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June 22, 2011

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW, Room 2046
Washington, DC 20551

Dear Chairman Bernanke:

Though the comment period has long since closed on the Federal Reserve Board's rule implementing debit card interchange fee reforms, we are compelled to respond to the deluge of comments that banks, credit unions and their trade associations have sent the Federal Reserve in recent weeks. Bankers have been quite outspoken about their intention and ability to influence the Federal Reserve to change its rules and in doing so they have called the independence and integrity of the Federal Reserve into question. The Federal Reserve is not a political body that should be swayed by pressure politics – that is why we have not swarmed the Fed with additional letters and lobbyists following the close of the official comment period on the rules. If the Fed can be influenced by these tactics then it opens itself to accusations of political influence not only on this issue but on many other issues as well.

Unfortunately, bankers and their associations are attempting to politically influence the Federal Reserve and asking it to adopt rules that do not comport with the law. The most brazen such attempt comes from a recent letter sent by the American Bankers Association. The ABA has asked the Fed to change its rules based upon a failed vote in the Senate on a proposal to delay the rules. We should all be clear that this vote failed in spite of the fact that banking associations and coalitions spent tens of millions of dollars promoting it. There is absolutely no credible basis for the Fed to override or alter a provision of law based upon a vote that failed in one body of Congress. The vote in favor of debit interchange reform in 2010 was supported by 64 Senators and then the provision was included in the version of the Dodd-Frank Wall Street Reform Act reported by the House-Senate Conference Committee. That bill received a majority vote in the House, more than 60 votes in the Senate, and was signed into law by the President of the United States. The ABA suggestion that the actual law should be viewed differently or overridden based upon a failed vote of the Senate the following year is both wrongheaded and dangerous.

The banking associations' arguments to the Federal Reserve advocating for changes to the debit interchange reform rules would also contravene law. You need not even take our word for that. The banking associations themselves spent months telling Congress that the law did not

allow the Fed to include fixed costs, fraud losses and other items in the cost calculation for debit interchange. That was the basis for the failed vote to delay the rules. Now, having lost this vote, the banking associations make the remarkable claim that the law passed last year allows the Fed to include all of these costs in its final rule. This breathtaking cynicism should be dismissed out of hand.

The Fed's legal responsibility is to write rules that are faithful to the law. Not only is that the only legal course available to the Fed, but it is the best policy for the U.S. economy. We will only briefly touch on a few points on this front because we provided ample factual and economic support for our position during the comment period on the rule.

Cost Cramming

The banks attempt to argue for the inclusion of fixed costs in the cost of debit interchange. But, the actual costs that they advocate be included are not costs of debit card transactions – they are costs of maintaining checking accounts (or, more broadly, general costs of running a bank). The debit card is merely a device allowing customers to access their funds in checking accounts. It costs less for the banks to allow such access through a debit card than it does for them to allow access through a check or a withdrawal slip. In other words, the bank comes out ahead every time a consumer uses a debit card to access his or her funds before there are any fees involved in the transaction at all. And the law instructs the Federal Reserve in writing rules on debit interchange to consider the fact that checks (which cost banks more) do not have interchange fees (as generally required by Fed rules).

Banks should not be able to argue that the costs they have of dealing with customer checking accounts should all be recovered through debit interchange. That argument ignores that checking accounts create a wide variety of lucrative revenue streams for banks (not least of which is that it allows banks the use of funds in the accounts to lend). In fact, these deposits are the lowest cost source of funds for banks to lend. Bank arguments for illegitimate costs such as maintaining customer service call centers (which would be necessary to deal with customers whether or not debit cards had ever been invented) and building bank branches (the need for which is actually reduced by the existence and use of debit cards) should be rejected because they simply are not costs of handling debit transactions.

Incentivizing Fraud

The most dangerous request made by banks throughout consideration of debit interchange reform is that they need to be paid for losses suffered as a result of fraudulent transactions. The law does not allow banks to recover fraud losses for a very good reason – doing so would end the financial incentives for banks to reduce fraud. If the Federal Reserve were to allow banks to recover the cost of fraud losses through interchange, there is no question that we would all suffer steadily increasing debit card fraud. In fact, banks' ability to recover a large percentage of fraud losses through interchange and chargebacks right now impairs fraud prevention and leads to higher costs. Just this month, Consumer Reports published an article discussing the lack of proper economic incentives for banks to reduce card fraud. That article ("House of cards: Why your accounts are vulnerable to thieves"

http://www.consumerreports.org/cro/magazine-archive/2011/june/money/credit-card-fraud/overview/index.htm) not only discussed this problem but pointed out that the Federal Reserve's proposed rule on debit interchange represents a "carrot" for the banks to actually improve upon their woeful record of fraud prevention. Paying the banks for fraud losses as they propose would remove the carrots and the sticks incentivizing banks to reduce fraud. We look forward to the Fed's rule allowing banks to receive an interchange adjustment for effective efforts to prevent fraud. That is the only appropriate consideration in this area, is authorized by the statute, and was part of the proposed rule.

Timing

While the volume of comments received has delayed issuance of the final rule that should not unduly delay implementation of those rules. The card networks routinely raise interchange rates with very little notice to acquirers and merchants. Often, there is less than a month between the announcement of these changes and implementation. It is clear that changes such as those contemplated by the debit reforms can happen very quickly – particularly in light of the fact that the card networks have had the proposed rules since December 2010. In fact, prior to the failed Senate vote to delay debit interchange reform, Visa wrote a letter to at least one Senator promising to cut its interchange fees immediately upon passage of the delay legislation. Clearly, the changes contemplated by the Federal Reserve's rules can similarly be implemented without delay. The banks and card networks might complain about implementation time, but those complaints are simply inconsistent with their own experience and representations.

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The bottom line is that the letter of the law as passed by Congress and signed by the President is the best policy for the payment system and the U.S. economy. Regardless of the political pressure and the huge funds spent lobbying by the banks, there is no basis for the Federal Reserve to do anything other than implement the debit interchange reform law as written. We urge you to do just that and look forward to seeing the final rule when it is due to be released in conjunction with the Board's meeting on June 29th.

Merchants Payments Coalition