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Regulation II: The Big-Box Boondoggle Paid for by American Consumers

The Federal Reserve is proposing a new limit on the amount banks can recover from the cost of facilitating debit card transactions, often referred to as interchange fees. This proposal, announced Oct. 25, 2023, lowers the limit that banks can charge by 30-40 percent from current levels set in 2011, pursuant to Regulation II of the Dodd-Frank Act.

The Federal Reserve, with the support of big-box merchants, is basing its proposal on insufficient data, which fails to adequately account for all of the costs issuers banks incur to offer debit cards, such as card production and delivery and transaction monitoring costs. When Regulation II was considered in 2011, big box merchants argued that if the Federal Reserve agreed to help them avoid paying for the service of processing debit card payments, they would return the favor and pass on savings to customers. Instead, merchants pocketed the difference while customers were left with higher checking account fees and fewer free checking account offerings. The new proposal seeks a repeat of history and will only exacerbate this problem further.

How do banks cover the cost of offering debit card purchases?

Every time a consumer uses a debit card to make a purchase, the merchant pays a small fee to the cardholder's bank. This reimbursement helps to cover the cost of banks offering debit cards, managing the technology, implementing fraud prevention measures and ensuring that money gets from point A to point B.

For every $100 spent, the merchant reimburses the bank between 26-27 cents. The proposal would reduce those rates, capping reimbursements at 18.4 – 19.3 cents:

- 14.4 cents for every transaction (↓ reduced from 21 cents)
- 0.04% for the value of the transaction (↓ reduced from 0.05 percent)
- 1.3 cents for fraud-prevention efforts (↑ increased from 1 cent)

Banks facilitated $4.2 trillion in transactions in 2021, giving customers around-the-clock access to the goods and services they need. But processing large payment volumes has a cost.

Banks were reimbursed $31.59 billion from card transactions in 2021, according to the most recent data from the Federal Reserve. These interchange fees are added to each transaction and are reinvested in new technologies and fraud prevention efforts and help to support banks' ability to offer deposit accounts. Smaller banks especially rely on these funds to stay in business. Without access to these funds, it would quickly become unfeasible for smaller institutions to offer free checking accounts. Low- to no-cost deposit accounts, such as Bank On certified accounts, would also be at risk. These accounts serve as an important tool to increase financial inclusion and reduce the number of unbanked by bringing low-income consumers into the banking system.

Regulation II has harmed vulnerable consumers and small banks alike. The latest changes will make it worse.

- **Checking account fees will increase, and the availability of free accounts will decline, which has led to customers becoming unbanked in the past.** Within the first few years after Regulation II's issuance in 2011:
  - The percentage of regulated banks offering free checking accounts declined from 60 percent to less than 20 percent.[1]

[1] Sarin, Natasha, "Making Consumer Finance Work" (2019) at 1537. Faculty Scholarship at Penn Carey Law. 2047. https://scholarship.law.upenn.edu/faculty_scholarship/2047.

- Checking account fees more than doubled, from less than $4 to more than $7, for regulated banks.
- The average minimum balance requirement at regulated banks for noninterest checking accounts increased by $400, or 50 percent.[2]
- For interest-bearing checking accounts, minimum balance requirements at regulated banks rose even more, by $1,700, or 55 percent.[3]
- Almost 30 percent of respondents who previously had a bank account reported that they became unbanked because account fees were too high and unpredictable, according to a 2017 FDIC Survey of Unbanked and Underbanked Households.[4]

- **It's a tax on the resources banks require to invest in technology and combat fraud.**
  - From 2011 to 2021, fraud losses as a share of transaction volume more than doubled (17.5 bps in 2021 vs. 7.8 bps in 2011). As the volume and speed of transactions grow, so does the cost of facilitating these services safely.
  - While the proposal marginally increases the amount banks can charge for fraud prevention (increasing the allowance from 1 cent to 1.3 cents per transaction), these measures may not be sufficient to cover large-scale fraud mitigation and prevention strategies.
- **It doesn't just affect banks with over $10 billion in assets, as proposed. Banks of all sizes have been harmed since Regulation II became effective in 2011.**
  - Between 2011 and 2021, small institutions that were exempt from Regulation II saw a 16 percent decline in revenue for single-message network transactions – transactions that are typically made using a PIN number.[5]
  - In 2014, 73.3 percent of surveyed exempt banks indicated that "debit card interchange fees policy" had a negative impact of some kind (either "significant" (29.1 percent) or "slight" (44.2 percent) on their earnings.[6]

Big-box merchants see Regulation II as a tactic to boost profits without passing on savings to customers.

- Some estimates indicate that big box merchants had pocketed more than $42 billion as of 2016, and that number has only since grown.
- According to a merchant survey conducted by the Federal Reserve Bank of Richmond and Javelin Strategy & Research in 2014, 75 percent of merchants reported that they did not change prices due to Regulation II, 23 percent reported that they increased prices and only 2 percent reported that they decreased prices.

The Federal Reserve is letting merchants get away with this multibillion-dollar boondoggle, designing their methodology to achieve the desired outcome.

- The Federal Reserve previously concluded that an imposed limit on reimbursement was appropriate so long as 80 percent of issuers could recover their costs. Any issuer that fell in that remaining 20 percent was tagged as "too inefficient," without regard to a long list of factors that may influence higher costs.
- But under the Federal Reserve's new methodology, 34 percent of issuers will be unable to meet their costs. Therefore, the Federal Reserve is making the unfair assumption that 1/3 of issuers should either offer their services at a loss based on an arbitrarily imposed limit, or exit the market.[7]
- Moreover, the Federal Reserve continues to refuse to consider all the relevant costs issuers incur to provide debit card services to consumers.

Regulation II is bad policy, and these changes will only make matters worse.

Reg II has proven to be bad for consumers and bad for banks of all sizes. When considered alongside a litany of other major policy proposals related to capital, long-term debt fundings and late fees, the proposed revisions to Reg II would pose an event greater threat to consumers as well as the health of financial institutions and the payment system. The Federal Reserve should prioritize consumers rather than caving to pressures from big-box retailers.

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[2] Mukharlyamov, Vladimir and Sarin, Natasha, "The Impact of the Durbin Amendment on Banks, Merchants, and Consumers" (2019) at 4. Faculty Scholarship at Penn Carey Law. 2046. https://scholarship.law.upenn.edu/faculty_scholarship/2046.
[3] Manuszak, *supra* note 1 at 5.
[4] Sarin, *supra* note 2 at 1538.
[5] Board of Governors of the Federal Reserve System (2022), "Average Debit Card Interchange Fee by Payment Card Network."
[6] Hester Peirce, Ian Robinson, and Thomas Stratmann, "How Are Small Banks Faring Under Dodd-Frank?," Mercatus Center Working Paper No. 14-05 (Feb. 2014) at 85, available at https://www.mercatus.org/system/files/Peirce_SmallBankSurvey_v1.pdf.
[7] Debit Card Interchange Fees and Routing *supra* note 17 at 28.