Statement for the Record

On behalf of the

American Bankers Association, Bank Policy Institute, Consumer Bankers Association, Credit Union National Association, and National Association of Federally-Insured Credit Unions

before the

United States Senate Committee on the Judiciary

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On behalf of their thousands of card-issuing members, the American Bankers Association, Bank Policy Institute, Consumer Bankers Association, Credit Union National Association, and National Association of Federally-Insured Credit Unions appreciate the opportunity to submit a statement for the record for the hearing titled "Excessive Swipe Fees and Barriers to Competition in the Credit and Debit Card Systems."

This hearing is about the following moment of everyday life: a customer approaches a merchant with a payment card and the merchant accepts it as payment. Right then, the customer and merchant access a vast, sophisticated, and costly messaging apparatus, data flows through protected channels, money moves instantly, and the customer is assured that their purchase is protected if there is a problem. The merchant is paid faster and more easily than by check or cash, and the customer has access to myriad benefits and protections they would not get through those older methods.

And the question becomes: **who pays for all of this?**

We believe that the consumer should always pay last and that the two commercial parties to the transaction — the financial institution and the merchant — will cover the vast majority of transaction costs in a market-driven card ecosystem. Unfortunately, some large merchants seek to use political pressure to increase their margins. For them, the answer to the question of who should pay is simple: anyone and everyone, except them.

Interchange regulation, both rate caps and routing requirements, is about creating a world where transaction costs are disproportionately borne by the non-merchant parties to the card-based payment transactions, notwithstanding the fact the merchant receives the most value from card-based payments. The Durbin Amendment, as implemented by Regulation II, imposes rate caps on non-exempt debit card issuers, prohibits all issuers and networks from restricting the number of networks over which debit transactions may be processed to less than two unaffiliated networks, and prohibits all issuers and networks from inhibiting a merchant's ability to direct the routing of a debit transaction over any network that the issuer has enabled to process it. The Durbin Amendment shifted the burden of merchants' normal contributions onto debit card customers and their banks. While presented as "fairness," the law has made payments more regressive and expensive for consumers, many small businesses, and community banks, while ensuring big merchants pay as little as possible. Merchants promised Congress they would lower prices after the Durbin Amendment passed, but did not. Having misled Congress and the American people once, merchants again promise that they will lower prices if Congress intervenes on credit card interchange. The reality is that they won't — and they have already acknowledged as much publicly on earnings calls and in other forums.

Our statement will be brief because our argument is simple: interchange is a fair and normal way to ensure that consumers pay as little as possible for payment services. On the other hand, the Durbin Amendment forces consumers to pay for costs merchants would otherwise cover. It should be repealed, not expanded.

The Card Payment System Benefits Merchants by Design

The card system was created as a *merchant payment system*. Before the card system was created, merchants faced delayed payment associated with check processing and were at risk of having the payment returned as fraudulent or without sufficient funds to cover the transaction. Even with respect to cash-based transactions, merchants had to pay the processing, sorting, and additional safety costs associated with those transactions, which required far more time and presented a higher risk of fraud borne by the merchant. The card system was created as a system that was geared towards one principal and primary goal – giving merchants a fast and reliable form of payment that sought to protect them against the risks associated with each of the other types of payments. During a card transaction, money moves in one direction: to the merchant. This may seem obvious, but large retailers have painted financial institutions as the sole beneficiary of card transactions. If you follow the money, this assertion does not sync with the facts.

When a consumer pays with a debit card, the consumer gives up some of their money to the merchant and the merchant receives it. The consumer can no longer spend or invest those funds. In the same moment, the financial institution loses access to those deposits and takes on a wide range of regulatory and customer service responsibilities related to the transaction. When a consumer pays with a credit card, the financial institution transfers its own funds to a merchant and the consumer becomes responsible for repaying a loan; many times outstanding balances will be repaid in full during the statement cycle and therefore will not accrue interest, and other times the loans will not be repaid, in full or in part (historically, 3–4 percent of these loans are not repaid).[1] In the case of both debit and credit cards transactions, the card system facilitated removal of funds from a customer's financial institution and its transfer to the merchant. While everyone participating in a card transaction benefits from it, it is the merchant who always ends up with more funds and without further obligations. For the merchant's convenience, they contribute to the system in the form of a *fee* at the moment of a transaction, while financial institutions have paid into the system before a card is swiped and will continue to incur costs after. These costs include account maintenance, security, consumer rewards, fraud prevention/reimbursement, customer service, and other actions essential to ensuring that the merchant's customer has a safe and seamless payment experience.

The card system is designed to make being paid as easy as possible, and our members would like it no other way: America's banks and credit unions are proud to support the economic success of merchants. The benefits to merchants are substantial, including higher transaction values; reducing costs associated with cash handling, bounced checks, and counterfeiting; access to prompt and guaranteed payments; a speedier checkout process; and e-commerce facilitation. In short, accepting cards makes a business stronger and more efficient.

[1] Board of Governors of the Federal Reserve, Charge-Off Rates for Credit Cards, 2022.

Interchange Fees are Fair and the Card Market is Competitive

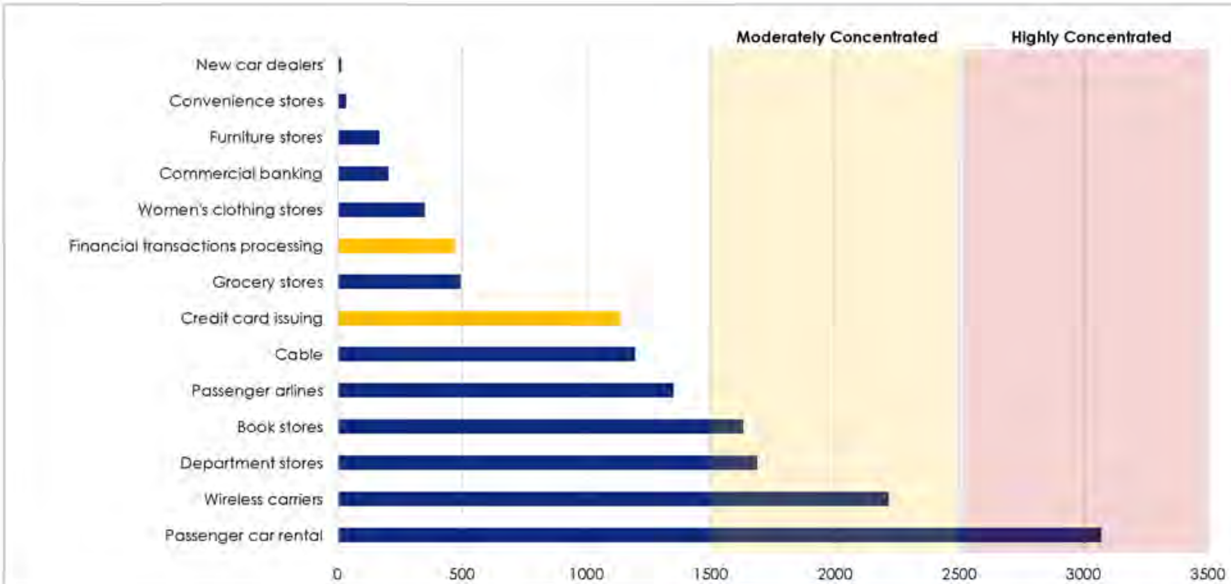
While it has been alleged that credit cards are unfair to sellers, the fact is that merchants themselves invented the credit card. Department stores once issued store cards, which allowed them to extend credit to their customers to increase sales. Merchants also shouldered the responsibility of holding loan risk on their books, assessing interest on their customers' accounts, and collecting on debts after the sale. Merchants quickly exited the credit card space when banks and credit unions made it possible for them to accept *anyone's* card rather than only the card they issued themselves — for a small interchange fee, the financial institution would handle the rest. Best of all, the merchant was paid immediately and the customer's bank or credit union took on all the risk and costs of collecting loan payments. It was a mutually beneficial agreement that merchants gladly accepted.

A basic tenet of the American system is fair compensation for services provided. That, in a nutshell, is what interchange is: financial institutions that issue cards, extend credit, and maintain the accounts that underlie them are compensated for some of the value and the risk transfer/mitigation they provide for merchants. Without financial institutions issuing cards, merchants would not have access to card payments and the myriad benefits that accepting cards generates. Focusing solely on their share of the cost to keep the system functioning ignores the benefits — which, as illustrated later in this letter, more than justify the costs. In essence, merchants want all of the benefits of the electronic payments system without bearing any of the costs.

Because card transactions are a high-volume business involving millions of parties, the market has a strong tendency towards efficient and competitive price discovery. It would be unusual under these circumstances of constant market testing for one provider's prices and terms to vary *dramatically* from others. Yet a normal amount of market variations does exist and the market functions as one would expect: the price merchants pay to accept the most "expensive" cards has fallen in recent years, moving closer to the prices of less-expensive cards.

The U.S. Supreme Court recently examined the credit card market and stated they could find no indicators of it being an anticompetitive marketplace. The metric (HHI) used by the federal government and courts to evaluate competiveness places credit card issuance squarely within the "competitive" category, as shown below. There are thousands of banks and credit unions that issue cards and there have been no mergers of major payment card brands. New merchant options like Square, Clover, and Toast have rapidly gained scale, reflecting low entry barriers – another key attribute of a competitive market.

Herfindahl-Hirschman Market Concentration Index for Select Industries, 2017



Source: Census Bureau

Two Sides to the Market, Two Sides to the Story

Critics cast interchange fees as mere "swipe fees" and assert that they are money-for-nothing – a "junk fee" charged by financial institutions to powerless merchants, at artificially-high rates set by a handful of payments brands. This narrative is sleight of hand: it focuses on only one side of the market (merchants who accept cards) and ignores the other side of the market (consumers who use cards and the banks and credit unions that issue them). When an honest observer zooms out, it becomes apparent that the fees paid by merchants are directly related to the value of high-quality payment services they and their customers receive, and that the fees earned by financial institutions during a transaction correspond to the work they have done to ensure the merchant is presented with a functioning and funded card. Consumers enjoy most of these benefits for free. Economists call this a two-sided market, where a platform (like a card brand) stimulates the development of supply and demand in two separate but connected markets.

Interchange Rates are Set by Markets, Not Arbitrary Network Decisions

In a two-sided market, the value that each end-user group derives from using the platform depends on the extent to which the other group participates. Due to this interdependency, market forces exerted by both cardholders and merchants jointly determine the price to participate in the electronic payments system — of which interchange is a component. The resulting price balances the need to attract merchants (e.g., by providing the benefits outlined above) with the need to increase the number of cardholders (e.g., by offering incentives, including frequent flier miles and cash-back rewards). Put another way, the interchange charged must be reasonable enough for merchants to make the economic decision to accept cards, while also being sufficient for banks and credit unions to continue issuing and supporting cards (including offering rewards and benefits to consumers to increase participation). Over time, these rates may change to account for the unique transaction characteristics of each merchant type.

The Supreme Court Believes that the Credit Card Market is Competitive

Recently, the U.S. Supreme Court examined the credit card market and affirmed that it is a two-sided market where policy analysis must take into account both merchants as well as issuing financial institutions and their customers. The Court also found no evidence of the market being anticompetitive.[2] Whether the Durbin Amendment and its implementing regulation comply with the two-sided market analysis required by this ruling has not been tested in litigation.

We urge the Committee to look at the full picture and analyze these complex issues without writing consumers and financial institutions out of the picture.

Cards are Rewarding for Consumers and Merchants

Studies consistently show that card rewards programs (which are largely funded by interchange) are extremely popular.[3,4] America's financial institutions are proud to provide ways to pay that help merchants earn better sales and turn those purchases into holiday trips, cash back, and other benefits for American families. Using data from 2020, the Consumer Financial Protection Bureau (CFPB) found that over 60% of subprime credit cards and 70% of near-subprime cards featured rewards. For average risk borrowers (prime tier), 80% of credit cards feature rewards.[5] According to Verisk Financial, the figure is even higher: 86% of cardholders have an active rewards card, including 77% of consumers with an annual household income of less than $50,000.[6]

Last year, an ABA white paper summarized the benefits to consumers and merchants alike, including lower-income consumers, of credit card rewards.[7] Among other findings, the paper concluded that households of all incomes benefit from rewards cards, that most interest is paid by higher-income cardholders, and that credit card rewards are <u>not</u> a wealth transfer. Regarding this last point: merchant groups often argue that credit card rewards are a "reverse Robin Hood" offering whereby lower-income credit cardholders fund rewards for higher-income credit cardholders. Using a comprehensive and representative sample of credit card accounts provided by independent payments data company Verisk Financial, ABA's study found that this view is simply inaccurate. On the contrary, policy proposals based on conjecture and misunderstanding of data about the Reverse Robin Hood theory could lead to serious unintended consequences for the very populations they intend to help.[8]

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[2] *Ohio v. American Express Co*. U.S. Supreme Court, 2019.

[3] *Emerging Trends at Point of Sale*. Hanover Research, 2020.

[4] *The Value of Rewards*. Electronic Payments Coalition, 2019. http://www.electronicpaymentscoalition.org/wp-content/uploads/2019/03/EPC-Value-Of-Rewards.pdf

[5] *Report on the Consumer Credit Card Market*. Consumer Financial Protection Bureau. 2021

[6] *The Benefits of Credit Card Rewards: How Rewards Provide Value to Merchants and Consumers of All Incomes*. American Bankers Association, 2021. https://www.aba.com/news-research/research-analysis/the-benefits-of-credit-card-rewards.

[7] *ibid*. See also: *Assessing the Costs and Benefits of Credit Card Rewards: A Response to "Who Gains and Who Loses From Credit Card Payments? Theory and Calibrations*. Steven Semeraro, Thomas Jefferson School of Law Consumer Law Review, 2012. https://lawecommons.luc.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1918&context=lclr

[8] *ibid.* ABA's analysis was based on balance-active credit card accounts, taken from a nationally representative depersonalized sample of nearly 40 million open accounts (16 million customers) sourced from Verisk Financial.

The paper also found that *merchants* gain far more from credit card rewards programs—billions in direct and indirect revenue—than they pay in transaction fees. These benefits accrue through higher purchase values, increased security, lower risks, and avoided costs of cash.

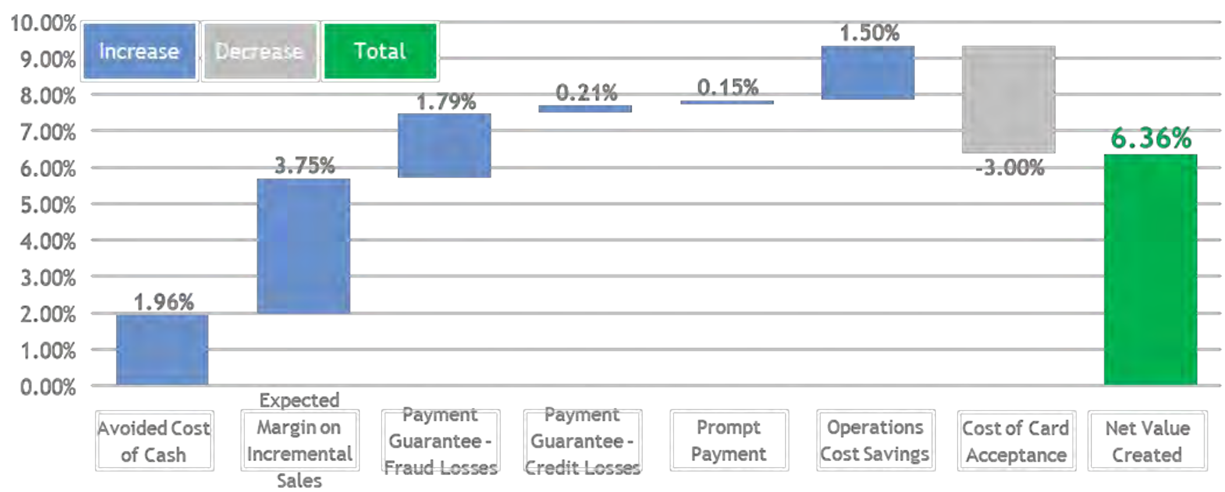
Indeed, a 2017 study conducted by Javelin Strategy concluded that instead of seeking out payment processing packages that have the lowest possible price, most small merchants care more about choice and flexibility than price.[9] Further, those who demonstrate an understanding of the interchange process are overwhelmingly satisfied with the rates they pay, and are more willing to pay a premium for higher-quality payment processing packages.

Value of Interchange Fees May *Lower* Retail Prices Paid by Consumers

Because the efficiencies created by the card system deliver more benefits than the amount merchants pay in interchange, there is little evidence that merchants pass the costs of card acceptance on to consumers.

Some have argued that the costs of card acceptance (including interchange) cause merchants to raise prices on consumer goods and services, effectively "passing through" the cost of fees to consumers. In reality, merchants gain far more from accepting rewards cards than they pay in interchange, as shown in the figure below. Even after accounting for the cost of acceptance, credit cards provide a net benefit of 5% to 6.4% of the purchase value to merchants. Indeed, the positive return-on-investment from accepting credit cards suggests that if merchants pass through any aspect of credit card acceptance to cash users, it could occur in the form of lower prices, not higher.[10]

Net Value of Credit Cards to Merchants (Share of Transaction Value)



Source: Peter T. Dunn & Company LLC (2020).

Merchants Are Signing Up for Payments Services More Expensive Than Cards

Interestingly, merchants are rapidly signing up for Buy Now Pay Later (BNPL) services, which reportedly charge merchants interchange fees that are significantly higher than what they would pay when a customer uses a credit card for a transaction. This enthusiastic merchant adoption of a more expensive payment method like BNPL indicates that cost is not the primary factor when a merchant offers their customer a

[9] Javelin Strategy (2017), "Small Merchants on Interchange: Value More Important Than Cost."

[10] *ibid.*

payment method. Rather, the primary motivation — similar to the motivation for merchants to develop the card payment system and their decision to accept more expensive payment services (e.g., BNPL) — has remained consistent: getting a reliable form of payment that allows for larger purchase values and more completed sales. If card interchange rates were prohibitive, it would be unlikely that merchants would so quickly accept BNPL's higher costs. We have seen no reports of merchants increasing retail prices to cover the higher costs of offering BNPL.

Capping Interchange Fees and Routing-by-Regulation: the Durbin Experience

Twelve years after the passage of the Durbin Amendment, the evidence is clear: the large merchants who advocated for the law's passage have reaped the vast majority of its benefits in the marketplace at the expense of consumers and small businesses.

Contrary to merchant promises to Congress and the American people that consumers would benefit from the Durbin Amendment, there exists no evidence that consumers and small businesses have benefited from the law. Instead, any savings from the reduction of interchange was pocketed by large merchants at the expense of, and in contravention of the promises made to, the American people.[11] Small businesses have also been disserved by the Durbin Amendment, as interchange fees have actually increased for small-ticket transactions. Evidence of this outcome was presented in research from the Federal Reserve Bank of Richmond: interchange fees increased for almost one-third of all merchants after the Durbin Amendment was implemented, and merchants who specialize in small-ticket items are nine times more likely to have encountered an increase in interchange cost than a decline.[12]

Additionally, multiple independent studies have found that the Durbin Amendment harmed consumers. Because of the nature of the two-sided market, banks had to make up lost interchange fee revenue through increases in other fees. This unintended consequence was highlighted in a recent report from the Government Accountability Office, which found that "debit card interchange fee limits imposed by the Durbin Amendment and Regulation II are associated with increases in the costs of checking accounts."[13] Per research from the Federal Reserve Board and the University of Pennsylvania, banks were 35 to 40 percent less likely to offer free checking accounts following the passage of the Durbin Amendment.[14] Consumers also paid higher monthly fees and had to adhere to higher minimum balance requirements.[15] Studies have

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[11] *The Cost of the Durbin Amendment.* Electronic Payments Coalition (2021). https://electronicpaymentscoalition.org/resources/the-cost-of-the-durbin-amendment/. Also see: *Out of Balance: How the Durbin Amendment has Failed to Meet Its Promise.* Electronic Payments Coalition (2022). https://electronicpaymentscoalition.org/resources/new-epc-study-reveals-how-the-durbin-amendment-tipped-the-scales-at-the-expense-of-consumers/

[12] Wang, Z., Schwartz, S., and Mitchell, N. (2014). *The Impact of the Durbin Amendment on Merchants: A Survey Study*. Federal Reserve Bank of Richmond and Javelin Strategy & Research, 194.

[13] Government Accountability Office (2022). *Regulators Have Taken Actions to Increase Access, but Measurement of Actions' Effectiveness Could be Improved.*

[14] Manuszak, M. and Wozniak, K. (2017). *The Impact of Price Controls in Two-sided Markets: Evidence from US Debit Card Interchange Fee Regulation.* Federal Reserve Board, Washington, D.C., and Sarin, N. and Mukharlyamov, V. (2019). *The Impact of the Durbin Amendment on Banks, Merchants, and Consumers*. Faculty Scholarship at Penn Law. 2046.

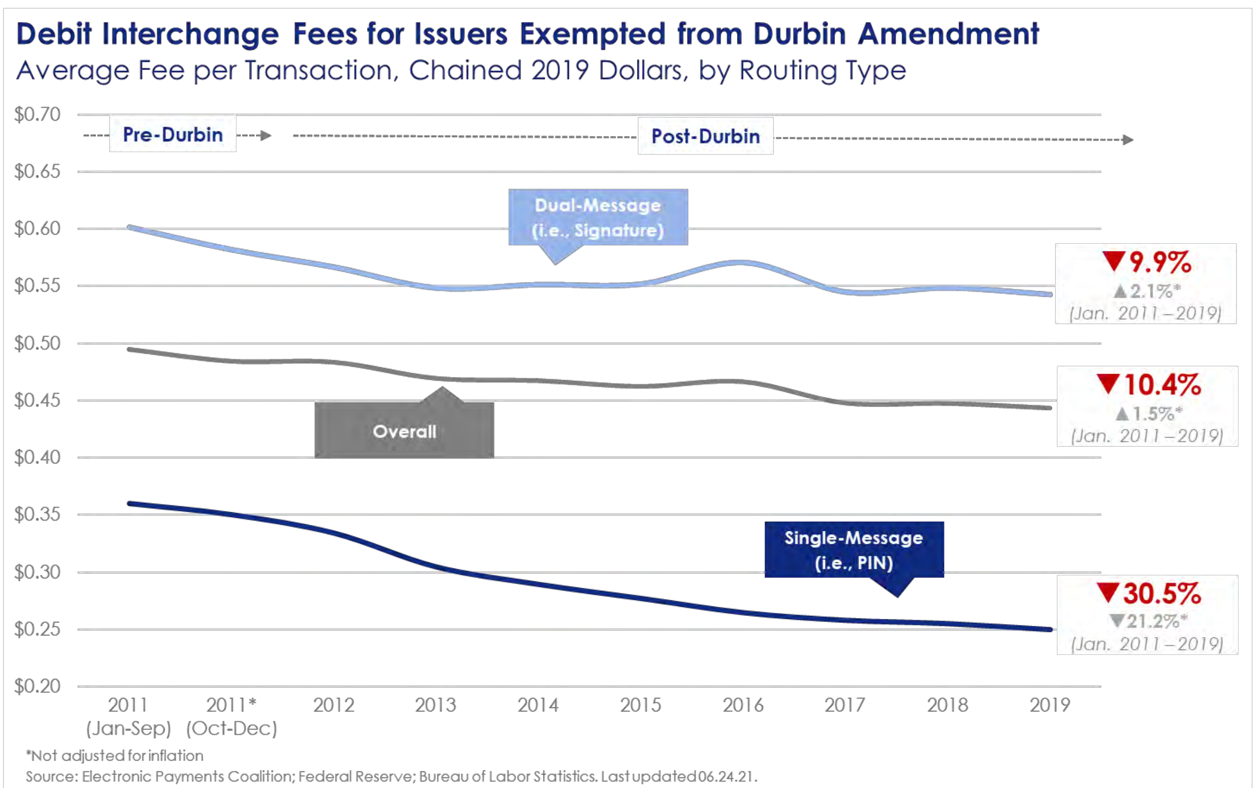
[15] Manuszak, M. and Wozniak, K. (2017).

found little evidence of across-the-board price reductions from merchants, indicating that merchants did not pass through the savings from lower interchange fees to consumers.[16]

As ABA concluded last year, price controls, like interchange and interest rate caps, can severely impact access to credit for some consumers, and lower-income consumers would likely bear the brunt of these negative effects. Such regulations could also cut rewards programs, which are enjoyed by cardholders of all incomes. Policy decisions around credit cards should be grounded in data and a full understanding of how the two-sided credit card market benefits consumers and merchants alike.

Community Financial Institutions Pay a High Price for Interchange Regulations

While community banks and credit unions were nominally exempt from the Durbin Amendment's rate caps, they are fully subject to its routing requirements. The negative impacts of this law on community financial institutions are well-documented, both by academic and Federal Reserve staff researchers. Most recently, the Federal Reserve's *Debit Card Issuer Cost Study* found that community financial institutions (less than $10 billion in assets) experienced a 21% decrease in per-transaction debit card revenue (PIN) from 2011 to 2019.[17] Adjusted for inflation during this period, this is equivalent to a nearly 31% revenue decline (see figure below). The conclusion is clear: smaller institutions were excluded from one prong of the law (i.e., the interchange transaction fee caps); however, this "exemption" has not shielded community banks and credit unions from the distortive effects of the Durbin Amendment's routing requirements.



[16] Sarin, N. and Mukharlyamov, V. (2019).

[17] Federal Reserve Board (2019). *Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions*.

Merchant trade groups have argued for Durbin-style dual-routing requirements for credit cards. Under these proposals, credit card issuers would be required to have their card transactions processed by two different networks, with the merchant being given the choice of which network to use at the point of sale. However, the major credit card networks have invested in offering a wide range of protections for transactions that are processed on their networks. For example, some card networks provide consumers an extended warranty for products purchased on their networks. The card network also may provide a satisfaction guarantee, so that if the consumer is dissatisfied with the purchase and the merchant will not accept the item for a return, the card network will actually reimburse the consumer out of its own pocket, or the card network may provide price protection for consumers, in case a merchant changes prices after the sale is finalized.

There are a wide range of other services that card networks provide to cardholder, including cell phone insurance, auto rental insurance, travel insurance and related services, and identity theft protections.

If Congress takes up the merchant proposal to require credit card issuers to bootstrap low-cost networks on their cards, merchants will choose to route transactions using one criteria: the lowest interchange fee. As a direct result of this merchant-lobbied initiative, consumers would lose these important protections. It is not fair to American consumers that they will lose these benefits, solely to pad merchants' margins.

Policy Recommendations

We urge the Committee to consider the following policy recommendations:

- **Repeal the Durbin Amendment.** Study after study has found that the Durbin Amendment has failed to lower retail prices as merchants promised and as time goes on, an increasing number of smaller banks and credit unions will be subject to its rules because its thresholds were not indexed for inflation. Repealing this law will prevent these harms from continuing to mount and will restore a fully functioning market for checking accounts.

- **Urge the Withdrawal of Regulation II Expansion.** The Committee should urge the Federal Reserve Board to withdraw its 2021 Proposed Rule to expand the Durbin Amendment to virtually any kind of debit card transaction, a vague and confusing standard. Its implicit endorsement of a mandate that community financial institutions accept so-called "PINless" transaction types would fundamentally transform the payments system in a manner not required by Congress, while removing card issuer discretion in preventing fraud – a harsh blow to small banks and credit unions operating payment systems on tight margins. The Proposed Rule was issued without the analyses required by law, including a credible examination of its impacts on small entities.

- **Do Not Extend Durbin Amendment to Credit.** Congress should not once again give credence to merchants' promises that they will lower prices for American consumers if Congress intervenes in credit card interchange. Rate caps or routing restrictions in the credit card context will have a dramatic effect on consumer protections and services associated with the credit card products that are overwhelmingly popular with the American public.

- **Examine PINless Debit and Fraud.** The Durbin Amendment has been used as leverage by bank software and payments processors to force some small financial institutions to accept novel, so-called 'PINless' transactions from the processor's own, lesser-known debit networks. These payment processors have acquired their own payments networks in recent years, and increasingly, routing happens over their in-house networks even if the financial institution desires otherwise. This consolidation that has resulted in the same corporations owning both bank-side payments management services and merchant-side processing has empowered merchants to route transactions in a manner that dramatically reduces the interchange a financial institution earns while increasing their liability for fraud losses. While merchants are having their concerns addressed today, the Committee should give equal consideration to how these powerful combined bank software-payment processor-card payment network companies are using the Durbin Amendment as cover to coerce small banks and credit unions into using transaction services that may harm their sustainability as independent institutions.

Conclusion

America’s financial institutions are committed to a competitive, secure, and sustainable payments system based on sound economics and fair play for all parties in this two-sided market, but most importantly for consumers. Once again, we are pleased to provide these comments to the Committee and our members stand ready to provide perspectives on any of the comments raised.