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Statement on Proposed Revisions to Regulation II's Interchange Fee Cap
by Governor Michelle W. Bowman

I would like to begin by recognizing staff for their work in preparing today's proposal and the accompanying presentation for today's open Board meeting. As I noted during yesterday's open board meeting, I am encouraged by the Board's renewed commitment to considering important regulatory matters through open Board meetings. Addressing important policy issues in this open forum promotes public transparency about the important work of the Board.

Today, the Board is considering a proposal to amend the regulatory cap on debit interchange fees. The Dodd-Frank Act mandates that the Federal Reserve establish a cap on debit interchange fees that is reasonable and proportional to the cost incurred by the issuer with respect to debit transactions.

In my view, before engaging in a significant regulatory proposal, it is critical to reflect on the broader context, and understand the potential consequences of the revisions. While the proposal suggests that it could result in benefits to consumers, I am concerned that the costs for consumers—through the form of increased costs for banking products and services—will be real, while the benefits to consumers—such as lower prices at merchants— may not be realized.

Consequences and Costs.

The debit card payments ecosystem is a vitally important part of the overall payment infrastructure in the United States, and as staff has noted according to the most recent industry data collection from 2021, debit cards remain the most popular form of noncash payment. When we are considering proposed changes to the fees that support this important form of payment, we must take into account the broader context: the wide range of business models and sizes for issuers subject to the interchange fee cap; the effect of the rule on bank capital and earnings; the potential benefits and costs to consumers; the cumulative effect of regulatory changes and rules; and other unintended consequences.

While today's rule acknowledges the varied size, business models, and product offerings of banks subject to the interchange fee cap, the fee cap aims to achieve "rough justice" by establishing a single cap that applies to all covered issuers. This fee cap is the product of aggregated data reported by issuers.

Both setting a single cap for all issuers and basing that cap on data reported by a wide range of issuers is regressive in several ways. Larger issuers—those with the highest transaction volumes, greater negotiating power, and the most efficiencies that come from scale—will continue to have a significant competitive advantage under this rule. Even the lower interchange fee may allow them to continue profitably operating their debit card programs.

By contrast, smaller issuers subject to the cap—those with smaller transaction volumes, less negotiating power, and fewer efficiencies in scale—may be at a significant competitive disadvantage. Because retail banking is such a core function for many smaller issuers, this pricing dynamic may not ultimately force smaller issuers to abandon their debit card programs. But it is possible that banks will be forced to either pass costs through to customers or operate their debit card programs as a loss leader, which many banks do today. Under the proposed rule, nearly one-third of bank issuers would not be able to recover even the subset of costs that factor into the interchange fee cap, let alone those debit card program costs that are disregarded in the cap. Because debit card programs are important to the functioning of the payments system, any increase in price or reduction in availability of debit cards could be harmful for bank customers, particularly low-income customers who may not qualify for credit card products or other alternatives.

The proposal also acknowledges that a lower interchange fee cap will result in an ongoing, permanent decrease in gross revenue from interchange fees. This consequence will be felt at banks of all sizes. While the banking system remains strong and resilient, I am concerned that the cumulative effect of regulatory changes—including a lower interchange fee cap, higher capital requirements, new debt-funding requirements, increasing data collection requirements, and many others—could pose ongoing risks to the health of certain financial institutions and the overall U.S. banking system.

While banks charging fees for services has been criticized by some regulators, in many instances these fees support a bank's ability to offer low-cost or no-cost banking products or services to customers. It is difficult to predict the impact of this rule on bank product offerings, but one consequence may be that banks discontinue their lowest-margin products, including options designed to increase financial inclusion and access for low- and moderate-income individuals and families. I sincerely hope that this is not the case, but this is a real and important risk. While the newly revised CRA rules create incentives for banks to offer responsive deposit products, other rules should not impede ongoing progress to improve broader financial product access and availability.

Before finalizing any rule, it is incumbent upon policymakers to understand the intended and unintended consequences of our revisions. This is particularly important when we are talking about vital payment tools like debit cards.

Formula for Periodic Updates

Today's proposal also includes a formula that would periodically adjust the interchange fee cap based on data collected by the Board over time. Once a formulaic approach is adopted, it will be hard to overcome inertia to revisit and reopen that approach, even if there are good reasons to do so. There is merit in the Board periodically reconsidering whether the data we collect as the foundation for the cap is appropriate and accurate. There also is merit in revisiting from time to time the policy decisions embedded in the formulaic approach to setting the interchange fee cap. And, there is merit in responding to changing conditions as the payments system evolves, given new market entrants and the increase and evolution of fraudulent activity in the payments system.

One evolution relates to the recent significant revisions adopted by the Board related to debit card transaction routing rules. We do not yet know the effects of those revisions, and I would have preferred that the Board pause to collect data on evolving conditions before proposing this rule change, and follow a more deliberative approach for future updates to the interchange fee cap.

Scope

While today's rule only applies directly to a subset of issuers, those with more than $10 billion in assets, I am concerned that the impact of the fee cap has and will likely continue to affect a broader range of issuers, including community banks. Virtually all retail banks offer checking accounts and debit cards to their customers, and many of these retail banks are community banks, banks that are intended to be exempt from the interchange fee cap.

These smaller debit card issuers do not exist in a vacuum. Issuers of all sizes use the same payment rails, and smaller issuers inevitably face some degree of pricing pressure, at least indirectly, from the interchange fee cap. And while the interchange fees many smaller issuers have collected since the introduction of the interchange fee cap may have remained largely stable, it is difficult to determine how this compares to the aggregate costs of processing, fraud and fraud prevention, and the many other inputs for running a debit card program. It is not clear that interchange fees have kept up for many smaller issuers, and I am concerned that even if the interchange fee cap does not directly apply, smaller issuers will continue to face ongoing fee pressure in operating debit card programs.

Transition Period

Today's proposal suggests that any final rule would become effective "at least 60 days" after the final rule is published in the Federal Register. I look forward to public comment on whether such a brief transition period is reasonable for issuers to make any changes to systems, products, or terms and conditions that may be necessary to adjust to an amended debit card interchange fee cap. I suspect that this short transition period will put undue burden on banks. Requiring them to make changes under a 60-day timetable could significantly increase their short-term operational risk.

Conclusion

While I look forward to reviewing feedback from the public, for the reasons noted above, I cannot support the proposed revisions to Regulation II's interchange fee cap and plan for periodic updates.