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Federal Reserve's meeting on the proposal governing debit card interchange fees, the fraud prevention adjustment, and routing and exclusivity restrictions.

CHAIRMAN BERNANKE: Good afternoon, everybody. We're meeting today to review the final rule implementing the Debit Card Interchange provision to the Dodd-Frank Act. We're approaching the one-year anniversary of Dodd-Frank. The Federal Reserve has been given substantial and important new responsibilities under this act, and we have been working diligently to implement the statutory requirements under our purview.

The interchange rule we are considering this afternoon has been one of our most challenging rulemakings under Dodd-Frank to date. We received well over 11,000 comments on our proposed rule. We have taken the time needed to review these comments carefully. They've been very helpful to us, and the final rule reflects a number of changes suggested by the commenters. I believe the final rule that we will discuss today gives careful and appropriate consideration to the statutory language, the cost data available to us, and the complexities of the debit interchange payment system.

The Board plans to monitor developments in the debit card market on an ongoing basis. That monitoring will include collecting and publishing data related to debit card costs and interchange fees. These data will help the Board, as well as issuers both large and small, merchants, networks, consumers, and Congress assess whether the statute and the rule are effectively accomplishing their intended goals. I know that staff has spent significant time and effort on this rulemaking, and I want to commend them for their hard work and dedication.

Let me now turn to Vice Chair Janet Yellen, who chairs the Board's committee on Payments, Clearing, and Settlement, the committee which has reviewed the staff's proposal. Janet.

VICE CHAIR YELLEN: Thank you, Mr. Chairman. Debit cards are a critical component of the nation's retail payment system. They're an efficient form of payment and provide many benefits to both cardholders and merchants. Over the past decade, consumers have substantially changed their methods of payment and are increasingly using debit cards where they once relied on checks or credit cards. Debit cards are accepted at about 8 million merchant locations in the U.S., and have become by a wide margin the most prevalent form of noncash payments in this country. Board staff projects that U.S. debit card volume may exceed 50 billion transactions this year, and recent annual growth continues to be at double-digit rates.

The debit card success story has been marred by the level of discord between merchants and issuers on the interchange fee issue, which has played out in the courts, in the Congress, and more recently here at the Board. The continued vitality of the debit card system requires balancing of the legitimate needs of depository institutions that issue debit cards; merchants that accept them; networks that process them; and, very importantly, the consumers or the customers of both the banks and the merchants.

I hope that the banking industry, the retail industry, and the card networks will work together in a collaborative manner to ensure that the debit card system and card systems more broadly are designed in a manner that best balances the needs of all parties. I want to thank the staff who worked so tirelessly on this rulemaking. I believe their recommendations reflect a careful consideration of the comments received and an appropriate implementation of the statutory requirements.

I will now turn to Mark Manuszak, who will walk us through the draft final rule.

MARK MANUSZAK: Thank you. I will be discussing the recommended final rule for Regulation II, which covers debit card interchange fees and routing, and implements Section 1075 of the Dodd-Frank Act.

The final rule has two main components. First, it establishes standards for assessing whether debit card interchange fees that issuers may receive are reasonable and proportional to the cost to issuers. Second, it prohibits network exclusivity and merchant routing restrictions.

Since the release of its proposal last December, the Board has received input from more than 11,000 commenters, including issuers, merchants, consumers, payment card networks, acquirers, processors, trade groups, government agencies, and members of Congress. These commenters raised numerous and often complex issues related to all facets of the proposed regulation. We've carefully considered the issues raised by the commenters. The comments have provided valuable input into our rulemaking process and have led to a variety of revisions to the proposed regulation. I will provide a brief description of the comments received on each aspect of the proposed rule in my presentation.

Let me now turn to the substance of our recommended final rule. I will summarize each major statutory requirement, the approaches to implement each requirement in the proposed rule, and comments received on the proposal. For each statutory requirement, I will then describe our recommended final rule. In developing our recommended final rule, we considered the comments received; the language and purpose of the statute; the available data; and the practical results of various interpretations of the statute.

The first major aspect of the final rule is the interchange fee standards. The statute requires the Board to establish standards for assessing whether the amount of any interchange fee that an issuer receives for a debit card transaction is reasonable and proportional to the issuer's cost with respect to the transaction. Based on exemptions contained in the statute, the standards do not apply to certain government-administered debit cards; certain other prepaid cards; or debit card issuers that, together with affiliates, have assets less than $10 billion.

In the proposed rule, the Board invited comment on two alternative standards for assessing debit card interchange fees. Under the first alternative, an issuer would comply with the standard if it receives an interchange fee that does not exceed the lesser of its allowable costs and a cap. An issuer could also comply with the standard by receiving an interchange fee that does not exceed the level of a safe harbor. The proposal recommended that the cap initially be set at 12 cents per transaction with a safe harbor set at 7 cents per transaction. Under the second alternative, an issuer would comply with the standard as long as it does not receive an interchange fee above a cap, again recommended to be 12 cents per transaction.

For both alternatives, the proposal defined the allowable costs to be the average value of an issuer's costs of authorizing, clearing, and settling transactions that varied with the number of transactions performed by the issuer over a calendar year—in other words, the average variable cost of authorization, clearance, and settlement. The values of the cap in both alternatives and the safe harbor in the first alternative were derived from information gathered through a survey of covered debit card issuers that the Board conducted last fall.

The Board received numerous comments about all aspects of the proposed standards, including the proposed definition of allowable costs and the two implementation approaches. Issuers and networks overwhelmingly supported expanding allowable costs to include a wider range of debit card-related costs beyond the variable costs of authorization, clearance, and settlement. Among the costs these commenters argued should be included were fixed processing costs, network fees, and fraud losses, as well as the costs of card production, customer inquiries, rewards, and accounts set up in maintenance. These commenters noted that debit cards provide a valuable payment guarantee to protect merchants against insufficient funds in a cardholder's account, and that issuers are exposed to the risk of fraudulent debit card transactions.

In contrast, merchant commenters overwhelmingly supported the proposal to limit allowable costs to the average variable cost of authorization, clearance, and settlement for each transaction. These commenters argued that other debit card-related costs either would not be recouped by a check writer's bank from a merchant's bank in a check transaction or are not specific to a particular debit card transaction. They further argued that the payment guarantee in a debit card transaction is not really a guarantee as merchants are frequently subject to charge backs after the initial transaction and, as a result, bear fraud losses.

After carefully considering the comments submitted, staff recommends that a somewhat broader range of costs that are directly related to affecting particular electronic debit transaction be included as a basis for establishing the interchange fee standard. The statute instructs the Board not to consider costs that are not specific to a particular transaction. We have interpreted this provision to exclude costs that a debit card issuer would not incur in the course of affecting any electronic debit transaction, such as corporate overhead; general account costs; and general debit card program costs, including marketing, research and development, and card production and delivery costs. The remaining costs would include those that the statute explicitly instructs the Board to consider, namely, the incremental cost of authorizing, clearing, and settling a particular transaction, as well as other costs that the Board may consider because they're occurred in the can course of effecting an electronic debit transaction.

Of these other transaction costs, we recommend that, in addition to the costs allowed under the original proposal, allowable costs include network processing fees and other transaction processing costs, such as the costs of network connectivity and the cost of processing equipment and software. In addition, we recommend that costs of transaction monitoring be included as an allowable cost because these activities are integral to the authorization decision.

We further recommend that a portion of fraud losses be incorporated as an allowable cost because issuers may incur losses for fraud that they cannot prevent. Allowing a portion of fraud losses to be recovered through interchange fees will not eliminate the incentive for issuers to monitor and prevent fraud. Because the cost of fraud losses varies with the amount of the transaction, we believe that fraud losses are best incorporated through an ad valorem component in the interchange fee standards.

Turning to the implementation approaches, numerous issuers, their trade groups, networks, and individuals objected to the fee limits embodied in the cap under both alternatives and the safe harbor under the first alternative. However, many of these commenters recognized the administrative appeal of a cap or a safe harbor and acknowledged that a pure issuer-specific standard would be difficult to implement and enforce.

Although many issuers argued against both alternatives, a significant number preferred alternative two, the standalone cap, over alternative one, the issuer-specific framework with a safe harbor and a cap, due to the second alternative's ease of compliance. However, many of these commenters suggested raising the cap value to reflect an expanded definition of allowable costs and to cover the costs of a larger percentage of covered issuers.

Merchants uniformly supported alternative one as being the most consistent with the statute. Merchant commenters generally preferred a more issuer-specific approach because issuers would receive interchange fees tied to their actual respective costs, although some of these commenters acknowledged that a cap or a safe harbor would make the interchange fee structure simpler for merchants to understand, which could increase transparency. However, they advocated a lower safe harbor value, arguing that a higher safe harbor would allow a large fraction of covered issuers to receive interchange fees above their actual allowable costs. Similarly, merchants generally supported a lower cap to discourage issuers from incurring and being compensated for excessively high costs.

We believe that the best reading of the statute's reference to "an issuer" and "a transaction" is to interpret those terms to refer to a representative issuer and a representative transaction rather than a specific issuer and a specific transaction. An approach based on a more specific reading of those terms would be virtually impossible, as an issuer's actual costs for each specific transaction, which may vary, cannot be ascertained at or before the time the issuer receives the interchange fee.

Therefore, with respect to the implementation approach, we recommend that the final rule adopt a modified version of the second alternative in the proposed rule—that is, a standalone cap applicable to all covered issuers. Under the final rule, the maximum permissible interchange fee would be the sum of a base component and an ad valorem component. We recommend that the base component per transaction be set at 21 cents, which corresponds to the 80th percentile issuers' average-per-transaction allowable costs as reported in the Board's survey of covered issuers. We further recommend that the ad valorem component be set at 5 basis points of the transaction value, reflecting the median issuers' fraud losses as reported in the same survey. Each covered issuer would be permitted to receive an interchange fee that did not exceed the sum of these two components without demonstrating that issuer's actual per transaction allowable costs.

With respect to the statute's requirement that the interchange fee be reasonable and proportional to the cost of the issuer, we believe that the cap delineates the separation between a reasonable fee and a fee that is not reasonable. Moreover, because the cap is based on certain costs incurred by covered issuers for effecting particular electronic debit transactions, the standard ensures that fees are proportional to those costs as required by the statute. These interchange fee standards would be effective on October 1, 2011. The final rule also contains provisions that prohibit circumvention or evasion of the standards.

The statute authorizes the Board to allow for an adjustment to an interchange fee, to account for an issuer's costs in preventing fraud, provided the issuer complies with standards established by the Board related to fraud prevention activities. The proposed rule did not include a specific adjustment to the amount of interchange fees for an issuer's fraud prevention costs. Instead, the proposal requested comment about two broad approaches to designing fraud prevention standards. The first focused on general fraud prevention activities and costs. The second focused on recouping only costs related to new or substantially improved fraud prevention technologies.

Although commenters did not uniformly favor either of the approaches presented in the proposal, they generally agreed that the Board should not mandate use of specific technologies. Merchant commenters favored a requirement that an issuer adopt technologies that would demonstrably decrease fraud in order to be eligible for the adjustment.

In contrast, issuers and payment card networks preferred a nonprescriptive approach that would allow issuers the flexibility necessary to tailor their fraud prevention activities to address most effectively the risk faced by the issuer associated with changing fraud patterns. We believe that the dynamic nature of the debit card fraud environment requires standards that permit issuers to determine the best methods to detect, prevent, and mitigate fraud losses for the size and scope of their debit card program and in response to frequent changes in fraud patterns.

As a result, we recommend that the Board issue an interim final rule with a request for comment that bases eligibility for the fraud prevention adjustment on general standards for an effective fraud prevention program rather than prescribing specific measures or technologies. The general standards would require an issuer to establish policies and procedures reasonably designed to maintain an effective fraud prevention program.

As in the case of the interchange fee standards, we considered a variety of approaches for implementing the fraud prevention adjustment. We recognize that both issuers and merchants make substantial investments in fraud prevention, and the statute does not require the Board to set an adjustment so that each issuer fully recovers its fraud prevention costs.

As a result, we recommend that the fraud prevention adjustment be implemented through an addition to the cap applicable to all covered issuers. Based on information about fraud prevention costs gathered through the Board's survey of covered debit card issuers, we recommend that the Board permit a fraud prevention adjustment of no more than 1 cent per transaction, which is based on the median issuers' fraud prevention costs as reported in the survey less the costs of transaction monitoring that were included as an allowable cost in determining the interchange fee standard.

When combined with the maximum permissible interchange fee under the interchange fee standard, a covered issuer eligible for the fraud prevention adjustment could receive an interchange fee of up to approximately 24 cents for the average transaction. As suggested by virtually all commenters, the fraud prevention adjustment would be effective on the same date as the interchange fee standard, October 1, 2011. We may recommend that the Board make revisions to the adjustment as appropriate at a later date after we consider the comments received.

In addition to rules related to interchange fees, the statute requires the Board to prescribe rules related to the routing of debit card transactions. First, the Board must adopt rules that prohibit issuers and payment card networks from restricting the number of networks on which a debit card transaction may be processed to fewer than two unaffiliated networks. Second, the Board must adopt rules that prohibit issuers and networks from restricting the ability of merchants to route debit card transactions over any network that may process such transactions. These provisions apply to all issuers, including small issuers and certain prepaid card programs that are exempt from the interchange fees restrictions.

The proposed rule included two alternatives for implementing the prohibition on network exclusivity arrangements. Alternative A would require a debit card transaction to be able to be routed over at least two unaffiliated networks, irrespective of the authentication methods enabled on the card. Alternative B would require a debit card to have at least two unaffiliated networks for each method of authentication available to the cardholder. Under either alternative, issuers and payment card networks would be prohibited from restricting merchant routing choice among the networks enabled on a card.

Issuers and payment card networks universally preferred alternative A, which they believed was more consistent with the statutory language, would impose less severe operational burdens, and would not have as large a negative effect on the development of new authentication methods. Merchant commenters universally preferred alternative B, which they believed would provide the broadest merchant routing choice, including for transactions that currently cannot use PIN-based authentication, such as many online transactions. Merchants also believe that this alternative would not require substantial operational changes for issuers and networks.

We recommend that the final rule adopt alternative A with respect to the network exclusivity provisions. The recommended final rule requires two unaffiliated networks to be enabled on each debit card without regard to authentication method. Under the final rule, an issuer could comply by having one signature network and one unaffiliated PIN network or, alternatively, two unaffiliated PIN networks or two unaffiliated signature networks enabled on a card. We believe that this approach is consistent with the statute, which prohibits issuers and payment card networks from restricting the number of payment card networks on which a debit card transaction may be processed to fewer than two unaffiliated networks. Moreover, the statute does not require that there be two unaffiliated payment card networks available to the merchant for each method of authentication.

We further believe that this approach would minimize the compliance burden on institutions, particularly small issuers; would present less logistical burden on the payment system overall; and would be less likely to limit the development and introduction of new authentication methods. The statute does not establish an effective date for the network exclusivity and routing provisions.

Under the final rule, the prohibition on network exclusivity arrangements would be effective on April 1, 2012, with respect to issuers; and October 1, 2011, with respect to payment card networks. The final rule includes a delayed effective date for certain prepaid cards that may face technological or operational difficulties with complying by April 1, 2012. If the effective date for the prohibition on merchant routing restrictions, which prohibits an issuer or network from restricting merchant routing choice, would be October 1, 2011. This earlier effective date will enable merchants to take advantage of enhanced routing flexibility for cards that already carry multiple unaffiliated networks.

My colleagues and I would be happy to answer any questions you have.

CHAIRMAN BERNANKE: Thank you very much, and thanks to the staff again for a tremendous amount of work on this very challenging rule.

We've been talking a lot about issuers and merchants and networks. But, of course, the ultimate beneficiary—we hope—is the consumer. How do you think this rule will affect consumers?

ROBIN PRAGER: So—I'll answer that question—it's very hard to predict the effect that the rule will have on consumers because the effect is going to depend on the actions taken by various participants in the payment—in the debit card system.

On one hand, card issuers are likely to implement changes in response to the reduction interchange fee revenue that may be harmful to consumers. This might involve raising fees or reducing benefits for debit cards or for deposit accounts more generally. Although the staff thinks it's unlikely that issuers would actually impose fees on debit card transactions, per se, or engage in other activities that are designed to steer their customers away from using debit cards, we would expect that at least some card issuers would change some terms facing their account customers, such as reducing or eliminating benefits, rewards associated with debit cards; perhaps imposing certain fees on deposit customers more generally; or reducing benefits on deposit customers more generally.

At the same time, the rule's likely to lead to a decrease in merchants' costs of debit card acceptance, which could be passed on to consumers in the form of lower prices. The extent to which these savings do get passed on will depend on the competitiveness of the markets in which the merchants operate. Merchants who operate in highly competitive markets with low margins are likely to pass on substantially all of those savings to their customers. Merchants in less competitive markets may keep a larger portion of that savings for themselves. If merchants continue their current practice of not marrying prices with payment method, any savings that do get passed on will be shared by all consumers, regardless of whether they pay by debit cards or other forms of payment.

So, on that, the effect on any individual consumer is going to depend on their payment behavior—do they use debit cards or not—on the competitive of merchants with whom they do business; on any changes in merchant acceptance of various payment card methods; and on the banks' reactions in terms of how they adjust any account terms. So it's very hard to predict how any individual consumer will be affected and, in aggregate, how all consumers will be affected. There are benefits and costs, and we can't really say in advance how those are going to play out.

CHAIRMAN BERNANKE: Thanks. One of the differences–one of the most importance differences between this rule and the preliminary rule is the expanded set of costs that you are allowing in calculating interchange fees. Can you talk about how you decided which costs would be included and maybe what the legal reading is that supports that?

STEPHANIE MARTIN: So let me try and answer that one. We first focused on the statute prohibits the Board from considering, and those were costs that are not specific to a particular debit transaction. And as Mark alluded to in his presentation, that would include corporate overhead, audit and legal department, HR department, those kinds of costs.

So what the Board is allowed to consider under this statute are the costs that are specific to particular debit card transactions. And those would include the costs that the Board proposed to permit as allowable costs; the incremental costs of authorization, clearance, and settlement, which the statute, in fact, requires the Board to consider; but then a range of other costs that are also specific to particular transactions.

And some of—we considered those, and we looked at the data we had on those. And some of those are included in the final rule, and some are not. So, for example, fixed costs of software, hardware that goes towards affecting a particular transaction, those are included in the proposed fee standard. Other costs such as rewards, customer inquiries, arguably, those are particular to specific transactions. But for the reasons we laid out in the Federal Register notice, those were not included in the interchange fee standard.

CHAIRMAN BERNANKE: OK. Thank you. Vice Chair?

VICE CHAIR YELLEN: Thank you, Mr. Chairman. Mark noted in his presentation that the proposed interchange fee standard has to meet the statutory requirement that the amount of interchange fee standard be reasonable and proportional to an issuer's costs. I noted in looking through the public comments that a number of commenters indicated that, in rate-makings for public utilities, the interpretation that would typically be given to the term "reasonable" would include some markup to allow for a fair rate of return. And I wondered whether or not this was something that you've thought about, if you decided how to interpret reasonable and proportional.

STEPHANIE MARTIN: So getting back to the costs that the Board is prohibited from considering, those would be costs that are not specific to a particular transaction. So a rate of return overall on your debit card program is difficult to attribute to a particular transaction. I would also say that many of the rate making cases use a term of art, "just and reasonable rates." Here we have a different term here: reasonable and proportional to cost. So we looked at those two terms and thought, you know, if Congress wanted us to rely on rate making jurisprudence, they could have used that term of art. And they did not. So we were interpreting it differently.

VICE CHAIR YELLEN: OK. Thank you very much. One other question is I wonder if you'd talk a little bit about what impact you think this rule is likely to have on innovation in the payment system more broadly. I noted some commenters were concerned that this is a rule that could inhibit innovation, and I wonder if you agree and what your perspectives are.

MARK MANUSZAK: So we did receive a lot of comments that expressed concern about the potential effect of the rule on innovation. And these commenters would note things like the effect on the development of new authentication methods, which would be like biometrics, or new form factors, which would be things like mobile payments, or new fraud prevention technologies. And so there were commenters that expressed concern that the rule in certain forms could inhibit the development of new technologies.

There were also commenters, however, who wanted the rule to be applied evenly across new as well as existing technologies in order to create a level playing field so as not to advantage one type of technology over another. And we recognize the importance of having a vibrant and innovative payment system. We also recognize the importance of establishing basic ground rules that create a level playing field across different types of technologies.

And so, ultimately, the final rule does not generally exempt innovative technologies from the provisions of the rule, and we think that this does establish the level playing field that some of the commenters were looking for and also creates regulatory certainty for potential innovators going forward. At the same time, we recognize that certain aspects of the rule could have an effect on innovation because future innovators will have to develop their technologies recognizing the restrictions in the rule. And that is going to impact the types of technologies and the way in which they develop those technologies.

But there's certain features of the recommended final rule that should have something of a mitigating effect on those negative effects on innovation. So, for example, in the exclusivity portion of the rule, we're not requiring multiple networks associated with each authentication method, so this should help for the development of new authentication methods where an innovator does not have to open up the technology to additional parties. And similarly in the fraud prevention adjustment, we are not using a technology-specific standard. So there will not be any dictates about what technologies are or are not acceptable, and the market can develop the technologies that are most effective.

So ultimately we think there will be an effect inevitably on innovation as innovators have to meet the restrictions associated with the rule, but certain aspects of the rule should help to mitigate some of those effects. And we also believed that it was important to establish consistent ground rules across new and existing technologies.

VICE CHAIR YELLEN: Thank you.

CHAIRMAN BERNANKE: Thank you. Governor Duke.

GOVERNOR DUKE: Thank you, Mr. Chairman. Following up on the Chairman's question about impact on consumers, other countries have implemented restrictions on interchange fees. Could you talk a little bit about the experience they're seeing with respect to account holder fees, savings passed on by retailers, changes in discounts for different methods of payment?

MARK MANUSZAK: Sure. So there are two types of scenarios that I think one could look at when looking at other countries. One would be places where there has been a government intervention to lower interchange fees. The second would be countries in which they have a payment card system that has historically had low or zero interchange fees. And it generally can be hard to draw conclusions about the effect of interchange fees on the outcomes for consumers, banks, and the payment card networks because there are a lot of moving parts, and the data can be very noisy.

But I think there are a couple of general conclusions that one can draw by looking at the case studies in other countries. One is that, in response to a change in interchange fees due to a government intervention, there often are changes in account terms for cardholders. So, for example, in Australia, when the Reserve Bank of Australia lowered credit card interchange fees in their particular case, rewards for many cards went away, and certain account fees and other terms got somewhat less attractive from the point of view of the consumers, as Robin was sort of suggesting.

So a first lesson would be that there generally is some adjustment in terms of the account terms for cardholders. But at the same time, the evidence doesn't suggest that having a high interchange fee is necessary for the debit card or the payment card system to function effectively. So, again, in Australia, when they cut their credit card interchange fees, banks continued to offer the credit cards, and consumers continued to use them. And similarly in Canada, where there is no interchange fees on PIN debit transactions, PIN debit remains an important part of the deposit relationship between banks and consumers. And consumers continue to widely use debit cards, and they're widely expected.

So I think we will expect there to be some adjustment in terms of the fees, but we wouldn't necessarily expect to see a significant contraction in the supply of or demand for debit card services based on the evidence in other countries.

Now, in terms of the effect of the interchange fee regulation in other countries on prices, that can manifest itself in two ways. First is in terms of the merchant discounts that merchants receive—or pay. I'm sorry. And I think there is evidence that many of the decreases in interchange fees are passed through in merchant prices or in merchant discounts. The evidence for consumer prices is much weaker because there are so many factors that are buffeting consumer prices that there's not been strong evidence documenting that any decreases in interchange fees and subsequent decreases in merchant discounts are passed through in terms of lower consumer prices at the point of sale.

GOVERNOR DUKE: If after the implementation of this rule you were to, a couple years from now, try to determine what the impact had been on the consumer here, are there any authorities that you would need to collect data that you don't have today?

LOUISE ROSEMAN: Well, we currently under the statute have authority to require PIN card networks and issuers to provide us information, particularly information that is helpful for us in establishing the interchange fee standards. It doesn't explicitly give us the authority to require that merchants, for example, would give us information or other parties. But we can have surveys that they can voluntarily comply with in terms of providing us that information.

GOVERNOR DUKE: Thank you, Mr. Chairman.

CHAIRMAN BERNANKE: Governor Tarullo.

GOVERNOR TARULLO: No questions. Thank you.

CHAIRMAN BERNANKE: No questions. Governor Raskin.

GOVERNOR RASKIN: Yes. Thank you, Mr. Chairman. Looking at the—at how issuers' cost accounting systems capture cost data, I'm wondering whether there are any external sources of cost estimates that were used in crafting the regulation that would serve as a way to cross-check against the information that the staff saw that came from—came from the surveys put out by the Fed.

MARK MANUSZAK: So we didn't explicitly use any external cost data to develop the standard. We used the data that we gathered through our survey of debit card issuers.

But having said that, we did look at various external cost studies associated with issuer costs. And there are various problems with doing a survey of issuer costs including, as you mentioned, the cost accounting systems can differ a lot across firms. And in addition, whether or not a firm outsources things to a third party or does things in-house may affect their ability to identify certain types of cost components. And finally, we recognized as we were performing the survey the incentive effects associated with reporting for respondents who are engaged in the type of exercise that we're looking at, we were examining the relationship between costs and fees. But when we did look at those external studies, which have been performed by consultants and processors and payment card networks, the numbers that they got for issuer processing costs were largely comparable to what we received from our survey.

There are caveats associated with that in that they didn't survey the same issuers that we surveyed. We don't have their data, so the level of granularity in terms of the distribution of issuer costs, we don't know how well that compares. But at least it's sort of an aggregate level. Their estimates are largely comparable to what we got, which makes us think that our numbers are not radically off or that the surveys were not radically misreported in our formulation.

GOVERNOR RASKIN: Thank you.

CHAIRMAN BERNANKE: OK. Thank you. At this point, I'd like to hear positions. Let me start with you, Vice Chair.

VICE CHAIR YELLEN: Thank you, Mr. Chairman. I support adoption of the proposed final rule on debit card interchange fees and routing, and the interim final rule on the fraud prevention adjustment.

I want to commend and thank the staff for the painstaking effort they've invested in preparing this final rue. Importantly, staff carefully analyzed over 11,000 comments that were received, and these comments raised important issues relevant to the appropriate interpretation and implementation of the Durbin Amendment. They were extremely helpful in guiding the revision process, and, in particular, as Mark mentioned, significant changes have been incorporated in the final rule in response to the comments received.

In crafting the final rule, staff carefully assessed the legal requirements governing our rulemaking under Section 1075 of Dodd-Frank and to the extent possible also considered the likely economic impact that would result from alternative implementation choices. The final rule carefully adheres to Congress's mandates relating to network exclusivity and routing, and to its direction to establish standards for assessing whether the amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit card transaction is reasonable and proportional to the costs incurred by the issuer with respect to the transaction. The final rule strives to ensure that issuers retain incentives to reduce operating and fraud costs over time. And it aims to avoid consequences that could be deleterious to the future development of the payment system.

A long-held goal of the Federal Reserve has been to facilitate a transition from a payment system reliant on paper check and cash to more efficient and convenient electronics-based technologies. Debit cards have certainly helped speed that transition. In designing this rule, staff have recognized the importance of establishing an environment that will be conducive to continued innovation in the payment system in the years ahead, one that's receptive to the adoption of promising new technologies. They further sought to establish a standard that will be transparent; minimize compliance costs for banks and networks; and reduce the burden on supervision.

The legislation directing this rulemaking was motivated in part by the fact that interchange fees in the United States have increased substantially over time; whereas, in those countries where interchange fees have starkly been low or have been limited by government intervention, the use of debit cards has remained robust. This escalation in U.S. interchange fees may well reflect a market failure.

Economic theories suggest, however, that the determination of prices in two-sided markets like the debit card market are complex, involving important network and usage externalities. It is therefore challenging to craft regulations that will predictably improve social welfare. The literature recognizes that networks are valuable because they can serve to reduce transactions costs and that pricing and strategy in such two-sided platforms will be influenced by these network affects.

Our Federal Register notice provides economic analysis pertaining to the costs and benefits of the proposed rule for the key effected groups: merchants; large and small financial institutions; and banks and unbanked consumers. The analysis notes that the ultimate welfare effects are impossible to ascertain in advance. The impact of the rule will depend on the behavioral responses of all affected parties: how covered issuers respond to the reduction in revenue from lost interchange fees and their pricing and product offerings; how consumers respond in their choice of payment methods; how the networks differentiate interchange fees between covered and uncovered issuers; whether merchants pass through to consumers any interchange fee cost reductions; and how market participants more generally respond to the interchange fee network exclusivity and routing provisions, which could affect pricing and competition throughout the broader retail payments market. This response cannot be easily predicted based on existing information.

Because this rule will touch the lives and affect the livelihoods of consumers, businesses, and financial institutions large and small, as well as the evolution of the payment system, it will be important for all of those interested in sound public policy to study and carefully assess the impact of this rule on the well-being of the affected groups, and the efficiency and dynamics of the payment system in the years ahead.

CHAIRMAN BERNANKE: Thank you. Governor Duke.

GOVERNOR DUKE: Thank you, Mr. Chairman. I want to start by acknowledging the quantity and the quality of work that's gone into this proposal. In both the initial proposal and the final rule, the staff has demonstrated the comprehensive understanding of the structure and economics of debit interchange that they've gathered from surveys and numerous conversations with market partners. In addition, the individual members of the team brought their own experience, knowledge, insight, creativity, and, perhaps most importantly, patience as they worked through the countless alternatives and debated the merits of various approaches.

This has not been an easy law to implement. But I believe that every effort has been made to choose carefully from among the implementation schemes that were possible under the statute. Issuers, networks, merchants, consumers, other regulators, and members of Congress commented forcefully, passionately, and voluminously. On nearly every aspect of the proposal, the comments received were often in diametric opposition to one another. As I read through each section of the discussion in the final rule, I concluded that the final decisions reflect thoughtful attention to the positions argued by all sides.

I'd like to comment on the sections on standards, network exclusivity, exemptions, and the anticipated effects of the rules on various parties.

With respect to standards, we first had to address which costs should be included or excluded in determining whether the interchange fee was reasonable and proportionate to costs. Within the costs determined to be relevant in establishing the cap, we had a determine where to draw the line. While there will always be room for argument, I believe the costs included in the approach taken is reasonable. Further, I believe the discussion to follow alternative two, the establishment of a cap, is the best approach. While recognizing that of the alternatives, it's the furthest away from the relationship between an individual issuer's costs and the fee it would receive, I think that it is permitted by the statute and that the advantage of simplicity and transparency will lead to more effective implementation. Establishing a cap below which issuers can earn profits or cover other costs creates an incentive to reduce costs, which could then translate to lower caps as the amount is recalibrated with updated information.

In establishing rules governing network exclusivity, I believe the choice of alternative A, the requirement that cards be enabled with at least two unaffiliated networks without regard to authentication method, is the correct option. I believe it meets the requirements of the statute in a way that is less complicated and costly to implement than having two networks for each authentication method. It also accomplishes the objective of the provision, which is to change the competitive dynamic for payment networks by allowing merchants to choose the lowest cost routing available. And, finally, it's the most conducive to innovation as it would not require pioneers of new authentication methods to wait for a second competing network to become available.

It is when I think about issuers that are exempt from debit interchange standards that I run into problems with this rule. The statute exempts three types of issuers: financial institutions with combined assets of less than $10 billion; government-administered programs; and reloadable general purpose prepaid cards not marketed or labeled as gift cards. We received numerous comments expressing concern that the exemption would not be effective in practice.

I agree with this concern. Indeed, when I asked about the exemption at our previous board meeting on this issue, the staff acknowledged that there was no way to know whether the exemption would be effective. The staff pointed out then and in the final rule that the statute and rule permit but do not require the networks to establish higher interchange fees for exempt issuers than for covered issuers. While we have received information from some networks indicating they plan to provide for different fee structure for exempt issuers, we have no way to know if or how this will work, and we have no authority to enforce such a structure.

I applaud the decision to provide networks with lists of small—of exempt small issuers in an effort to save the small issuers the administrative cost of proving their exemption. However, the other method whereby we plan to promote the exemption seems just as likely to work to reduce the incentive to offer different rates to exempt issuers as to create such an incentive. We plan to survey issuers and networks, and publish annually a list of the average interchange fees each network provides to its covered and exempt issuers. This information could enable exempt issuers to find the network that offers the most favorable rates. But it could just as easily leave merchants and acquirers to route away from those networks.

So what are the consequences to exempt issuers if the exemption proves not workable in practice? For small issuers, the result is a significant increase in regulatory burden, if you define as I do regulatory burden as the cost or loss of revenue resulting from regulatory action. Ironically, small issuers may be held by the market to an interchange fee that is targeted to be reasonable and proportional to the cost incurred by larger institutions. But because they were exempt, the costs incurred by smaller institutions were not even considered in setting the standard. I believe that the reason Congress exempted small issuers was a desire not to impose this burden on them. But we have so far not found any authority that would act to enforce the exemption or any remedy should the exemption not work in practice.

Similarly, the exemption may not work for government-administered programs or prepaid cards. Even though I'm concerned about the impact on small institutions, I do recognize that small institutions can offset the cost by charging higher customer fees for debit cards, checking accounts, or other services. Debit cards issued by financial institutions are not a standalone service, but rather one of many methods of accessing a checking account. In contrast, cards issued in connection with government-administered programs and prepaid cards are standalone services. For these prepaid cards, the reduction in revenue can only be offset, and the profit required to incent their issuance in the first place can only come through fees charged through the government entities administering the programs or the cardholders using them.

In a time of austerity at every government level, a time when governments, including the federal government, are issuing benefits electronically to save the cost of issuing paper checks, it seems unlikely that governments who contract for card services will be in a position to absorb the additional cost, so most of the fees will likely fall to the beneficiaries who use the cards. Moreover, if the exemption cannot be realized anyway, the incentive to prepaid card issuers not to charge overdraft fees and to allow a single free withdrawal from the issuers' ATMs in order to qualify for the exemption will be negated.

I read with great interest the section concerning anticipated effects of the rule on various parties. I also read a number of studies on the impact of interchange regulations imposed in other countries. Could not find, however, any study of another country's experience that offered convincing evidence as to the ultimate impact on consumers. Similarly, our own discussion indicates that we are unsure what those ultimate effects might be. I would hope that in the future we would undertake a study to quantify the overall effect of this rule on consumers. And to the extent that we do not have the authority to gather the data that would be required to conduct such a study, I hope we will define and request such authority from Congress.

Finally, I'd like to comment on the one seemingly unavoidable impact of this rule: higher fees on checking accounts. One of my first projects in banking was the study of checking account products and specifically the elimination of free checking. At that time, I was working for a community bank that was contemplating service charges on checking accounts to offset the likely interest expense associated with now accounts, which were expected to be authorized in coming legislation.

What I discovered in that study was that low-balance, high-activity checking accounts were very expensive to process. As we imposed service charges, we saw a reduction in those smaller accounts and a corresponding reduction in expense that was significant enough to improve profitability even if we generated no additional revenue from fees. Years later as more and more banks brought back free checking, it took me a while to figure out what had changed, until I discovered that debit interchange fees had changed the dynamic and made the low-balance, high-transaction account profitable.

Now, even though I have reservations about the workability of the small issuer exemption, I have every confidence in the industry, and in small banks and credit unions in particular, to find new product models that restore profitability to the payments function in checking account products that are central to their businesses—just as I did so many years ago.

But the restoration of bank profitability is likely to come at the expense of less availability of low-cost checking accounts offered to consumers. The experience of other countries would suggest that overall usage of debit cards for payments will not decline significantly as a result of this regulation. But as fees for checking accounts rise, I would expect more consumers to turn to prepaid debit cards or even cash as a lower cost alternative. And I am concerned about the level of consumer protection covering prepaid, reloadable cards. Strengthening protections for these cards was on the Board's agenda. But the work required to implement other parts of the Dodd-Frank Act, frankly, we couldn't get to it before the time came to transfer regulatory responsibility to the Consumer Financial Protection Bureau. I'm proud of all the rules we did propose and implement in the last three years, but I wish we could have done more on this front. So I can only call on the CFPB to carefully watch developments in this market and to place a high priority on revisiting consumer protection issues with prepaid cards.

Mr. Chairman, I'm appreciative of all the work that has gone into this rule and I'm supportive of much of the final result. But given my conviction that the exemptions will not work in practice, I cannot support the increased regulatory burden on small issuers, and the higher cost imposed on issuers and recipients of government benefits distributed through prepaid cards that I believe will result if we cannot find the way to make the exemptions effective. For that reason, I oppose the final rule.

CHAIRMAN BERNANKE: Thank you. Governor Tarullo.

GOVERNOR TARULLO: Thank you, Mr. Chairman. Let me begin by explaining the standard that I've imposed on myself in judging the recommendation from the staff, and I think it's a two-part standard. First, as would be applicable in any action that we take on proposed regulation, the question is whether the proposal is consistent with the intent of Congress as manifested in the language of the statute. But, second, I think we have to focus on the fact that we are required to act here. This is not a question of discretion on our part whether to act, only how to act. And so the second part of my self-imposed standard was whether I have a concrete alternative proposal that would better realize my own policy preferences while also remaining consistent with the statutory language.

With respect to the consistency of the proposed regulation with the intent of Congress, I believe that the staff proposal is consistent with the language of the statute. Now, it needs to be said that there's a good deal of ambiguity in several of the key provisions of the statute, as discussed in the draft Federal Register notice circulated by the staff and as Mark alluded to in his presentation a few moments ago. There are some possible readings, such as one that would craft standards to make an assessment on a transaction-by-transaction basis, that would entail enormous levels of uncertainty on the part of issuers, networks, and merchants alike as to what fees were acceptable.

I think here and in other areas, the staff has rightly opted instead for permissible readings of the ambiguous provisions that accord more closely with sound economic incentives and greater certainty for all relevant actors. Still, there are provisions whose language simply does not admit of interpretations that some might have preferred and for which there might be good policy arguments. Mark mentioned and Stephanie did as well some of costs that staff excluded, such as R & D expenditures, not I think on economic grounds but just on the grounds that statutory language would not admit of that interpretation.

So that leads to the second part of my self-imposed standard, which is whether I have a concrete alternative that would better realize what I consider to be sound policy positions while remaining consistent with Congressional intent. And I should say in this regard that I share a lot of Governor Duke's concerns, particularly about the effectiveness of the exemptions applied.

But while I share those concerns, I don't have an alternative that is consistent with the language of the statute that would better achieve the statutory aims. And so I find myself in a position, I think, as the staff did of focusing on what the staff proposal was. And so I do support the proposed regulation as presented by the staff.

Since the proposed regulation was issued, the staff has done a heroic job of assimilating and summarizing for us the over 11,000 comment letters—and, in fact, I think when Louise writes her autobiography, it's going to be titled 11,000 Comment Letters [laughing]—responding to the questions we posed at the public hearing on the proposed regulation and modifying that proposal on the basis of all these comments and questions so as to improve it substantially.

I'm sure—I'm positive—there are many merchants, issuers, consumers, and networks which would want to change much of what has been proposed, just as some of us at the Board may want to do were this a matter of our own preferences. But it's not. We have to act in accordance with the language of the statute. And so, again, it's on those grounds that I agree with the staff recommendations.

Now, there is one matter on which Congressional intent was quite clear, and that was the desire to exempt small issuers from the limits on interchange transaction fees imposed by the statute. Unfortunately, though, the statute does not give us the authority necessary to assure achievement of that aim. There is reason to hope that the aim will be realized, again, as explained in the Federal Register notice; but it's by no means certain.

For this reason, Mr. Chairman, I would like to propose a formal monitoring system by the Board to evaluate how effective this exemption proves to be. And actually, just for everyone's convenience, I did have—I did write up this proposal, and, Penny, if you could circulate it. I won't spend a lot of time on it but I thought it was useful for people to see the language.

What I basically ask is that, by the end of six months following the effective date of the rule and again by the end of 18 months following the effective date of the rule, that the Board staff should determine and report to the Board, first, the extent to which networks have established separate interchange fee schedules for exempt and covered issuers; and, secondly, with respect to networks that have established such separate schedules, how the interchange fees received by exempt issuers compare with those prevailing before the rule became effective. I think that's a relatively straightforward thing for the staff to do based on the kinds of information that we contemplated them gathering in any case.

The second part, though, of this proposed monitoring system will take some more work and will require some expenditure of time and resources beyond the kind of monitoring that was contemplated. And that would be that, by the end of 18 months following the effective date of rule, the staff determine and report to The Board on three matters: first, changes in exempt issuers' interchange revenues over this period; second whether there's evidence that merchants have rejected debit cards of customers of exempt issuers; and, third, how the network exclusivity provisions from which these issuers are, of course, not exempt have effected small issuer costs. I recognize that the second and third in particular will not be susceptible to comprehensive study, but I think an effort to gather some relevant information will be useful for us, for the affected parties, and for the Congress in assessing whether the intended exemption has been effective in practice.

So, Mr. Chairman, I don't know how you want to proceed with this. I do not want this to be a formal amendment to the proposal, obviously. But in whatever way you'd like us to consider it is fine with me.

CHAIRMAN BERNANKE: Well, I agree it shouldn't be a formal amendment. But what we should do is make it is a sense of the Board, and instruct the staff to carry it out subject to any feasibility issues that arise in the process. Is that acceptable?

GOVERNOR TARULLO: Sure. That's fine. Thank you.

CHAIRMAN BERNANKE: So why don't we finish with you, Governor Raskin? And then, before we vote on the full rule, I'd like to hear quick reviews on Governor Tarullo's suggestion. Governor Raskin.

GOVERNOR RASKIN: Thank you, Mr. Chairman. Needless to say, the rulemaking process for this provision of the Dodd-Frank Act has been enormously controversial. Thousands of thoughtful comments have been submitted. Limiting bills have been drafted and voted upon. Speeches have been crafted. Lawsuits have been filed. Millions of lobbying dollars have been spent, and hundreds of meetings have occurred. Debates on the statutory provision, as well as debates on the proposed rule, have been robust and, at times, acrimonious.

I want to start by acknowledging also the work of the exemplary multidisciplinary staff team here who handled this work neither as a crawl nor as a sprint but handled it as the marathon that it was. They worked diligently and objectively and efficiently to make sure that we fulfilled the statutory requirement set out in the law.

It bears repeating that the law states that the Board shall prescribe regulations, and that mandate is what brings us here today. We are not at liberty to say no to what Congress has statutorily required us to do. The staff has proceeded with the utmost of good faith and considered a number of alternative formulations. It has attempted in the face of ambiguous statutory language to craft an implementing regulation that is as close an approximation to Congress's intent as is possible, to create a standard that is capable of being complied with and capable of being examined for, and that minimizes as much of the statutory language provided by Congress allows, the possibility of adverse or perverse economic incentives.

I also want to thank for the record all the entities who have informed this rulemaking through their submission of public comments. I want to especially underscore my appreciation for comments that are prepared for submission by groups and institutions for whom the cost of preparing such comments is a large part of their budgets.

One issue consistently raised in comments and debates was the importance of ensuring that financial institutions are reimbursed for legitimate debit card costs. This issue was a theme in comments from consumers as well as comments from banks and credit unions. The law provides for various costs to be included in the calculation of the interchange fee. In this final rule, while not inclusive of all costs, is inclusive of a broader swath of costs than was originally proposed. This broad swath of costs, according to the Federal Reserve Board survey of costs and various private sector surveys of costs, supports an interchange fee that is higher than the initially proposed fee and permits a recovery of costs by the vast majority of issuers of debit cards. Because this interchange fee cap leans towards the inclusion of all permissible costs, there's little justification for this rule alone to be the basis for making those banks and credit unions that operate efficiently less accessible to low- and moderate-income consumers and communities.

The Federal Reserve, though, needs to continue to play close attention to this possible result as well as how the regulation affects the viability of small banks and credit unions, which often provide safe, lower cost financial products to millions of Americans. As a former state bank and credit union commissioner, I'm extremely sensitive to the potential impact of the regulation on small banks and credit unions. One virtue of the Board's final rule is that it provides the ability to watch whether a two-tiered price structure by the networks is maintained or eroded, and to reexamine and potentially reset the interchange standard.

Not only do we need to monitor the effectiveness of the small issuer exemption, we need to keep our eyes focused on the future of the evolution of payment methods that currently are exempt from this law. In particular, what will this rule mean in terms of the development and usage of prepaid, reloadable non-gift cards? And from the perspective of the consumer, will different types of payment methods provide Americans with the ability to have their core financial needs met in our economy?

I want to underscore my colleagues' unease with this kind of regulatory intervention. Indeed, when a regulator has to intervene in a market to better align pricing with costs, that market must be somehow working less than competitively. We didn't create this market. We didn't craft the Durbin Amendment. We're only doing what Congress has directed.

That said, it's no secret that consumers have had significant concerns about escalating debit and interchange fees. By some estimates, those fees amounted to $16 billion in 2001 and stood at $48 billion in 2009. These fees have a disproportionately harmful effect on the 25 percent of the population that is unbanked and other consumers that pay by cash and checks, since those consumers never receive the benefits of any card reward programs that are funded by interchange fees. The Hispanic Institute has reported that the bottom 50 percent of income earners pays at least $669 million more in higher prices to subsidize at least $554 million in payment card rewards.

So whether we ultimately disagree on whether the manifestations of this malfunction merits Congressional intervention, it appears to me that we have no choice in this matter but to adhere to Congress's directive, even when the guideposts for achieving its requirements are far from clear. The staff's proposed rule is a worthy attempt at this mandate, and I recommend it move forward.

CHAIRMAN BERNANKE: Thank you, Governor. This was indeed a very difficult rule. I think very few rules the Fed has ever written took more person hours than this one and many, many difficult decisions. And, again, I'm appreciative of the staff effort.

I think the final rule shows a lot of responsiveness to the many comments that we received. And I do think it's a good faith and carefully executed attempt to implement the will of Congress in setting these parameters. Like a number of my colleagues, the concern I've had in terms of achieving the intent of Congress has been making the exemption for smaller issuers effective. Smaller issuers are not exempt from the network exclusivity rule, which means they are subject to the same competitive forces that other issuers will be subject to. And the Federal Reserve does not have the power to require networks to maintain a two-tier pricing system.

I think the efforts we are going to make, though, will give us the best shot at making that exemption effective. And in particular, as described in more detail in the rule, we have—we intend to set up a very transparent system in which we will regularly publish the interchange fees that networks collect from both exempt and nonexempt issuers. And we will also monitor developments in these markets as well as the effects of our regulations going forward. So if it doesn't work, we'll know. And then we can think about what else can be done.

I think it's encouraging that many networks have indicated that they will maintain a two-tier system. I very much hope that they will follow through with their commitments and that those networks who have not yet committed will consider doing so. Again, given that I think this is the best available solution that implements the will of Congress and also makes good economic decisions—for example, the use of a cap both simplifies supervision and also is best for inducing cost minimization by issuers—I will support the rule.

Let me go around quickly and ask my colleagues if they have any questions or comments on Governor Tarullo's proposed informal instruction to staff and see what response is to that. Vice Chair.

VICE CHAIR YELLEN: I'm supportive of Governor Tarullo's proposal.

GOVERNOR DUKE: As am I.

GOVERNOR RASKIN: I am also.

CHAIRMAN BERNANKE: OK. So, as we vote on this and as—as we vote on this rule, then we will do that in the understanding that we will continue to monitor various aspects of the interchange market and that we will use that information, including updates and costs and so on, in thinking about appropriate measures in the future. I need a motion.

VICE CHAIR YELLEN: So moved.

CHAIRMAN BERNANKE: Second?

GOVERNOR TARULLO: Second.

CHAIRMAN BERNANKE: Let's go around. Vice chair.

VICE CHAIR YELEN: I support. I'm in favor.

CHAIRMAN BERNANKE: Governor Duke. Governor Tarullo. Governor Raskin.

GOVERNOR DUKE: [inaudible]

GOVERNOR TARULLO: [inaudible]

GOVERNOR RASKIN: I support.

CHAIRMAN BERNANKE: I do as well. All right. The motion carries. Again, I thank the staff and thank the audience, and meeting is adjourned.