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Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses

Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris

April 25, 2017

Fact Sheet

(FULL PAPER AVAILABLE AT HTTP://LAWECONCENTER.ORG/IMAGES/ARTICLES/ICLE-DURBIN_UPDATE_2017_FINAL.PDF)

INTRODUCTION/BACKGROUND

- In the words of Senator Durbin, his eponymous Amendment aspired to help "every single Main Street business that accepts debit cards keep more of their money, which is a savings they can pass on to their consumers."
- To achieve its end, the Durbin Amendment required the Federal Reserve Board (FRB) to ensure that "[t]he amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction." It also provided an exemption for "small issuers" (defined as issuing banks with assets of less than $10 billion).
- While the Amendment's basic concept of price controls is straightforward, "the Durbin Amendment was crafted in conference committee at the eleventh hour, its language is confusing and its structure convoluted," as the court put it in its opinion reviewing the Federal Reserve's implementation of the law.
- Moreover, debit card interchange is part of a complex, interdependent financial ecosystem. Although economists disagree about the efficiency of establishing interchange fees through market processes, they universally agree on one conclusion: that price controls on payment card interchange fees will result in higher prices and lower services for card users.
- By imposing price controls on one part of this ecosystem, the Amendment has driven predictable but (presumably) unintended changes elsewhere in the ecosystem, with various troubling effects.

Effects of the Durbin Amendment

- After implementation of the Amendment in 2011 via the FRB's rule, known as Regulation II, the average fee charged by issuers covered by the rule fell by more than 50% to $0.24 per transaction, and has remained at about the same level since.
- Despite Congress's purported effort to protect smaller banks from the effects of the regulation, during that same period the average interchange fee for exempt banks also fell — from an average of $0.53 per signature-authenticated (Visa, MasterCard & Discover) transaction in 2011 to $0.50 per transaction in 2015, and from $0.32 per PIN-authenticated transaction in 2011 to $0.26 per transaction in 2015.
- Prior to implementation exempt signature transactions represented 28% of the total number of signature transactions. By 2015, however, the relative proportion of exempt signature transactions as well as the share of revenue from interchange fees for exempt signature transactions increased by 8% to 36% and 35%, respectively.
- Non-interest income including interchange fees comprises almost half of banks' annual operating income. The cap on such fees had a substantial negative effect on revenues at banks with assets of more than $10 billion. Early estimates suggested annual combined revenue losses at large banks in the range of $8 billion. More recent estimates put the figure closer to $14 billion, which represents more than five percent of noninterest income.
- The Durbin Amendment cap on interchange fees had a nominally smaller, but likely still significant, negative effect on revenues at smaller banks.
- Banks have succeeded in implementing certain, arguably regressive, practices and different types of fees — including reducing the availability of free checking, raising the monthly fee on non-free checking accounts, increasing other fees (such as for overdrafts), and eliminating rewards programs — to make up some of the lost revenue.
- According to one estimate, banks have been able to recoup approximately 30 percent of their annual revenue loss caused by the Durbin Amendment through higher bank fees.

A. Effects on Access to Banking Services

- It has been estimated that the annual cost for a bank to maintain a checking account is between $280 and $450.
- For free accounts, debit interchange fees (along with intermittent overdraft fees) are the primary source of revenue — but even before the Durbin Amendment, less than half of *all* checking accounts were profitable.
- Nevertheless, by 2009, the proportion of bank accounts offering free checking had increased to over 75%.
- In 2011, as the implications of the Durbin Amendment became clear, the proportion of banks offering free checking accounts fell dramatically, to 45%. And as the costs of Regulation II began to hit, the proportion fell still further, to under 40%, where it has since remained.
- In 2008, the average minimum deposit required in order to avoid fees on non-interest-bearing accounts was $109.28 — a figure that had fallen consistently from a high of $562.27 in 1999. Immediately following implementation of the Durbin Amendment, however, average required minimum deposits to avoid fees increased sharply and dramatically, surpassing previous levels

and reaching a new peak of $723.02 in 2012. That figure has remained high and, as of 2016, stands at $670.74 — considerably higher than the highest pre-Durbin Amendment level.
- Prior to the Durbin Amendment, average monthly checking account maintenance fees were $5.90 (in 2009). Following the Amendment's implementation, however, the monthly average shot up above the pre-Amendment high to $12.23, and have since climbed to $13.25, according to a recent analysis.
- Other banking fees have seen similar, record highs since the Amendment's enactment, as well. For instance, average monthly ATM withdrawal fees, which were already rising prior to the Amendment's passage, have continued to rise since; they now stand at a record high of $1.67.
- Notably, the increase in the mandatory minimum balance necessary to retain access to free checking is much easier for higher-income households to meet. Higher-income households are also likely to be able to purchase additional bank products (such as home mortgages or auto loans) that will help them meet the requirements for free checking.

B. Effects on Debit Card Characteristics

- Many covered banks also eliminated their debit card reward programs in order to reduce costs. According to one industry analyst, the availability of debit card rewards programs declined 30% in the first year the Durbin Amendment was effective, and banks that maintained rewards dramatically scaled back their generosity.
- This decline in debit card rewards has had a regressive effect. Low-income consumers have not only been impeded in their access to debit cards and debit card rewards, they have also experienced a significant drop in credit card ownership.
- Debit card adoption for the lowest-income households (under $25K per year) has fallen by almost 10 percentage points relative to households earning between $50K and $75K per year since implementation of the Durbin Amendment.
- The loss of cash-back rewards is tantamount to a nominal price increase on all purchases. The cash-back rewards on debit cards (which in 2010 were available on approximately 17% of debit cards, up from 8% in 2003) were typically about 1% of spend.

C. Effects on "Main Street" Businesses

- While larger merchants have almost certainly seen a reduction in costs, many smaller merchants have almost certainly seen costs increase as a result of Regulation II. And these costs increases have affected small "Main Street" merchants most significantly.
- According to the results of a recently published survey of merchants undertaken on behalf of the Federal Reserve Bank of Richmond in late 2013 and early 2014, 57.6% of merchants reported no change (or were unaware of any change) in the costs associated with debit transactions, 11.1% reported reduced costs, and 31.3% reported *increased* debit costs.
- There are two reasons why most merchants not seen a decrease in their costs of debit card acceptance. First, many small merchants lost the preferential interchange rates they enjoyed before the Amendment's passage; for these merchants, the interchange rates set by Regulation II operate primarily as a floor rather than a ceiling. Second, acquirers, which intermediate the

transactions between issuers and merchants, may have captured some of the surplus generated by the Durbin Amendment that was *intended* for merchants and consumers.

- Simply reducing interchange fee rates does not necessarily mean that consumers or businesses will be better off in the end, and it *certainly* does not mean that consumer prices or merchant costs will necessarily be reduced.
- Whether that will be the case depends on two things: *first* whether and by how much the cost reduction is passed-through, both from the acquirer to the merchant as well as from the merchant to the consumer; and *second* whether and by how much any cost reductions incurred by acquirers are transferred to merchants in the form of improved services rather than lower costs.
- A recent survey of 500 small (under $10 million in annual revenues) merchants by Javelin Strategy & Research found that small merchants are being charged an average MDR of 2.3%, suggesting that pass-through rates have not changed substantially since our prior analysis.
- Prior to the Durbin Amendment, interchange fees varied significantly depending on the type of merchant, the size of purchases, and other criteria. After the implementation of Regulation II, however, the ability to engage in fine-tuned, differential pricing was effectively removed for the majority of transactions, and Regulation II's *maximum* rate became, in practice, the *only* rate.
- Consider the effect of the Amendment on the interchange fees charged for small ticket items. Prior to the Durbin Amendment, the interchange fee for signature debit purchases set by Visa and MasterCard on transactions of $15 or less was 1.55% of the transaction value, plus $.04. Thus, the interchange fee for a $5 purchase was $.11. After the implementation of Regulation II, however, this more than *doubled* — to $.23 (*i.e.*, $0.21 + $0.01 + 0.05%).
- In the Richmond Fed survey, 31.8% of merchants reported that for small ticket items debit costs had risen, while only 2.8% reported that costs had fallen. That survey also found that debit acceptance costs rose more in some sectors than others. In particular, the study found that costs rose for 65.7% of fast food merchants, 54.1% of grocery stores and 47.8% of home improvement stores.
- According to the Richmond Fed survey, the proportion of merchants requiring customers to spend a minimum amount for debit card purchases rose from 26% to 29%.
- On balance it seems clear that the Durbin Amendment has almost certainly had a net adverse effect on many merchants, especially merchants selling predominantly small-ticket items. Meanwhile, only a small proportion of merchants appears to have clearly benefited from the Amendment. And likely many merchants have received some benefit in terms of the value of payments processing services, regardless of whether their processing costs have gone up, stayed the same, or been reduced.

D. Effects on the Economy: The Meaninglessness of Robert Shapiro's Fanciful Counterfactual

- In a 2013 white paper, Robert Shapiro claims that, in 2012 the Durbin Amendment's cap on interchange fees saved consumers $5.87 billion and supported more than 37,500 additional jobs. Despite being widely cited by Durbin Amendment supporters (and opponents of the Amendment's repeal), both of these claims are fanciful and every step of the analysis required to reach these conclusions is flawed.

- Although Shapiro asserts a 69% pass-through rate from merchants to consumers, he fails to recognize that these are so-called "four-party systems" in which there is also another intermediary: the merchant's acquiring bank or payment processor. By assuming away these entities, Shapiro effectively assumes a 100% pass-through of interchange fees from issuers to merchants. But this is simply not plausible.
- Even assuming for the sake of argument that none of the interchange fee reduction was captured by acquirers, Shapiro's claim that 69% of the savings were passed on from merchants to consumers was simply lifted from a single study that calculated a rate based on data that was highly specific to certain classes of merchants and unrelated to changes in the interchange fee or MDR. Shapiro's analysis is inconsistent with the evidence of the *actual* effects of caps on interchange fees, which finds little evidence of any pass-through at all.
- What's more, Shapiro inexplicably ignores the *other* side of the two-sided payment cards market, thus ensuring that his calculations are woefully off-base. Regardless of how much of their cost savings merchants pass on to consumers, because most of those consumers are also banking customers, any increases in costs (or reductions in revenue) to banks resulting from Regulation II could *also* be passed on to consumers, reducing their net benefit.
- Shapiro also fails to account for the effects on consumers (and employers) on *both* sides of the market and his job-growth calculation entails several steps, each of which is problematic.
- And he asserts that "half of the retained cost-savings flow through to higher spending by merchants," and that "one-quarter of the remaining retained earnings ultimately went to labor." The claims are based on completely unsupported, seemingly random assertions.
- The most significant flaw in his job growth calculation is the absence of any consideration of the effects on consumers' budget constraints and banks' labor-investment decisions resulting from the increase in bank fees paid by consumers and the reduction in revenue earned by banks as a result of the Durbin Amendment. This is a glaring and inexcusable oversight.
- In simplified terms, even with an unrealistic 100% pass-through, any change in the interchange fee amounts to a one-to-one transfer from banks to merchants (or vice versa): Cost reductions realized by merchants are incurred by issuing banks as revenue reductions in the same amount. That means that by however much a reduction in interchange fees increases merchants' ability to pay for labor, it also reduces banks' ability to pay for labor by the same amount.
- And because banks have attempted to recoup some of their lost revenue in the form of increased fees charged to consumers, the net effect on consumer budgets (and thus their ability to increase consumption) is also ameliorated, leading to a further, unacknowledged reduction in Shapiro's asserted employment effects resulting from consumer activity.
- Just as any speculative pass-through of cost savings to retail customers must be weighed against the unambiguous increase in bank fees that has resulted from the Durbin Amendment, any speculative employment gains must be weighed against the resulting job losses in the retail banking sector, as well.
- All told, Shapiro's analysis is essentially meaningless as a guide to the economic effects of the Durbin Amendment on consumers and workers.

E. Effects on Consumer Prices

- According to the Richmond Fed Durbin Impact Study, the vast majority of merchants — 77.2% — did not change prices at all following the implementation of Regulation II, and only 1.2% reduced prices — leaving a significant minority (21.6%) that actually *increased* prices.
- And even if merchants *did* pass on their entire cost to consumers, the savings would be small: according to one estimate, it would result in a maximum retail price reduction of only $.07 on a $40 purchase.
- But with such small cost changes, it is possible that the savings would not, in fact, be passed on at all. Particularly in markets with fluctuating prices, such small price changes would be difficult (or impossible) to discern.
- Australia first imposed price controls on interchange fees in 2003, but there remains no tangible evidence that consumers have benefited from lower prices as a result. A comprehensive 2012 study found that the same was true for Spain, which first imposed interchange fee price controls in 2005. Moreover, as in the United States, in neither country is there any evidence that purported pass-through of savings by retailers has exceeded the costs to consumers from higher fees and reduced rewards.

F. Effects on Small Banks and Credit Unions

- Despite claims that the Durbin Amendment would create a safe harbor for small banks, the effects of the Amendment appear to have spilled over to smaller institutions.
- The average interchange fee for *exempt* banks has fallen since the end of 2011. According to a 2014 study conducted by the Mercatus Center, 73.3% of surveyed small banks indicated that "debit card interchange fees policy" had a negative impact of some kind (either "significant" (29.1%) or "slight" (44.2%)) on their earnings.
- In 2015 the average per-transaction authorization, clearing and settlement (ACS) costs for high-volume issuers were 3.8 cents and for mid-volume issuers they were 11.6 cents. But for low-volume issuers ACS costs were 56.8 cents — about 15 times higher than for the largest banks. Even at the pre-Amendment, higher interchange rates, many small-volume issuers would barely break even on debit card transactions. To the extent that the Durbin Amendment has eroded interchange fees for small-volume issuers, then, it has made it even harder for them to cover their costs.
- There is also evidence that the $10 billion asset ceiling for exemption from Regulation II has encouraged inefficient bank combinations at the margin, and distorted the optimal balance of smaller and larger banking entities. A bank whose assets are growing close to the asset ceiling faces a choice: marginally grow above $10 billion in assets and face an immediate revenue shortfall as it becomes subject to Regulation II, or acquire another, smaller bank that will push the combined entity far enough over the $10 billion ceiling that it can readily bear the regulation's effect on revenues.
- As a Boston Federal Reserve study notes: "To avoid the interchange fee restrictions, firms just above the threshold may have an incentive to shrink their assets to get below it, whereas firms just below the threshold may have an incentive to limit their growth to avoid crossing it. If the benefits of avoiding the interchange fee restrictions outweigh any costs of adjusting assets, this behavior would be a natural response to the threshold."

THE DURBIN AMENDMENT'S EFFECTS ON LOW-INCOME HOUSEHOLDS

- An inevitable and predictable consequence of the Durbin Amendment's price controls is that, for consumers, debit cards have become less-attractive, less-valuable payment instruments for retail transactions. As a result, consumers are marginally more likely to use alternative forms of payment — *e.g.*, cash, checks, money orders, prepaid cards or credit cards — following the Amendment's implementation. And in most cases where payment would have been made via debit, use of these alternatives is more costly.
- Using conservative estimates that are still applicable today, in our previous paper we estimated the magnitude of the harm to low-income consumers as a result of the loss of free checking as between $1 billion and $3 billion.

A. Effects on Household Wealth and Consumption

- The cost of making debit cards less attractive relative to other forms of payment is *greater* for lower-income consumers than it is for wealthier consumers. Low-income consumers have fewer alternative forms of payment to choose from and are considerably less likely than wealthier consumers to have access to a credit card (which is the payment alternative least likely to cost more than debit). In fact, according to data from the Boston Fed's Survey of Consumer Payment Choice, credit card adoption is significantly correlated with income.
- While 91% of high-income ($75K-$100K per year) and almost 95% of very-high-income (over $100K per year) households have credit cards, only 66.7% of low-income ($25K-$50K per year) and 37.8% of very-low-income (under $25K per year) households do. And since the implementation of the Durbin Amendment, the rate of credit card adoption by lower income households has fallen, while that of high income households has increased. Meanwhile, low-income and high-income households use debit cards at fairly similar rates (80.7% and 84.7%, respectively).
- The effect is particularly pronounced for unbanked consumers (a disproportionate share of whom are low income), who instead must turn to more expensive and/or less convenient forms of payment like money orders, prepaid cards, and check cashers.
- While overall credit card usage has increased, the shift to credit cards is significantly more pronounced among wealthier households. According to a recent study published in the RAND Journal of Economics that looked at the effects of making debit cards less attractive to consumers: "The difference over the income range is striking, with welfare falling more than twice as much for consumers from low-income consumers than for consumers from the wealthiest consumers in the long run, and 2.5 times as much in the short run."
- Likewise, the change in rewards structures for electronic payments disproportionately harms lower-income consumers.
- Finally, the higher prices charged by some merchants as a result of the implementation of the Durbin Amendment have likely had a disproportionate effect on lower-income households, which tend to spend a larger proportion of their income on the types of goods for which prices have increased. In particular, lower-income households spend a much larger proportion of their income on food (over 14% for each of the bottom four income deciles and 16% for the lowest decile) than higher-income households (between 10 and 13% for the top 6 deciles) and the main

sources of their food, grocery stories and fast food merchants, were among those most likely to have increased prices as a result of changes to the cost of debit card transactions.

B. Effects on Financial Inclusion

- Low-income consumers are more affected by the bank account fees that arose after implementation of the Durbin Amendment because these fees represent a larger — and increasing — share of their incomes. At the same time, they are also more likely to *incur* these fees because, *e.g.*, minimum balance requirements are now more stringent (and the fee for each infraction is also higher than before, in part due to the Durbin Amendment).
- In 2015 the average overdraft fee accounted for 65.3% of reported consumer bank charges, and the median fee 75.6% — and these numbers have increased since Regulation II went into effect, *despite* federal regulations implemented in 2010 aimed at minimizing their incidence.
- For many lower-income households, the imposition of higher fees has resulted in the loss or closing of checking accounts. Meanwhile, as a result of many pre-paid cards having been reclassified as debit cards large banks offer prepaid cards with limited functionality in order to avoid having to charge the high fees to consumers that would be necessary to make up for the revenue losses they would incur if the cards were subject to the Durbin Amendment.