



Editorial Perspective:
*Durbin, Debit Interchange and Rewriting Regulation II:
Will History Repeat Itself?*



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The Durbin Amendment and Federal Reserve Regulation II, which spelled out the ways in which the provisions of the Durbin statute would be codified into law, transformed the debit landscape two years ago by:

- Capping interchange rates for financial institutions with over \$10 billion in assets and
- Mandating network non-exclusivity (i.e., requiring the use of more than one transaction network) for all financial institutions regardless of size.

As a last-minute addendum to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the Durbin Amendment was conceived of as a means of reducing costs to consumers by capping the size of interchange fees that non-exempt card issuers could charge and that banks and merchants would then build into their pricing and pass along.

Durbin: The Law of Unintended Consequences

Things didn't quite work out that way, however, once the new debit interchange caps took effect in October 2011. No constituency—from Big Banks to credit unions, Big Box retailers to mom and pop stores—was happy; but users of traditional bank services would turn out to be the least happy of all.

- **Big banks** and non-exempt financial institutions over \$10 billion in assets saw their debit interchange rates reduced by over 50% on signature-based transactions, while brand-exclusive arrangements with Visa and MasterCard required modification.
- **Credit unions** and community banks, which generally fell into the loosely-defined "exempt" category of financial institutions under \$10 billion in assets under Regulation II, moved into a "worst-of-both-worlds" gray area, characterized by declining interchange rates coupled with increasing uncertainty due to the lack of specific enforcement provisions for exempt institutions.
- **Merchants** were also unhappy partly because they felt that their regulated interchange rates were too high but also because, in some small-ticket merchant categories, the capped rates actually ended up being higher than rates prior to Regulation II.

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- **Consumers** doing business with large, non-exempt banks felt the greatest pain of all as the free checking accounts and debit rewards programs that had built their original loyalty became relics of the past.

From Wall Street to Main Street, Regulation II Becomes a Lightning Rod

It didn't take long before the reaction to the adverse economic and policy consequences of Regulation II forged an unlikely, unprecedented and strongly motivated consensus of key stakeholders who believed that, as originally worded, Regulation II needed to be challenged. In retrospect, the Fed should have realized the depth of negative constituent reaction when it received over 11,500 letters during its formal comment period prior to release of the now-current Final Rule.

Indeed, the unanimity of the coalition was underscored by the fact that it took exactly one month from the time Regulation II was implemented for a group of merchants, which included the National Retail Federation, the Food Marketing Institute, the National Association of Convenience Stores and a group of individual merchants, to band together to file a major lawsuit against the Fed aimed at striking down Regulation II. The lawsuit argued that Regulation II was unlawful on the grounds that there were key discrepancies between the language of the original Durbin statute and the language of the Fed's regulatory interpretation. Specifically, the plaintiffs contended that:

1. The Federal Reserve went beyond its authority by including costs in the interchange cap calculation that were not allowable under the statutory language of the Durbin Amendment. In other words, the plaintiffs argued that the Federal Reserve had set regulated interchange rates too high.
2. In the area of network non-exclusivity, the Federal Reserve did not comply with the statutory language of the Durbin Amendment in its interpretation of the meaning of non-exclusivity. The plaintiffs contended that the Durbin Amendment requires that all debit *transactions* have the ability to be run over at least two unaffiliated networks, while Regulation II requires that all debit *cards* be able to be run over at least two unaffiliated networks. In other words, the plaintiffs argued that at least two unaffiliated networks must be available for each transaction type—Signature and PIN.

The District Court Ruling and the Appeal

In late July 2013, Richard J. Leon, U.S. District Court Judge for the District of Columbia, handed down a 58-page opinion that minced no words in ruling on behalf of the merchant plaintiffs and pointedly called Regulation II "fundamentally deficient and unlawful." By making that ruling, Judge Leon essentially set the stage for a rewrite of Regulation II to bring its language into compliance with the Durbin Amendment, which remains law.

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The Federal Reserve ultimately decided to appeal the verdict, although it waited until the last moment to do so. Judge Leon stayed his district court verdict pending the appellate court's decision, which means that nothing changes with the existing Regulation II until the Fed's appeal is ruled upon.

A New Definition of Fed Watching: What Happens Now?

What hangs in the balance—however uncertain the time frame—is the tantalizing opportunity to rewrite history and get it right this time. Will that happen? For credit union managers who have followed the twists and turns of the interchange court case through two years of litigation, at this juncture three key questions emerge:

1. What is the most likely case for the appellate court decision given the range of possible outcomes and timing scenarios?
2. What could happen to interchange rates and network non-exclusivity if the Fed loses its appeal?
3. What can and should credit unions do to be proactive while awaiting the appellate court verdict and a possible rewrite of Regulation II?

Possible Outcomes:

Given the Fed's lack of vested interest in defending the policy behind Regulation II, its initial reluctance to appeal the verdict, the strength of Judge Leon's expressed bias against the existing language of Regulation II and the Fed's historical lack of success on appeal, Advisors **Plus** believes that credit unions should be prepared to consider the possibility that the Federal Reserve will be unsuccessful in the appellate process.

Effect on Interchange Rates:

If the Fed loses its appeal, it will cause the interchange bar to be lowered even further for non-exempt issuers. Moreover, almost certainly some degree of decrease in interchange rates will find its way to credit unions as exempt issuers.

While recent news and commentary on the district court verdict and appeal has been laser focused on interchange rate implications, very little attention has been paid to the issue of network exclusivity itself, which actually impacts all debit card issuers, regardless of asset size. The District Court ruling stipulates that the Federal Reserve will need to require two or more networks for each *type* of debit transaction, versus two or more networks for each debit card. Thus, if the district court verdict is upheld, merchants will be able to decide whether to route signature-based transactions to MasterCard or Visa, Visa or Discover, etc. in addition to the similar decisions they currently make on PIN-based transactions.

Managing Your Credit Union for Change

Credit unions have not only been put into a holding pattern as they await the Regulation II appellate court decision to resolve, it is a holding pattern in which critical decisions affecting them will be made without their consideration. Instead, those decisions will be made in consideration of non-exempt institutions

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such as large money center banks. It will be the job of the credit union managers—with a fraction of non-exempt institution assets and resources—to live creatively with the consequences.

At Advisors **Plus** we have given considerable thought to steps that credit unions can take to mitigate the risks and take advantage of the opportunities inherent in this uneven but unchangeable state of affairs. My debit consulting team has prepared a detailed POV white paper entitled, "*Are Changes Ahead for Debit Interchange? Helping Your Credit Union Be Aware and Prepared*" that outlines a comprehensive action plan. The plan includes the following elements:

- Appointment of an internal "debit interchange" policy guru to follow future developments in the pending court case via Advisors **Plus** white papers, e-mail and Twitter postings to keep your credit union in the loop.
- A game plan to analyze and reserve for possible financial risk exposure associated with interchange rate fluctuations.
- Ways to work with Advisors **Plus** debit consultants to optimize existing payment networks and plan for the future for compliance purposes as well as to maximize financial and operational efficiencies.
- Emphasis on marketing and branch programs to attract and educate a possible next wave of disillusioned and disenfranchised Big Bank customers who may be seeking the value and transparency of the credit union member experience in the wake of a new wave of bank service cuts and fee increases.

As debit consultants, Advisors **Plus** doesn't claim to have a crystal ball when it comes to knowing the outcome and timing of what will happen with rewriting Regulation II. However, we believe that the more valuable perspective for any credit union is to be aware and prepared regardless of external forces. By remaining in a position where your credit union's resources—financial, operational, and interpersonal—are optimized and can be nimbly deployed, you will always be in a position to create value and delight for your members. Visit us at AdvisorsPlus.com to read and learn more about our range of debit consulting services including our innovative Instant Insight Debit Diagnostics[®].



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About Advisors Plus Consulting Services Debit and Checking Consulting

Advisors **Plus** takes a comprehensive approach to reviewing debit and checking portfolios and making strategic recommendations. Our Consulting Services Debit and Checking Consulting is one-of-a-kind in the credit union industry, with no other competitor offering the type of insight and intellectual capital that Advisors **Plus** delivers.

The Advisors **Plus** team begins each engagement by partnering with a credit union for an uncommonly thorough review process. Because Advisors **Plus** offers a complete analysis of debit P&L and the role that debit and checking play within the entire business model, the majority of Advisors **Plus** clients re-engage our Debit and Checking Consulting team annually to revisit the review and provide updated results and recommendations.

In 2012, our average Net Promoter Score in 2012 was 84 as measured by client surveys.

About Advisors Plus

Advisors **Plus** was established in 2005 to provide consulting and marketing services to credit unions. Our range of services covers the key areas of strategy, credit cards, debit and checking, marketing, contact center, operations, and branch sales.

The experienced consultants at Advisors **Plus** work with a credit union's staff through the entire process from project analysis to implementation and management. Our goal is to ensure that each credit union client achieves sustainable business growth, exceptional member experiences and operational efficiencies. As of December 31, 2012, Advisors **Plus** has superior NPS Scores of: 79 – Credit; 84 – Debit and Checking; 91 – Contact Center. For more information, please visit AdvisorsPlus.com.