

**Meeting of the Board of Governors and
the Federal Advisory Council
May 13, 2011**

Board members: Chairman Ben Bernanke, Vice Chair Yellen, Governor Duke and Governor Tarullo

Council members: Joseph L. Hooley, Robert P. Kelly, Bharat B. Masrani, James E. Rohr, Richard D. Fairbank, Daryl G. Byrd, David W. Nelms, Richard K. Davis, Stanley A. Lybarger, Richard W. Evans and Russell Goldsmith

Summary: Members of the Federal Reserve Board met with the Federal Advisory Council (“the Council”), a statutorily created advisory group that is composed of twelve representatives of the banking industry (one member from each Federal Reserve District). The Council ordinarily meets four times a year to provide the Board with information from the banking industry’s perspective.

The Council discussed the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act and presented its views on standards for qualified residential mortgages under the proposed interagency rule on risk retention and on the Board’s proposed rule on debit card interchange fees and routing. During the discussion on interchange, Council Members expressed concerns about increasing risks to the overall payments system, including the fact that alternative payment servicers were generally not subject to Bank Secrecy Act and other regulatory requirements.

The information collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

Housing and Mortgage Markets

(Comments related to Board rulemakings under the Dodd-Frank Act are provided below.)

What is the Council's view of the recently proposed QRM [qualified residential mortgage] and risk-retention standards?

- The majority of Council Members believe that the recently proposed QRM requirements are defined too narrowly.
- The proposed QRM exemption imposes minimum down payments on purchase mortgages of 20 percent and equity requirements of 25 to 30 percent for refinancing, ignoring the fact that well-underwritten, low down payment loans have been a significant and safe part of the mortgage finance system for decades.
- These proposed QRM underwriting standards would likely favor borrowers with higher incomes and wealth, while requiring low- to-moderate income borrowers to enter the non-QRM market, which will likely have higher rates due to the risk-retention requirements.
- Narrowly defined QRM requirements combined with higher rates in the non-QRM market will reduce the population of borrowers that are eligible for home purchases and refinance transactions, further delaying recovery in the housing market.
- For as long as the GSEs [government-sponsored enterprises] remain in government conservatorship, Council Members agree that loans sold to Fannie Mae and Freddie Mac should be exempt from risk-retention requirements, provided this does not delay an orderly exit of the GSEs from the mortgage market.

Interchange Fees

What effect will the proposed caps on debit interchange fees have on technological innovation in payments processing?

Discussion

While any regulatory constraint on the pricing of payment services will inherently limit technological innovation, the Board's proposed caps on debit interchange fees are an overly restrictive application of the Durbin Amendment and will unnecessarily stifle technological innovation and undermine the integrity of payment processing.

- The proposed caps on debit interchange fees are far below a debit issuer's costs of providing debit services to consumers. As a result, debit issuers will have little, if any, incentive to invest in new or improved debit products and services (such as mobile payments, contactless debit solutions and person-to-person payments), which require substantial expenditures in research and development, procurement or modification of system hardware and software, marketing and training, among other areas—all costs that are not recoverable under the proposed rule.
- With fewer technological innovations in the traditional debit marketplace, consumers may increasingly turn to alternative payment products or services that are not within the scope of the proposed interchange fee caps, resulting in negative unintended consequences to consumers and the payments system.

- Consumers may leave the banking system and migrate to substitute products that are exempt from the proposed interchange fee caps and therefore more likely to offer innovative features. Because the traditional demand deposit account serves as a gateway product for entry into the financial services mainstream, this migration will have detrimental impacts on both consumers and the economy. Further, substitute products often carry high fees that are less transparent to consumers.
- Providers of alternative payment services often are not subject to prudential regulation (unlike financial institutions that issue debit cards), so consumer migration from traditional debit products to alternative payment services may introduce additional risk to the overall payments system by encouraging the growth of an unregulated shadow payments system.
- Under the burden of the proposed interchange fee caps, issuers may limit the use of debit as a form of payment for transaction types that expose them to increased, uncompensated risk, such as e-commerce transactions. Given the prevalence of debit cards as a form of payment for e-commerce transactions, this outcome would adversely affect consumer payment choice and could undermine the continued growth of the Internet marketplace.
- The proposed interchange fee caps will encourage issuers to reduce investment in debit system infrastructure to reduce costs, possibly increasing system outages, reducing the efficiency of debit as a payments system and compromising data protection and security.
 - Unless ameliorated by an adequate and flexible fraud prevention adjustment, the proposed interchange fee caps would reduce issuer investment in fraud prevention innovations, such as enhanced fraud detection technologies and more secure methods of authorization, ultimately reducing the safety and integrity of the debit payments system.
 - The proposed interchange fee caps will encourage issuers that outsource processing functions to use payment processors that charge the lowest fees, even where the cheapest processor is less secure or less reliable than its competitors. As a result, processors will be encouraged to focus on cost cutting as opposed to investing in technological improvements and enhancements.
- While the Board suggested in its discussion of the proposed interchange fee caps that issuers have sources other than debit interchange fees through which to recover the costs of technological innovations (in particular through increasing customer fees), consumers are accustomed to receiving the benefits of innovation without charge. Issuers will be reticent to make significant investments in technological innovations where the opportunity for recouping such investments is limited to speculative revenue sources.
- The negative effects of the proposed interchange fee caps on debit system innovation will be even more pronounced when coupled with the merchant routing requirements. Merchants will have an incentive to direct transactions to the debit network that charges the lowest fees, even where the cheapest network is less secure, less reliable or provides fewer consumer benefits than a network that has invested more in network infrastructure. As a result, the Board's Proposed Rule will stifle innovation and infrastructure investment by both debit issuers and debit networks.
- The interchange fee caps will have a disproportionate negative effect on low-income consumers, i.e. the elimination of free checking.

- There will also be a disproportionate effect on small banks that will virtually lose all interchange fees, after having already lost most overdraft fees. They will become more dependent on credit and interest rate risk.

Recommendations

- The Board should revise the proposed caps on debit interchange fees to encourage, rather than discourage, the technological innovations that have made debit a thriving and growing payments system. It provides benefits to consumers, merchants and the economy as a whole, and contributes to the United States' global leadership in financial services. The Board has significant discretion to revise the proposed interchange fee caps to reduce the negative impacts on technological innovation and infrastructure investment by:
 - Allowing issuers to recover through debit interchange fees the full costs of such beneficial investments,
 - Establishing a fraud prevention adjustment that fully compensates issuers for their costs of implementing desirable security features and fraud prevention controls, and
 - Using the same fee regulation for both large and small banks.