Federal Advisory Council

Federal Reserve Board Interchange Fee Proposal

On February 4, 2011, the Federal Advisory Council met with the Board of Governors to discuss the Board's proposed rule on debit-card interchange fees, routing, and payment-network exclusivity (Docket R-1404). The council provided written views, which are provided below.

"What is the Council's view of the Federal Reserve Board's proposal concerning debit card interchange fees, routing, and network exclusivity?

We have gathered unprecedented feedback from across the financial services industry and there is broad and deep opposition to the Federal Reserve's proposed approach, which we strongly believe misinterprets and misapplies the Durbin Amendment. If enacted as proposed, the results would be extremely damaging to consumers, the U.S. payment systems and financial institutions of all sizes. Given the serious flaws in the Proposed Rule, we urge the Board to withdraw the current proposal, fundamentally revise its overly narrow interpretation of the Durbin Amendment and issue a new proposed rule that takes fully into account both the requirements of law and the significant consumer and economic considerations at stake.

- Debit card transactions have become the most popular means of purchasing goods and services in the United States.
- Millions of consumers and merchants benefit from the debit card infrastructure that has been developed at a great cost by banks and credit unions.

The Durbin Amendment authorizes the Board to establish interchange fee standards that will largely preserve the benefits of the debit card payment system by enabling issuers to recover a broad array of their costs plus a reasonable rate of return.

- Rather than encouraging the continuing development and use of debit card transactions, the Proposed Rule goes well beyond the requirements of the Durbin Amendment and would disrupt the market process by imposing price controls which would severely curtail the growth of one of the most popular and efficient means of transacting day-to-day purchases for American consumers.
- The statute does not require the Board to cap interchange fees nor does it require the Board to restrict fees to issuers' incremental costs of authorization, clearance, and settlement.
- To the contrary, the statute requires the Board to establish *"standards for assessing"* whether an interchange fee "*is reasonable and proportional to,"* broadly, *"the cost incurred by the issuer with respect to the transaction."* The Board misconstrues this requirement in three crucial respects:

    - First, the Board fails to accept the normal meaning of "standards for assessing," which connotes an evaluative process, and instead reads this phrase as requiring pre-determined caps.

  - Second, the Board wrongly interprets "reasonable and proportional" to mean equivalent to some "costs," contrary to the clear statutory language.
  - Third, contrary to the Board's view, Durbin does not prohibit the consideration of incremental costs beyond those associated with authorization, clearance or settlement of a particular transaction. Incremental costs not included as allowable costs under the Proposed Rule include fraud losses, fraud prevention, network processing fees, customer service inquiries and disputes and debit card production and delivery.
- By wrongly interpreting the phrase "reasonable and proportional" to mean equivalent to some costs, the Board fails to give effect to the courts' long-standing construction of similar phrases like "just and reasonable" in ratemaking schemes to require the inclusion of all costs and a reasonable rate of return, in large part to conform such statutes to constitutional norms.
- After reciting several economic definitions of "incremental costs", the Fed has disregarded all of them. In contrast, commonly-used economic definitions of "incremental costs" would have resulted in a broader range of allowable costs.
- The Proposed Rule thus raises serious constitutional concerns to the extent it is likely to be confiscatory in precluding issuers from recovering their costs plus a reasonable rate of return. The Proposed Rule's suggestion that issuers can recover sufficient revenue from "other sources" to cover all the costs of debit-card systems plus a reasonable rate of return is far from demonstrable, and, in any event, it does not cure the constitutional flaws in the Proposed Rule.

Price controls are disfavored because they invariably lead to unintended and harmful consequences and distort markets. This sound public policy concern is reflected, in part, in Section 904 of the EFTA, which requires the Federal Reserve to consider the effect of any Proposed Rule on the following: (i) "costs and benefits to financial institutions, consumers, and other users of electronic fund transfers"; (ii) "competition in the provision of electronic banking services among large and small financial institutions and the availability of such services to different classes of consumers, particularly low income consumers"; and (iii) to the extent practicable, "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions". Had the Proposed Rule considered statutorily mandated factors, we believe the Proposed Rule would have reached a different result.

- Consumers will bear the brunt of the Proposed Rule, with the benefits accruing mainly to the largest retailers in the form of a windfall wealth transfer that could exceed $12B.
  - Banks cannot operate debit programs at a loss and will have no option but to try to recover costs in other ways, including fees on depositors and the limitation or withdrawal of services that are now provided free or at low cost. Early commentary suggests that some of the banking population will be driven into the ranks of the unbanked by such changes to bank pricing.

    - Any benefits to consumers are highly speculative. Merchants are not required to pass on any cost savings, and experiences in foreign markets suggest that they will not. Furthermore, small merchants may see little benefit due to the bundled pricing they are typically charged by merchant acquirers, with the gains accruing almost solely to the very largest retailers.
- Small banks and credit unions, though nominally exempt from the specific legal restriction on interchange fees, are nevertheless likely to be harmed significantly through the reduction of their interchange fees as the markets and payments infrastructure respond to pressures generated by the Proposed Rule.
- The debit card payment system itself also will suffer. Barred from recovering through interchange the costs of maintenance and innovation of the system, such expenditures are likely to be reduced, stifling future investment and innovation that would benefit consumers and merchants and reduce the risk of system failures and security breaches. Likewise, the general availability and specific benefits of the current debit card payment system, including debit availability for high transaction amounts or for certain kinds of transactions (e.g., internet), may be eliminated or curtailed, potentially replaced by higher risk payment methods (e.g., cash and check).

Additionally, Congress directed the Board to prescribe regulations *"providing that an issuer or payment card network shall not, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to (i) 1 such network; or (ii) 2 or more such networks which are owned, controlled, or otherwise operated by (I) affiliated persons; or (II) networks affiliated with such issuer.*

- The Board's proposal for network exclusivity restriction Alternative B also exceeds the statutory requirements and results in unjustifiable harm to consumers, issuers and networks.
- Alternative A provides merchants with adequate transaction routing choices except where merchants have voluntarily elected not to support multiple methods of transaction authorization (e.g., not deploying PIN pads).
- Alternative B will require networks, issuers, merchants and processors to incur substantial costs to modify current infrastructure that, in many instances, does not support the processing of transactions from a particular method of authorization over multiple networks, and may spur greater consolidation within the debit network market, ultimately resulting in less competition and less choice for all participants.
- Emerging payment technologies, such as mobile payments and biometrics, should not be subject to the statute's network exclusivity restrictions. For the foreseeable future, all consumers with a mobile phone will also have a traditional plastic debit card, thus preserving choice to consumers and merchants.

Notes on economic impact

- From the Federal Reserve Board's commentary, total industry debit interchange revenue in 2009 was $16.2 BN.
- If all transactions for all issuers are priced at $0.12, industry revenue will fall to $4.4 BN, a decline of $11.8 BN.
- If interchange pricing to smaller issuers (under $10 BN in assets) does not change, industry revenue will drop to approximately $8.3 BN.

- If interchange rates for many large issuers cluster around the safe harbor rate of \$0.07, then total industry revenue will drop to approximately \$3.3 BN, an 80% reduction."