you, there's a period before you get assessed, a late fee or interest. It just seems to me that it's counterintuitive if you're trying to maximize, you're trying to save money. Do you agree with that or am I missing something?

Zarik Khan:

I think there's certain phenomena that have happened, which might actually be behind why debit cards have actually taken off, particularly in the last two years. So that is true, right? Credit cards have the advantage of deferring actual payment. You also get a nice rewards program depending on which issuer you're going with. But the thing is that with the economy sort of going in, perhaps not as fast-paced as it was in 2021, even late 2020, and things kind of slowing down, especially with inflation in 2022, a lot of folks frankly may not be able to have credit card or even be eligible for credit the way they might've been in 2020, '21. A lot of issuers, a lot of banks have tightened their credit standards. And so, the thing about debit is it's essentially taking the funds directly out of your deposit accounts. And beyond that, many consumers have tightened their own spending belts as well, recognizing that, hey, things have changed and we can't spend the way we used to.

So while they still want to take advantage of the technology, which is digital wallets, for example, you can load debit cards into there, still use things like tap and pay, NFC, et cetera. Going with a debit card may be an opportunity that's more easily available to consumer just by being forced to use a debit card or they may on their own initiative decide, you know what? We're going to pull back on credit transactions and are spending and we'll just be using debit. That may be a reason why things have changed. It may not necessarily be preferential, but more just a sign of the times.

Alan Kaplinsky:

Yeah. Got it. So, all right, let's roll back the clock now, right? And we're going to go back to Senator Durbin and him putting into the Dodd-Frank Act, what we're calling Durbin I, and then the regulation that the Fed issued and what's been the result or the impact of it.

Zarik Khan:

So talking about Regulation II, we can get into technical components of it, how it's made up, and I can give an example to make it a little more manageable. So Durbin, which is another way folks refer to it, was as we talked before, cut the interchange fee, put a cap on interchange fees for debit transactions to what they would call a base of 0.05% of any transaction value plus 21 cents. And then in some cases if there's fraud protection involved for that particular transaction, then an additional 1% cap. So this basically resulted in a 52% decline in the average per transaction interchange fee, just when this first initial amendment was levied. It used to be 50 cents down to 24 cents. And so, the one thing to note is that this was applicable to institutions that made over 10 billion in assets, and we'll talk about that volume a little bit later.

So for example, if I want to put this in more tangible terms, if I'm a customer buying a $100 item or if I'm a merchant selling a $100 item, my total interchange, if I do all that math, it would come out to 26 cents for that specific transaction per Durbin. Now you say for one transaction, 26 cents, hey, that's no big deal. Now if you're a merchant that has high volume, you make a lot of transactions through a day, through a week, through a month, that can certainly add up. And for a merchant perspective, that's great, but if you're the issuer and that your production, we'll talk a little bit about some of the changes that happened in some of their balance sheets as a result of this over a 10-year period, there's been some studies and research being done that you can get into.

So as we talked about, the idea was that, hey, what could be so bad about this regulation? It's going to cut costs for customers and merchants and everything's going to go as Senator Durbin has envisioned. But instead, because the issuers were losing out on interchange fee revenue, many of them decided, hey, we got a business to run, yes, we are providing a service, but this is also a business. So many of them decided, which they had at the time, to any free checking accounts that they had, they'd potentially be pulling back on those. In some cases for their deposit accounts, they didn't have minimum balance requirements. Well, they ended up instituting minimum balance requirements and to maintain some of those accounts, they didn't necessarily have any fees associated with maintaining them, but then they decided as a result they'd need to institute maintenance fees.

So all this was essentially a reaction to which you could fairly say is lost revenue as a result of having the interchange fees capped. So that's on the issuer side, but you think about, hey, well as long as it benefits the consumers, okay, like [inaudible 00:27:36] for the issuers and maybe the merchant benefits, but not so fast. There's even been some research that indicated that consumers didn't really see any benefit as well. There's specific study that was actually done by some faculty from the University of Georgetown and Pennsylvania, and I think that's great. I cite this specifically, because there's no, as we'd like to say, maybe industry bias that's behind this kind of research. And so, what they found, again, supporting what we talked about with what was lost from the offerings of issuers is that pre-checking accounts declined by 40% over basically two years after the initial Durbin passed. And there was an over $3 a month increase in average checking account fees per account, I believe.

And so, then the study beyond just looking at issuers, they also then went in on how retailers responded. This is where the benefit to consumers could really be analyzed if there was any. And so, one thing that they did was they looked at gas prices in the six months after Durbin was enacted, and they noticed no noticeable change, which when you think about that, say, hey, well, if the merchants are getting savings by having less interchange, then they should pass that savings on the consumer. And by holding it steady at a minimum, that's basically saying that they're just pocketing basically the extra fees that they didn't have to give back to the issuer in that case. And so, you could say, well, they just looked at gas prices, right? The study did indicate that they were able to focus on gas stations, gas prices, because there were certain levels of granularity in the data that they couldn't get for other retailers.

And so, my thought when I looked at this was, well, it'd be interesting to see for other types of retailers what the impact would be. So luckily, the Fed of Richmond, this, again, even the Fed itself, the Richmond branch, did a survey back in 2013 and 2014, they covered more industries and they found a very similar result that the vast majority of merchants that were covered in their survey, so that's to be clear, they did a survey while the faculty did more of a data analysis without reaching out. So there is some potentially response bias, but still the vast majority of the merchants that respond to the survey, which was about 77%, did not change their prices post-regulation. And then very few merchants, which is only about 1%, reduced prices, and then about 20% of the merchants actually increased their prices. So it kind of goes to show that the effects that Durbin and what he was hoping to get out the amendment, that happened even as quickly as three years after the passing, it was having the opposite effect, especially for the consumers that this is supposed to benefit.

Hey, the merchants did benefit, but they didn't pass any of their benefits on to consumers, they just pocketed for itself. Now, with all that said, the one thing to add, and this comes back to the 10 billion applicability point that I raised earlier, there's actually only about 500 banks across the country that Durbin applies to. When you look at the Fed data, they do put out an occasional report saying that this is the list of exempt banks, which Regulation II doesn't apply to, and then this is the list of non-exempt banks that Regulation II does apply to. So there's only about 500 banks as of current day that Durbin applies to, and then there's around 9,300 that are exempt from Durbin. I do think that kind of puts it in perspective a little bit around from an issuer side who's really hurting. But at the end of the day, I think the most important thing, at least from my perspective, is this bill was meant to benefit ultimately the consumer and have merchant savings passed on to consumer, and it's not doing that.

So I think that unfortunately weighs a little bit heavier on my side, even though from the issuer perspective, you can argue, well, is a majority of issuers getting hurt by this? Maybe not. But certainly from a customer perspective, we haven't really seen the benefit.

Alan Kaplinsky:

One thing, just an observation I'm going to make. FinTech companies were very quick to figure out how they could take advantage of partnering with exempt banks, banks with less than 10 billion in assets. Am I right? And a sort of cottage industry has developed that doesn't make a lot of sense that there should be this discrepancy, but can you comment on that?

Zarik Khan:

Well, Alan, there could be a whole nother podcast on the FinTech bank partnership space. Recently, the Fed the same Fed that issued this proposal over this past summer, they along with the OCC, and FDIC put out refreshed inter-agency guidelines on usage of third parties. And so, that was actually aimed at the bank to essentially tell them that, hey, we're going to start scrutinizing your FinTech partnerships a lot more closely, so just get ready essentially, because there's already been some regulatory action against some of the banks focusing on those partnerships. So that is a whole, as you said, right, many of them did make sense, and now unfortunately, because perhaps you could say those marriages of convenience, the Fed is now starting to look into those partnerships as well. So yeah, very interesting.

Alan Kaplinsky:

Right, but all right, let's fast-forward now to October and the meeting held by the Fed on the 25th. I got to admit, I was sort of blindsided by this thing. I had no idea that the Fed had been working on an amendment to the Reg II. I learned about it maybe a week before the October 25th meeting when they put it on the agenda for the Fed meeting. So can you tell us a little about that? What are they proposing to do now?

Zarik Khan:

Yeah, so this is going back to that calculation we talked about earlier. So I'll use the same example a little bit later. But what they're saying is that the base component, which is a static amount, which as we said before that was 21 cents cap, that cap would go down to 14.40 cents. It's a little bit of a decimal there. I don't know how you can get 14.40 cents, but then the 0.05% amount that's on top of that, which they call five basis points, that would go down to four basis points. And again, that's multiplied by the value of transaction. And so, the fraud prevention adjustment would increase by 1 cent to 1.30 cents. So you'd say, hey, at least they're increasing the cap from that perspective on accounting for fraud. But it's small consolation when you look at that $100 purchase example where we said that the interchange fee that the issuer gets back would be 26 cents, that in the calculations gone down would now be down to 18 cents.

So when you think about it from the issuer's perspective, that's almost a 31% decrease just in that example alone, which is very significant. It's definitely not significant. It's definitely not just, oh, it's not minor, it's a pretty big deal, 31%. So why does the Fed think this is necessary? So according to them leading up to this meeting, they did some research, and I think Alan you mentioned that in your introduction. So what they found from their perspective is that, well, the transaction processing costs of the average debit card transaction have gone down by 50%. They said that it's around 7.70 cents per transaction in 2009 to 3.90 cents in 2021. And then they also said that issuer fraud losses went down over this period, and then fraud prevention costs have gone up. But again, that's one dimension of looking at the transaction with the data.

I'd be curious as to why they didn't consider some of the data around the merchant costs and then how specifically consumers were impacted by prices, because this is all looking at costs to the issuers, which they say, well, if your costs are going down, then you don't need, essentially that's what they're saying, if the costs are going down, you don't need to keep as much of the interchange fees that you're levering on merchants. But I would argue that a much more compelling analysis would've looked at what the merchants were doing to consumers and whether the interchange fees that was being levied was actually the reduction in it was actually being passed on the consumer, which it seems that the Fed was silent on that.

And so the other thing to point out that changed was that there was the initial proposal and then there was this provision, but if you think that was enough, they put a caveat in the proposal to say that going forward, they're going to be basically reassessing those three components, which is that base component, the basis points against which are multiplied by the transaction, and then that fraud prevention assessment. So the three components of the calculation, they're going to basically reassess that every other year, again, based on this data that they used in this example, looking at the transaction processing costs, fraud costs, et cetera. I would certainly hope that if they consider data, they would bring in the consumer impact into play, but it just kind of tells us that this is going to be an ongoing exercise if this proposal does go into effect, and unfortunately we may be hearing about this on a regular basis.

Alan Kaplinsky:

So this thing passed by a vote of six to one, one of the members of the Board of Governors, Michelle Bowman, voted against it. And let me just summarize the essence of what she said and get your reaction to this. She raised concerns about the data that was collected from covered issuers, the unintended consequences on low and moderate income customers, and whether there was a basis to support the benefits suggested by staff that merchants would pass the cost savings through to consumers, something that you just mentioned. She issued a public statement that she read during meeting addressing the consequences and costs, the formula for periodic updates, the scope of the rule, and the transition period. She stated that the fee cap aims to achieve what she referred to as rough justice by establishing a single cap that applies to all covered issuers. She described the rules as regressive rulemaking and emphasized that policymakers must understand both the intended and the unintended consequences of what they're doing.

She also cautioned whether a brief 60-day transition period that is from the old interchange fee to the lower amount, whether that would place undue burden on debit card issuers. So what's your reaction to that? Is she right, or what do you think?

Zarik Khan:

Yeah, no, I think she unfortunately seems to be the only one in her group of peers that actually took the time to consider all the data and not just what ended up making its way in the proposal. And talking about the timing. Unfortunately, this seems to be a common refrain with not just the Fed, but also with other regulators. CFPB put out a recent proposal around what's called open banking, which again, only had around 60 to 90 days for public comment, and then the thought is that that's going to get implemented. So just as in that case here, there have been some organizations that have put out a request, and I believe this was a couple of weeks ago, this is the Credit Union National Association, the National Association for Federally Insured Credit Union. They put out essentially a request to the Fed to extend the common period by at least 90 days, and hopefully push out that implementation period as well, because it doesn't seem reasonable that you have such a short deadline for comments and then a short deadline for implementation.

This is obviously a change that's coming after over 10 years, and certainly you'd need to give folks time to basically get into compliance. So from that perspective, it doesn't seem reasonable. I think she's right on the money with her comment.

Alan Kaplinsky:

Yeah, yeah. So other than what Michelle Bowman had to say, are there other implications that you'd like to mention?

Zarik Khan:

Yeah, so I think we've talked about those institutions that are going to be impacted, the ones over 10 billion. Interestingly though, I think what I found fascinating, I did a bit of research into this myself, looking at data. So those banks that are impacted, many of them, they had to eliminate pre-checking accounts, raise the minimum balance requirements, charging the maintenance fees. And so, a lot of it is that, yeah, the banks are losing money, because of this. They need to make up the losses. And the only party that really, maybe rightfully so got accused of being a little bit greedy was those merchants and retailers, which didn't pass the savings on. But let's be clear, just because the largest banks have decided that they need to recoup some of their lost revenue and maybe rightfully so. Unfortunately, one of the negative effects of just this not only Durbin, but now the proposal, is that even the banks that are not necessarily impacted right or wrong have also decided to maybe unfairly increase some of their fees and take away some of their options for their customers that they aren't even necessarily affected by.

So again, the impact of that is on the consumer as well. So I mean, just in terms of analysis, I looked at three different banks. So we'll take one of the large banks, and I'm not going to say the names, I think it's probably appropriate that it won't, but we'll take one of these large banks. So in 2011, their quarterly interchange revenues, this is looking at call reports that are publicly available for any of the banks that are put out there by the FFIEC, which is one of the regulatory bodies. So this bank's interchange revenue, which does include debit and credit, was 2.7 billion, and that was for one quarter. So in 2023, that is down to 1.9 billion. So you can truly see that the impact of Durbin I and what it's had on just one of these largest banks, that's almost 800 million reduction over a 10-year period.

So I mean, that completely makes sense and it shows the impact of Durbin on large banks. But interestingly, there's a couple of smaller banks, which are well outside of the 10 billion threshold, and they're very much listed in the exempt bank register that the Fed has put out there. So in one of the quarters, their interchange revenue was around $180,000. It's a pretty small community bank, they're based in Florida. In 2023, the same period, their interchange fee is now up to just around 500,000. So because even though they're not necessarily covered by this exemption, they have no reason to make changes one way or another. You could argue that, hey, they've used this sort of fog around this regulation and perhaps some of the noise to say, hey, you know what? We might as well take advantage of the fact that, hey, we may have lost some revenue as well, even if they haven't, and increased some of their fees.

And then there's another regional bank, which they had around 494,000 in interchange fees, again for both debit and credit. So they've since increased their interchange fees for that period, the same period except 10 years later to 750,000 in a quarter. So again, the folks who are getting impacted, it's unfortunate for them, the folks who are not, which you could argue is the merchants and even some banks that aren't affected, they're increasing their fees, they're pocketing savings, again, all at the expense of the consumer. So even where this regulation isn't directly applicable, just indirectly, it's having a bad effect on the consumer with what I would argue, again, this could be more scrutiny that needs to be given, but some unscrupulous activity and the consumer is the one who suffers in the end. So like I said, I can see where the bigger banks, the ones who are directly impacted are coming from, and certainly merchants are playing ball and consumers aren't benefiting, but some, not all, but some small institutions are likely taking advantage of noise and increasing their margins when it doesn't even concern them frankly.

So coming back to the customer's implications for them. So reference the study earlier, we talked about the number of merchants that had increased their prices and very clear that these merchants aren't passing along their savings but actually raising the prices, there are actually some state laws which have tried to prevent, at least for credit card interchange merchants from basically holding back the savings, which you could argue, well, is that another sign of overreach? But again, there's nothing for debit. So this is only something that has recently come into play. I think Connecticut and Massachusetts have some state laws which try to stop those fees from being passed on to consumers. And then New Jersey is working on something, but again, that's on the credit side, that's not on the debit side.

Alan Kaplinsky:

And you wonder how those state laws, how even police it, how can you make a determination of what's been passed on and what's not been passed on. It seems like a very, very difficult task to me anyway.

Zarik Khan:

And the thing to point out is that if you've ever worked or been around any issuer, and I've had the chance to dig into issuer data in the past, getting transaction level data from merchants, it's specifically what was bought within a specific charge is notoriously difficult. So trying to find out the specifics around what was purchased. Yeah, you have MCC, merchant codes, et cetera. But it's very hard, as you said to police that because even issuers themselves aren't able to get the full details around some of these purchases.

Alan Kaplinsky:

So what do you think, what's ahead for this regulation? You share my view that the Feds going to go ahead with it.

Zarik Khan:

Well, I think the Fed will certainly try to, I think the institutions are doing what they can to try and stop it. I think you reference the lawsuit that is in progress. And so, I think the one thing is that when you think about timing, although there is a 60-day implementation period that you referred to earlier, looking at the proposal, they did talk about the updating that formula. The first time they proposed for that update is 2025. So I can imagine that even if it does go into effect, there's so much wrangling in so much up and outcry about this that I do feel that there's going to be quite a lot of back and forth on this that'll probably end up taking the whole year. I think the earliest I could see this going into play would be that 2025 date, because they obviously came up with that formula based on data as a certain point in time.

If this doesn't go into play until later in 2024, by that time, they're already getting pretty close to 2025. So then you could almost argue back say, well, that data which you based this new cap on, that's already out of date, so you need to do your calculation again. And at that point, you might as well wait until 2025. I think there's also a possibility though, that this is going to be tied very closely to whatever happens with the CCCA, the Credit Card Competition Act, which as we referred to earlier in Durbin II. So I do think that as far as Durbin II, what's happening there is that actually very recently there was some updates that the prospects are probably getting to the point where we're not going to see anything happen on it this year. And certainly nearing the end of December when we're recording this, I think at this point we can safely say it's likely going to be next year before anything happens at that point.

Alan Kaplinsky:

Zarik, maybe you could just give people a quick overview of what's in that statute that applies to credit cards, not debit cards, and it has a completely different approach.

Zarik Khan:

So we're with Regulated II, Durbin I, which A is focused on debit, and B, takes the tactic of looking at more of a formulaic approach, which is kind of across the board and capping debit interest fees. With the CCCA, which is as we mentioned, is Durbin II, that's kind of going at things in a slightly different way where that's actually taken the whole infrastructure of how credit card issuers would operate in terms of using network. And that is specifically requiring that issuers would have to offer at least one other card network beyond Visa and MasterCard specifically. So it's really getting into a unprecedented, it's specifically calling out to networks and saying that there has to be an alternative to either of those two. And so, it's less about formulas and caps and it's more about just options for the merchant. I could argue that there's probably more pros than cons on that particular case. I mean, you can still make the case that it's potentially some overreach into just how credit cards are used.

And certainly there's a thought that credit card rewards might suffer from that sort of legislation, but certainly the way it goes about it's very different. And I would argue the reason for that is probably because there was such backlash and around having a specific cap, which we're talking about 10 billion and over, there's issuers and banks of all different sizes. So does the same cap applying to every single eligible issuer that falls into the threshold of legislation? Does that make sense? I think perhaps they learned from that, the CCCA, but then interestingly, this amendment to the original Durbin came out after the CCCA was already in place, so makes you think, well, maybe they didn't learn anything from all the feedback that came into play from the First Amendment.

So where that's going now is that I think Durbin, who's the sponsor of the CCCA as well, and then Roger Marshall, who's a Republican co-sponsor for Kansas, they're hoping that at least by the end of this Congressional session, which is the end of 2024, that they would at least get a vote on the floor for this particular bill. And it was interesting. The most recent thing I've heard that happened is that Senator Marshall actually held a press conference at a Casey's general store in Topeka Kansas just to underscore how important this bill was for him. And I think emphasized that this is something that from his perspective is really going to benefit retailers. And they've also talked about how they've gotten support recently from the Teamsters Union and then the Service Employees International Union as well. So certainly the battle lines are being drawn on this one, and I think there's probably more to come next year, but I could certainly see that any sort of execution or movement forward on the Fed's proposal here around Durbin I, may potentially be tied into whatever happens with the CCCA.

I could see, I could imagine, for example, that the CCCA failed, maybe it makes this proposal less likely to go through. Perhaps there could be some good arguments and reasoning that come forward in those debates and discussions around the new bill that could then influence the outcome of the amendment to the original.

Alan Kaplinsky:

The one thing I want to add, because we're drawing to the end of our show today, is that there were two cases. I already talked about one case pending before the Supreme Court, the Corner Post case that deals with the six-year statute of limitations for challenging a regulation and when it begins to run. But there are two other cases deal with an entirely different issue, but could very well have an impact on Reg II as originally drafted and as proposed to be amended. And that is the names of the cases are, I'm going to give just the names of the plaintiffs. One is called Raimondo, R-A-I-M-O-N-D-O. The other is called Relentless. And both of those cases are giving the Supreme Court, which has accepted review of the cases, the opportunity to determine whether or not they will overrule what's called the Chevron Deference Framework.

The Chevron Deference Framework emanates from a 1984 opinion of the Supreme Court in a case involving Chevron, where the court said that if a statute is ambiguous or vague with respect to a particular issue, and if the federal agency then promulgates a regulation which is reasonable, then the court is required to validate the regulation. The Supreme Court has not liked that Chevron doctrine, even though it still is binding precedent in the lower courts. It's in other cases that have come up to the Supreme Court in the last several years that involve whether to defer to a regulation promulgated by an agency. They hate the doctrine so much, they don't even cite the Chevron case. They've figured out ways to decide the case on other grounds, but now they decided to take this issue head on, and we know how much the majority of the Supreme Court, the conservative members like the administrative state and what all the regulators are doing, they don't like it. They think that they're usurping the role of Congress, and very often they're pushing the envelope and overreaching.

Well, a lot of Supreme Court watchers and experts in administrative law believe the Supreme Court took these two cases to reject the Chevron doctrine to overrule it. And if that happens, then they're not required to defer to a regulation, even if it's reasonable. Then at that point, they can take their own look at the statute and the regulation and say, do they have the authority under the statute to promulgate the regulation that they promulgated? That could create additional problems for the Fed, and it's going to create problems for all the federal agencies, including the CFPB, the federal banking agencies. But I see that as being a potential problem for the Fed, and given the timing that you have laid out on when this Regulation II would conceivably become effective, by that time, we're going to have this opinion in Raimondo and Relentless and the Chevron doctrine may not exist any longer. So that may create even more incentive for the banking industry to challenge what the Fed has done if they end up finalizing a regulation that looks like the proposal that you and I have been talking about.

Well, anyway, we've come to the end of our program today and Zarik, want to thank you once again for being a guest on our show. You are a font of knowledge when it comes to the payments industry, so thank you again.

Zarik Khan:

Thank you. It's a pleasure as always and really appreciate the time.

Alan Kaplinsky:

I also want to thank all of our listeners today for downloading the program and remind them that to make sure you don't miss any of our future episodes, you can subscribe to our show in your favorite podcast platform, be it Apple, Google, Spotify, or wherever you listen. Don't forget to check out our blog consumerfinancemonitor.com for daily insights on the financial services industry. And there is a lot of content on our blog about the topics that we have been talking about today. And if you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com. Stay tuned each Thursday for a new episode of our show. Once again, thank you for listening and have a good day.