

**Meeting between the Federal Reserve Board and Staff,  
the Merchants Payments Coalition and Consumer Group Representatives  
February 23, 2011**

Representatives from the Merchants Payments Coalition (MPC) and consumer groups met with the Board of Governors and other Board staff (see attached list for meeting attendees) to discuss the interchange fee and network routing and exclusivity provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Act”).

Representatives of the MPC and consumer groups provided background on why regulation of the debit card industry is needed and stated that the Board’s proposed Regulation II (Debit Card Interchange Fees and Routing) would restore competition in the debit card market, as well as provide necessary relief on the level of interchange fees. Representatives of the MPC stated there was no reason for the Board to delay issuance of a final rule. Representatives of the consumer groups expressed concern about higher bank fees on consumers, particularly low-income consumers, and the effect of higher fees on consumers’ ability to obtaining banking services. Representatives of two consumer groups that also represent small issuers requested that the Board pay attention to the proposal’s impact on small issuers. Documentation describing the MPC’s views is included.

Additional topics discussed at the meeting included the proposed rule’s potential to change the debit card business model; whether the ability to differentially price forms of payment would provide relief for merchants; investment in payment card network infrastructure and programs; the likelihood that merchants would pass savings from reduced interchange fees onto consumers; and current barriers to merchant investment in PIN technology.

## **MERCHANTS PAYMENTS COALITION SUBMISSION TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

### Regulation of the U.S. Debit Industry is Necessary

The U.S. debit market has not functioned properly for close to two decades. Debit has thrived around the world without any form of interchange subsidy from merchants to issuers, with at-par pricing prevailing in 7 of the 8 leading countries for debit usage. At-par pricing was the norm in the early days of debit in the United States as well, because banks saw benefits in giving their customers debit cards, such as avoiding the costs and inefficiencies of paper checks and, thus, they did not need interchange to motivate issuance. This paradigm thrived until the early 1990s when Visa (and subsequently MasterCard) established their dominant positions in the debit market, power that persists to this day.

Specifically, beginning in 1990, Visa implemented a strategy that leveraged its dominant position in the payment system to force merchants to accept its Visa Check signature debit product at high, unprecedented, ad valorem interchange rates. It used that interchange stream to attract banks to issue Visa Check cards and thus began a dynamic where networks used ever-increasing interchange rates paid by merchants to finance their competition for issuers. In the same time frame, Visa extended its power to PIN debit when it acquired the leading PIN debit network, Interlink, and immediately jettisoned its at-par interchange model and instead put in place high positive interchange that merchants paid to issuers. Since then, Visa has used Interlink to drive up PIN debit pricing on numerous occasions, resulting in a 166-percent price increase to merchants since 1998 — at a time when payment industry costs almost certainly were declining. And underpinning this strategy was the basic fact that thousands of issuing banks exploited the network rubric to collectively fix interchange prices to merchants, prices that every merchant that accepted these cards had no choice but to pay. The complete absence of issuer or network competition for merchants has been a consistent feature of this industry for the past two decades.

Simply put, merchants cannot reject the dominant networks' debit cards without seriously harming their businesses. While thousands of banks can fix prices through the networks, merchants have to make individual decisions about the debit cards they would accept to avoid antitrust liability. This asymmetry makes it virtually impossible for merchants to reject the dominant networks' cards, and that has contributed to the networks' ability to raise prices without fear of losing merchant acceptance. Competition has failed in this industry and that is why Congress stepped in to fix the problem.

### The Durbin Amendment Addresses These Market Failures in the Debit Industry

Congress has come forward with a narrowly-tailored approach to address this market failure. The Durbin Amendment governs only collectively set interchange fees. Under the Durbin Amendment, banks are free to compete individually and charge whatever fees they please to merchants, provided that they do not impose those fees under the market power they have formed through the networks. Moreover, the regulation allows the banks to continue to get an interchange subsidy from merchants for the incremental cost of authorizing, clearing and settling

the transaction even though, as noted above, debit has thrived around the world (and initially did so in the United States) without any interchange at all. And the suggestion that banks cannot cover their costs with reduced interchange cannot withstand scrutiny. Tellingly, when networks and banks are talking to investors, and subject to the securities laws, they emphasize that their debit card programs can readily adapt to the changes and thrive going forward. MasterCard has even predicted that its debit program is going to benefit from these regulations, an admission that is starkly inconsistent with bank claims about regulation leading to less usage of debit.

Regulators in other nations have also found these doomsday assertions to be false. Following debit reform in Australia, fees on debit cardholders have not increased and banks remain quite profitable. Rather than boosting fees, bank operations became more efficient — a positive outcome. Similarly, European regulators concluded that reduced interchange would not correlate to higher consumer fees on checking accounts. They pressed the banks for evidence of the relationship that banks claimed existed between interchange and consumer checking fees and it could not be produced. In short, putting limits on an anticompetitive market (interchange) does not injure what is already a competitive market (consumer fees).

#### Small Banks Will Not be Harmed by the Regulations

They will not. The networks have admitted that they can set two sets of interchange rates, one for regulated banks and the other for unregulated banks. Moreover, the suggestion that merchants will discriminate against smaller banks because they will receive higher interchange is belied by the fact that the networks' Honor All Cards rules — which Congress did not alter in the statute — require merchants to accept all issuers' cards without discrimination. In other words, a merchant that agrees to accept Visa debit cards must accept all Visa debit cards, no matter the issuer, regardless of size. Any attempt to reject exempt cards would violate those rules and risk fines of a magnitude that could sink some merchant businesses.

#### The Exclusivity and Routing Regulations Are Necessary

After the regulations go into effect, merchants will still have no choice but to accept the dominant networks' cards and those networks will still have the incentive to exploit that power to attract and maintain issuers. That reality makes it essential that merchants have competitive debit network options on all debit cards for all authentication methods, as well as a meaningful ability to take advantage of those options by routing to cheaper networks. If that happens, true network competition, which may lessen the need for regulation over time, could actually take hold in this industry.

#### Conclusion: Consumers and Merchants Will Benefit from this Regulation

At the end of the day, the regulation of debit interchange will benefit the entire merchant community, consumers and competition. For merchants that operate on tight profits margins, including millions of small merchants, the average interchange fee is often more than their profit margins and, thus, substantial reductions in these fees likely will preserve jobs and save small businesses. Because the retail industry is vigorously competitive, reductions in interchange fees almost certainly will be passed along to consumers in the form of lower retail prices or other consumer benefits. The Australian Reserve Bank indicated that this is happening in Australia and there is no reason why the same will not happen here. In the process, the regressive nature

of the current system — where less affluent cash customers subsidize the rewards of the wealthy — will be eliminated (at least for debit transactions). And, lastly, if multiple networks are required on all debit cards for all forms of authentication, merchants will for the first time have the ability to check the networks' ability to raise prices to them and the networks will have to compete for merchant acceptance. That competition will lower prices for both merchants and consumers.

Before concluding, a word about the purported need for delay is in order. The consequences of inaction are clear; the dominant networks (and their banks) will continue to impose supra-competitive interchange fees on all merchants — more than \$1 billion per month of fees that are ultimately borne by consumers. Those that urge delay in the name of free market principles, in truth, want to perpetuate this anticompetitive structure. And the suggestion that delay is warranted by the need for further study is refuted by the thoughtful analysis in the notice of proposed rulemaking, which addresses and answers most of the key questions. Against that backdrop, we urge the Board to complete the rigorous work the staff has done to date and faithfully implement this modest regulatory fix to a serious and pernicious failure of the market.

## **MEETING ATTENDEES**

### **Mechants Payments Coalition**

Mallory Duncan (National Retail Federation)  
Susan Ehrlich (Sears Financial Services)  
Sonja Hubbard (E-Z Mart Stores, Inc.)  
Ric Jurgens (Hy-Vee, Inc.)  
Douglas Kantor (Steptoe & Johnson LLP)  
Kathy Miller (The Elmore Store)  
Henry Polmer (Law Offices of Henry Polmer)  
Terry Scully (Target Financial Services)  
David Seltzer (7-Eleven)  
Jeffrey Shinder (Constantine Cannon LLP)

### **Consumer Group Representatives**

David Balto (Law Offices of David Balto)  
Mike Calhoun (Center for Responsible Lending)  
Gail Hillebrand (Consumers Union of U.S.)  
Adam Levitin (Georgetown Law School)  
Ed Mierzwinski (U.S. PIRG)  
Travis Plunkett (Consumer Federation of America)  
Lauren Saunders (National Consumer Law Center)

### **Federal Reserve Staff**

Louise Roseman  
Stephanie Martin  
Jeff Marquardt  
Scott Alvarez  
Robin Prager  
Vivian Wong  
David Mills  
Chris Clubb  
Ky Tran-Trong  
Nancy Riley  
Michelle Smith  
Brian Gross  
Linda Robertson  
Mark Manuszak  
David Stein  
Julia Cheney (on detail from FRB Philadelphia)