From: Small Business & Entrepreneurship Council, Raymond J Keating

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Name: Raymond J Keating
Affiliation: Small Business & Entrepreneurship Council
Category of Affiliation: Other
Address:

City:
State:
Country: UNITED STATES
Zip:
PostalCode:

Comments:
"Federal Reserve Debit Card Interchange Fee Price Controls" Raymond J. Keating Chief Economist Small Business & Entrepreneurship Council February 22, 2011 Comments to the Federal Reserve Board The Small Business & Entrepreneurship Council (SBE Council) is concerned about the negative fallout for entrepreneurs, small businesses, community banks and consumers from the imposition of price controls on debit card interchange fees. My name is Raymond J. Keating, and I serve as chief economist for SBE Council, a nonpartisan, nonprofit advocacy, research and training organization dedicated to protecting small business and promoting entrepreneurship. With nearly 100,000 members and 250,000 small business activists nationwide, SBE Council is engaged at the local, state, federal and international levels where we collaborate with elected officials, policy experts and business leaders on initiatives and policies that enhance competitiveness and improve the environment for business start-up and
growth. As the Federal Reserve reported in a 2010 payment study, debit card use is the leading noncash payment used in the United States, coming in at roughly 35 percent of all noncash payments. The Federal Reserve, of course, has been mandated under the Wall Street Reform and Consumer Protection Act, signed into law in July 2010, to establish standards for debit card interchange fees received by card issuers that are "reasonable and proportional" to the cost incurred by the issuer. In December 2010, the Federal Reserve came up with two alternative interchange fee standards. As described in a Federal Reserve Board release: "one based on each issuer's costs, with a safe harbor (initially set at 7 cents per transaction) and a cap (initially set at 12 cents per transaction); and the other a stand-alone cap (initially set at 12 cents per transaction)." The release later noted: "If the Board adopts either of these proposed standards in the final rule, the maximum allowable interchange fee received by covered issuers for debit card transactions would be more than

70 percent lower than the 2009 average, once the new rule takes effect on July 21, 2011." Unfortunately, this is nothing but a case of government overruling private markets, and imposing price controls. As most economists will tell you, price controls come with consequences, namely, new and/or shifting costs. And small businesses, entrepreneurs and consumers will feel the impact of these shifting and/or added costs. The ills of price controls really are Economics 101. Consider a quick review of the basic economics of price controls offered by a leading college economics textbook - Economics: Private and Public Choice by James Gwartney, Richard Stroup, Russell Sobel, and David Macpherson. The authors noted the following points on price controls: "Imposing price controls might seem like a simple, easy way for the government to help buyers at the expense of sellers (or vice versa). The problem is that doing so typically creates secondary effects that, over time, make both sides worse off." One example offered is the regulation of ATM fees in various states. The results? Fewer ATMs available to consumers in those states. As explained: "The regulation of automated teller machine (ATM) surcharge fees is one example. Many states, after being lobbied by consumer groups, enacted regulations forbidding or severely restricting the ability of ATM owners to charge fees for using their machines. The unintended consequence of these regulations is that there are now fewer ATMs available to consumers in these states because there's less incentive to own and operate them. Consumers in these states benefit by paying lower ATM fees, but they also bear the cost of reduced ATM access." "In the real world, there are two ways that sellers can raise prices. First, they can raise their money prices, holding quality constant. Or, second, they can hold the money price constant while reducing the quality of
the good. Faced with a price ceiling, sellers will use quality reductions as a way to raise their prices." While some politicians might not like reading these points, none of this is controversial from economics and business perspectives, as Federal Reserve economists surely understand. The economics of price controls make clear that government setting debit card interchange fees means that both debit-card issuers and consumers will suffer. Facing limited returns due to price controls, there will be less investment and innovation in the industry, and reduced services. That, in turn, is bad news for consumers. The Mercator Advisory Group released an analysis on June 8, 2010, assessing the impact of the Durbin Card Swipe Fee Amendment, which eventually is what landed in the actual law. The study captured the major problems with these price controls. A few key points/findings are worth highlighting: "The cost of financial services will rise for cosumers across a wide range of economic levels." "The smaller financial institutions, though exempt from portions of the amendment, are unlikely to escape undamaged. This is evident as wide government mandated pricing discrepancies between large players whose fees are price-controlled and smaller exempt issuers would be difficult to sustain from a network perspective. This problem is recognized in major public statements by smaller issuers expressing concern over the loss of their customers to those institutions mandated to charge artificially low rates." "Debit interchange income has become a closely watched, reliable income source for community banks that has been relatively stable through varying economic cycles. Declines in this income would surely need to be replaced from other sources, such as account-based or debit transaction-based fees charged to checking account holders. For consumers at the margin, new fees could suppress their use of debit cards or even checking accounts." And regarding the consequences of price controls: "Consumers will pay more for financial services as operating capital is removed from the market. This impact has been documented in other countries where debit card interchange is regulated. In these countries, consumers pay periodic account fees, checking account fees, transaction fees,

and do not have access to beneficial loyalty programs or more innovative, convenient, and efficient payment services since available investment capital is more limited." In the end, government regulation and interference in the marketplace always come with costs, and that is definitely the case when government tries to interfere with the fundamental market work of setting prices. A recent report - "The Consequences of Debit Interchange Price Fixing" released by the Financial Services Roundtable on February 16, 2011 - also provided valuable information regarding the problems and costs that come with price controls on debit card interchange fees. The study summed up who wins and who
loses this way: "The Durbin Amendment has established a price fixing scheme for debit interchange, implemented by the Federal Reserve. Banks will be forced to offer debit card services to retailers at sharply below cost. The beneficiaries will be giant retail chains, as 1.5% of merchants account for over 80% of debit transaction volume (and the top 100 merchants alone account for 50% of the debit transaction volume). The corresponding harm will fall largely on consumers, as (1) there is no requirement or expectation that retailers will pass along their $14 billion windfall to their customers; and (2) banks, forced to lose money on debit interchange transactions, will be forced to compensate by increasing fees for deposit customers." Again, the problems with price controls are correctly noted: "Prior to the Durbin Amendment, Congress had not enacted price control legislation for many years. Not only is such legislation inconsistent with basic American free enterprise principles, but it has generally proven to be a failure, producing unintended consequences, stifling innovation and competition, and harming the very consumers the legislation was designed to protect." This report also highlights the enormous benefits that debit cards provide to retailers - most certainly including small merchants who arguably reap the greatest benefits through reduced costs and enhanced sales. Two points here: "Retailers have benefited enormously from the value that banks and credit unions have created in debit card networks by fully embracing and accepting the widespread use of debit cards and by benefiting from the higher sales generated by the proliferation of debit cards. Retailers are not required to accept debit cards but have chosen to do so because they benefit from them in multiple ways." "Retailers also benefit from the ease with which consumers can access their funds and pay for products and services more quickly; from the ability of retailers to process payments quickly
and efficiently, at little or no risk; from lower fraud losses; from faster service to customers; and from faster credit for sales." Likewise, regarding small merchants, the Mercator Advisory Group report noted: "Debit cards offer merchants guaranteed payment, proven increased sales (i.e., 'ticket lift'), lower labor costs (e.g., significantly reduced tender time at check out and deposit preparation time), as well as the reduction or elimination of bad check costs (e.g., fraud and costs associated with check verification and guarantee services). Additionally, debit cards enhance merchant's capabilities to create comprehensive e- commerce and telephone sales and bill payment strategies. In sum, the function and benefits of debit card transactions for both consumers and merchants are far superior to those involving checks." In addition, as for small financial institutions, the Mercator study noted: "Debit cards have llowed community financial institutions to offer 'big bank' global transaction services to their retail customers, without having to build large scale internal operations to enable the capability. Without this ability, community financial institutions would be hard pressed to compete for customers with the big banks." Ironically, it is the enormous value that debit card, as well as credit card, usage delivers to merchants that has driven the backlash among some in the retail community against interchange fees. It is peculiar, to

say the least, that some private businesses and/or their representatives argued for government price controls, as they no doubt would vehemently oppose such government mandates on their own businesses, and should understand the negatives in terms of supply, service, innovation and investment. The Financial Services Roundtable report drives home the point on the incentives to invest under a price control scenario: "The financial services industry has invested billions of dollars over many decades to build an infrastructure that facilitates the use of payment cards on a global basis and has effectively migrated trillions of dollars worth of transactions from paper to electronic form. Fixing prices at 20% of current rates will stifle any future investment and innovation that benefits consumers and merchants (e.g., mobile payments, guaranteed fraud protection, photo card, contactless payments, account alerts, etc.)." Indeed, why invest when the government is imposing draconian price controls? By definition, limiting prices means limiting returns on investment. And the reality of debit card interchange price controls obviously raises questions and uncertainties regarding price controls on credit card interchange fees as well. It's important to note how this drastic government intervention promises to influence and alter how community banks, for example, do business. On February 17, 2011, the Independent Community Bankers of America released the results of a survey of community banks regarding the impact of the Federal Reserve's proposed rule on debit card interchange fees. The four key findings, as reported by the ICBA, were: "Ninety-three percent of community bank survey respondents said that they will be forced to charge their customers for services that are currently offered for free. These include services that customers have come to expect and value, such as use of a debit card with no annual, monthly or transaction fees and free checking, online and mobile banking." "Nearly half of community banks say the rule will harm their customers - both consumers and small businesses - because it will make it difficult for them to continue offering competitive rates on deposits and loans." "Sixty-five percent of community bank respondents say they will have to raise their qualification standards, either by strengthening debit card qualification thresholds or closing higher-risk transaction accounts." "Nearly 20 percent say they will have to eliminate jobs or halt plans to open new bank branches - extending the impact from individual consumers to communities." Again, we see, predictably, cost shifting, diminished service and new costs arising out of price controls on interchange fees. How far and deep will these costs be felt? A February 15, 2011, a Reuters report noted the problem of unintended consequences hitting certain consumer groups. The story noted the following: Banks may cut their services to the poorest Americans as a result of new U.S. financial regulations, including federal caps on debit card processing fees, Citigroup Inc Chief Executive Vikram Pandit said on Tuesday. "On the retail side, margins will tighten, requiring banks to reevaluate the feasibility of extensive branch networks, think hard about who they serve, and devise new fee and cost structures," he said. "One inadvertent impact could be an increase in people in this country who lack access to financial services," he added. His comments echoed those of JPMorgan Chase & Co CEO Jamie Dimon, who warned last month that up to 5 percent of Americans could lose access to traditional bank accounts from the law. Federal Deposit Insurance Corp. Chairman Sheila Bair understands the economic realities, as reflected in her observation recently before Congress: "I think the likelihood of this hurting community banks and requiring them to increase the fees they charge for accounts is much greater than any tiny benefit retail customers maybe get from any savings." But what about that exemption for smaller banks and credit unions with assets of less than $10 billion? Testifying before the Senate Banking Committee on February 17, even Fed Chairman Ben Bernanke admitted, "It is possible that the exemption will not be effective in the marketplace." In a House hearing that same day, Federal Reserve Board Governor Sarah Bloom Raskin also admitted that "there are legitimate question" as to whether or not small institutions actually would be protected. Quite simply, the costs of running two-tiered payment systems are likely to be too high, and community banks and credit unions will have to the lower, mandated fees to remain competitive. Finally, there is the argument that has been made that debit card transactions should simply be the same as cash and checks? Not surprisingly, there is a fundamental misunderstanding, or ignoring, of the total costs involved. The Financial Services Roundtable report does a nice job at debunking this: "Retailers argue that cash and checks 'clear at par,' with no additional transaction costs, and debit cards should be priced in the same way. It is simply not true that cash and checks do not have transaction costs. Merchants bear significant costs when processing cash and checks, including the cost to move and store cash and checks, security and insurance, robberies, cash handling fees and fraud. It has been shown through many different studies that it costs merchants 75-150 basis points to process a cash transaction and 75-100 basis points to process a guaranteed check." Indeed, all costs need to be included in the equation to completely understand the issue. To sum up, the small business community will suffer under debit card price controls due to a mix of the following: increased costs for other banking services, reduced financial services and innovations, fewer choices in the credit market, tighter credit standards, reduced access to credit, and reduced sales due to costs falling on consumers. The Federal Reserve Board's price control proposals are drastic, and there's no need to go this far under the statute. In fact, operating in a competitive market - governed by profit, loss and price signals - certainly is "reasonable and proportional" relative to costs, and no need exists to impose price controls and the many problems that accompany such controls. But in the end, this entire misguided government intervention into the marketplace comes via Senator Richard Durbin's amendment to the Dodd-Frank financial regulation measure. Ideally, the new Congress needs to clean up this mess by repealing the Durbin amendment. Small Business & Entrepreneurship Council