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The Durbin Debit Card Interchange Fee Cap Hurts Consumers

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An obscure, technical provision in the massive Dodd–Frank financial regulation bill will make it harder for consumers to use debit cards, hurt banks and credit unions, and increase fees that banks change consumers for other bank services. Inserted in the bill at the insistence of Senator Richard Durbin (D–IL), the provision was supposed to help consumers, but it is so flawed that portions of it have been criticized by most of the financial services regulators. Legislation has already been introduced to delay the effective date of the provision while its potential effects are thoroughly studied, but Congress should not stop there. Instead, it should repeal the provision entirely.

How the Durbin Provision Would Work. On its surface, the provision seems very simple and even pro-consumer. It directs the Federal Reserve to regulate the fees that banks charge businesses when consumers pay for a purchase with a debit card. Typically, these fees, which are set by the bank or credit union that issued the card, are set at 1 percent to 2 percent of the purchase amount. Debit card fees are usually a lower percentage of the transaction than the fee the card issuer charges to merchants when a customer uses a credit card. Merchants benefit when consumers use debit or credit cards because consumers are usually willing to spend more using a card than when paying with cash. However, some consumer advocates and merchants had argued that the debit card fees were higher than necessary and allowed financial institutions to make "excess" profits.

The Durbin amendment agreed with those claims and directed the Federal Reserve to set standards that would allow it to assess whether the fee is "reasonable and proportional" to the costs of providing debit card services. Instead of setting standards, the Fed chose to place a cap on those fees by proposing rules that would reduce the average fee by about 70 percent, from an average of about 44 cents per transaction to no more than about 12 cents per transaction. The Fed argues that this level would cover all of the costs of setting up and operating a debit card system. However, both the card issuers and some bank regulators argue that the Fed used an exceptionally narrow definition in deciding which costs to consider, and it appears to have excluded the significant costs of dealing with fraudulent transactions.

The Supposed Small Bank Exemption. Supporters of the amendment seem to recognize that smaller card issuers have to spread their costs across a much lower volume of transactions, and thus they must charge higher fees than larger issuers if they are to survive. For this reason, smaller banks and credit unions with less than $10 billion in assets would be exempt from the Durbin amendment, and would remain free to charge whatever debit card fees they chose.

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However, several banking regulators, including Federal Reserve Chairman Ben Bernanke, say that in practice this exemption may not work and the overall price cap could still apply to all sizes of debit card issuers. Both they and representatives of smaller issuers argue that merchants could refuse to accept debit cards issued by smaller banks and credit unions because the merchants would have to pay higher fees. Faced with artificially low fee caps because of the regulations, even smaller issuers that are exempt from the regulations would face a major cost squeeze that would force many of them to exit the market. That could lead to even more concentration in the banking industry.

How Consumers Would Be Hurt. Sponsors of the measure assume that card issuers would eat the cost of reducing debit card fees. They also assume the reduced cost to merchants would be passed on to consumers in the form of lower prices. Finally, they expect that there would be no change in the number of consumers using debit cards or in the way those cards are used. However, the reality may be very different.

Faced with sharply lower profits from debit card use, card issuers are almost certain to react by doing one or more of the following: imposing an annual fee on debit cards; raising other fees that would be paid by consumers; or reducing the interest rates paid on consumer deposits. While such a response would hurt all consumers, it would especially damage those with moderate and lower incomes.

Increased fees on debit cards will discourage some consumers from using them. Instead, they might go back to using credit cards, which typically have higher fees and interest charges. In the wake of the recent recession and legislation that tightened regulatory controls on credit cards, many banks and credit unions have tightened credit standards by lowering credit limits, increasing interest rates and fees for certain cardholders, and refusing to issue cards to certain less profitable customers.

Consumers who are unable to qualify for credit cards or who are discouraged by higher fees on debit cards may turn to stored-value cards instead. These are cards issued by merchants or financial institutions where consumers put money on the cards before they use them. A record of the card's value is kept on the card itself or stored in the computers of the issuer. Depending on the card, it may be restricted to use at only one or a limited number of merchants, and usually offers no protection to the consumer if the card is stolen or lost. In addition to tying up a consumer's money on cards that may have limited use, stored-value cards usually have fewer consumer protections than bank-issued or credit union-issued debit cards and may have a fee structure that appears to be small, but actually costs the consumer a much higher percentage of their money than other types of cards.

Sending the Wrong Message to Consumers. A key value of debit cards is that they allow consumers to spend their own money rather than borrowing it from the card issuer. This makes it easier for them to budget and to handle their finances responsibly. Over the last few years, a significant number of consumers have moved from using credit cards with high interest rates to using debit cards. This is an extremely positive development, for while credit cards certainly have legitimate uses, millions of Americans have unwittingly found themselves deep in debt from careless or irresponsible credit card use. Many of them ended up in financial difficulties if their incomes dropped because of the recent recession.

By increasing the cost of debit cards to consumers, the Durbin amendment would make it harder for consumers to manage their own finances and drive them back to credit cards or to stored-value cards. While at one time checks were an alternative, increased fees on their use combined with merchants' reluctance to accept checks make it unlikely that consumers would move back to them. Any law or regulation that artificially increases the cost to consumers of using their own money and directs them toward greater uses of debt or riskier debit card substitutes is inherently anti-consumer.

The Dangers of Simplistic Legislation on Complex Systems. The Durbin amendment also sends a powerful message about the wrong way to legislate. The payments system is very complex, and simplistic "solutions" such as the Durbin amendment have wide unintended consequences. Rather than attempt seemingly easy fixes that are added to

legislation at the last minute, Congress should thoroughly examine issues before legislating.

The Solution Is to Repeal the Durbin Amendment. While the legislative language of the Durbin amendment is seriously flawed, its effects would become even worse if the over-reaching Federal Reserve draft regulations are approved. The best response for consumers to the serious policy errors in the Durbin amendment would be a complete repeal. Congress should not make it harder for consumers to spend their own money and manage their finances.

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