Introduction

Imagine you are at the grocery-store checkout line and it is to pay. You enter your credit card in the terminal, assuming that your payment will be routed over the network operated by the brand on your card (typically Visa or Mastercard). But you learn after the fact that the grocery store has chosen instead to route it over China Union Pay.

Most of us would be uncomfortable ceding to the merchant the authority to route transactions over the cheapest network, without considering our concerns about security, reliability, and other card features (including rewards). Yet that is already the case for many point-of-sale transactions made with debit cards—the result of a 2011 regulation implemented by the Federal Reserve. Consumers can, however, often still force the transaction to run over their preferred network by pushing the "credit" button.

But new rules under consideration by the Federal Reserve would extend merchants' ability to determine how debit transactions are routed to online transactions, while also making it more difficult for consumers to control who gets to handle their personal data and process their transactions.[1] Perhaps more worryingly, a new bill (the "Credit Card Competition Act") introduced by Sen. Richard Durbin (D-Ill.) would, in the name of "competition," impose similar routing requirements on credit cards, while ignoring important differences in the competitive framework of debit and credit cards.[2]

Since they emerged more than 50 years ago, payment-card networks have come to play an increasingly important role in our lives, both directly and indirectly. Directly, they facilitate hundreds of billions of transactions every year, representing tens of trillions of dollars in value.[3] Indirectly, they have contributed to a near-complete shift from paper-based to electronic value exchange and accounting in the United States and many other countries. This has, in turn, resulted in enormous efficiency improvements and wider social benefits, such as the development of online commerce, greater ease of travel, and reduced tax avoidance.[4]

The shift from paper to electronic value exchange has been driven almost entirely by voluntary decisions made by businesses and consumers. Despite such clear evidence of market success, over the past three decades, governments have increasingly sought to correct alleged "market failures" in payment-card markets. The main tool governments have used is price controls on interchange-fee rates. More recently, however, several governments—including the United States, the European Union, and Australia—have sought to reduce rates further still by regulating the manner in which payments are "routed" (i.e., the way that messages pertaining to a transaction are sent between the merchant and the issuing bank). This has important implications for consumer protection, fraud prevention, and financial inclusion.

In previous studies, we have shown that regulation of interchange fees typically has slowed the shift to more innovative, quicker, more convenient payment systems, while also reducing other benefits and particularly harming poorer consumers and smaller

merchants.[5]

Prohibitions on exclusivity in routing have similar effects as direct price controls. But imposed routing requirements will have additional effects that go beyond those of price controls and would result in various harms to consumers and the economy. This study seeks to delve deeper into the problem, focusing primarily on the justifications for and effects of regulations that affect the way in which transactions are routed. While "routing" may seem arcane, it is fundamental to the effectiveness of payment networks. Understanding the likely consequences of such regulation is thus important. That is the purpose of this paper.

We begin, in Section II, by describing the technological and economic elements of payment-card routing. Supporters of forced routing requirements contend that they will promote more efficient competition in consumers' payment-card usage. But we show that this superficial argument ignores the basic economic realities of payment-card networks, as well as the fundamentally different nature of consumer competitive choice, both in debit-card markets (where routing requirements currently exist) and in credit-card markets (the intended target of Sen. Durbin's proposed law). Section III reviews the evidence regarding the effects of regulating payment networks. We summarize the pernicious effects of price controls and then explain how the routing mandate created by the 2011 Federal Reserve regulation, known as Regulation II, has had similar effects. Section IV considers the proposed changes to Regulation II and the new Durbin proposal to regulate credit-card routing, with a particular focus on the likely harmful effects of the changes on the incidence of fraud and the knock-on effects on issuers, cardholders, and merchants. Section V concludes.

[1] *Debit Card Interchange Fees and Routing*, FR 26189 (2021), available at: https://www.govinfo.gov/content/pkg/FR-2021-05-13/pdf/2021-10013.pdf.

[2] Credit Card Competition Act of 2022, S. 4674, 117th Cong. § 2 (2022), available at: https://www.congress.gov/117/bills/s4674/BILLS-117s4674is.pdf.

[3] *Global Network Card Results in 2021*, Nilson Report Issue 1224, https://nilsonreport.com/mention/1672/1link.

[4] See the appendix to this paper and references therein.

[5] See Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, ICLE Financial Regulatory Program White Paper Series (Jun. 2, 2010), available at http://laweconcenter.org/images/articles/zywicki_interchange.pdf; Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, *Unreasonable and Disproportionate: How the Durbin Amendment Harms Poorer Americans and Small Businesses*, International Center for Law and Economics (Apr. 25, 2017); Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, *Price Controls on Payment Card Interchange Fees: The U.S. Experience,* George Mason Law & Economics Research Paper No. 14-18, (Jun. 6, 2014).