

Price Controls on Payment Card Interchange Fees: The U.S. Experience

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The Durbin Amendment

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- Part of 2010 Dodd-Frank legislation
 - ▣ IF must be “Reasonable and proportional to incremental costs”
- Applies only to debit cards
- Applies only to banks with \$10 billion in assets

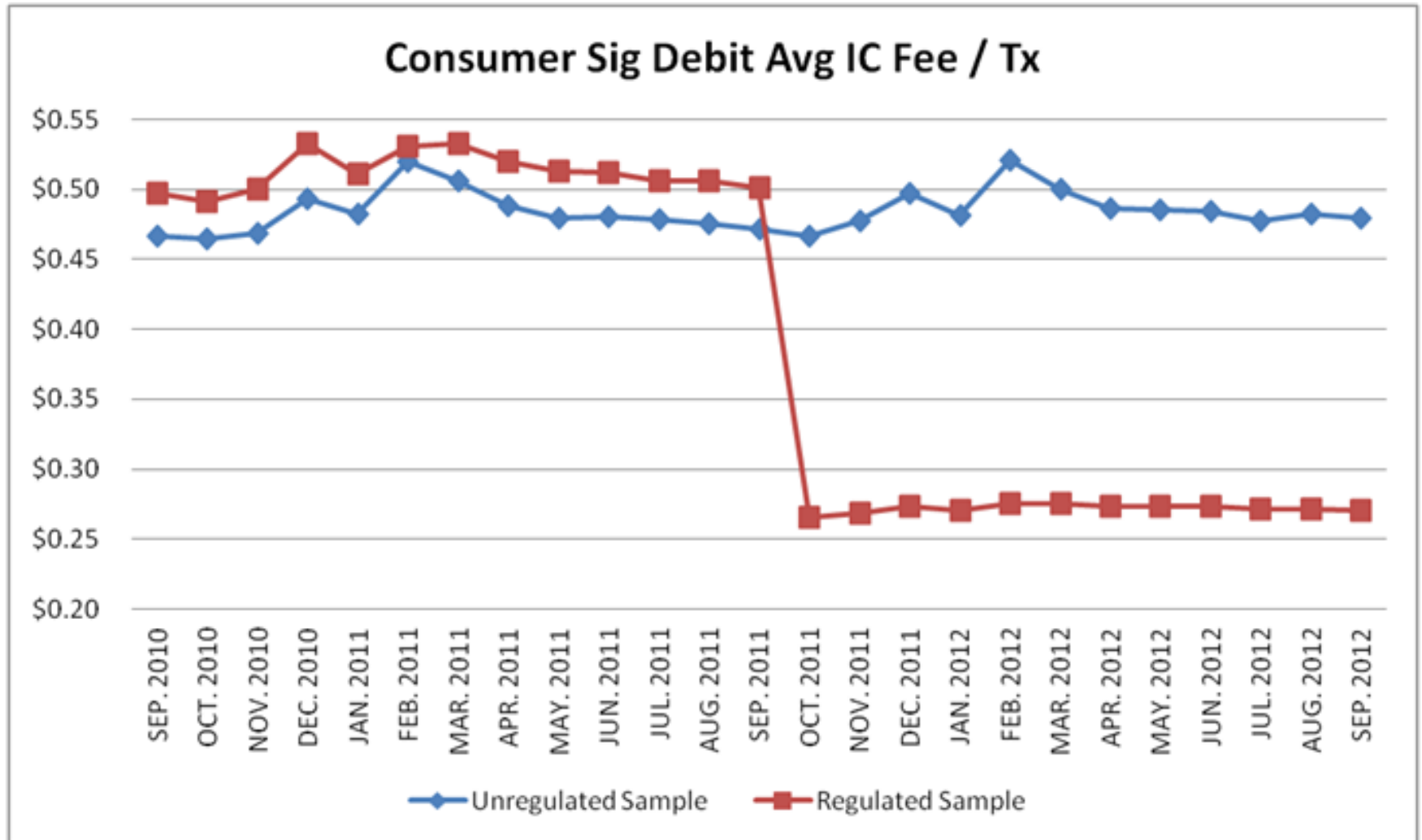
The Federal Reserve Rulemaking

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- Effective October 1, 2011
- Determined meaning of “Reasonable and proportional to incremental costs”:
 - ▣ Permits \$0.21 plus .05% of transaction value plus \$0.01 for fraud protection
 - ▣ Excludes capital and other non-transactional costs
- Cut average interchange fee for covered banks from \$0.50 to \$0.24 per transaction (52%)
- Interchange fee for exempt banks (under \$10 billion) not affected

Effect on average interchange fees (MasterCard Signature Debit)

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We test four hypotheses

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- (1) Cardholder costs increased to offset interchange drop
- (2) Costs to cardholders increased at regulated banks relative to control group of unregulated banks
- (3) This change in relative costs led consumers to substitute less-expensive alternatives, such as credit and prepaid
- (4) The increased cost to cardholders was not offset by larger decrease in costs for retail consumers

The simple economics of interchange fees

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- Costs of payment card system have to be paid by some combination of:
 - ▣ Merchants (those who accept cards);
 - ▣ Banks (those who issue cards); and
 - ▣ Their respective customers.
- Estimated loss to banks of approximately \$6.6 to \$8.6 billion as a result of Durbin Amendment
- Banks sought to recoup those losses

How banks recouped losses

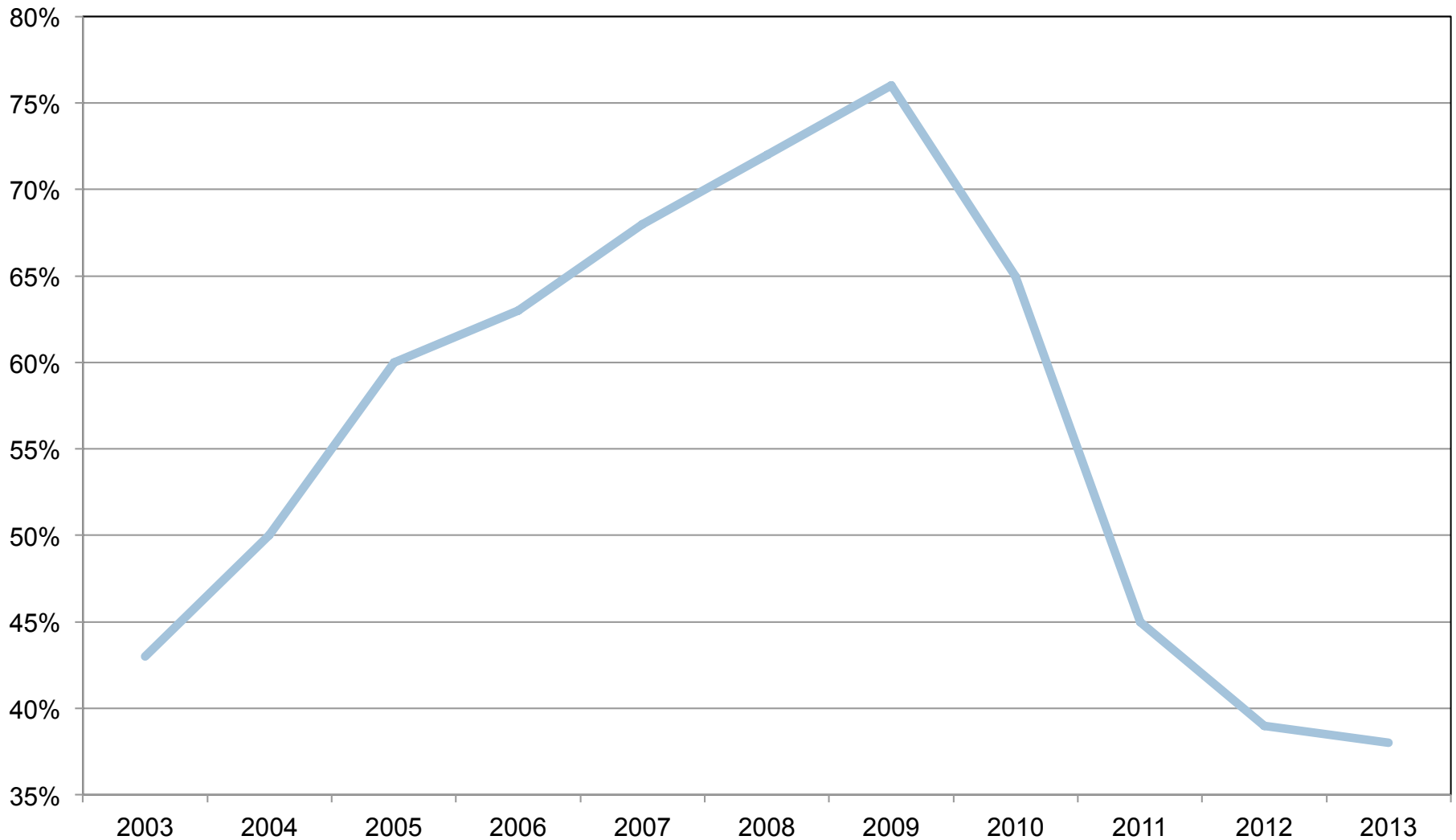
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- Bank of America first proposed direct monthly maintenance fee on users of debit cards of \$3-\$5
 - ▣ Transparently linked Durbin Amendment costs to debit card users
 - ▣ Reversed course after PR blowback

- Instead: Higher bank fees, reduced access to free current accounts, reduced quality/services
 - ▣ Especially harmful to low-income consumers

Banks offering free current accounts 2003-13

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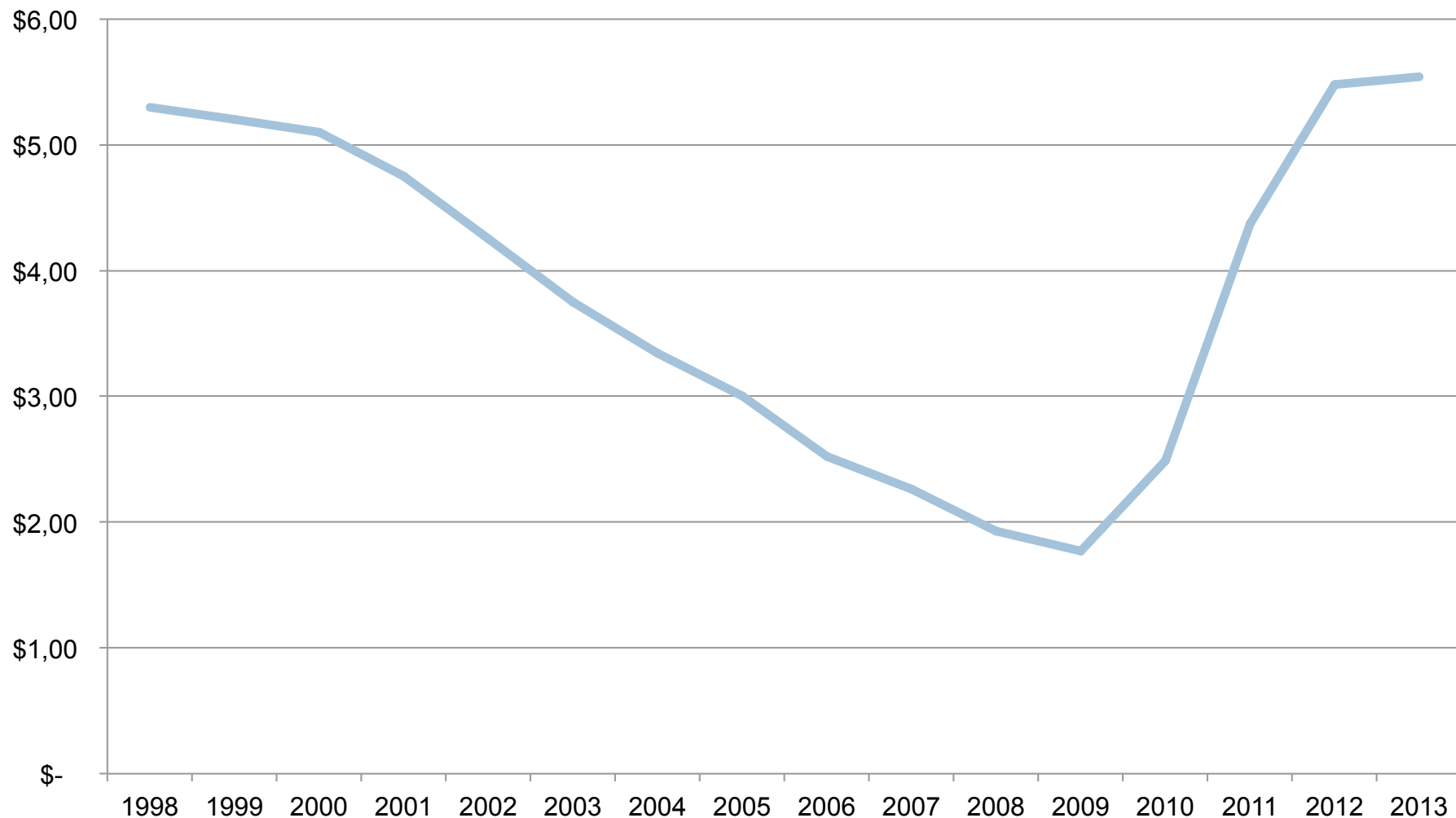
Average minimum holding needed to avoid fees (non-interest accounts)

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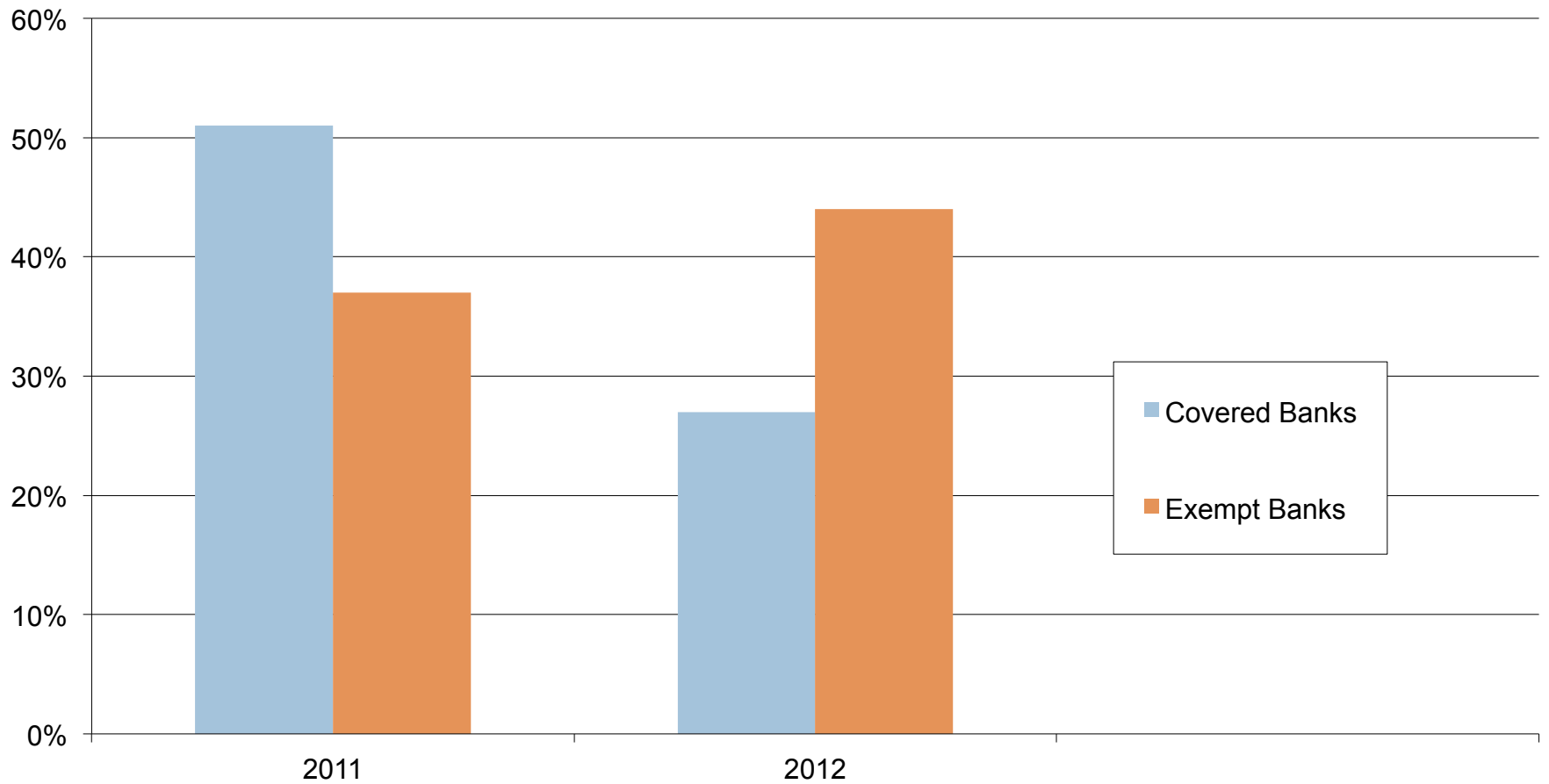
Effect on bank account fees (on accounts where monthly minimum not met)

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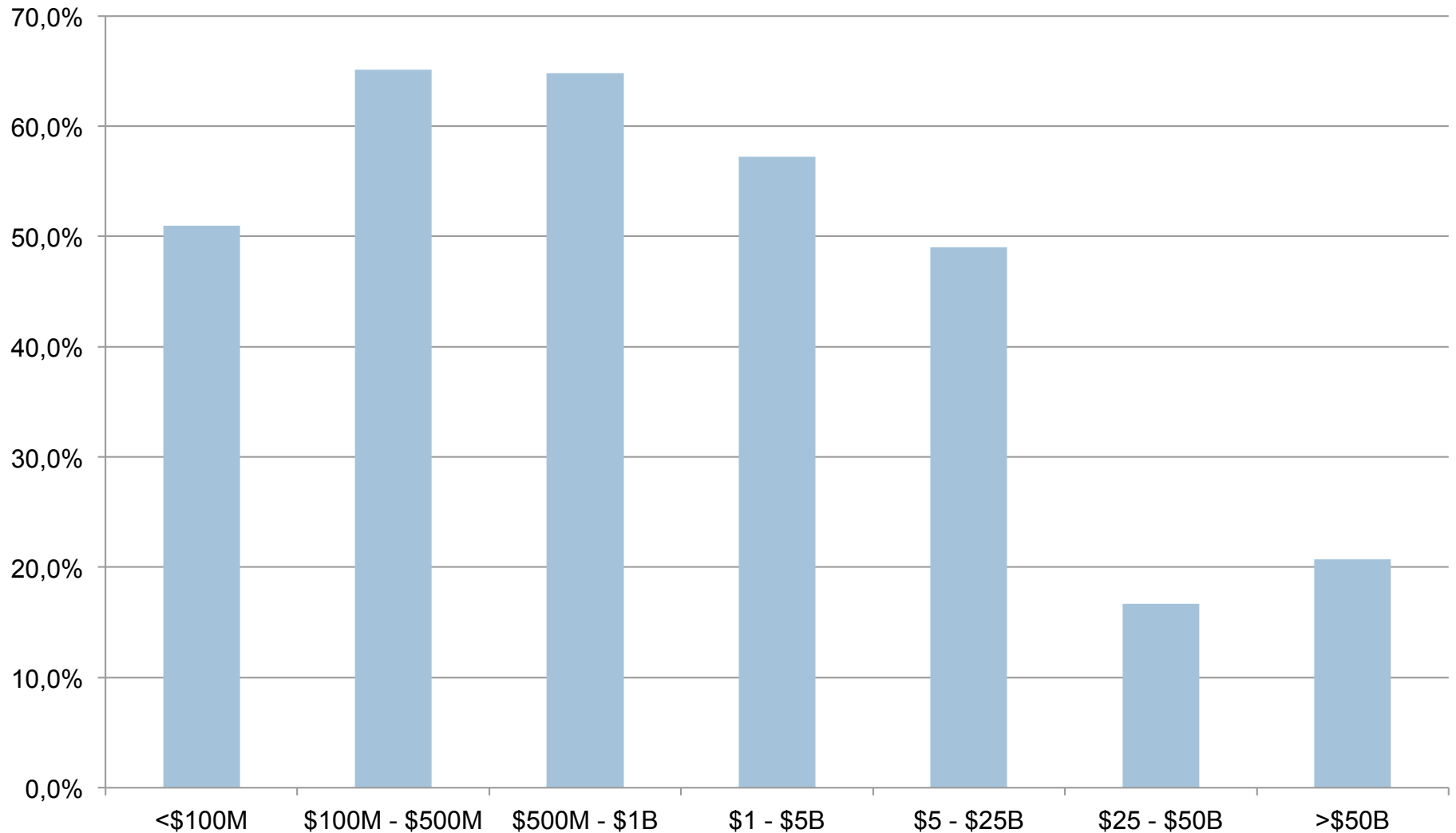
Free current accounts: covered v. exempt banks

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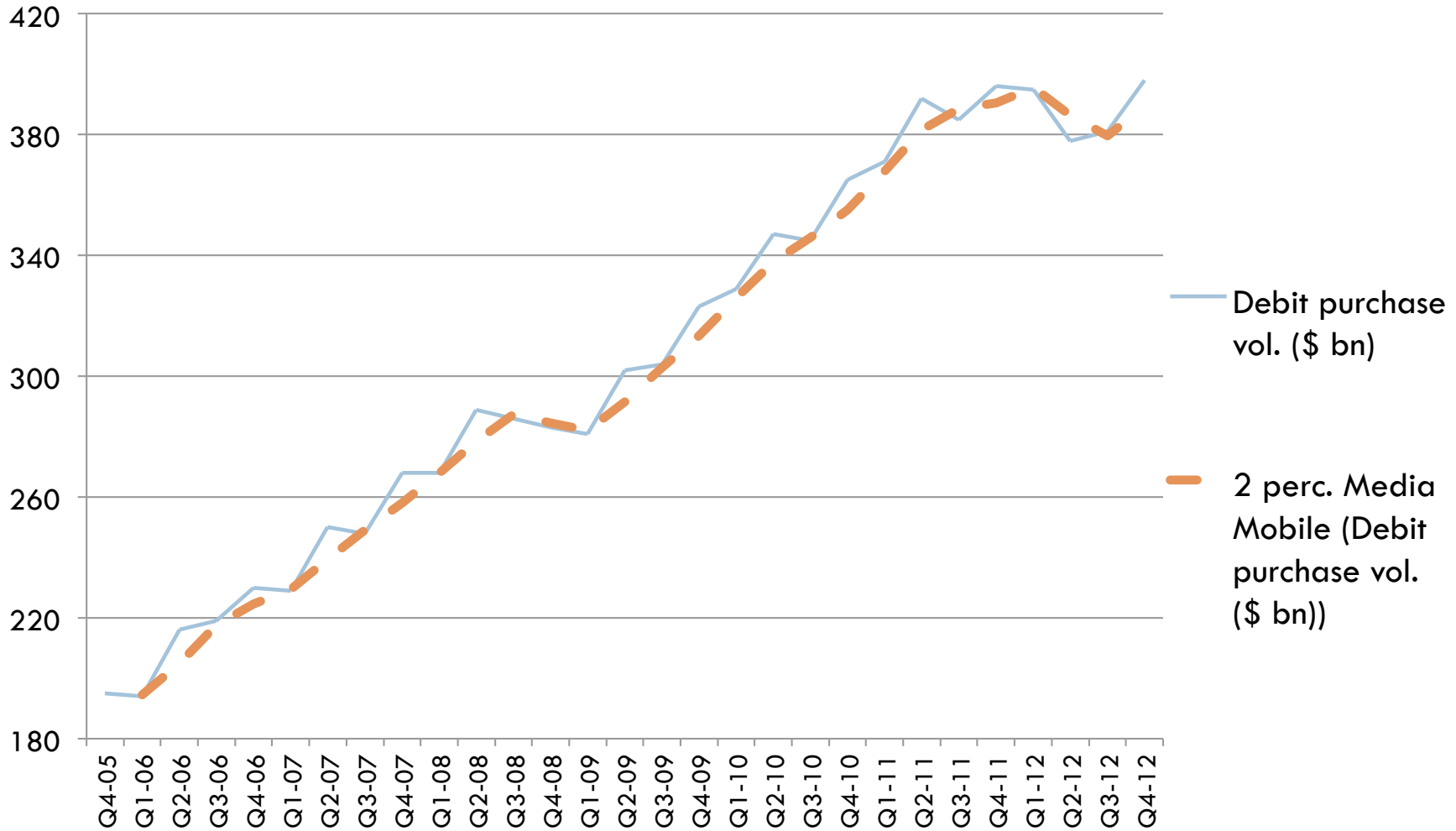
Banks offering free current accounts, by size of bank (2012)

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Effects on debit usage

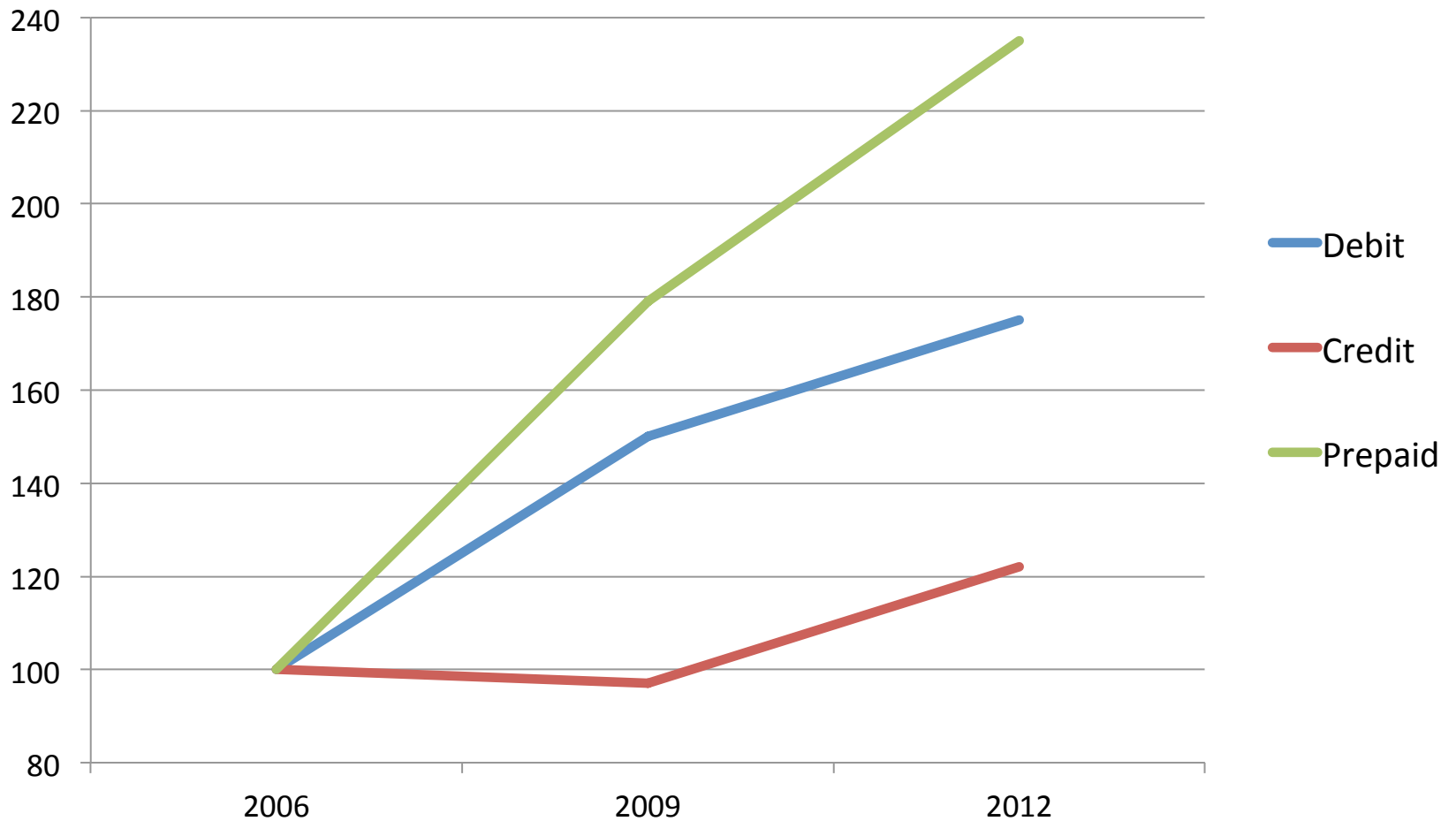
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Banks incentivized consumers to switch to credit

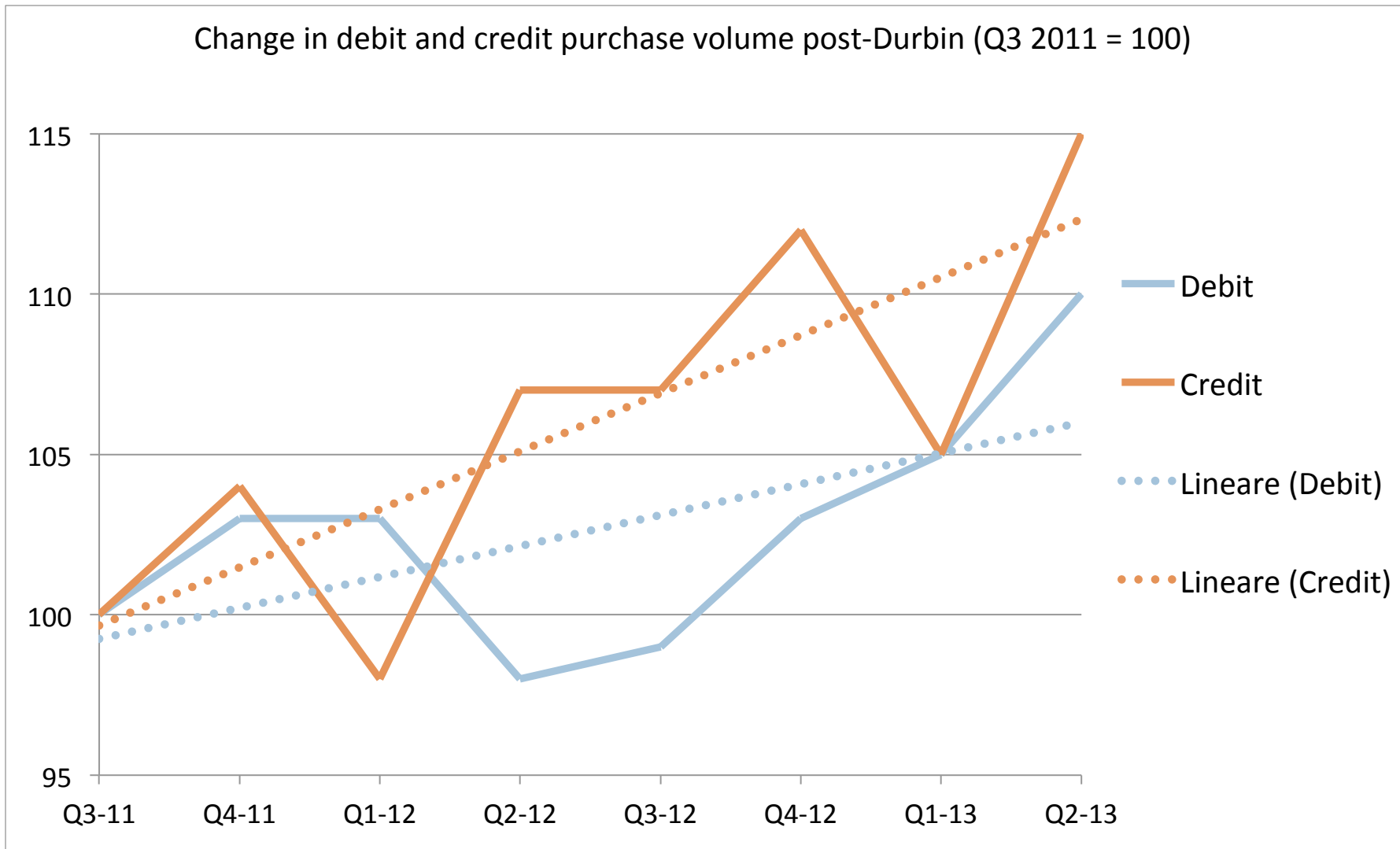
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Growth (decline) in transactions by card type (2006 = 100)



... and consumers responded

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Net consumer effect: Was the windfall passed through?

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- Issuing banks **have** passed on most *costs*
- **No** evidence retailers have passed on interchange fee *savings*

Effect on 20 largest merchants

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CONSUMER SIGNATURE DEBIT				
MERCHANT		INTERCHANGE RATE (%)		12-month IC FEE SAVINGS / (INCREASE)
		6 MONTHS PRE-IC RATE APR-SEP '11	12 MONTHS POST-IC RATE OCT '11-SEP '12	
1	WALMART	0.63%	0.54%	\$ 5,479,165
2	AMAZON.COM (ON-LINE)	2.25%	1.38%	\$ 20,248,846
3	TARGET	0.76%	0.57%	\$ 3,334,101
4	SHELL	1.28%	1.04%	\$ 6,047,066
5	PAYPAL (ON-LINE)	1.91%	1.07%	\$ 16,845,641
6	KROGER	0.74%	0.66%	\$ 1,427,780
7	BRITISH PETROLEUM / BP	1.30%	1.08%	\$ 4,492,624
8	AT + T WIRELESS	1.64%	0.77%	\$ 13,473,917
9	SPRINT	1.69%	0.83%	\$ 13,895,186
10	EXXONMOBIL	1.31%	1.08%	\$ 3,901,518
11	VERIZON	1.72%	0.61%	\$ 74,128
12	MEIJER	0.71%	0.62%	\$ 1,144,540
13	DIRECTV (NSR)	1.04%	0.66%	\$ 5,574,667
14	SPEEDWAY	1.34%	1.14%	\$ 3,072,658
15	WALGREENS	1.46%	1.22%	\$ 2,564,471
16	CHEVRON	1.22%	0.95%	\$ 3,853,041
17	COMCAST CABLE (NSR)	0.98%	0.52%	\$ 5,804,181
18	MARATHON OIL	1.36%	1.18%	\$ 2,269,526
19	CITGO	1.31%	1.11%	\$ 2,055,799
20	SAM'S CLUB	0.45%	0.38%	\$ 680,457
TOTAL 12-MONTH SAVINGS:				\$ 116,239,312

Comparison of
Actual
Interchange Fee
vs. Hypothetical
Fee at
September 2011
Effective Rates

But where *transaction size* is small ☹️

CONSUMER SIGNATURE DEBIT							
MERCHANT	TRANSACTION VOLUME (\$)		INTERCHANGE FEE (\$)		INTERCHANGE RATE (%)		IC FEE (\$)
	6 MONTHS PRE-VOL APR-SEP '11	12 MONTHS POST-VOL OCT '11-SEP '12	6 MONTHS PRE-IC FEE APR-SEP '11	12 MONTHS POST-IC FEE OCT '11-SEP '12	6 MONTHS PRE-IC RATE APR-SEP '11	12 MONTHS POST-IC RATE OCT '11-SEP '12	12 MONTHS SAVINGS / (INCREASE)
MCDONALD'S	\$ 999,394,343	\$ 2,246,041,183	\$ 16,335,410	\$ 52,032,754	1.63%	2.32%	\$ (15,320,515)
REDBOX DVD	\$ 116,153,543	\$ 318,886,410	\$ 5,497,452	\$ 16,044,814	4.73%	5.03%	\$ (952,182)
SUBWAY	\$ 395,672,515	\$ 890,961,219	\$ 7,743,399	\$ 19,350,288	1.96%	2.17%	\$ (1,913,980)
WENDY'S	\$ 258,075,900	\$ 587,049,033	\$ 5,194,376	\$ 13,391,968	2.01%	2.28%	\$ (1,576,245)
7-ELEVEN	\$ 239,244,255	\$ 452,760,633	\$ 4,284,840	\$ 7,525,728	1.79%	1.66%	\$ 583,168

Pass-through: Acquirers to merchants

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□ Effects based on average transaction size

“Debit card interchange fees have *increased* by 12% for merchants on an average retail sale under \$10”

Scott Strockoz, FDIC

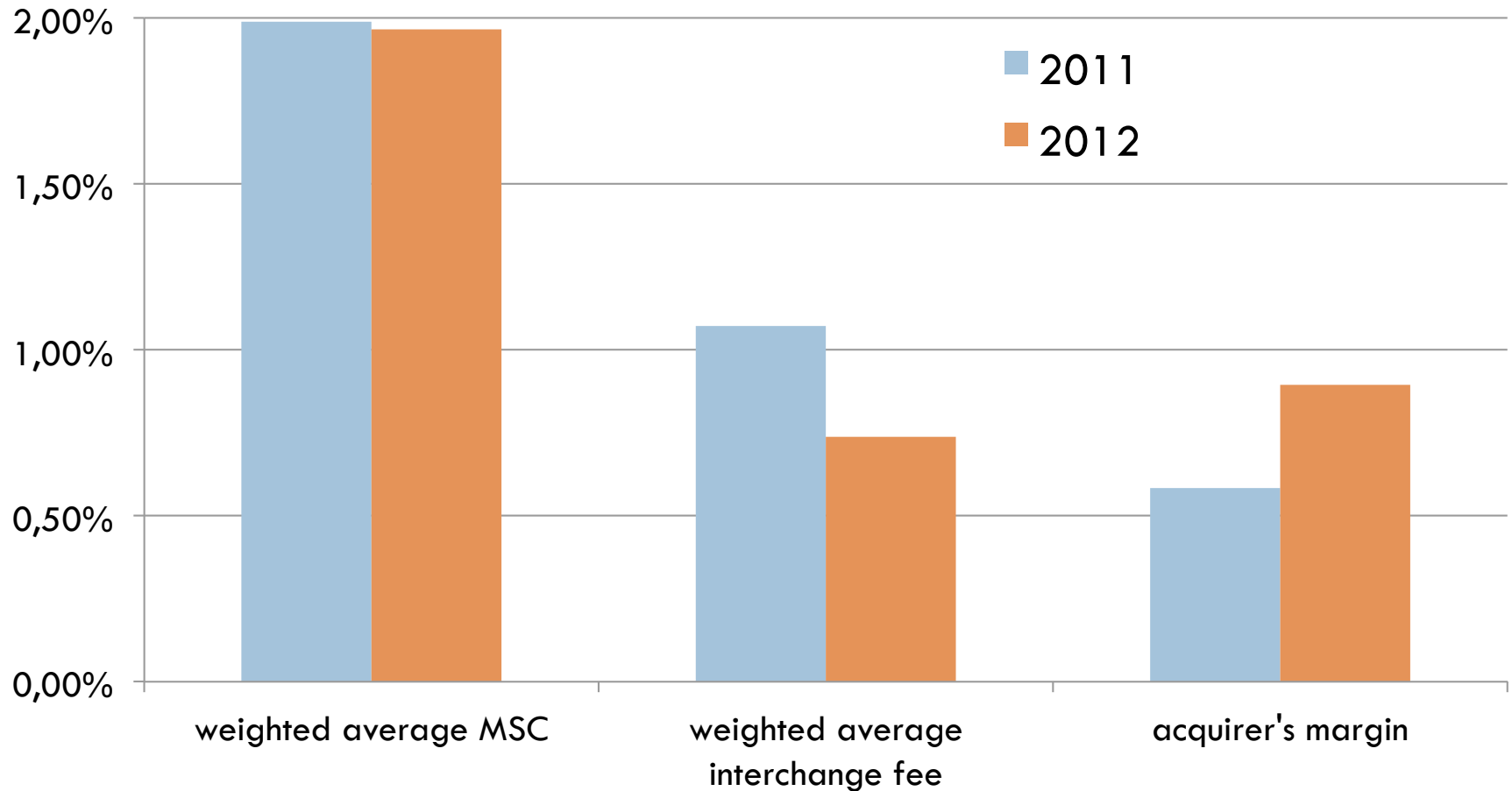
Pass-through: Acquirers to merchants

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- Effects based on merchant size
 - ▣ Large retailers generally did well, saving about 0.7% of purchase volume
 - ▣ For SMEs only 7% of interchange fee reduction passed through to merchants
 - ▣ For an average small business with \$3m annual sales, annual savings would be about \$720 (approx. 0.02% of purchase volume)

For Small-Medium size merchants ...

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Pass-through: Merchants to consumers

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- Nearly 100% of costs passed-through by banks
- No evidence of pass-through from retailers to consumers
 - ▣ Home Depot: “On the Durbin side, we think the benefit to the Home Depot could be \$35 million a year.”
 - ▣ Gasoline retailers
- Even if **all** savings passed on, consumers would save maximum of \$.07 on avg. purchase of \$40

What does it all mean (for consumers)?

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If the full benefit were passed on, average annual “savings” per household from Durbin would be less than \$7 per month):

Interchange Cost per Household Pre-Durbin	\$427
Number of Households in US	114,235,996
Total US Interchange Fees	\$48,778,770,292
Durbin Reduction in Interchange Fees per Year	\$8,629,975,385
New Interchange Cost per Household Post-Durbin	\$351
Reduction in Interchange Cost per Year per Household	\$76
Reduction in Interchange Cost per Month per Household	\$6.30

Effect on consumers

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- Evans, Chang & Joyce (2013):
 - ▣ Pass-through by banks much larger than pass-through by retailers
 - ▣ Huge wealth transfer from consumers to merchants
 - ▣ Net expected loss for consumers of \$22-\$25 billion NPV
- Manne, Morris & Zywicki (2014):
 - ▣ Implications of low pass-through from merchants to poor consumers

Households with income below \$50,000	60 million
Households that have lost free bank accounts	15 million
Monthly cost of household bank account	\$10
Total annual cost to poorer households	\$1 to \$3 billion

Effects on financial inclusion

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- Increased fees helped drive consumers out of mainstream banking system
- Increase of 1 million unbanked (10%) '09-'11
 - ▣ Mostly lower-income consumers
 - ▣ Face higher cost of cheque cashing
 - ▣ Higher cost of loans (payday lenders, pawn shops)

In summary

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- Durbin capped interchange fees at covered banks
- Banks increased other fees and reduced services
- Big merchants (and acquirers) = 😊
- Except those that sell small things = 😞
- Small merchants made nothing; some suffered 😞
- Millions of poor gave up bank accounts 😞
- Wealth transfer of \$1 to \$3 bn per year from poorer consumers to owners of large merchants
- Consumers paying more and getting less

Italy: effect on banking system participation

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Cittadini con più di 15 anni di età che non dispongono di un conto corrente bancario (anno 2012)

Nazione	numero	%
Italia	14.648.958	29%
Romania	9.860.121	55%
Polonia	9.688.265	30%
Bulgaria	2.952.688	47%
Spagna	2.712.265	7%
Ungheria	2.270.949	27%
Grecia	2.103.122	22%
Repubblica Ceca	1.685.908	19%
Portogallo	1.685.616	19%
Francia	1.571.688	3%
Regno Unito	1.537.405	3%
Germania	1.404.097	2%
Slovacchia	902.426	20%
Lituania	656.173	26%
Belgio	363.352	4%
Austria	213.731	3%
Irlanda	212.058	6%
Lettonia	173.172	10%
Paesi Bassi	136.394	1%
Cipro	106.298	15%
Svezia	77.956	1%
Slovenia	52.256	3%

- Cost of current accounts likely to increase, especially for poorer consumers
- Will further discourage people from opening bank account
- Perpetuating problem of the unbanked – currently nearly 30% of Italians over 15 years'

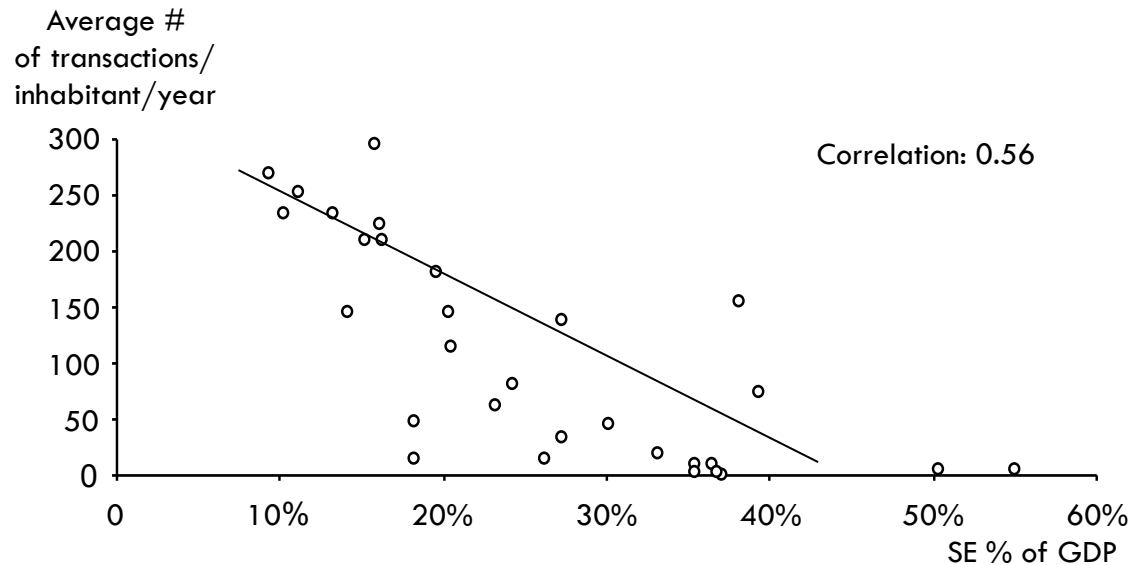
Italy: dynamic efficiency and growth

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- Electronic payments increase economic efficiency
 - ▣ Faster, more secure, less susceptible to fraud
 - ▣ ECB: average of 1% of GDP lost (likely higher in Italy) due to low usage of electronic payments
- Financial inclusion impacts investment
 - ▣ Bank account a pre-requisite for mortgages and other secured loans important for entrepreneurs

Italy: shadow economy (c. 20% ...)

Use of electronic payments and the shadow economy in Europe



- Cash is difficult to trace and anonymous and so facilitates the underreporting of sales
- Countries with large unbanked populations tend to have big shadow economies
- Cash is a key enabler of the shadow economy

Conclusion: One Size Doesn't Fit All

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- Optimal interchange fee varies:
 - ▣ Extent of acceptance/usage
 - ▣ Relative cost of alternative payments & elasticity
 - ▣ Transaction size
 - ▣ Competitiveness of retail/banking/acquirer markets
 - ▣ Labor rates
 - ▣ Fraud rates
- Varies across country, industry, and time
- External effects: Work in coherence with other policies (crime, tax evasion)