International Alliance for Electronic Payments

Panel on EU Interchange Fee Regulations, Brussels, Belgium, March 17

Remarks of Iain Murray, Vice President, Competitive Enterprise Institute (USA)

Thank you, Dan. Despite my accent, I'm here to present the lessons for the EU from the American experience of interchange fee restrictions. Now most people tend to think of America as a laissez-faire economy where anything goes and regulations are few and far between. America is actually a highly regulated economy with more and more regulations coming on the books. In fact, America invented the very first regulatory agency as we know them today, the Interstate Commerce Commission, in the 1880s, to regulate the railroads that were seen to be charging too much to the shippers that relied on them. So in many ways, much of the European model, and particularly the regulations we are discussing today, are actually based on an American idea. All I have to say about that is, I'm sorry.

Debit card interchange fees have been in place in America since the Dodd-Frank financial reform act of 2010. That law was promoted as being the answer to the financial crisis and too-big-to-fail, but it was admitted by Senator Chris Dodd of Connecticut as being too good of an opportunity to bother with such things as forging a bipartisan compromise, so it grew to encompass all manner of issues unrelated to the financial crisis.

One of these was interchange fee caps, championed by Senator Dick Durbin, an Illinois Democrat. Just as over here, the merchants had been bridling at what they saw as too-high service fees, and demanded a cap. The Durbin Amendment imposed a cap to be set by the Federal Reserve on debit card – not credit card – transactions. The Federal Reserve initially proposed a cap at 12 cents per swipe, but eventually lifted that to 21 cents plus 0.05 percent of the transaction, which works out to an average of 24c per card swipe (yes, we still call them swipes over there – I can explain why the US has been so slow to introduce chip and pin afterwards if you wish).

In percentage terms, that original 12 cents proposal is about the same as the EU's rule, so you can see that the effects of the Durbin Amendment are not as draconian as the EU proposal, especially considering the lack of any cap on credit card fees. Nevertheless, it still represents a significant cut to banks' revenues, as the average fee before the Durbin Amendment was 44c per swipe. It's not quite a halving, as small banks were exempted from the terms of the Amendment, and that 44c figure includes credit cards as well, which are generally used for higher cost purchases, so when you take that all into account, the cut is actually about 5c per transaction.

I should add that the banks sued the Fed to try to impose a lower cap, arguing that that was the clear intent of the Amendment. They won at District Court level, but

that was overturned by the Appeals Court, which refused to second-guess the Fed, and noted that "Congress put the Board, the district court and us in a real bind...given that the Durbin Amendment was crafted in conference committee at the eleventh hour, its language is confusing and its structure convoluted."

Nevertheless, that's the law, and the cap has been in place for over four years now, which gives us an opportunity to see what its results have been, remembering all along that the US cap is not nearly as severe as the EU proposal.

Let's look first at the merchants. By all accounts, they gained a collective cost saving of about $7 billion in 2012, a figure that will increase as years go on.

It is a central part of the rationale for interchange fee caps that the fees represent an artificial inflation of the price of goods and services, and that if the fee is reduced, merchants will pass the savings on to consumers. This contention has been examined by Evans et al of the University of Chicago. They found that, yes, some cost savings were passed on to consumers, although they are one of the few to do so. I am sure Matt will explain why this is the case, but for the moment I want to take this as a very generous estimate of the benefits for consumers.

The fact is that full pass-through of savings happens only in a world of perfect competition. Retail markets are generally not as competitive as they might at first seem. So you would not actually expect every cent of savings to be passed through. Evans and his colleagues estimate that around 50 percent of the merchants' savings were passed on, so consumers benefitted to the tune of around $3.5 billion in reduced prices. That's not insignificant, but it's also not the massive windfall for consumers trumpeted by the merchants. They kept the rest as increased profits. Banks, of course, lost $7 billion. Now when you have a windfall in revenues like the merchants had, you can afford to be generous. The shock of a reduction in revenues is quite different. You will naturally seek to make up the lost revenues.

So the very first reaction by the banks was to impose a visible fee on their customers for use of their debit cards. This provoked an understandable customer reaction, and they quickly dropped the direct fee. Their further reactions provide a nice case study in what Frederic Bastiat called "the seen and the unseen." For every economic event there is a series of obvious events, the "seen" or visible effects - in this case, the nice addition to the merchants' bottom line.

But there are also unseen events, outcomes that can be traced to the initial event by a careful economist, but which aren't visible to the average observer.
In this case, the careful economists are Todd Zywicki and Geoffrey Manne of George Mason University, and Julian Morriss of the Reason Foundation. Their study found that bank reactions, in increasing unconnected fees and withdrawing free or inexpensive products had the following results:

- Banks reduced the availability of fee-free current accounts. The total number of banks offering free current accounts fell by 50% between 2009 and 2013. In comparison, fee-free banking actually *increased* at banks not subject to the Durbin Amendment.
- Banks more than doubled the minimum monthly holding required on fee-free current accounts between 2009 and 2012, from around $250 to over $750.
- Banks doubled average monthly fees on (non-free) current accounts between 2009 and 2013, from around $6 to more than $12.
- Consumers have shifted their payment usage from debit cards to credit and prepaid cards, which were not subjected to price controls.
- Here's the biggest unseen effect. Increasing fees generally makes things unaffordable for a small section of the public. Collectively, these fee increases and loss of access to free checking contributed alongside other regulatory effects to an increase in the unbanked population of approximately 1 million people, mainly among low-income families.

Just think about that: a relatively small decrease in the interchange fee resulted in a series of shifts in the banking industry that have pushed a million Americans out of the system all together. Instead, they are using reloadable prepaid cards, check cashers, or payday lenders to manage their finances. Now each of these things does actually play its part in the system, but if we're concerned about them then the last thing we should be doing is making banking more expensive by artificially restricting where banks can make their money.

Todd's findings were backed up by the Evans study. They found that banks have passed on about 80 percent of their revenue losses in the form of these increased fees. The result is a net welfare loss to the American consumer. Discounted to its present value over several years, Evans et al estimate this as around $22 billion. Zywicki et al agree, with a further qualification. They estimate that around $1 to $3 billion a year is being transferred from low-income households to merchants, mainly large firms, as a result of the Durbin Amendment.

Once again, I stress that these results are from a comparatively toothless regulation in the US. The results for the EU will vary across member state, but I have no reason to think that on aggregate there will be any real benefit to consumers. Instead, consumers will be worse off, and any study that suggests otherwise is ignoring Bastiat.