UNDERSTANDING THE FEDERAL RESERVE'S PROPOSED RULE ON INTERCHANGE FEES: IMPLICATIONS AND CONSEQUENCES OF THE DURBIN AMENDMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

FEBRUARY 17, 2011

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UNDERSTANDING THE FEDERAL RESERVE'S PROPOSED RULE ON INTERCHANGE FEES: IMPLICATIONS AND CONSEQUENCES OF THE DURBIN AMENDMENT

Thursday, February 17, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 11:30 a.m., in room 2128, Rayburn House Office Building, Hon. Shelley Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Marchant, Royce, Manzullo, Hensarling, McHenry, Pearce, Westmoreland, Luetkemeyer, Huizenga, Duffy, Renacci, Canseco; Maloney, Watt, Baca, Miller of North Carolina, Scott, Velazquez, Meeks, Lynch, and Carney.

Also present: Representatives Green, Welch, Peters, Perlmutter, Clay, and Cleaver

Chairwoman CAPITO. This hearing will come to order. I would like to welcome everyone to the Subcommittee on Financial Institutions and Consumer Credit's first hearing for the 112th Congress.

Before we start, I would like to remind everyone briefly of our rules. Ranking Member Maloney and I have agreed that both sides are going to waive our opening statements in light of this chaotic schedule that we have.

So normally, we would have 10 minutes for the purpose of opening statements on each side. Without objection, we can have all members' opening statements be made a part of the record. I would like to remind the witnesses as well that you have 5 minutes to give your oral statements, and without objection, your written statements will be made a part of the record.

The last item of housekeeping is to first of all say how thrilled I am to have the gentlelady from New York as the ranking member of this subcommittee. She has a long history of dealing with issues, and I am very excited that we are going to be able to work together on this subcommittee. But I would like to recognize her for the purpose of making a unanimous consent request.

Mrs. MALONEY. Thank you. I join the chairwoman in welcoming all of the witnesses who will be testifying today, as well as the members of the subcommittee. I congratulate the Chair on her ap-

pointment and express my deep desire to work constructively to move forward in a positive way for our country.

I am thrilled to be here. We have a very good panel; welcome to Governor Raskin. Due to time constraints, I am yielding back and will place my statement in the record. And I am delighted that this thoughtful hearing is among our first. Thank you.

Chairwoman CAPITO. Thank you.

I would also like to ask for unanimous consent for Representative Welch to participate in the hearing. If there are no objections, is is so ordered.

With that, I would like to say before I introduce our first witness, this is obviously a topic of great interest to a lot of people, so we are going to be listening very closely and I appreciate everybody's weighing in on the topic. And hopefully the point of this hearing is to hear all sides of the issue so we understand it better. So with that, I would like to welcome the Honorable Sarah Bloom Raskin who is a Governor on the Federal Reserve Board.

STATEMENT OF THE HONORABLE SARAH BLOOM RASKIN, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. RASKIN. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to discuss the Board's proposed Regulation II which the Federal Reserve was directed to implement pursuant to Section 1075 of the Dodd-Frank Act. Generally unnoticed by the customer, each time a debit card is swiped to make a purchase here in the United States, interchange fees are paid by the merchant to the bank that issued the debit card.

Interchange fees are a controversial feature of the debit card system. And their substantial rise in recent years has precipitated a national and international debate about the appropriate level of those fees. Supporters of the current interchange system contend that interchange fees play an important role in balancing the two sides of the payment card market by encouraging merchants to accept cards and encouraging card issuers to issue cards and consumers to hold and use them.

Critics of interchange fees contend that due to characteristics of the debit card market, merchants generally do not have the leverage to control their cost of accepting debit cards. And network competition tends to result in higher interchange fees as networks strive to attract issuers and cardholders.

Critics of interchange fees note that non-card-based payments take place without any such compensation being provided by merchants' banks to consumers' banks. So for Section 1075 of the Dodd-Frank Act, Congress engaged in this debate and enacted a law that addresses the concerns of interchange fee critics in several ways.

First, I will discuss what is referred to as the prohibition on network exclusivity arrangement and routing restrictions. Second, I will discuss the part of the law that requires the Board to establish an interchange fee standard. The statute exempts small issuers, government benefit programs, and certain prepaid cards from this

interchange fee standard but it does not exempt them from the exclusivity and routing restrictions.

Turning first to the prohibition on network exclusivity, the statute requires the Board to 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.

We requested comments on two alternative interpretations of this prohibition. One interpretation would require issuers and networks to allow a debit card transaction to be routed over at least two unaffiliated debit card networks, for example, one signature-based network and one unaffiliated PIN-based network.

Another interpretation would require a debit card to have at least two unaffiliated networks for each method of authorization that can be used with that card, such as signature and PIN. This latter approach would provide more merchants with routing choice but would entail far more substantial operational changes by networks, issuers, merchant acquirers, merchants, and their processors.

Additionally, the statute requires the Board to adopt rules that prohibit issuers and networks from inhibiting the ability of merchants to route debit card transaction over any network that may process such transactions. The proposed rule includes examples of actions that would impede merchants' routing flexibility. These network exclusivity and routing provisions, along with the statutory provisions that give merchants more flexibility to set differential prices based on method of payment used, could promote competition among networks and place downward pressure on interchange fees.

But let's turn to interchange fee standards. In addition to these market approaches to constraining interchange fees, the statute limits any interchange fee that an issuer may receive for a debit card transaction to an amount that is reasonable and proportional to the issuer's cost with respect to the transaction.

To establish standards for assessing whether an interchange fee meets this statutory reasonable and proportional requirement, the law directs us to consider a number of things. First, the functional similarity between debit card transactions and checks which clear at par without interchange fees.

The statute also directs us to distinguish between the issuer's incremental cost to authorize, clear, and settle a particular transaction which by law, we must consider. And the other costs that are not specific to a particular transaction which by law we may not consider. Given the statute's mandate to consider the functional similarities between debit card and check transactions.

Our proposal includes as allowable costs only those incremental costs that the statute explicitly directs us to consider. There is no single generally accepted definition of the term "incremental cost" as it applies to a particular transaction. So the proposal uses average variable cost as a proxy. We have requested comments on whether other costs of a particular transaction should be included as allowable costs and how these costs should be measured.

The Board requested comment on two alternative approaches for implementing the interchange fee standard. The first approach is

based on each issuer's allowable cost with a safe harbor and a cap. The second approach adopts a cap that is applicable to all covered issuers.

We also requested comment on different conceptual approaches for implementing a fraud prevention adjustment to the interchange fee standard. Comments on the proposed rule are due by next Tuesday, February 22nd. We have already received thousands of comments raising a variety of issues and expect to receive many more in the next several days. The other Board Members and I are reserving judgment on the terms of the final rule until we have the opportunity to consider these comments.

As you can see, the debit card interchange provisions of the Dodd-Frank Act raise a number of complex issues. The Board is devoting substantial resources to understanding and addressing these issues within the parameters established by the statute. We welcome input from the public and from members of the committee in this effort. And I would be happy to answer any questions you may have.

[The prepared statement of Governor Raskin can be found on page 179 of the appendix.]

Chairwoman CAPITO. Thank you, Madam Governor. And I would like to lead off the questions. I appreciate your testimony. On the issue of the exemption, on page five of your testimony, you talked about the—and you said this in your statement that the statute applies these provisions to all issuers, talking about the exclusivity portion of it, including the small issuers and the government-administered payment and other pre-paid programs.

As you are well aware and you stated in your statement, this is an issue that has brought many questions as to whether the exemption for community banks and credit unions can actually result in exempting them from the interchange fee. And you mentioned in your statement pretty—and actually Mr. Bernanke said today which I am sure you are probably not quite aware of because he just said it in another committee, that there are some risks that the exemption will not be effective.

Could you speak a bit about how this exemption can hold up through the different parameters that you are charged with?

Ms. RASKIN. Certainly. And thank you. Thank you for that question. Yes, small banks are exempt. They are exempt from the interchange rules portion of this section of the law. And they are also made to be exempt in the proposed rule that the Federal Reserve has put out for comment.

The small issuer exemption is looked at from the perspective of asset size. So we have set a $10 billion level and that is looked at from the perspective of the size of the issuer as well as its affiliates and subsidiaries. But as you note, small banks and credit unions do in fact have concerns about this exemption. And they note in particular that the law does not put a similar exemption that it has in the interchange fee portion into the other portion of the law.

So the exemption does not apply in the provisions having to do with network exclusivity and the routing restrictions. Just to elaborate, Chairman Bernanke's earlier comments, there are, I think, legitimate questions regarding how in fact small issuers are going to in essence have this exemption work in their favor because there

is indeed no statutory authority provided in the law that would permit the networks to in fact engage in two-tier pricing.

So it is a matter of whether the networks in fact will put two tiers of pricing in place and the extent to which that pricing becomes maintainable or whether in fact it gets rerouted by market forces.

Chairwoman CAPITO. Right. And the question being that if you are an issuer from a community bank or a credit union, that your interchange fee could remain higher, will there be, as you said, dollar pressure to move customers towards the lower cost interchange issuers?

The second question I have is on the fraud provision, because this is the one that I have heard a lot about. And in your statement, you mentioned that the—considering the comments they received, the Board plans to issue a specific proposal on the fraud prevention adjustment.

My understanding is that the Federal Reserve felt that the language was written so tightly that to calculate for fraud prevention was not included in the parameters of—when you were looking at the cost, the incremental cost.

What do you mean by the comment? Are you actually going to be calculating this? Or is this something that is going to come through in the comments? Do you have a comment on that?

Ms. RASKIN. Sure. The whole issue of fraud prevention cost is dealt with explicitly in the statute. So, the statute has directed the Federal Reserve Board to allow for a fraud prevention adjustment that takes into account fraud prevention cost. And essentially, what we are directed to do by law is to develop standards for what those fraud prevention—

Chairwoman CAPITO. But not a pricing standard?

Ms. RASKIN. It is actually silent on standards, but essentially, the law requires us to develop standards. And what we have done, because this is an area that I think is something we want to learn more about, is in our proposed rule, we have asked for comment on what fraud prevention costs might, in fact, be. These are costs that we should consider before we promulgate the final rule.

So we have, in fact, adhered to the notion that fraud prevention causes something that standards need to be developed for. And we really await, with some eagerness, the comments that we receive and we will review them so that we can determine what makes sense.

Chairwoman CAPITO. Right. Thank you.

I will turn to our ranking member for questioning.

Mrs. MALONEY. Thank you very much, and congratulations on your appointment, Governor Raskin.

As you may know, I had the honor of serving on a conference committee with Chairman Frank and Mr. Meeks and Mr. Pearce and Mr. Watt. Many of my colleagues were on this panel.

We did work quite a bit on the compromise language that we put forward on interchange. And part of it was that everybody be treated fairly and that the financial institutions be able to recoup the price or cost of providing a service, but also limiting it to a reasonable amount.

When do you think you will finish your review of fraud prevention, which regrettably is becoming a huge issue, along with identity theft and the other items that are part of our financial system? When do you think that review process will be over?

Ms. RASKIN. By law, we are required to have final rules in place by July 21st.

Mrs. MALONEY. July 21st, okay.

Ms. RASKIN. For effectiveness. And by April 21st, we need to have—after we back up from the date of effectiveness, by April 21st, we would need to have final rules in place.

So, backing that up further, the comment period is now coming to an end, but there are still some more days to it, and on Tuesday, the comment period ends. And as I noted before, one of the issues we put out explicitly for comment has to do with the fraud adjustment issue. So those comments are coming in and we will consider them carefully after they are all in and make a determination as to how to appropriately contemplate including them or not in the rule.

Mrs. MALONEY. In relation to the comment period, some organizations, some constituents have suggested that the process was not as thorough as it should be, that the Federal Reserve should have had more time to study the issue and to survey a wider set of financial institutions and retail establishments.

Can you go through your review process and whether or not you believe it was extensive enough? And what studies have been done either by the Federal Reserve or by others? Can you comment on your review process?

I know from the credit card bill of rights, which I track daily, it was expensive and exhaustive. But this one, I have not—with the elections and everything else—tracked as carefully. So, if you could go through the details of the review process, please?

Ms. RASKIN. Certainly. It was quite a massive set of efforts because, as you know, the Dodd-Frank Act passed July 21, 2010. So, from July to October, the Federal Reserve Board staff engaged in a number of industry surveys; from July to September, those surveys were developed in-house.

We essentially arranged for multiple public drop-in calls for industry participants to comment on the draft surveys. I should note that some calls had well over 100 participants and there were more than 50 phone call lines that had to be opened up for this process.

We accepted many written comments on draft. And the input, I think, really did help us refine the survey instrument so that by the time September 13th came around, surveys were sent to all the covered issuers.

Surveys were also sent to payment card networks and to large merchant acquirers. And what we indicated in those drafts in those final surveys was that we would like the responses due October 12, 2010.

Let me say a little bit about what those surveys, who they went out to and what they covered. Essentially, there were three major surveys: a debit card issuer survey; a payment card network survey; and a merchant acquirer survey.

For the debit card issuer survey, it was sent to about 131 financial organizations which had over $10 billion in assets. Of those

131 organizations, 89 responded with data, 13 did not have debit card programs, 3 declined to participate, and the Board didn't receive any communication regarding 26 of them.

The questions that survey included were very broad in terms of cost. So, they not only included authorization clearing and settlement costs, but included fixed and variable costs and other broad definitions of cost.

In terms of the payment card network survey, that was sent to all 14 networks which we believe to be active in debit card—

Chairwoman CAPITO. Just a second. I am going to let you go on, if you could kind of summarize it more quickly, because this is an area of very great importance. So, we will try to stick to the 5-minute—

Ms. RASKIN. It was very thorough.

Chairwoman CAPITO. Do you think you need more time to study this issue?

Ms. RASKIN. I would leave that to your discretion. I can complete the answer for the record and you can evaluate whether you think it was something that we possibly missed.

Mrs. MALONEY. I think that would be appropriate if we can get in writing a review of your entire review system and other studies that you know that are out there. Thank you.

Chairwoman CAPITO. Thank you.

Mr. Marchant, from Texas.

Mr. MARCHANT. Thanks, Madam Chairwoman.

The issue I would like to stress this morning is the claim by the small banks and credit unions that the regulation of this fee, lowering it from, according to everything I have been able to read, 44 cents to about 12 cents, 12 to 15 cents, results in a loss of the income of about $12 billion. Is that a number that the Fed has recognized? Is that a recognized number, is that a claim or—

Ms. RASKIN. I have heard that number used.

Mr. MARCHANT. Is it a reasonable argument that this regulation will limit the amount of fee income that the banks and credit unions can charge?

Ms. RASKIN. The interchange fee portion of the rule essentially requires the Fed by law to look at the reasonable and proportional cost that the issuing bank faces.

One methodology that we follow in order to try to understand the broad nature of what those costs might be was essentially to engage in the set of surveys that I described.

Interestingly enough, what those surveys revealed was a broad range of average variable cost—and as I mentioned before, the average variable cost proxy was used for incremental cost. The language of the statute uses the term "incremental cost," that was a little bit hard to translate into something workable. And we thought the notion of average variable cost came closest to it.

So, in our survey, we looked at a range of issuing banks and tried to understand what their average variable costs were. And we saw interestingly enough quite a range, so that there are some issuing banks that can do this at very low cost and others that do it at very high cost.

When the amount that you cite, of 12 cents and 7 cents, when those amounts were arrived at, they were really derived from

standards regarding those average variable costs. So, the 7 cents, essentially, is the median point that we found in our survey, so the median issuing banks that would be covered by this proposed rule has average variable cost of 7 cents a transaction, the 12-cent number was arrived at in terms of looking at the 80th percentile of issuing banks that had responded. So, 80 percent of the banks in the sample survey were essentially at 12 cents or lower in terms of their average variable cost.

Mr. MARCHANT. My concern is that at a stage in the country's banking system where many banks are trying to rebuild their capital base, they are trying to maintain some degree of profitability, and they are desperately trying to stay open, in many cases, especially the small banks and the credit unions that we, at this time, decide that we are going to go in and review standards and cap the amount of fees that they can charge on this, in effect, lowering their profit, not allowing them to put profit into their capital base and something that is very, very counterproductive in this day and age that we are in.

Why has it become so critical to do this now? Is there a feeling—I understand that you have been instructed—the Fed has been instructed to do it. But I don't receive any complaints in my district from people who are complaining that their debit card fees are too high or that their—that in fact, they love their debit cards, they love the ability of the banks to offer them a debit card and not have to pass on exorbitant fees.

So, I think that—I would like for you to take more time, I would like for you to consider the impact that this is going to have on small to medium-sized banks and on their ability to add capital to their banks so they can have more money.

Chairwoman CAPITO. Thank you.

Mr. Watt?

Mr. WATT. Thank you, Madam Chairwoman.

Governor Raskin, I know you can't control the pace of this process, and you can't tell us whether we put you under too tight of a deadline, but I need to push you a little bit more on Mrs. Maloney's question. It seems to me that from what I gather, you had at least a two- or three-stage process: a survey; a proposed rule; and a comment period on one aspect of this and not on the fraud cost aspect of it—9 months to do something that we punted to you as a Congress, it wasn't the House bill, it was in the Senate bill, we had to reach reconciliation.

My question to you is not should we or ought we, the question is whether you would benefit from a further extension of time to evaluate these multiplicities of comments, particularly on the fraud calculation section of this, and go through a more thorough process.

Ms. RASKIN. Thank you for that question, and I want to say that we are doing—

Mr. WATT. I understand that, Ms. Raskin. I am just trying to figure out whether you would benefit or wouldn't benefit. Don't be vague. Either you would or you wouldn't.

Ms. RASKIN. It is hard to—it is actually hard to know and I am not trying to skirt that—

Mr. WATT. Okay, then, that is the answer. Okay.

Ms. RASKIN. You know.

Mr. WATT. Let me go to the next question. If that is the answer, then you don't have an answer, that is really what you are saying—

Ms. RASKIN. I am saying the comment period is still moving strong and we still—

Mr. WATT. You know you are going to get a substantial number of comments, you know you have gone through more stages on one aspect of this than you have on the other aspect of it, the fraud section, because you just said that. But I will draw my own conclusions from that.

The other real question I have is whether there is something in this rule that really addresses what we would be trying to get to, I think in this whole discussion, and that is whether—is there anything here that allows you to assess who benefits from this process, whether the issuer benefits, whether the merchant benefits, our ultimately beneficiary we were hoping was the consumer.

I guess my question is, is there anything in what we gave you as instructions to rule make about that would make some assessment of whether this is just a fight between merchants and issuers or whether ultimately the consumer really is going to benefit from this cost reduction or cost shift.

I have been troubled by that from the beginning of this discussion because I haven't been able to see how we ensure that the ultimate beneficiary that we were advocating for—that we all should be advocating for, consumers, really get the benefit of this. Is there anything in the legislation or your rule-making process that will allow you to address that?

Ms. RASKIN. It is an excellent question and the consumer effects are always in the forefront of our deliberations. The statute itself didn't direct us to look at the consumer effects but that is beside the point. The consumer effects are something that we have tried carefully to articulate and to the extent we can try to measure.

I am going to describe a little bit what those—

Mr. WATT. No, no. I am trying to figure out what in this rule would do that? Is that what you are getting ready to say?

Ms. RASKIN. What I am getting at is essentially, I think the theory behind—

Mr. WATT. Oh, I know the theory. I am trying to talk about the practice. Is there something in the rule that gets you to that determination?

Ms. RASKIN. Yes. The idea—

Mr. WATT. Okay, tell me what that is. I know the theory.

Ms. RASKIN. The idea is that lower interchange fees, it is argued, would lower cost to merchants who possibly in competitive environments, could lower their cost to consumers. That is one consumer effect. Not that that effect was directed by Congress to be looked at explicitly but that is what animates, I believe, the statute.

So, there is that one consumer effect. Another consumer effect which may work in a different way has to do with debit card holders who get rewards. Those rewards are often made possible through higher interchange fees.

If those rewards were somehow to be reduced or changed, I think that would be a factor that would be involved in evaluating the consumer well-being. Similarly, we would want to think about

banks that charge fees for other services. If banks were to change that portfolio of services, query as to whether consumers would be helped or hurt.

So, I think that there are consumer effects, and my sense from the statute is that these consumer effects animated the statutes but they are not particularly noted explicitly.

Chairwoman CAPITO. Thank you.

We will go to Mr. Royce, from California.

Mr. ROYCE. Thank you, Madam Chairwoman.

I think some of the surprising things in life are the things we all take for granted. And when I think about the attacks on our payment system that occur every day, there are attempts to find new innovative ways to create fraud. And you look at the billions and billions of dollars that are invested by card issuers and invested in the system, in building a network that in such an extraordinary way today allows the system to stay ahead, for the most part, to the extent that the consumer himself or herself does not have to pay for that fraud. There is a guarantee that the system works well enough, and I guess what is surprising to me is how often, in most cases, the fraud is actually discovered by these complicated processes that have been developed to pick this up in the process of the fraud being committed before the consumer ever knows that she or he have been defrauded.

And so, you look at the billions that are invested into that and I was going to ask, why does the proposed rule lack a full accounting of several things? One would be the fixed cost in all of this and the next would be the network fees and other costs. But why did the Board omit adjustment for fraud prevention cost or actual fraud cost? I ask that because in watching the way in which fraud evolves so quickly, it is clear that whatever we invested yesterday, it is not going to be enough tomorrow to keep up with all the miscreants who are finding new ways to attack the system.

Could I have your thoughts on that?

Ms. RASKIN. Certainly. The fraud prevention costs, as you can imagine, are probably something that are going to be substantial. And I imagine that through this comment period, we are going to be hearing about what those different programs look like, what the technologies look like, what in fact the parameters are for so-called legitimate fraud prevention efforts.

And part of the reason for this comment period was really to get a more robust understanding of what you are talking about in making sure that essentially we understand what efforts and costs go into fraud prevention. That said, I do want to suggest something that the statute was silent on, and that has to do with costs that are related to a particular transaction that are not related to authorization, clearance, and settlement. So if you read the law carefully, as we have now done many times, the law directs us to look at a couple of things.

We are supposed to consider, for example, functional similarity, that is, the similarity between debit card cost and debit card transactions as compared to check clearing. But, we are also supposed to consider the incremental cost that is incurred by an issuer when that issuer engages in authorization clearance or settlement. And we are supposed to make sure that those costs are specific—debit.

Mr. ROYCE. Okay.

Ms. RASKIN. So, what you are suggesting in terms of fraud losses, could be something that falls in a so-called bucket that the statute is silent on, which doesn't mean that it would be either—

Mr. ROYCE. Right, right. No, I understand your point but there is going to be less bank incentive, clearly. There are going to be fewer resources for fraud prevention and less likelihood that the billions that need to be invested in the future will be there.

Another point I was going to make is one that Chairman Bernanke made today. He said we are not certain how effective the exemption might be when it—as merchants might reject small banks' cards, there are some risks that the exemption will not be effective going back to the argument made earlier. Chairman Bernanke said that there is a possibility that merchants won't accept more expensive cards or the cards won't offer two-tier pricing.

So as you look at all of these different issues that are coming up, there is at a minimum some confusion about the provision in this rule and if done incorrectly, this could be the final nail in the coffin for many of the smaller financial institutions, I think, that have been decimated by a weak economy and piles of new regulations from Washington. And larger financial institutions can maybe pass these costs on to consumers, but this isn't the case for smaller banks.

And for those—I will yield back, Madam Chairwoman. Thank you.

Chairwoman CAPITO. Mr. Baca, from California?

Mr. BACA. Thank you very much.

Ms. Raskin, one of the questions that was discussed earlier about profits for small banks and others—how much profit—will they still be able to make a profit?

Ms. RASKIN. It is a very good question. The small banks and small credit unions, in fact any small issuer, remember by law are exempt from the interchange fee provisions. Whether or not they still are able to make a profit is going to depend on the market dynamics on how this all looks in the end. So, it will depend on obviously what the final rule looks like, but it is also going to depend on some of the things that Congressman Royce pointed out, some of the different dynamics regarding what kind of routing becomes, what the costs are of that routing.

Essentially, a bank by bank kind of perspective is needed because some banks have different portfolios of products so it is going to depend, I think, particularly on the portfolio of that issuing bank.

It is important to note that what I think the statute has directed us to do is to look at one payment stream that is related to debit cards. So, it is this interchange fee payment stream. Now, there are other payment streams that are associated with the issuance of debit cards, there are payment streams that are associated with other kinds of cards, there are other accounts and other kinds of products that banks offer and all of those products have different revenue streams associated with them. And it is complicated in terms—

Mr. BACA. But would it level the playing field in terms of the debit card, because I am concerned from a diversity perspective in

terms of who is actually being charged "X" amount about—without the regulation it is quite open right now, so diversity in certain areas would be charged "X" amount of dollars based on the debit card versus someone else.

Under the new regulation on the cap, this sort of sets a standard that applies to everybody on a fair and equal basis versus the way it was it before, is that correct, the possibility?

Ms. RASKIN. With the exception of what is carved out, so with the exception of small banks.

Mr. BACA. Okay, let me ask another question. Another critique about the proposed rule is the calculation of fraud. You allow for two options: one based on new technology being used; and the other being a small flag fee taxed on the interest change rate.

Can you describe how you came to this conclusion, and in your mind, should the calculation of fraud take into account the overall amount of the transaction?

Ms. RASKIN. Certainly. When we put out the fraud adjustment rule, or a portion of the rule for comment, we really wanted to hear from commenters, so we really wanted to make sure we were hearing enough about the robustness of their fraud prevention effort. We wanted to make sure we understood the variety of them, essentially what they did and how they did them, what was necessary in terms of cutting edge technology.

At the time we put out the rule, we did not know enough really to set out definitive standards, and the idea—and the proposed rule really opened the debate—was to make sure we were hearing everything we needed to hear before we promulgated something final.

Mr. BACA. Thank you. Other countries have taken steps to curve the interchange fees much like the proposed rules that would be done here. Can you comment on your analysis of other countries' rules and the market's reaction? That is question number one.

Question number two, could you see the benefits passed on to the consumers or did you see the eliminated, or eliminating the financial products offered to the consumers?

Ms. RASKIN. Sure. I will talk a little bit about one well-worn example which is Australia, actually. The Reserve Bank of Australia actually regulates credit card interchange on a cost basis. Aready we see, there is a difference here to what Australia has done, which applies to credit card interchange. We are obviously looking just at debit card interchange.

But essentially, the Reserve Bank of Australia was given authority under something called the Payment Systems Act of 1998 to establish benchmark interchange fees for credit cards and this happened in 2002. And then for signature debit cards in 2006.

And so what the Reserve Bank of Australia did for credit card interchange fees was they established the cost-based benchmark with a cap and they capped it at a half of a percent on an annual value weighted basis. For signature debit card interchange fees, the Reserve Bank of Australia also established a cost base benchmark and they capped it at 12 cents and that is in Australian 12 cents which I am told is approximately the same in U.S. dollars.

So 12 cents per transaction, again, on an annual value weighted basis. So although interchange fees for PIN debit transactions are paid from the issuer to the acquirer in Australia, in 2010, the Re-

serve Bank of Australia applied the same 12 cents per transaction benchmark in debit interchange fees.

Throughout all of this, what have been the—

Chairwoman CAPITO. Sorry. Can you just kind of wrap it up there because—did you have a one-line summarization of the question, which in my view was, what did this result in?

Ms. RASKIN. Inconclusive in terms of prices to the consumer.

Chairwoman CAPITO. Thank you.

Mr. Hensarling, from Texas.

Mr. HENSARLING. Thank you, Madam Chairwoman.

Governor Raskin, I want to follow up on a question that my colleague, Mr. Royce from California, was asking you. And I want to make sure I understand this. I believe that essentially your testimony is that in the interpretation of the Fed under the statute, you cannot recoup fraud prevention because that is a fixed cost, correct?

Is that a fair assessment of the Fed's interpretation? So apparently, it is not?

Ms. RASKIN. Not exactly, no.

Mr. HENSARLING. Okay. What is it exactly?

Ms. RASKIN. Okay. Let me—

Mr. HENSARLING. I still don't understand this. And I have been listening carefully.

Ms. RASKIN. In terms of what can and can't be done, the statute sets out allowable cost, it sets out disallowable cost, but then there are costs like you mentioned which were not explicitly put into either allowable or not allowable.

Mr. HENSARLING. I thought I heard you say that actual fraud losses may be a permissible cost to be recouped in response to his question. Did I hear you correctly?

Ms. RASKIN. You did.

Mr. HENSARLING. Okay. And you also allow for the possibility that fraud prevention cost may not be recouped, is that correct?

Ms. RASKIN. That is also correct.

Mr. HENSARLING. Okay. So does that mean that we could end up with the rather perverse conclusion that if a credit card company prevents fraud, they don't recoup their cost, but if they allow the fraud to take place in the system, you will allow them to recoup their cost?

Ms. RASKIN. Obviously, this is why we want to collect comments. We want to make sure that when we hear of different combinations of things that we don't allow what is a very difficult statute—

Mr. HENSARLING. The world works off of incentives. If I was the credit card company and you wouldn't allow me to recoup my fraud prevention cost, and you would allow me to recoup my fraud cost, I guess I would allow fraud in the system. My guess is that it would not be good for our economy.

Looking at the Federal Register of December 28th when you asked for—to open up the comment period, you said there is not a single, generally accepted definition of the term "incremental cost." Yet again, you seem to interpret it in such a way that fixed cost would not be allowable, but on page 8, 1, 7.3, 6, I read the Board requests comment on whether it should include fixed cost in the cost measurement.

So it seems, and maybe I am misinterpreting something, it seemed like on December 28th, you interpreted the statute to permit fixed cost to be recouped but I think you are saying in your testimony today that your interpretation is different.

Is this correct?

Ms. RASKIN. Let me try to clarify what our understanding is of the statute and it is a difficult statute to interpret so—

Mr. HENSARLING. Could you help me here—is your interpretation different today than it was on December 28th, when you put out the—

Ms. RASKIN. No.

Mr. HENSARLING. It is not.

Ms. RASKIN. No.

Mr. HENSARLING. Okay. So on December 28th—I don't know; I don't believe I am taking this out of context—the Board requests comment on whether it should include fixed cost and the cost measurement which it seems like if you are haven't changed your legal interpretation on December 28th, you agreed that you had the flexibility to put fixed cost into the incremental cost measurement?

Ms. RASKIN. And we requested comment to hear what those costs might look like to see essentially whether we could move them through another part of the statute regarding functional similarity with checks, which is also required by law.

So we needed to understand what the dimensions were of the different—

Mr. HENSARLING. You think your hands are tied, but they are not tied by that particular language, is that what you are telling me?

Ms. RASKIN. They are tied in various ways. But in terms of that particular language, you are describing a part of—a category of cost that the statute is silent on. And I think what we need to do is understand what that category of cost could—

Mr. HENSARLING. I am trying to understand your legal interpretation of where Congress may need to act, and where Congress may need not to act, and it still appears to me you are saying that fixed cost could be part of the transaction fee that you set. I see my time is running out.

I know that under the statute, you were to consult with other Federal agencies. I have to tell you, my mailbox is full from community banks telling me that this is going to harm their bottomline. Let's put the consumers aside for a second. We have discussed that, but a number of small community banks said, "We are going to get left off this system. It is going to hurt our net revenue."

I am concerned also, what is the impact on their bottom line and did you consult with the FDIC, I know you are a bank regulator—and the other bank regulators, ultimately what will be the impact when fees by estimates are going to be reduced 73 percent?

Ms. RASKIN. Yes. And the law requires us to consult and we would consult anyway with our colleagues in the other banking regulating agencies. And yes, so we have spoken to the FDIC, the NCUA, the OCC, the Small Business Administration, and others. We continue to have discussions with them, and as recently as yesterday, the NCUA has essentially looked at the issue of exempting

small banks from not just the portion of the law regarding interchange but the other portions as well.

Chairwoman CAPITO. Thank you.

Mr. Scott?

Mr. SCOTT. Thank you very much, Madam Chairwoman.

And welcome, Governor Raskin.

If there is one thing that I hope you will take from this hearing this morning, it is that a delay in the implementation of this rule is definitely in order. Several of my colleagues have asked if that would be a benefit to you and the Fed.

I would like to rephrase that question. It is not the question of whether the delay would benefit you, the question is, would it benefit the American people and the institutions, the financial institutions, the merchants, the people who are on the ground who would have to make this work. And the answer is yes, there are just some profound questions here, starting off with what is reasonable and proportional.

It is questionable to me, a move from 45 cents down to 12 cents, that is a glaring 73 percent reduction. Is that fair? Is that proportionate to the situation?

This debit card situation is beginning to be the fulcrum around which our entire commercial retail system operates. Just last year, I think the debit card transactions accounted for over 35 percent of all of the transactions that were non-cash, some 39 billion different payments there.

This is a profound impact. And I think we owe it to the American people, to these institutions to be able to delay and make sure that we get this rule right. So I hope and I admonish you very strongly to put a delay on the implementation of this rule without protections, for example, provided by debit interchange fees, the networks can restrict some high-risk retailers such as internet merchants from accepting debit cards at all.

Was this taken into consideration when the Federal Reserve developed its formula, that is a very serious question. My colleagues have gone over the fraud adjustment issue that has to be cleared up. It is the case of the larger cards issuing banks with significantly higher volumes and will be able to negotiate a smaller interchange fee than the smaller community bank.

So has the Federal Reserve considered the potential anti-competitive environment that this proposal would create against smaller banks and credit unions, for example, that currently issue these debit cards, these are very profound questions. And what will this cost be to the consumer and the bottom line?

It all ends up. The banks are not going to pay for this, the merchants are not going to pay for this, do you know who is going to pay for this? It is going to be the American consumers at the end of the line.

So we need to pause. We need to reflect on this and we need to give this rule implementation the kind of serious study that it needs to make sure we get it right and I am convinced and I hope you will be convinced at the end of this hearing that we need more time on this issue.

So let me just ask you this question. Do you feel that there is a possibility that consumers eventually could bear the majority of the burden of this regulation?

Ms. RASKIN. First of all, let me tell you that I do take your statement very seriously, and we are committed to doing everything we can to get this right. We have engaged in a process that is thorough and continues to be very thorough. We are hearing all of the same kinds of comments that I imagine you are, this is indeed very controversial, and we are trying to take everything into account that has been presented our way while still making sure we reflect what is in the law.

So I want you to know it is something that is taken very seriously and I do hear you loud and clear.

Mr. SCOTT. With all due respect, Governor, would you consider a delay in this in view of the points that we have made this morning so far within this issue?

Ms. RASKIN. I think that is Congress' prerogative. If, in fact, you determine that these deadlines are unrealistic, then of course we would adapt to those new deadlines. We would continue gathering information and analyzing information as I have heard today and we have been hearing through the comment period. We would, most definitively, defer to Congress' desire in that regard.

Mr. SCOTT. Thank you very much for your service.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Huizenga?

Mr. HUIZENGA. Thank you, Madam Chairwoman. I appreciate the opportunity.

Governor Raskin, it is good to see you again, and I appreciated our visit earlier. I think we are all hearing a very common theme and, yes, I am sure we will hear from our retailer and merchant friends a little later about that delay or discussion of that. And I am trying to take it back maybe a step more to the basic, since I am a freshman Member, I was not here during the time of the writing of both the underlying Act as well as this Durbin Amendment that was proposed in the machinations that went into adopting that and what was going on.

Ms. RASKIN. That makes two of us.

Mr. HUIZENGA. Okay, we are on par then with this. So you were talking about downward pressure on the Act and what was happening. I am wondering if you didn't want any kind of perspective as to the Fed's view of what and why there was not any sort of this downward pressure on pricing pre the act.

And really, do we have any way of knowing the cost of implementing this regulation? Is it going to be proportionally beneficial to not only the large banks but the small banks as have been indicated, the retailers and the merchants that are going to be getting it and most importantly of consumers. Are they going to actually be seeing any kind of benefit?

Ms. RASKIN. I know these are all excellent questions and different impacts that are all occurring in a dynamic environment at the same time, and it is very hard to measure exactly how one will affect another.

I will try on a couple of fronts to answer some of those questions. In terms of the market structure, in most markets, competition leads to prices going down. In payment card markets, we have seen something that seems a little bit more unusual where you have competition but interchange fees are going up.

And so, there were clearly issues regarding market structure, I think, that were animating the development of this statute. I don't think it came out of nowhere. They are clearly with the sense that merchants had prohibitions on how essentially they could route transactions, but those prohibitions had cost implications that they could not control.

Mr. HUIZENGA. And it could be that price pressure is swimming upstream because of some of the expectations that the consumers and/or regulations that have been put on those that are handling those transactions?

Ms. RASKIN. That is interesting. I don't know if I have thought about it from that perspective exactly, but I think the increase in fees has actually come—it will be hard to evaluate the extent in which the regulatory environment has brought any of that about.

But essentially, it is what they call a two-sided market where you have the networks looking at fees both to the issuing bank and to the merchant side. And typically, the networks use those two sides to balance—to have credit cards and debit cards accepted in the marketplace.

And it is a balance that had some kind of possibly perverse pricing consequences. Essentially, we have issuing banks now who are taking these directives from the networks and increasing their interchange fees to merchants. So, there is that characteristic.

The other characteristic that you pointed out has to do really with the impact on consumers. And the consumer really doesn't even know, right? When you swipe your debit card or hand it to the cashier, you don't even know essentially that there is an interchange involved. But that interchange fee is somehow being paid for. And the impact of what changing the interchange fees would do is something that has been postulated would be of savings to the consumer. But we don't quite know.

Mr. HUIZENGA. It seems to me that we need to just blame intergenerational expectations. The staff section doesn't carry cash, the rest of us actually do. And we still want to go buy a $1.90 coffee somewhere. And we expect to be able to use whatever is convenient for us, not necessarily what is convenient for the retailer or convenient for those of us who are dealing with it.

So, thank you. I appreciate that and I look forward to continuing to pursue that. So, thank you, Madam Chairwoman. I yield back.

Chairwoman CAPITO. Before we go to the last—I would like to ask unanimous consent to submit for the record letters from the EPC, KFC Franchisees, the ICTA, NAFCU, U.S. PIRG, the Prepaid Card Coalition, TCF Financial Corporations, an ACS education letter, the Food Market Institute, Senator Durbin, IV Supermarkets; as I said, there is a lot of interest.

Ms. Velazquez?

Ms. VELAZQUEZ. Yes. Thank you, Madam Chairwoman.

Governor, thank you for being here today. This is a very important issue that has implications for both sectors—financial institu-

tions, small businesses—and as the ranking member of the Small Business Committee, and a member of this Financial Services Committee, I am very concerned about this issue.

At a recent conference hosted by this European Central Bank, policymakers and banking experts suggested adopting a card fee system that took into account the cost that businesses will pay to operate their own credit systems. This seems to me only reasonable. Why weren't these costs taken into account in the Fed's proposed fee cap?

Ms. RASKIN. Thank you. The European Commission, as you mentioned, did in fact initiate an investigation of cross-border debit and interchange fees. And essentially, they used different criteria that were not based on issuer cost. So they arrived at numbers and I should say they look to be about a 0.2 percent interchange fee which is about 8 cents on an average $40 transaction.

But the European Commission used criteria that were not based on issuer cost. Our reading of the statute is that we need to stay focused on issuer cost. And so, that was primarily the focus of our effort in putting forth the proposed rule.

Ms. VELAZQUEZ. So, you are telling me that the cost criteria that they used are different from what is in the statute here?

Ms. RASKIN. Yes, either that or else they look at criteria that were even cost based. They might have looked at other explicit customer consumer well-being kinds of matters.

Ms. VELAZQUEZ. Okay.

Ms. RASKIN. They had a different set of criteria.

Ms. VELAZQUEZ. I would like to talk a bit about the Australia experience. Since Australia placed a cap on interchange fees in 2003, their Central Bank found a sharp decrease in the availability of rewards and no conclusive proof of lower prices for consumers, why do you believe that the Fed's proposal to cap rates on debit cards in this country will produce better results for consumers?

Ms. RASKIN. Actually, I don't know. I don't know what the results exactly will be in terms of the ability of merchants to actually pass on costs to consumers. I don't know exactly. I would say that theory tells us that if it is a competitive market that the retailers would pass on those savings, but I don't know exactly.

Ms. VELAZQUEZ. Theory dictated that in Australia and apparently didn't produce the results.

Ms. RASKIN. I am not exactly sure of that either, because I think the results in Australia actually are difficult to interpret. It is hard to know the extent to which the price change had to with the factors outside of the change in the interchange fee standard.

Ms. VELAZQUEZ. Okay. Thank you. Last April, the world's largest card company voluntarily reduced interchange fees on debit transactions in Europe to 0.2 percent of the total cost of a transaction. In that same period, the same company increased the same fees paid by U.S. businesses to almost 1 percent of the transaction total.

Are there any practical reasons why it should cost 5 times as much to process a debit transaction in this country as it does in Europe?

Ms. RASKIN. It is a very, very important kind of distinction and I would encourage you to ask that on the next panel and see what kind of answers you get.

Ms. VELAZQUEZ. Thank you.

Chairwoman CAPITO. Mr. Renacci?

Mr. RENACCI. Thank you, Madam Chairwoman.

And thank you, Governor, for being here.

Yesterday, I appreciated the opportunity to have some time to spend with you and ask you some specific questions. A lot of them are being asked again today about cost. And as I told you, I come from a very unique perspective, because I have been involved with banks, I have been a retailer, and I have been a CPA who audited both.

So when it comes to my CPA background, I always look at cost and what are the true costs of any transactions. And yesterday, we had an—I asked you the same questions that many of my colleagues are asking you, do we have all the costs?

If we are going to impose, as I called it yesterday a price fix, and I know you corrected my by saying a standard. It doesn't matter what we call it. If we are going to impose a set fee, do we have all the costs to compare? I think your answer yesterday and I think your answer today has been the same thing. We do not have under statute the ability to look at all those costs.

And that concerns me, because if we are going to come up with a standard and you are being given this task to come up with a standard rate, you need to be able to look at all costs.

Over the last couple of weeks, I have talked to retailers, and I have talked to bankers, and I have had costs submitted to me which I told you yesterday showed that they are a lot more than 7 cents to 12 cents.

But truly the questions here is, how do we get to the right standards, as you called it yesterday? And my concern is that you have been tasked with only coming up with a standard and your hands are tied at looking at all these costs. But also available, that is not just fraud, there was—as a CPA there are costs, there is overhead there is the labor, the technology, all the things that are necessary to run a debit card.

So my question for you is in moving forward in establishing this final rule, would you be willing and able to identify, and willing to identify and consider those additional costs? And if you can't, because of statute, would you need a congressional fix so that you can look at these things?

My other question is, and I know a lot of people talked about delay, it is not about how fast we get it done; it is about getting it done right. So, I have asked you a couple of questions there. But would you consider looking at those costs without a fix, a congressional fix?

Ms. RASKIN. Thank you for that. And I have benefited enormously from our conversation. The idea of cost is absolutely critical in terms of getting this right. We want to make sure that we are looking at all the costs possible. And then I think it is fair to say we should sift those costs through the parameters of the statutes to determine which would be permissible by law assuming that is the law that we are dealing with.

The surveys that we did turn out to have been quite comprehensive in terms of gathering costs. While in the proposal you are seeing a fairly narrow band of permissible costs, for purposes of our

methodology, we in fact, collected quite a breadth of costs. So we went beyond the authorization clearing and settlement costs.

We looked at fixed cost. We looked at all variable costs. We essentially tried to get a broad understanding, now whether it is broad enough for your CPA mind, I am not sure, but my understanding is that it was a fairly broad based set of costs.

And what I am more than happy to do is make sure that we provide that aggregate data to you and your colleagues so that you could actually provide some kind of feedback regarding how essentially that looks.

Mr. RENACCI. But are you agreeing that all costs are not being evaluated because the statute does not allow you to evaluate all costs?

Ms. RASKIN. We should evaluate. We need to look at costs, okay. And we were trying to pull them out through the survey and through this comment period we are going to continue—

Mr. RENACCI. I guess I want to ask you, yes or no. Do you agree that yes, there are costs that were not able to be evaluated because the statute has limited your ability to look at all costs?

Ms. RASKIN. I don't know if I can answer it with a simple yes or no, because we need to look at a lot of costs and move them through the parameters of the statute and see whether they would be permissible.

Mr. RENACCI. Again, it is an interpretation, I understand. But I think there are a lot of costs that were talked about but really are not being evaluated. And we need to get them all. If we are going to do this, we need to do it right. And I appreciate the comments from my colleague on the other side who said we need to delay this to the point to get it right.

A delay for just having a delay is not a good delay, but a delay for doing it right is important.

Ms. RASKIN. And again, a delay is fully within the prerogative of the Congress.

Chairwoman CAPITO. Mr. Lynch?

Mr. LYNCH. Thank you, Madam Chairwoman.

Madam Governor, I want to thank you for coming before the committee and helping with us with our work. I do want to just comment, the gentleman from Texas earlier mentioned that he didn't hear any complaints on anybody in this district regarding debit cards.

I just want to say that I heard a lot of complaints from the merchants in my district and across Massachusetts about the amount of money they were paying in these transaction costs. And I get the sense that there was some overreach on the part of the issue—on the part of the banks here and I am not sure where reasonable is in terms of the cost that are really related to the transaction. And I think that is what we are trying to get at. But there is probably a lot of credibility in the claim of the merchants and we are trying to get that price down.

Now, you are limited by the language in the statute and I understand that. And, with respect to the reasonable and proportionate language in there, it further limits you in terms of what you can consider in terms of incremental costs. One of the things that you cannot consider is something that my colleague from California,

Mr. Royce raised earlier, and that is the integrity of the system, the fixed costs, the connectivity.

And in the Boston area where I represent, we have had a huge, huge scandal there and a huge hacking incident with TJX and Boston Chicken and—and 7-Eleven, 46 million credit cards were stolen. The numbers were stolen with the PINs. These hackers are getting much more sophisticated, and let's face it, the way we transact business in the United States has changed enormously. I think that these electronic transfers are 35 percent of the non-cash transactions now in the country.

I am tremendously concerned about the integrity of the system and I am wondering if you think that you should have been allowed to consider the—I guess the systemic cost and maintaining a system that has integrity in light of all this hacking and it is going every single day. We just prosecuted a young fellow who got 20 years, but the damage that he caused there was tremendous.

I just think that we have to make sure that we are continuingly updating the systems that we transact business on going forward. And would it help if we allowed—if Congress allowed you to consider the underlying cost in maintaining a system with integrity because I guess forgot to mention that a lot of this happened because the merchants were storing the PIN number and were storing the ATM numbers within their systems and they were hacked out of that system.

It wasn't hacked against VISA or whoever the facilitator was; it was some of these merchants. So there is a shared cost in maintaining a system with integrity and I am just wondering if we gave you a broader mandate, whether you might be able to better protect consumers going forward.

Ms. RASKIN. Thank you for that, and I, too, share your concern about the integrity of the system and the importance of fraud detection software and processes and systems that essentially can help limit the kinds of experiences that you have had first-hand experience of. In terms of your specific question, the notion of cost-effective fraud prevention technology is one that is currently in the statute.

So I fully anticipate that we are going to need to look at exactly the questions that you are raising in the context of the information that we are currently gathering. The comments that are coming in now and continue to come in on this point are going to have to be evaluated from the perspective that you described.

Mr. LYNCH. And, again, I am probably repeating the questions that were previously asked, but in terms of the timing of this, do you think that some measure of delay might be in order here in order to get this right or do you think we pretty much have it? I don't think you will ever get it absolutely 100 percent perfect, but I would just be very nervous about going forward with something that might inhibit the system, given the widespread use of the system.

Ms. RASKIN. I think you see how controversial this is and how difficult and challenging it has been for us to make sure we come very close to what Congress intended in passing this. And, from that perspective, it is your prerogative regarding in fact how much

longer you want us to look at this regarding essentially questions of timing.

Mr. LYNCH. Yes. It is controversial, I think, and let me just say this. I think we sometimes overlook the degree to which we have transformed the way we conduct business in this country with the respect to electronic transactions. I think we take it for granted now. I try to explain to my daughters how we used to go the bank on Saturday and try to take out enough money in order to cover the whole week, and they just think that is hilarious.

And, even my daughters have a debit card, which is obviously a glitch in the system. But it is one more reason that—two more reasons that we need to get this right. But thank you and again, I appreciate it. Madam Chairwoman, thanks.

Chairwoman CAPITO. Thanks. Mr. Canseco?

Mr. CANSECO. Thank you, Madam Chairwoman, and thank you, Governor Raskin, for being here today and subjecting yourself to questions. Let me just start off by saying that the breadth of rulemaking that has resulted from Dodd-Frank is just extraordinary and I feel that the current timetable for implementing this interchange rule is not sufficient for those who are affected whether you are the consumer or the retailer or the bank and it is going to be very difficult for them to adjust. Would you support a delay of this implementation? And with that, I am also echoing what the gentleman from Georgia, Mr. Scott, and the gentleman from Ohio, Mr. Renacci, have asked you before.

Ms. RASKIN. Again, I would echo your concerns, essentially this has been very difficult. I think we are doing a thorough job. We are doing our best to meet the standard, it is obviously your prerogative to extend the timing if in fact you think that is warranted—

Mr. CANSECO. I think it is highly necessary. But let me go on to a question—one that is one of my main concerns with the proposed rules by the Federal Reserve. It is—seemingly a lack of economic rationale behind the rule in Dodd-Frank that requires that interchange fees be reasonable and proportional.

And in the rule proposal that the Federal Reserve, it noted there and found only limited examples and I am referring to the Federal Register Volume 75 Number 248 Section 235.3 Subsection A1 where in the middle it says, "EFTA Section 920 does not define 'reasonable' or 'proportional.' The Board has found only limited examples of other statutory uses of the terms 'reasonable' or 'proportional' with respect to fees."

The Fed was tasked with creating a rule that not only lacked an economic argument behind it, but was basically unprecedented in this premise. This requires further examination, would you not agree?

Ms. RASKIN. What we have done best with what we have been given and I agree that there are quite a number of provisions in this set of directives that have been difficult to interpret. And reasonable and proportional fall within that category as do the notions of incremental cost, as do the notions of what constitutes appropriate fraud prevention cost.

Mr. CANSECO. But reasonable and proportional is so, so broad that it really bears some very heavy study and more logic behind it. Let me ask you this. What economic considerations were given

to the proposed rule by the Fed in order to—with regards to reasonable and proportional?

Ms. RASKIN. The terms "reasonable" and "proportional" are baked right into the statute and what we have attempted to do through the construction of two possible alternatives which are now, as you know, out for comment is try to embed what those terms could possibly mean. So for example, in one alternative, we have looked at a very issuer-specific kind of way of evaluating the reasonable and proportional cost that is again baked into the statute.

And so, one alternative essentially tries to determine what the median average variable cost would be and give issuers the ability to stay within that amount without any kind of extensive compliance cost or proof, kind of matters—the idea of having some kind of cap I think is only reasonable for those—for those entities in fact that have very high cost. And I think the Congress directed us to somehow try to bring those costs into some reasonableness parameters.

Mr. CANSECO. But it seems by reading the Federal Register and your report that it was made by pure discretion as to what reasonable and proportional was, that there was not actual factual process that went into it other than being esoteric in its nature. Is that true?

Ms. RASKIN. No. I agree that "reasonable" and "proportional" are quite esoteric, but essentially what we tried to do is anchor those terms with the results of the surveys that we conducted and as I have described the process, it has been quite thorough in trying to understand what those costs and the range of those costs might be so that we can somehow anchor those very vague terms.

Mr. CANSECO. In the past, has the Fed been given such discretion before on rule writing and if so, what was the outcome?

Ms. RASKIN. That is an interesting question. I can't speak to the whole realm of interpretation that the Fed has been asked to do over its long history. But I can state from the perspective of statutory interpretation always that it is a complicated task and that it is sometimes very difficult to get meaning around words.

Mr. CANSECO. Thank you very much, Governor. My time has expired.

Chairwoman CAPITO. Thank you. Mr. Carney?

Mr. CARNEY. I am new at this. I have two lines of questions that are similar to others that you have answered today. I don't know that—I think I am a little bit more confused than I was when I walked in the room about cause and effects here. The gentleman from Ohio, my freshman colleague there, who is the CPA, had questions and I thought they were right on point and I will try to be direct. Do you feel like you understand all the costs involved in these transactions?

Ms. RASKIN. I feel that we are in the process of collecting all the costs that could be involved yet.

Mr. CARNEY. You mentioned that in your testimony—I apologize. I haven't had a chance to get all the way through, but on page seven that you reached out and you have asked for comment on other costs, other costs that should be allowable. Have you gotten any preliminary feedback on that?

Ms. RASKIN. We have gotten quite a lot of feedback, about 7,000 comments worth of feedback in fact and it is probably premature to comment on it. Yes.

Mr. CARNEY. Fair enough. So we have thought a lot about fraud, do you have a sense that you are allowed to consider all the costs associated with fraud? We talked about fraud prevention. I thought I heard you say or somebody say that it does not include losses—does not include other, detection, maybe other things. I don't know exactly that. Can you comment on that, please?

Ms. RASKIN. Sure. And it is interesting because the statutory language for fraud, fraud losses with that piece essentially says that the Board may allow for an adjustment to the fee amount if, and I am skipping over pieces to just to give you the relevant sections, if the issuer complies with the fraud-related standards established by the Board which standard shall and then it tells us what those standards need to do.

So it says those standards shall be designed to ensure that any fraud-related adjustments of the issuer are limited to the amount described in clause one above, which are the costs of preventing fraud and takes into account any fraud-related reimbursements. We have to figure out what that means and take into account any fraud-related reimbursement. And then we have in parentheses including amounts from charge-backs received for consumers, merchants or payment card networks in relation to electric debit transactions involving the issuer.

So the question of fraud losses, if you interpret—takes into account to mean you look at it, that is one interpretation in terms of what you do with those fraud-related losses or just takes into account means to track it. In other words, don't include it in your determination of standards for the fraud prevention cost. So, this is difficult stuff and I—

Mr. CARNEY. So it, so do you feel like you understand it clearly enough to make the kind of judgment that the Congress is asking you to make there?

Ms. RASKIN. Again, I really want to underscore that I understand how important it is to get this right. But then again, it is Congress who will need to—with the same concerns that we have, and if it is something that you are concerned about essentially and you want us to take more time, we would do that.

Mr. CARNEY. And touch a little bit on fixed costs. I am not sure I understand what they are, I understand what they are in other contexts, the development of systems, capital investments, all that kind of thing not able to recover this cost in this context. Is that correct? Under what? What part of that includes—I read your comment there on page seven or eight. What part of that includes ongoing maintenance if you will of existing systems?

Ms. RASKIN. The overall standard just refers to reasonable and proportional to the issuer's cost. Okay. So that is the general bracing which by any definition would look to be fairly broad. First, it would have to be reasonable and proportional, but the first look in terms of cost appears to be broad in the statute.

If you read through the statute, we are also directed to take those costs into certain kinds of consideration. So in other words, we need to consider the functionally of the debit transaction and

compare that functionally with the functionality of checks. And so, we read that to mean that the costs that we collect as being relevant need to be essentially moved through that functional—

Mr. CARNEY. My time is up, I see, and I haven't gotten to my other question, but thank you very much.

Chairwoman CAPITO. Thank you. Mr. Luetkemeyer?

Mr. LUETKEMEYER. Thank you, Madam Chairwoman. Ms. Raskin, do you realize that this morning here, you given very conflicting testimony a number of times with regards to your interpretation of fixed costs. You agree with Congressman Canseco and Congressman Hensarling in their comments with regards to previous statements made in December. With regards to Mr. Renacci, you allow that you are taking surveys that allow for fixed cost to be considered in your surveys and you are doing everything, I quote, "doing everything to get this right."

Yet in your written testimony, your written testimony says the proposed rule interprets the incremental cost to be an exclusion of fixed costs would be required. Which one is it?

Ms. RASKIN. It is actually both.

Mr. LUETKEMEYER. No, no, no. Yes or no? Which—we are not going there—take up my 5 minutes—very quickly. Which one is? Is it are we—are these guys right? Is your verbal testimony correct? Or your written correct?

Ms. RASKIN. I am afraid I don't see a conflict and I could—

Mr. LUETKEMEYER. I am sorry. I see a tremendous conflict when you say in your testimony, your written testimony says, "Proposed rule—incremental cost—dot, dot, dot—the inclusion of fixed cost is required." There is a huge incongruence there.

Ms. RASKIN. Fixed cost may be considered for purposes of the fraud protection adjustment and maybe that helps.

Mr. LUETKEMEYER. Okay. Moving on. Have you done any studies yet to show how the banks are going to make up the losses that they are going to incur as a result of not being able charge an appropriate fee for these interchange fees?

Ms. RASKIN. No, we have not been—

Mr. LUETKEMEYER. Okay. As a regulator, does it concern you at all that the industry is going to lose $12 billion? That your bank is going to lose $12 billion of income at a time when a lot of the big ones in fact are in very tenuous situations. Does that concern you at all as a Fed regulator?

Ms. RASKIN. We always look at the loss of revenue streams as a potential safety and soundness matter. So, yes, our examiners would look at this very carefully depending on the particular profile of the bank.

Mr. LUETKEMEYER. How are you going to mesh what you are doing with this rulemaking with what your regulators are going to do?

Ms. RASKIN. We are going to mesh it very carefully so that we are going to make sure that once a rule is finalized, that rule is put into examination guidelines and spelled out very carefully for examiners that need to make—

Mr. LUETKEMEYER. Are you going to make adjustments for your banks with regards to the amount of income they are going to lose when you go examine them?

Ms. RASKIN. I am sorry. Did you say adjustment?

Mr. LUETKEMEYER. Yes. And whenever you look at them and their inability to increase their capital accounts, increase their profit or loss for the year. Are you going to make any adjustments?

Ms. RASKIN. We will take this particular set of regulations, should they be made final, into consideration in our examination process.

Mr. LUETKEMEYER. Okay. I have—we are going down a very slippery slope here with this. And a minute ago, you made a comment something to the effect that you agreed that we need to be setting these prices so we keep those who are charging too much, from charging too much. But basically you agree that we are price—and as a government entity to set prices on the private sector is unconscionable.

We are taking a huge step down a road we don't want to go to, because suddenly we are starting to treat the banks and the people who do the interchange fees whether Visas, MasterCards or whatever as a utility company instead of a private sector entity.

Do you agree with that statement?

Ms. RASKIN. No, I don't think that a public utility—I don't see a—

Mr. LUETKEMEYER. You don't see setting the prices for a business by the government is the same as setting prices for a utility company?

Ms. RASKIN. I don't see this as price fixing.

Mr. LUETKEMEYER. Just a minute ago, you said that. You said it just a minute ago. You said that we need to set this price for those who are making more than this average, need to bring their prices down.

Ms. RASKIN. I possibly misspoke, but I don't view what we are doing as setting prices. We have been told to set standards and those standards had been promulgated and put forward—

Mr. LUETKEMEYER. I have a real concern with the direction of this entire bill, obviously. But what we are doing here is the same as the credit card company or interchange fee company here, we are not going to allow part of your cost of operation. Just like telling a pizza place that delivers pizzas, we are not going to allow you to put into your cost to your pizzas, the person who drives the car or the car itself, all we are going to let you do is charge for the gas. And that is what we are doing here. And that is wrong.

Where are we going with this? Have you looked at the possibility of what is going to happen if we don't allow debit cards for a lot of folks, especially community bank folks, instead of using debit card they use the credit card.

Ms. RASKIN. That is—

Mr. LUETKEMEYER. That is not even going to solve the problem of cheapening the ability of the merchants to lower the price to products. We are not accomplishing—are we?

We are shifting one way of payment to another. Would you agree with that?

Ms. RASKIN. This—

Mr. LUETKEMEYER. Yes or no?

Ms. RASKIN. This is something that the Congress has in its—

Mr. LUETKEMEYER. Are you taking that into consideration?

Ms. RASKIN. No.

Mr. LUETKEMEYER. Okay. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you. Mr. Perlmutter?

Mr. PERLMUTTER. Thanks, Madam Chairwoman. And Governor, let me just say I have a lot of sympathy for the position that you are in. The Durbin Amendment was added at the last minute. It has been a controversial subject—interchange fees, merchants with some legitimate points about their margins getting squeezed as the price of gas goes up but the interchange fee remains the same. They have some legitimate point.

On the other hand, I feel like you are in a box because you have been prescribed with language that really makes it, in my opinion, impossible for the network and the banks and the credit unions to recover their costs. But forget about profit, recover their costs.

So, you are in a pickle, and I appreciate my friends on the other side grilling the heck out of you, but it isn't your fault. Okay, you have to do what you have to do and we gave you 9 months to do it.

The beginning of the rulemaking says, "The Board shall prescribe regulations in final form not later than 9 months after the date of the enactment of the Consumer Financial Protection Act of 2010."

So, I just want to say, I appreciate the effort that you are making but I don't think you have been given all the tools or the time necessary to come up with reasonable and proportionate, you guys may call it esoteric, those are terms of art that are used every day and every contract in statute across the country. But you have to have time and the ability within the statute to figure out what reasonable and proportionate really means. We didn't give that to you.

So, I am one who is on the side of some delay here. Probably, Congress has to go back and take a look at this, that is my opinion, because of the language in here was done in Conference Committee. I think it should have been opened to much more discussion and I would like to introduce into the record, if I could, a letter from TCF Bank. Thank you very much.

And I would like to yield the balance of my time. I have lots of questions, but you are just, in my opinion, in a pickle. We have to—the statute doesn't deal with what was always brought to my attention which was the margin the merchants were able to deal with in escalating price scenarios. It goes much further than that and I would like to yield my time to Mr. Carney. So, you can ask your second question.

Mr. CARNEY. Thank you, gentleman from Colorado for that. And really quickly, at least there was some discussion earlier about looking into bank fees, revenue, and the effect on consumers. Could you comment on that at all again?

And in particular, whether if you curtail fee income in one area, an institution is going to look for it somewhere else. A lot of that happened as a result of the Card Act and now we have this provision here which could result in negative effects on the consumer.

There was some discussion about that earlier, and I would just like your thoughts on this, if you would?

Ms. RASKIN. The market dynamics of these are really pretty complicated and unclear. So, it is not exactly perfectly quantifiable re-

garding what is going to happen and then what magnitude anything would happen.

All I can really do is identify some of the potential consumer effects and I think these are consumer effects that you probably are aware of. But I really caution it by saying that I don't know the magnitude of what—

Mr. CARNEY. Right, is this something that you are looking at—there was some discussion about it earlier and you mentioned that it was something that you are looking at and—

Ms. RASKIN. We always look at it. It is very important to understand the effect of any regulatory change on consumers and especially in this area. So, yes, we do look at it, which isn't to say that you will find the word "consumer" necessarily displayed in the terms of the statute.

Mr. CARNEY. Thank you.

Chairwoman CAPITO. Mr. Pearce?

Mr. PEARCE. Thank you, Madam Chairwoman. And thank you, Governor. I think our friend from Colorado got it just right. You are in kind of a pickle here.

In your discussion of cost, are the overdraft risks associated, are they considered at all, the overdraft of the debit cards, are they considered at all in the costs?

Ms. RASKIN. I am not exactly certain what we did on that. My recollection is that might have been something that we put out for comment but I think I need to get back to you on that.

Mr. PEARCE. No, because I suspected it is not included, which is going to be, I am seeing headshakes through the group behind you, which then leads me to the same discussion my friends have been having.

How do we get it right if we aren't considering one of the most basic risks that are associated with the debit card? And as I—two amazing things happened last year along the campaign trail. The first and most amazing thing is that a publisher of a newspaper gave me a book, a big thick book titled, "Atlas Shrugged."

The second amazing thing was I actually read some of it and I was amazed that sitting here listening to your reading of the law of what constitutes fraud and doesn't sounded just like page 864 out of this book from the 1950s talking about the government getting into the manipulation of the market.

And so as I sit here and think, the market should be deciding who can run their affairs very well. They don't have to read that big, thick book. And they don't have to target it and get it right.

They need to get it right or go broke if they don't figure out the costs. And so, we are asking you as the government to—and I will use your words, set standards, which in effect sets the price. You seem to want to not allow the word to be used. So, I will—so you are going to set standards, which then sets the price that should be set by markets.

And in that setting of standards, you, one of the deciders is not even certain that one of the huge risks and because people do, they overdraft and they can't get the banks right now. Tell me if they don't have any protection against it. No ability to reclaim that.

If you have a comment, I would welcome it, but I suspect you are just in a pickle, I think like our gentleman said. I will be quoting you the rest of the day, sir.

Do you have any comment? Is that a fair concern on the part of the banks that they're stuck with the overdrafts without being able to go back and get it? And by the time they take six overdrafts in a year, now they have to set up a counseling service in order to talk to the people who are overdrafting so that they might see the wickedness of their ways and setting out the banks in business of religion and correcting people from their sins. And so, this is what we get ourselves into when we allow the government to run the markets.

Ms. RASKIN. Essentially. I will go to page 864 and do a close reading of it, but I do want to make sure I answer the question on overdrafts correctly, and we will go back to the office and get a good reading of that and let you know.

Mr. PEARCE. You see, my concern is that the Federal Reserve with all of its expertise in reading a law and threading a needle, my concern is that it is going to come up something like your index on inflation, you declare that inflation went up 1.6 percent last year and you have this tortured explanation of why it only went up 1.6 percent.

But when I read the paper 2 days ago, I saw that gas went up 69 percent, oil 127 percent, gold 60 percent, corn 78 percent, soy beans 43 percent. And I suspect when we get a standard, it is going to not include many of the risk factors; it is not going to allow businesses to thrive.

So, they are going to start shutting off customers from access. We are going to unbank more people than we bank, all in the name of protection of consumers, which has been arrived at by this reading of the rules that I heard just a couple of times ago when we are talking about the fraud protections and the difficult stuff of getting this right.

And with all due respect, I suspect that we are manipulating things to an extent here in Washington that American people know is not correct. They know that they are paying more for food. They know that inflation is happening. But they can't get anyone to confirm it. And whether they are going to see their cost, their ability—increase without understanding why.

And the frustration that we are seeing across the America that is causing people to walk around in the streets and complain loudly is going to continue. And we are going to be up here setting standards and making sure we follow exactly the definitions that will make everybody feel really good.

So, you are welcome to respond and to disagree or whatever. Thank you.

Chairwoman CAPITO. Do you have a comment or—

Ms. RASKIN. No, I obviously take what you are saying very seriously and you want to underscore that Congress has quite a bit of prerogative in terms of rulemaking and lawmaking and this is the law. And if there are changes that you would like to see in it, we will of course faithfully execute them.

Chairwoman CAPITO. Thank you. Mr. Welch?

Mr. WELCH. Thank you very much, Madam Chairwoman and Ranking Member Maloney. I appreciate your willingness to let me participate briefly. I was the sponsor of this legislation in the House. It eventually passed in the Senate and was part of the Conference Committee report. But there are two basic questions as I understand it.

Number one, is it necessary to provide some regulation? And then, number two, is the regulation that is being proposed doing the job that needs to be done?

We had that debate last year about whether there was a need for regulation, and my view was that there definitely was a need for it. I was hearing from one merchant after another who had no control whatsoever over the prices they were being charged.

It was becoming an increasingly large cost of doing business. They acknowledge, as I do, that credit cards and debit cards are very good and very important. They are good for consumers because they are convenient. They are very good for merchants because they are secure transactions.

But what happened, as I understand it, is that without any regulation whatsoever, the charges that have been assessed to our merchants are the highest in the world. And that is I think what drove—was the impetus of Congress passing this. I think there had been some very good questions asked by members on both sides about how you came to the rule that you came to.

I heard you say that your examination was thorough and comprehensive and you are going to submit at the request of the ranking member the chronology of what you did and how you did it, so that the members are going to be able to come to their own conclusions about that. But the one thing I want to ask about is in—on the debit card, that is essentially a direct transfer from a person's bank account, correct?

So, is there much of a fraud risk there?

Ms. RASKIN. That is what we need to look at carefully, because we have been receiving comments on precisely that point and quite a number of comments.

So, I probably want to reserve judgment from the perspective of making sure that we give all those commenters the chance to be heard. But, essentially, we are looking carefully at that question.

Mr. WELCH. The debit card it comes right out of my checking account, correct?

Ms. RASKIN. Correct.

Mr. WELCH. And if I have overdraft protection, which I now have to sign up for that—is that debit will be paid and then the bank will assess a fee to me on my account for the overdraft, correct?

Ms. RASKIN. As I understand it.

Mr. WELCH. Mr. Pearce, I think, made some good points about the market. But my understanding is the point of contention of—is whether the market in fact was free and open on the pricing side and historically, is it the case that when debit cards were originally introduced, the transaction fee was very, very small. The Maestro network was only charging $0.10 when the Visa network was charging like a $1.30 on a $100 transaction.

Is that more or less correct?

Ms. RASKIN. That is what I understand, yes.

Mr. WELCH. And what Visa did quite effectively from a self-interest standpoint is they raised the fees in order to encourage banks to offer more and more of their cards and penetrate the market. Is that more or less right?

Ms. RASKIN. I believe so. But, now, you clearly know more history on this than I do.

Mr. WELCH. So, you have the credit cards—the debit card was not so much competing with the checking account where there is no charge to the merchant. They get 100 cents on the dollar. They were competing with credit cards where the fees were higher. And this was allowed to go on without any push back. Merchants have literally no power individually to be able to negotiate a price.

So, we got to this point where the charges to our merchants, these are mom-and-pop stores as well as the Wal-Marts and Home Depots, became the highest in the world. Do you understand our charges are the highest in the world?

Ms. RASKIN. I understand that to be the assertion, yes.

Mr. WELCH. And I know that the Australian study came to no specific conclusion about whether the consumer benefited when the prices went down and you explained, as I understood it, that there were other variables that you couldn't possibly take into account.

But normal economics, if you are—you have one gas station on a corner and there are three competitors, most of us when we are filling up with gas, go to the one that is a penny or two cheaper. And is there any reason to think that wouldn't happen, that competition wouldn't force—I see my time is up.

Yes, thank you, I yield back.

Chairwoman CAPITO. Thank you. Mr. Duffy?

Mr. DUFFY. Thank you, Madam Chairwoman. Governor Raskin, first of all, I appreciate you being here today.

And I appreciate the number of people who kept coming to my office on both sides of this issue to explain their position. It seems like it hasn't stopped the last 2 weeks.

I guess I have a concern about what we are doing here, that we are going to do here, that we are going to set a price in a marketplace by way of Congress between $0.07 and $0.12.

I believe that the free market should be allowed to work. And I don't think we are doing that here, and as I have talked to a lot of different merchants out there, when we talk about Congress potentially stepping in and mandating prices or profits or salaries for their companies or CEOs, they take great offense to that. But they seem to advocate for Congress stepping in and advocating for price fixing in regard to Visa, banks, and their fees.

My concern is, in Wisconsin we have, especially in my district, quite a few small community banks and they have expressed great concern over what we are doing here. And when I look at the reports or the analysis that have been done, it is my understanding that you have provided a survey to 63 large banks, is that correct?

Ms. RASKIN. I want to get you the exact numbers—

Mr. DUFFY. Or is it fair to say that you didn't really do any of these surveys with small community banks?

Ms. RASKIN. The surveys that were done of issuing banks were done of the institutions that would be covered by the statute, and remember, the statute exempts institutions of $10 billion or less.

Mr. DUFFY. But I think it is going to—

Ms. RASKIN. —$10 billion or less were not included in the survey.

Mr. DUFFY. Right. But I think it is clear from your testimony and from the comments of Mr. Bernanke that we are not so certain that they are going to be excluded or this law is not going to impact them. It seems quite possible that our small community banks are going to be impacted by this rule, but then you haven't included them in your survey. Is that right?

Ms. RASKIN. They have not been included in the survey.

Mr. DUFFY. Right.

Ms. RASKIN. And if you recommend, or suggest, it is certainly possible for the exemption that exists in the interchange fee portion of the law to also be carried over pursuant to congressional direction to the network routing and those restrictions.

Mr. DUFFY. But this could affect our small community banks. And having that potential impact, the only thing that is beneficial is that we reach out to them and try to get their input by way of a survey?

Ms. RASKIN. Clearly, the impact on small banks, I think, needs to be understood.

Mr. DUFFY. So, it is fair to say then it might be beneficial to have more time to talk to our community banks and say, "Let's take a look at what kind of impact this is going to have on you."

Ms. RASKIN. I am happy to share the methodology that we have followed. And you can look carefully at the surveys and make it—

Mr. DUFFY. Let me ask you something, in the time that is remaining, can you get sufficient information from our community banks by way of a survey?

Ms. RASKIN. In the time that is remaining, I would argue—

Mr. DUFFY. No?

Ms. RASKIN. It depends on what comments we have received today. And we have a couple more days.

Mr. DUFFY. Now, there are a lot of folks who have suggested that if the structure of the fee is changed, we are not going to have free checking, and there are going to be more charges to consumers in the banking side.

And then we will also argue that on the consumer side, prices are potentially going to go down, because our merchants are going to save maybe 0.5 percent, or 1 percent, or 2 percent per transaction. Is that a fair assessment of how the argument is going?

Ms. RASKIN. There are arguments all different ways in terms of what the ultimate impact is on the consumer.

Mr. DUFFY. Do you think that Congress should step in and mandate that merchants—that Home Depot and Wal-Mart and Target—should be forced to reduce their prices by 1 percent or 1.5 percent if this law passes? Is that a proper role for Congress?

Ms. RASKIN. That is Congress' decision. It is certainly not the Federal Reserve's.

Mr. DUFFY. Okay. But it is the Federal Reserve's obviously by way of Congress to look at how this interchange fee affects merchants and banks and come up with a pricing structure that you guys think is appropriate.

Ms. RASKIN. That reflects the law that we have been given.

Mr. DUFFY. And is it fair to say that you capped the top fee at 12 cents?

Ms. RASKIN. We have put out alternative approaches, and that 12 cents fee represents the 80th percentile in the survey that we have conducted of average variable cost. And so, 80 percent is the—of the people, of the institution—

Mr. DUFFY. Have you capped that at 12 cents?

Ms. RASKIN. Nothing has been done yet. This is a proposal.

Mr. DUFFY. Do you anticipate it being capped at 12 cents?

Ms. RASKIN. This is a proposal. And we are taking comments.

Mr. DUFFY. So, it could be capped at 30 cents or 44 cents?

Ms. RASKIN. We are looking at comments as they come in.

Mr. DUFFY. Okay. I yield back, Madam Chairwoman.

Chairwoman CAPITO. Thank you. Do you have any questions, Mr. Manzullo?

Mr. MANZULLO. My only question is a follow up on what Congressman Duffy spoke about. You acknowledge in answer to his question that the smaller and community banks are impacted. And yet, you neglected to get their input in the first place.

Wouldn't that lead you to the conclusion that the results are flawed based upon your own testimony, Governor?

Ms. RASKIN. It is certainly an honest observation. And in fact, it is the case that when the survey went out because of interests of complying with the statutory deadline that Congress provided—

Mr. MANZULLO. So, you were under the gun and you rushed to judgment on this issue?

Ms. RASKIN. I don't want to say we rushed to judgment because we are trying to proceed carefully and we have had 9 months to do it. But it is very complicated—

Mr. MANZULLO. I understand. But why couldn't you have simultaneously brought in the community bankers and other stakeholders with all the resources that you have as a Fed and at least get their input on this?

Ms. RASKIN. We are getting their input. We talk to them frequently. They have—

Mr. MANZULLO. But not upfront.

Ms. RASKIN. They have submitted comments. And yes, there have been—

Mr. MANZULLO. But you didn't survey them.

Ms. RASKIN. We didn't survey them because Congress exempted them from the—

Mr. MANZULLO. That doesn't make any difference. Your job was to figure the impact on the consumer, and on the retail industry, and on the banking industry. And just because they were exempted, it does not mean that they were impacted. I think that your survey and your studies are flawed and you should miss that.

Ms. RASKIN. Yes, I am not ready to admit that. I think we have faithfully executed upon a very complicated—

Mr. MANZULLO. I would disagree because you would have stated in a direct answer to Congressman Duffy that those smaller banks are impacted by this legislation. And yet with all the hundreds and thousands of people that you have on hand there in 9 months that you don't have the time, or the desire, or the scholarship, or the

interest to examine other people, that would be the community banks that would be impacted by this.

People make mistakes all the time. If you don't have all the information before you and if they were not interviewed and questioned in the first place, why would you then take a look at their comments on the study as to which they have no input in the first place? Why not disregard their comments as they come in, then you would be consistent?

Ms. RASKIN. Based on the comments we have today, we have received plenty of information from small banks and small credit unions, and their particular perspective is being taken into account.

Mr. MANZULLO. The problem is this, you came to a conclusion without them being involved in the process in the first place. And now, they are playing defense. They have to come back and they have to show through their studies and—through their studies without being given the opportunity that the larger banks were given.

That is no way to come up with a regulation, Governor. It is flawed. And it is disingenuous.

Ms. RASKIN. I don't mean to be disingenuous. I am a former—

Mr. MANZULLO. You are not disingenuous. The study was just disingenuous. I think the numbers here we are looking at and I think what America is looking at is a study that is fair and balanced, takes into consideration all the stakeholders, and then comes to a conclusion as to what that charge would be.

I have the same people coming into my offices as Congressman Duffy. Some are saying it is too high. Some are saying it is too low.

What the incredible effect of business people being pitted against each other in a way I have never seen before in my 19 years of Congress. I have never seen this before with a criticism that has been leveled at it. And a lot of it has to do with the fact that the people, that a large group of people, the banks under $10 billion were excluded from this.

Their bigger concern also is that because they were exempted, they could go on there and charge whatever they want. That doesn't help them. They come under the force and pressure of the price that you have set.

And if they truly have expenses that are greater than what you have set, then they are going to be in the position of the larger banks trying to woo away the customers of the smaller banks saying, "Oh, by the way, our swipe fees are cheaper. And the way to get cheaper swipe fees would be for you to move your accounts to the larger bank."

I am just saying that those are some of the arguments that we are hearing. And if they have been—you guys are shaking your heads "no" back there. But maybe you are a part of the people who had been questioned.

But we are talking about the people who were not questioned and who wanted just a simple opportunity to be able to state their case even if, in fact, they were wrong doing so wrong on the facts they would have given you. Thank you.

Chairwoman CAPITO. I want to thank the Governor for her patience for pushing back when we began and for her diligence in an-

swering the questions. Without summarizing, and I think we still have a whole lot of questions left. And so, we are going to have another panel. So, I will dismiss you from the panel. And thank you very much.

Ms. RASKIN. Thank you.

Chairwoman CAPITO. The Chair notes that some members may have additional questions for this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place her responses in the record.

We will do a transfer quickly.

Okay. Sorry about that.

I would like to thank the panel for their patience. And we are going to begin the second panel.

I think the first witness is the guest of the ranking member. And I recognize her to make an introduction.

Mrs. MALONEY. Thank you so much.

I am honored to represent Mr. Prentzas. And I thank you for giving me the opportunity to introduce my constituent from the great borough of Queens, Gus Prentzas.

Gus owns two businesses in my district: Pavilion Florals; and Life & Health Fitness, a health club in Astoria. He is also president of the Long Island City Business group and an active member of the Queens community. And he has been a small-business owner for over 20 years and is actively providing jobs and services in the district I am honored to represent.

So, I welcome you Gus, and all of the panelists today. And I very much look forward to all of your testimony. Thank you.

Chairwoman CAPITO. We also have another guest. The next witness is a guest of Mr. Luetkemeyer. Would you care to introduce your guest?

Mr. LUETKEMEYER. Thank you.

Thank you, Mr. Chairman. My guest today is Mr. Kemper. I am pleased to introduce him. He is the chairman, president, and CEO of Commerce Bancshares Incorporated, an $18 billion regional bank holding company based in Missouri.

He began his career with Commerce in 1978 as vice president of commercial lending at the Commerce Bank of Tennessee. He was president of Commerce Bancshares in 1982 and held a wide variety of senior positions, being named chairman, president, and CEO of Commerce Bancshares in 1991.

David is a graduate of Harvard University. He received a masters degree in English from Oxford University and an MBA from the Stanford School of Business. Dave also served in an advisory capacity to Enterprise Holdings and Bungee North America.

In his spare time, he is the vice chairman of the board of trustees at Washington University and a member of the board of trustees at the Missouri Botanical Garden and the Donald Danforth Plant Science Center.

Mr. Kemper is also the past president of the Federal Advisory Council of the Federal Reserve. As you can see, David is involved in the financial services industry in a number of different capacities. I appreciate him taking the time today to be with us, and I look forward for his testimony.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

With that, I think we will begin with Mr. Prentzas. And we will proceed, as I said earlier, we would like to keep the initial comments to 5 minutes so we can have time for questioning. So, when you hear this, it means try to wrap it up. You can see the light on your table there.

So, Mr. Prentzas.

STATEMENT OF CONSTANTINO (GUS) PRENTZAS, OWNER, PAVILION FLORALS, AND LIFE & HEALTH FITNESS

Mr. PRENTZAS. Madam Chairwoman, thank you.

Madam Chairwoman, Ranking Member Maloney, and members of the subcommittee, thank you for inviting me to share my views regarding payment card swipe fees. My observations are based on my experience as a small business owner in Astoria, New York.

From my perspective, these fees, for both credit and debit cards, have long been out of control. In fact, they have grown so large, so quickly, that I was forced to lay off an employee.

While I understand that the Durbin Amendment only addresses debit card and not credit card fees, I believe this is at least one step in the right direction.

Therefore, I fully support the debit card rules proposed by the Federal Reserve and any other efforts to help curve swipe fees.

I own some small businesses in Astoria, New York: Pavilion Florals is a flower ship I have owned since 1998; and I have owned Life & Health Fitness for the last 4 years. Both businesses accept credit and debit card payments.

The health club is particularly dependent on credit and debit cards as a form of payment because we charge monthly membership fees and allow our members to set up automatic payment plans via credit and debit cards for their convenience. For the health club, approximately 78 percent of our payments were received by credit and debit cards.

I pay a monthly interchange fee of approximately $380. And I pay roughly the same amount for the flower shop even though the health club revenues are double the amount. And I note that the interchange I pay is not only based on the revenues I get, but also a percentage of the sales tax I collect, money that I don't even keep.

These fees have grown at an incredible rate. Indeed, they have doubled in the last 2 to 3 years alone. Our prices certainly have not doubled over the same period. So, there is no question that these fees themselves are out of control.

In fact, these fees have increased so much, so quickly, that I was recently faced with an unfortunate choice at my flower shop. I could pay these fees or lay off an employee. I was forced to lay off an employee because there were no realistic alternatives to accepting credit and debit cards.

Visa and MasterCard are another form of currency and we must accept them like we take cash. This is one reason why I believe that the debit card fee limit is a step in the right direction. Policymakers need to begin to see cards for what they really are—a new form of currency.

Approximately 60 percent of the flower shop's sales are paid by credit and debit cards, and 78 percent at the health club. We expect the percentage to increase as more young people patronize our stores.

Overall, for my small business, interchange fees have grown more rapidly and significantly than all other expenses. And the fact that I cannot control interchange fees the way I can control other expenses is a huge problem for me.

But our interchange fees are what they are. And we have absolutely no ability to change them or take our business elsewhere.

Finally, I want to share my experience dealing with credit card charge-backs to make clear that merchants like me are on the hook when problems like fraud come up.

A charge-back is when the card company doesn't give me the money for a sale even though it was properly authorized. My flower shop deals with high-value charge-backs.

In fact, charge-backs I get at the shop are about one-third of the amount of interchange fees I pay. That is a big loss of funds on top of what I am already paying, and it offends me when the card companies claim they guarantee payment. Nothing is guaranteed.

I can do everything right and still lose a sale along with a customer who has left my store with the flowers that I will never see again. There have been times when I checked an I.D., obtained a security code, and checked a zip code to make sure everything was authorized and in order. But when the card turns out to be stolen, I have still been charged back for a sale and lost the money on the goods. This is blatantly unfair. And losing an entire sale takes a big bite out of my business.

Not only that, I have to pay the interchange fees on the charge-back amount. Once again, I am paying for fees I don't get.

In conclusion, I feel fortunate to be able to serve my community as an owner of two small businesses in Astoria. The increases that I am seeing in credit and debit card fees are unreasonable.

If interchange fees, even debit card fees alone, were reduced to a more reasonable level, I would have the revenue that I could use to hire more people, offer discounts, and cut prices.

I ask you to please support the Federal Reserve's proposal and turn your attention to ways to bring some needed changes to credit cards as well.

I thank you again for inviting me to testify. And I am pleased to answer any questions you have. Thank you.

[The prepared statement of Mr. Prentzas can be found on page 174 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. Frank Michael, president and CEO, Allied Credit Union, Stockton, California, on behalf of the Credit Union National Association.

Welcome.

STATEMENT OF FRANK MICHAEL, PRESIDENT AND CEO, ALLIED CREDIT UNION, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION (CUNA)

Mr. MICHAEL. Thank you, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee.

Chairwoman CAPITO. You need to keep your microphone on a—

Mr. MICHAEL. Thank you very much for the opportunity to testify at today's hearing.

My name is Frank Michael and I run an $18 million—that is "million" with an "M"—Credit Union in Stockton, California, called Allied Credit Union.

We are not Bank of America. We are not Visa. We are not 7-Eleven. We are small. And we strive to fulfill our mission to serve our members every day. Our members want access to their checking accounts which means the ability to use a debit card. In fact, 1,100 of my 2,300 members use our debit cards.

Section 1075 of the Dodd-Frank Act will make it more expensive for my members to access their checking accounts. And I know that this is not what Congress intended because Congress included an exemption for institutions like Allied.

When the law was passed, the chief proponent said credit unions like mine would not lose any interchange revenues that they currently receive. We were skeptical about this statement in July.

And unfortunately, the proposed Federal rule makes it clear that will not be the case. And here is why. There is no guarantee that all the payment networks will operate a two-tier system. Even though Visa has said it would, it is not clear when it would start, for how long, or under what conditions it would do so. Visa is just one of several payment card networks. Who is to say the others will operate that way?

Even if they do, with the passage of time, market forces will cause at least some convergence of prices for the two-tiers and the absence of full implementation of the exemption that Congress intended.

In our view, the Fed's proposal errs by failing to include a provision enforcing the small issuer exemption. The Fed has the authority to write rules for innovation of interchange standards. And we would hope that the committee would encourage the Fed to use its authority to enforce the exemption and protect small issuers. In the absence of meaningful protection, credit unions are rightfully concerned about the potential impact that the regulation's other flaws will have on their member institutions.

At its most basic level, the Fed's proposal says that if you want to issue debit cards, you must do so under a set of government-imposed restrictions that require the program to operate at a loss because many of the costs of operating debit cards have not been considered by the Fed under the statute. Even for not-for-profit credit unions, the idea of government requiring the operation of the program at a loss is abhorrent. It flies in the face of safety and soundness.

Under the current proposal, we are going to lose money on every transaction. The only real question is, how much? If the carve out is entirely ineffective and credit union interchange fees converge on the rate set for very large institutions, credit unions will find their net income reduced by $1.6 billion. That represents about a third of credit unions' recent net income. Such a reduction in income will lower capital of debit card issuing credit unions by 10 percent after 6 years absent any reaction by credit unions.

However, that is not where the story ends, certainly not for credit unions. The real problem with this proposal will be its impact on its consumers, including consumers on the margin who may no longer have access to free checking. Credit unions cannot absorb this lot. Let's face it, our regulator will not allow it.

We are not-for-profit institutions but we are subject to safety and soundness standards. Regulators will expect credit unions to maintain current net income levels and replace the lost revenue because credit unions must maintain at least a 7 percent net worth to be well-capitalized. The choices facing credit unions are relatively straightforward and carry a consistent theme: charge more to members for services or reduce the services that members are offered. Either way, it is a bad deal for members.

CUNA surveyed its members: 91 percent of credit unions offering debit cards anticipate they will make changes to their rates fees and/or services as a result of the negative impact of this regulation. The four changes most often cited are: number one, increase debit card fees; number two, increase NSF fees; number three, eliminate free checking accounts; and finally, number four, lower the deposit rates.

If the exemption for small issuers prove completely ineffective, the $0.12 rate would require credit unions to impose an annual fee in the range of $35 to $55 a card, a transaction fee within the range between $0.25 to $0.35, or some combination of the two. In order to maintain the pre-reform revenue, there would be new fees for our members.

The timeline for formalization and implementation is very short and the consequences are potentially devastating for small financial institutions and consumers. There are problems with the rule that the Fed can and should address but there are significant statutory problems that Congress also needs to fix.

We urge Congress to stop, study, and start over. Enacting the moratorium against implementation of the Fed's interchange rules will provide time for the Treasury to study the operational impact of the regulation on all issuers including small issuers, the impact on the safety and soundness of depository institutions, and the impact on consumers.

Then the Fed should start its rule-making process again, taking into consideration the results of the study and set standards for a rate which is proportional of full cost and risk of the transaction.

Madam Chairwoman, it is important for Congress and the Fed to get this right, otherwise consumers face high costs for financial services and they aren't likely to recover those costs from the merchant. We ask Congress and the Fed to stop, study, and start over. Thank you very much for this opportunity to testify in today's hearing. I am pleased to answer any questions you may have.

[The prepared statement of Mr. Michael can be found on page 160 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. Michael.

Our next witness is Mr. David Kemper, who has already been introduced. He is the chairman, president, and CEO of Commerce Bank, on behalf of the American Bankers Association and the Consumer Bankers Association. Welcome.

STATEMENT OF DAVID W. KEMPER, CHAIRMAN, PRESIDENT AND CEO, COMMERCE BANK, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION (ABA) AND THE CONSUMER BANKERS ASSOCIATION (CBA)

Mr. KEMPER. Good afternoon, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee. My name is David Kemper, and I am the chairman and CEO of Commerce Bancshares. I am pleased to be here today on behalf of Commerce Bank, the American Bankers Association, and the Consumer Bankers association.

Commerce is a mid-sized Main Street bank founded in Kansas City in 1865. Our 5,000 employees serve customers across 5 Midwestern States. Commerce is one of only three banks in the country to hold Moody's highest rating for financial strength. Last year, our business and financial strength was recognized on the Floor of the House by Congressman Emanuel Cleaver and former Financial Services Committee Chairman Barney Frank. We did not contribute to the economic crisis by originating any subprime products.

The Durbin Amendment and the Fed's proposed rule implementing it will cost great harm to consumers. It will affect banks of all sizes and their ability to revitalize local economies.

On behalf of Commerce Bank and the thousands of banks represented by the ABA and CBA, I urge Congress to take immediate action to stop the proposed rule from being implemented. This needs to be done to avoid the profound negative consequences that the rule has for the payment system and for consumers.

I would like to make four points to the committee today. First, the Durbin Amendment and the Fed's proposed rule will severely affect consumers everywhere, causing new fees and pushing low-income customers out of the banking system. The fact is that both consumers and merchants value debit cards. They are faster at checkout, accepted worldwide, provide a payment guarantee, and protect from fraud.

Debit cards reduce the need for cash and checks and the cost of handling bad paper. The Durbin Amendment moves the payment system backwards, taking a highly efficient system where costs are shared by all who benefit, the one where merchants are almost entirely excused from contributing.

Some have argued that lower interchange rates will bring lower prices to consumers at checkout but this far from certain. What is certain is that banks will have to find other ways to recover revenue and this will ultimately lead to new fees for the consumer.

Second, the Fed's proposal implementing the amendment dictates that my bank and indeed every bank throughout the country must lose money on every debit card transaction unless we charge customers more. Let me put this in context, the reality is that today's checking accounts have become debit accounts.

Each month, our average active customer uses his debit card 26 times while writing only 5 checks. It costs Commerce Bank about $230 per year to maintain a checking account, including salaries, branch expenses, and issuing statements, among other costs. Our overall profit margin for that checking account is about $35 or 13 percent.

The Federal Reserve's proposal would cut our debit card revenue by about 85 percent or $60 per account. This means our profit on a typical checking account goes from $35 to a negative $27. We will lose money on average for each account. Mandating that banks cannot recover the cost of our most popular consumer product is unfair, unprecedented, and just bad public policy.

Third, the exemption for small banks will ultimately be ineffective. Every community banker—and I have spoken to a lot of them in the last 9 months—with whom I speak strongly believes his or her bank will be severely affected by the interchange price controls imposed on larger banks.

The economics are simple. Market share will flow to the lower-priced product of big banks, forcing small banks to lose customers if they don't follow suit. And finally, the process Congress used was deeply flawed. The amendment was added to the Dodd-Frank legislation on the Senate Floor at the last minute.

It was never the subject of any hearing in either the House or the Senate and never voted on by this or any other standing committee. A policy decision of such importance deserves much more thorough consideration. Commerce Bank, and indeed the banking industry, supported many of the key principles in Dodd-Frank.

We are all for sound banks, strong capital, and consumer transparency; however, the Durbin Amendment has nothing to do with these principles. It will stifle innovation, lower productivity in our economy, and force a number of our customers out of the protection of the banking system. On behalf of the ABA and the CBA, I urge you to take immediate action to stop the Federal Reserve from implementing the proposed interchange rule.

I would like to thank the committee for its time today and I look forward to your questions. Thank you.

[The prepared statement of Mr. Kemper can be found on page 147 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. Kemper.

Our next witness is Mr. Doug Kantor, a partner at Steptoe & Johnson, on behalf of the Merchants Payment coalition. Welcome.

STATEMENT OF DOUG KANTOR, PARTNER, STEPTOE & JOHNSON, ON BEHALF OF THE MERCHANT PAYMENTS COALITION

Mr. KANTOR. Thank you, Madam Chairwoman, Ranking Member Maloney, and members of the subcommittee. I appreciate the opportunity to be here and share with you my views about the Durbin Amendment and the debit card rule before the Fed.

If there is one thing that I would like you to take away from my testimony today, it is this: that the banks right now that issue debit cards all charge the same schedule of fees when they are under the Visa umbrella. And those under the MasterCard umbrella agree to the same schedule of fees as well.

This is the only area of their operations that we are aware of where they all agree with their competitors to charge precisely the same fees. On other things, they stand on their own two feet, decide on their own charges, the same lending rates, the same interest rates, they do that for themselves each bank individually. Here, they charge the same thing and lock arms in a centralized price-fixed way.

That is tremendously unfair to merchants across the country and it has led to an explosion in these fees where, as you heard in part from Gus Prentzas, from any merchants, this is the second highest operating cost that they have only behind labor but higher than rent. It is the fastest growing expense they face, growing faster even than health care costs, and for many parts of the merchant and retail industries, these fees are far, far higher even than their profits every year.

That is a problem that cannot continue and the billions of dollars that they are being paid cannot continue. And the thing that is key here is the Durbin Amendment and the Fed's rule presents these banks with a simple choice. It says, if you would like to charge any amount of money that you would like, governed only by the marketplace, go ahead, unregulated, just don't do it through a centralized price-fixing mechanism.

The Fed's rule and the Durbin Amendment only apply to centrally set fees. And so, if banks want to charge merchants whatever they want to charge, they can go ahead and that is fine. We believe in competition. Our members compete every single day. If they are going to fix the fee centrally though, there has to be some reasonable limits and that works where the Fed comes into play.

And I think it is helpful to understand how we got here. How we got here was that banks used to have a different business model. The business model was, they tried to attract consumers to give them their money. That was kept in the checking account or in the savings account.

And the bank would lend out those funds that was their capital, they would lend it out at a higher rate than the interest they paid to consumers. It is a good business model. It benefited everyone and still does. The consumers, however, had to have a way to get at their own money.

One of those ways was checks. And almost 100 years ago, the Congress and then the Federal Reserve by rule, prohibited the analogy of interchange fees on checks, the exchange fees that used to be there, now they are not there. Now merchants get 100 percent of the amount of the check when they accept the check. Those are prohibited, and have been for a long time. We haven't heard any lobbying against that; that was price fixing.

It has made the checking system much more efficient and made it work quite well. Then banks came out with ATM cards. That was a convenience to consumers. And in fact, some people put ATMs out there and invested money to do that. Interchange on ATM fees flows from the card holder's bank to the person putting the investment to put out the ATMs. They are providing a convenience.

But then they saw, hey, if merchants would take these cards in their store, that is a great convenience as well. That not only saves consumers in terms of convenience, it saves the bank. Every time a debit card is used, the bank saves money because someone didn't write a check. They used the debit card instead. That has nothing to do with the interchange.

It also saves money because they didn't go to a teller and take the teller's time to make a withdrawal. It saves the banks money; there are tremendous benefits for banks in debit which they don't tend to talk about when we discuss these types of issues. Mer-

chants have invested billions of dollars putting—stores, accepting debit cards and protecting from fraud. I have some of those numbers in my testimony, billions of dollars.

That investment isn't recognized through interchange to the merchant although at first, it was. When these cards were first introduced, that is precisely what happened for many merchants; there was zero interchange for some. The merchants we repaid on other instances to recognize that. However, over time that system has changed, and because the price is fixed, those fees have exploded to a point where merchants are suffering from that and consumers ultimately, unfortunately, are footing the bill.

Thank you very much. I realize my time is up. I am eager to answer any questions you may have.

[The prepared statement of Mr. Kantor can be found on page 101 of the appendix.]

Chairwoman CAPITO. Thank you.

Our next witness is Mr. Floum, who is the general counsel for Visa.

STATEMENT OF JOSHUA R. FLOUM, GENERAL COUNSEL, VISA INC.

Mr. FLOUM. Thank you, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee. My name is Josh Floum, and I am Visa's general counsel and a member of our executive team. We appreciate the opportunity to discuss the Dodd-Frank Act and the Federal Reserve Board proposal relating to the debit interchange and the routing of debit transactions and the great harm to consumers and to small businesses that may be caused by these government-mandated price and business controls.

The Durbin Amendment was enacted through a really extraordinary process with no consideration in any congressional committee and no opportunity for the House to consider debate or vote at all. The amendment will have significant long-term consequences for consumers, for financial institutions, for small businesses, and for the entire U.S economy, consequences so fundamental and extensive that their full impact may not be known for many years.

Because of this, Congress should consider extending the implementation date and requesting an impact study on unintended consequences. I would like to highlight the issues that may lead to those unintended consequences. Turning first to the price controls, there are three fundamental issues. First, the proposed regulations would result in a $12 billion annual value transfer to merchants, primarily to the big box retailers.

This makes it virtually impossible for issuers to recover the cost of the infrastructure and operations required to build and manage a world-class debit system and discourages future investment in fraud protection, in e-commerce, in mobile payments, and other important innovations.

This country should continue to drive innovation, technology, data security, and commerce. After all, digital currency was invented here and this country shouldn't get in a situation where it lags behind.

But, while the direct impact is on debit card issuers, big and small, it is the consumer who ultimately will pay the cost to advance the industry. The Federal Reserve Board itself admits that its interchange proposal will permit issuers to recover only a small fraction of their costs but explains that "issuers have other sources of revenue such as cardholder fees to help cover their costs." In other words, the Fed suggests raising fees to cardholders.

Already, we are seeing that the Fed had it right. Many banks have indicated that they will have to take the step. Earlier this week, for example, the ICBA released a study of its community bank members. More than 90 percent of them reported that they will be forced to increase other fees to consumers to compensate for the interchange regulation. Importantly, and many members have mentioned this today, there is no requirement or evidence that merchants will pass on this windfall to consumers. In fact, the opposite appears to be true.

When asked in 2008 whether consumers would benefit from lower interchange fees, the retailer representative truthfully testified, "There is not a businessman who doesn't attempt to keep the margin."

Ranking Member Maloney, you asked me to discuss the routing and exclusivity sections of this amendment, which were added with even less discussion and analysis, and also have significant unintended consequences. The retailers specific intent in adding these provisions was to establish a system that would further drive down their cost without regard to the need for networks and issuers to get a fair cost for the significant value delivered.

By requiring more than one network on a single card and taking the routing decision away from consumers, the retailers have set up a race to the bottom to drive rates down. The retailers will seek the least expensive options regardless of quality or value delivered to the consumer. This part of the rule will only do more to stifle innovation and shortchange consumers on new and improve payment services.

And unfortunately, the rule will have a particularly significant impact on community banks and credit unions and on the government and prepaid programs that rely in part on debit card revenue to fund their operations. Many people have concluded that these institutions and programs are exempt from all the Durbin Amendment provisions, but as we have heard today, the law does not exempt them from the exclusivity and routing control provisions. Of note, the routing requirement allows merchants, not consumers or card issuers, to decide how debit card transactions are handled now and in the future.

The new rules deprive the consumer of the ability to choose over which network transactions will be processed. Now, the merchant will decide without notice to or consent from the consumer how money from her DDA account is accessed. There is simply no disguising if this is an anti-consumer provision.

The exclusivity and routing provisions also compromise the security of debit transactions and compromise fraud prevention. Investment in data security and fraud prevention can only be made if there are sufficient economic incentives to do so and the opportunity to—I will—if I can have more 30 seconds, Madam Chair-

woman—and the opportunity to recover the cost of these investments. Finally, the exclusivity in routing provisions add unnecessary cost and complexity.

In conclusion, given all of this uncertainty and the many concerns being raised, we beseech Congress to extend implementation of the Durbin Amendment and request an impact study on unintended consequences. Thank you very much. I am happy to answer any questions.

[The prepared statement of Mr. Floum can be found on page 84 of the appendix.]

Chairwoman CAPITO. Thank you very much.

And our final witness is Mr. David Seltzer, vice president and treasurer, 7-Eleven, on behalf of the Retail Industry Leaders Association.

Welcome.

STATEMENT OF DAVID SELTZER, VICE PRESIDENT AND TREASURER, 7-ELEVEN INC., ON BEHALF OF THE RETAIL INDUSTRY LEADERS ASSOCIATION (RILA)

Mr. SELTZER. Good afternoon.

I would like to thank Chairwoman Capito, Ranking Member Maloney, and the members of the subcommittee for inviting me to testify today on an issue that is important to the thousands of franchisees who own and operate 7-Eleven stores.

My name is David Seltzer, and I am the vice president and treasurer of 7-Eleven. There are more than 6,700 7-Eleven convenience stores operating in 32 States nationwide. More than 5,000 of these stores are operated by small business franchisees.

In fact, sitting behind me today is Dennis Lane, who has been the operator of the 7-Eleven in Quincy, Massachusetts, for more than 36 years. I welcome this opportunity to share the views of 7-Eleven, companies of the Retail Industry Leaders Association, and small business owners like Dennis, on the topic of interchange reform. Putting this into perspective, a typical 7-Eleven franchisee owns a single store, employs 8 to 10 people, and works 60 to 70 hours a week.

After payroll, interchange is the largest cost our franchisees face and it is the only cost over which they have no control. The proposed rule is critical to our franchisees because it will provide meaningful relief. I acknowledge that debit and credit cards are important to 7-Eleven, and as a direct beneficiary of the credit and debit clearing system, we expect to pay competitive fees for the use of the system.

At 7-Eleven, 49 percent of our sales are paid using plastic, and 73 percent of these card transactions are on either a Visa or MasterCard. Unlike all other business expenses, the pricing mechanism for this clearing system is not determined in a competitive manner. Over the past 8 years, 7-Eleven credit and debit fees have quadrupled from less than $40 million in 2002 to $177 million in 2010. That is a 21 percent average annual increase. Debit cards are now used for over 80 percent of our card transactions. According to the Kansas City Fed, average PIN debit card interchange rates have risen by more than 500 percent over the past 10 years.

In October 2009, MasterCard increased its Maestro debit interchange rate by 98 percent. On small ticket transactions, the fee can be more than 20 percent of the sale. When we spoke to MasterCard executives regarding this rate increase, we were told that interchange rates were non-negotiable.

Further, we were advised that MasterCard views banks rather than merchants as their customer and the rates are set at levels needed to entice banks to issue cards on MasterCard rather than Visa. In other words, competition among the card networks translates into higher interchange fees for merchants. And as we have heard today, banks don't compete on or negotiate interchange fees; the rates are the same.

As the Federal Reserve noted, the financial incentives in the debit clearing services market work to encourage higher costs and more risky debit transactions. In short, this market is fundamentally broken. In 2009, we and our franchisees and customers petitioned Congress to address this issue and nearly 1.7 million people in 285 congressional districts signed petitions.

Since our petition drive, over 3 million more Americans added their names to similar petitions sponsored by members of the National Association of Convenience Stores. So now, more than 5 million Americans have signed petitions calling on Congress to reform interchange fees. We are delighted that Congress responded last year and the resulting Federal Reserve rule will lead to tremendous savings for hundreds of thousands of small businesses.

These savings will translate into lower prices for consumers, and more development and more economic activity in communities throughout America. In fact, Dennis has already hired a new employee in anticipation of the savings from the debit interchange reform. Given the intense price competition that exists within retail, there can be no doubt that debit savings will benefit consumers.

As to the impact on the banks, I want to make it clear that debit interchange legislation only affects about 100 financial institutions, leaving more than 99 percent of all institutions exempt. According to a recent article in the American Banker, some analysts believe that community banks and credit unions will benefit from this change as it will provide them with a competitive advantage against the larger financial institutions.

Madam Chairwoman, the facts are clear. The system is broken. Anyone who accepts debit or credit cards, whether or small or large businesses, and the more than 5 million consumers who signed petitions agree that interchange reform is necessary.

The Federal Reserve has proposed a rate structure, having received substantial input from card networks, banks, credit unions, and merchants. Though we believe the data submitted by the banks to the Federal Reserve supports a lower rate structure, we respect the process undertaken by the Federal Reserve and recognize that the proposed rates developed through this process will provide meaningful relief.

We encourage the Federal Reserve to complete its work to provide some common sense to debit fees for businesses large and small, and most importantly, their customers. Delaying this process would only harm American businesses and consumers to the tune of $33 million a day, or a billion dollars for every month that

passes. Thank you for the opportunity to appear before the subcommittee this afternoon.

I would be happy to respond to any questions.

[The prepared statement of Mr. Seltzer can be found on page 192 of the appendix.]

Chairwoman CAPITO. Thank you.

I would like to thank all the witnesses, and I have so many questions because honestly, conflicting information is what I have been seeing streaming through my office. So, I am going to ask some short questions and hopefully get some short answers.

Mr. Prentzas, you mentioned the cost of the debit interchange has gone up. Has your business—has your gross revenue gone up at the same time or is it a shift in the way people are paying for your services?

Mr. PRENTZAS. It is a shift in the way people are paying for their services, so the more they are using their debit cards, the more interchange fees I am paying.

Chairwoman CAPITO. Right.

Mr. PRENTZAS. But, what creates a problem for a small business person like myself and there are thousands out there in the United States, is that we don't know until the end of the month when we get that statement what our interchange fees are going to be. That creates a very big problem when you are trying to operate a business, not knowing what you are going to end up paying.

Chairwoman CAPITO. Okay. Let me ask you this, do you decide which routing your card goes on in all this?

Mr. PRENTZAS. No.

Chairwoman CAPITO. Okay. Who negotiates your fee for you?

Mr. PRENTZAS. The merchant company.

Chairwoman CAPITO. So, you go through like a merchant payment—

Mr. PRENTZAS. Correct.

Mr. KANTOR. If I could, Congresswoman, folks like us have their own service providers who sign them up and provide processing and we don't do that.

Chairwoman CAPITO. Okay. Mr. Kemper, on your debit cards right now, do you have any charges at all associated with debt for the consumer?

Mr. KEMPER. No, we don't.

Chairwoman CAPITO. No.

Mr. KEMPER. And as I said, it is extremely popular for being used and it has basically displaced the check.

Chairwoman CAPITO. Right, I know. I am in that generation where I am—he is writing checks, I am using my credit card, but my kids are using their debit cards so—has the cost—Mr. Kantor mentioned the cost going up, this is another conflicting piece of information. Has your interchange cost on debit cards gone up to the 98 percent that Mr. Seltzer mentioned?

Mr. KEMPER. My view is that is primarily because the debit card is the most successful product we have ever had.

Chairwoman CAPITO. Has the cost of the debit card—

Mr. KEMPER. No, the cost as a percentage of sales to us, and I think it is true pretty much across-the-board, has stayed fairly con-

stant. Maybe it has gone up a little bit, but I think the dollars are driven by the volume because everybody is using debit cards.

Chairwoman CAPITO. But if you had to average the average cost of interchange fees over 10 years or let's say 5 years ago because 7-Eleven made an assertion in their statement that it has gone up 500 percent over the last 5 or 10 years. Is that—

Mr. KEMPER. That would be nothing comp—I think that is driven by volume. Our debit fees have gone up because they have replaced checks and so the fees have gone up, as a percentage of the retail sales, they have stayed very steady.

Chairwoman CAPITO. Okay.

Mr. KANTOR. If I could, Congresswoman, just for a moment on this question. Actually, the rates have gone up very significantly over time. In fact, PIN rates were next to nothing about a decade ago and so—

Chairwoman CAPITO. This is what I mean.

Mr. KANTOR. Yes.

Chairwoman CAPITO. We are getting two conflicting—

Mr. KANTOR. We are happy to give you those numbers and I would know—there are a lot of things that are conflicting here. Commerce Bank's Web site says they do charge some of their customers for debit cards so there are a number of things—the facts of the—

Chairwoman CAPITO. We will let Mr. Kemper—

Mr. FLOUM. May I respond, Madam Chairwoman?

Chairwoman CAPITO. I want to ask Mr. Michael something because I really have only a minute 43 left. You fall into the category of the under $10 billion, obviously, with your credit union.

Mr. MICHAEL. Well under, yes.

Chairwoman CAPITO. Yes. Did you submit any comments to the Fed?

Mr. MICHAEL. I have not had the time. And in fact, until I was asked to speak in this hearing, I didn't have the time to really investigate the effects of this. That is one of the problems I think most have—

Chairwoman CAPITO. I would agree with that. Would it be a safe assumption probably that your association—the Credit Union National Association, I am sure has submitted something representative of—because only two credit unions fall into this category.

Mr. MICHAEL. They are in the process of submitting two separate comment letters to the Fed.

Chairwoman CAPITO. Thank you. Do you charge for your debit card right now?

Mr. MICHAEL. I have to, because I lose money on my transaction accounts.

Chairwoman CAPITO. So you do it like a fee?

Mr. MICHAEL. I have a fee on the transactions to try and allocate the cost and—most use it. I have too much in fixed cost and those fixed cost, I don't think they are being even considered as part of the Fed study. And for a small institution, that is a major portion of what we do.

Chairwoman CAPITO. Yes, I mean proportionately too, that has to be a problem.

Mr. MICHAEL. It is.

Chairwoman CAPITO. Because you don't have access to the larger networks, then you don't have the—obviously the lawyers and the accountants and everything else that has to go along with finding a—with doing the correct fraud and protections and all those kinds of things.

Let's see, the question that I really want to find out here and I assume—I don't know if the Fed actually knows this or not but is the cost—whether they have gone—I understand the volume of business has gone up so your interchange is going to go up because it is a greater part of your bottom line.

More people are paying with debit cards and so your interchange fee is going to go up with that because you have more people using the card.

Mr. PRENTZAS. Madam Chairwoman, if I may? As a small business owner, what I am really confused about and try to understand throughout this whole process and maybe some of the banks can explain this to me is, how is an interchange fee actually determined? There are so many different types of debit cards out there with rewards where I as a small business don't know what these fees are, what the percentages are, and I am at the mercy of a bank, at the end of the month, they give me a statement and tell me this is what you have to pay. And I have no understanding of what I am paying or why I am paying.

Chairwoman CAPITO. Thank you.

Mrs. Maloney?

Mrs. MALONEY. I want to thank all of the panelists for their thoughtful testimony and I would like to ask this apprentice, we talked a great deal about small businesses and trying to help them here in Congress and wanting them to prosper. They are the backbone of the economy. After Valentines Day and being a florist, is the economy improving?

Mr. PRENTZAS. There is a lot of love in the air this year.

Mrs. MALONEY. That is great to hear. Can you elaborate and others on the panel on what you think this rule will mean for you as a small businessman or as a bank or as a small community bank? And if there is any savings, Mr. Prentzas, how would you use those savings? What would you do with them?

Mr. PRENTZAS. Congresswoman Maloney, thank you for that question. Actually, that is a very important question. As a small business owner, we are in the business of competing everyday. And every dollar that we could save will be in our best interest to put it back into the market, into the consumer.

That also includes lowering prices. That is what is going to draw another customer to my shop and that is what is going to help me create more revenue where I could hire people and give the benefits that all Americans deserve. So, naturally, in my situation and as a small businessperson, I think it is going to trickle down to the consumer.

Mrs. MALONEY. Okay. I would like to ask all the panel members to comment on what they see as the benefit or perhaps detriment to consumers with the implementation of this interchange rule.

I have heard from financial institutions that this will mean that fees on their customers in others areas may be raised. And I have

heard from merchants that high interchange fees mean that the price of goods and services are higher.

I would just like Mr. Kemper, Mr. Seltzer, all of you, to comment on what this means to you.

Mr. KEMPER. Yes.

Mrs. MALONEY. And to your customers and to the consumers.

Mr. KEMPER. Great question. Josh used the number $12 billion to $14 billion that is going to come out of the banking industry primarily to retailers and primarily to the top 1.5 percent of retailers who are doing most of the business.

That $14 billion is 16 percent of banking profits for last year. Banks last year made about 6 percent on equity compared to 19 percent for the 3 biggest retailers. So, banks have gone through a tough time of rebuilding capital and are not particularly profitable.

This payment system is the most stable income and especially for small banks. We do a lot about the businesses, we are in money management, we are in commercial. But for small credit unions, for small banks, it is going to be devastating.

As I said, it is going to mean that our basic—system product is going to be unprofitable. We are going to have to raise fees. I think people have generally said we will be lucky to recoup a third to a half of these kind of fees, it was going to suppress profitability immediately, and we have a wonderful system. We have to step back and look at what the value of this system is, not what the cost.

I like to talk about the costs because they are very competitive. They are cheaper than checks, they are cheaper than cash, and a lot of studies have shown that. We have a wonderful system that we could ruin. And Josh, Visa, a lot of people are not going to be investing in the future in fraud, on innovation, and we are going to go the wrong way.

Mr. KANTOR. If I could address this question, because it is an important one. What we have shown—and I cited in my testimony, a study from Robert Shapiro, the former Undersecretary of Commerce. And he took a look at this and said if interchange fees, he looked at both credit and debit, were just cost plus a reasonable rate of return, that would return almost $27 billion to the pockets of consumers and create 242,000 new jobs in the United States.

If you look at just debit, those numbers are more than $10 billion to consumers and it is more than 95,000 new jobs created. As prices go down, people buy more, and that is good for everyone.

I would like to comment just again at the chairwoman's helpful observation about talking about facts here. Mr. Floum, in his written testimony, and again in his testimony early today before the committee, quoted a small businessperson, Tom Robinson, who testified a few years ago before the Judiciary Committee on this issue. But that quote was cut off at the critical point of that quote.

And Mr. Floum quoted Mr. Robinson in talking about passing on savings to consumers as saying there is not a businessman who doesn't attempt to keep the margin.

Mr. Robinson continued that statement. He said there is not a businessman who doesn't attempt to keep the margin, but the competition always drives it back out. And when you have a competitive market, and we definitely have a competitive market unlike some others, those benefits will go back to the consumer.

I expect this was an honest mistake on Mr. Floum's part. Unfortunately, this artificially truncated quote has been floating around for a while. When there was a markup in the Judiciary Committee, one of the Members who talked to him had to read it in and correct it, and I would just ask that this exchange in the transcript be made part of the record of this hearing so that we get it right and make it clear that merchants believe in free market and believe consumers will save.

Mrs. MALONEY. Thank you, and my time has expired. Thank you.

Chairwoman CAPITO. Thank you.

Mr. Marchant?

Mr. MARCHANT. Thank you, Madam Chairwoman.

What I would like to focus on is the expense that merchants no longer have to incur because of the debit card. In my life, I have worked in stores where a great amount of the time that the cashier and the management spent was in compiling the deposit, taking the check, checking the ID, taking the hot checks to the door as you walk out, and all the expense that went into just making this simple transaction take place.

It seems to me that the debit cards have made a lot of the positions that existed in your store, Mr. Prentzas, maybe you don't have to have a fulltime version that does that now. Now, you can—this debit card enables you to have safer transactions, quicker transactions.

Would you admit that there is some value to that versus the way it probably was when you started in business?

Mr. PRENTZAS. Thank you for that question.

What I could say to that is that I don't need that person, but I also had to lay off one other person because of these fees. And let me explain myself, Congressman. As a businessman, you need to be able to understand what you are paying for.

When it comes to interchange fees, I don't know what I am paying for and what these fees are. What is the rate of taking card "A", or what rewards are on that? I don't know. I am at the mercy, like I said earlier, of the statement that comes in at the end of the day. So, yes, it might be convenient, but I am not willing to give anybody a blank check to fill out a portion for that convenience. I want to know what I am paying for that convenience and how it is being derived at the end of the day.

Mr. MARCHANT. Okay. So, your point is you don't know what you are paying for. You don't know how—

Mr. PRENTZAS. Why it has been increasing so rapidly without having any additional services?

Mr. MARCHANT. The other thing that I am noticing as I am going down to the store is that with almost every transaction that I try to make, the retailer is trying to push me towards the transaction that the retailer would prefer that I make.

And the retailer absolutely does not want a check. Cash, I am pretty sure is okay, but retailers no longer want a check. The retailer really no longer wants a credit card because I am assuming the credit card is still 2 to 3 percent. Is that a standard bank charge for credit cards, Mr. Seltzer?

Mr. SELTZER. Mr. Marchant, for us, credit and debit are right on top of one another and I think on average—our credit rates are about 2.2 percent.

Mr. MARCHANT. 2.2 percent.

Mr. SELTZER. Our debit rates are about 2.1 percent of the transaction, so they are right on top of one another. And, I will speak to your other question. We absolutely believe there is value in cards, we are willing to pay competitive prices. And if there were competitive markets for this product, we wouldn't be here. There is no competition within the card space for debit cards.

Mr. MARCHANT. I think I might get to that if I have enough time to get to my question. The retailer, though, now is—even though there is no difference, I guess you are saying, between credit and debit, they are pushing me towards a debit transaction because I will now have to say that I don't—debit or credit. That is a standard question now so there must be some advantage to one transaction over the other.

Mr. FLOUM. Yes. Can I say a little bit about the facts? Because the one thing I agree with Mr. Kantor about is that facts are important. And there have been a lot of assertions about facts.

Chairwoman Capito, I am happy to provide you with excruciating detail about Visa's interchange rates. They are transparent, they are on the Web site, they are public.

So, let's talk a little bit about the facts. You asked whether the rates are going up because usage is going up or because the percentage rates are going up, and this is very important; it is because people are using debit cards more, and merchants are accepting them more. That is a good thing because they are less expensive than cash and they are less expensive than checks so merchants are achieving savings.

The debit card rates on average 10 years ago were about 1.4 percent. Today, they are about 1.4 percent. Some rates have gone up, some rates have gone down. The average effective debit card rate has remained stable over a 10-year period. Any assertion to the contrary, we need to look at the facts.

Credit card rates on average are higher, but the rates that merchants pay for use of debit cards and credit cards in the United States are far lower than what they pay in most other countries. So, it is important to get the facts correct and we would be happy to provide you with all of these facts for the record.

Chairwoman CAPITO. Mr. Watt?

Mr. WATT. Madam Chairwoman, I think I will allow Mr. Scott to go next. I missed the testimony, I do want to apologize for that, but I am trying to get into the flow here.

Mr. SCOTT. Thank you very much, Madam Chairwoman.

This is very, very interesting and, as I said, it is very profound. The issue, if I could frame it right is that everybody here agrees we need to change the fee. The issue becomes, what is reasonable and what is proportional?

Three of you have one set of feelings, and three of you have the other. So—if you could briefly just share with this committee what do you feel. What rate fee do you feel would be proportional and reasonable?

Let me start with you, Mr. Kemper.

Mr. KEMPER. Yes, thank you.

I think you have to go back. And I put this in my written testimony about the different costs of payments. The merchant can take checks, the merchant can take cash, the merchant can take debit, the merchant can take credit cards. And debit cards are the cheapest form of payment from a social cost. That is not my view, that is a Brookings study, and we can show you other studies.

So, it is a very competitive way of payment. It has huge benefits for everybody, for the bank.

Mr. SCOTT. I want to get to quite a few little points.

Mr. KEMPER. Okay.

Mr. SCOTT. So if you could just tell me, we are looking at a range here from 43 or 44 to 12?

Mr. KEMPER. As I mentioned, it costs us $230 for a checking account. And lots of those costs are revolving around debit. So, we have millions of dollars in cost of running our call center, issuing statements in fraud, all kinds of things that are not being included.

The Fed has too narrow a rule, and it is a train coming down a track.

Mr. SCOTT. Do you have a figure? Do you have a figure, let's say, from 12—

Mr. KEMPER. My figure is that we have a huge amount of cost that they are not even looking at.

Mr. SCOTT. Right.

Mr. KEMPER. And that is why we say you have to delay this, you have to step back and really understand the cost involved in this.

Mr. SCOTT. The one thing you would say is 12 is certainly insufficient?

Mr. KEMPER. Twelve is certainly—that is one thing I will say.

Mr. SCOTT. You don't want to say—

Mr. KEMPER. It is insufficient.

Mr. KANTOR. Congressman, thank you. It is a very helpful question because actually I do not agree that the centrally fixed interchange fee should exist at all. In fact, in seven of the eight nations around the world that have the highest per capita debit card usage, this fee does not exist at all.

It is important to recognize that, as I talked about in my testimony, banks get tremendous benefits every time there are customers.

Mr. SCOTT. I know, but I don't—I am just going to get—do you have—

Mr. KANTOR. There should not be a fee.

Mr. SCOTT. Period?

Mr. KANTOR. It should be zero. They should have to set their own fees at banks and not—

Mr. SCOTT. Twelve is even high to you?

Mr. KANTOR. That is absolutely right.

Mr. SCOTT. Okay.

Mr. KANTOR. It is far too high.

Mr. SCOTT. Let me go to the next point if I may, because we have some merchants here, and I would like to get their concerns about this.

Mr. Seltzer, let me ask you, you agree that if someone provides a service and someone else profits off that service, that the person profiting off that service should pay for that service?

Mr. SELTZER. Absolutely.

Mr. SCOTT. How much business would you lose if you stopped accepting the debit card transaction?

Mr. SELTZER. We sell groceries, we sell gasoline, so we don't believe that debit transactions or debit cards have increased purchasing volume for our consumers.

If we stop accepting cards because Visa and MasterCard have been successful in transforming American purchasing habits from checks to electronic checks as debit cards were originally marketed—

Mr. SCOTT. Would you say you—yes, and you would lose business 35 percent, 40 percent? Would it be in that range?

Mr. SELTZER. I don't know an answer to that. No retailer can—

Mr. SCOTT. But it makes a certain portion of your business possible. And you do feel that you should pay for that service. Is that correct?

Mr. SELTZER. Again, if there were competitive rates or competitive interchange—

Mr. SCOTT. Does 7-Eleven accept checks as a form of payment?

Mr. SELTZER. We do in our company-operated stores and our franchisees can—

Mr. SCOTT. Okay. Do you pay for a guarantee service, a check guarantee service to make sure that check—that you are covered?

Mr. SELTZER. We do on a guaranteed basis; checks are less than half the cost of debit.

Mr. SCOTT. Yes, so it is less than half the cost of debits? You would say that debit cards—how do they compare to the fees that you pay out to the check guarantee service?

Mr. SELTZER. Debit fees are substantially more expensive.

Mr. SCOTT. Pardon me?

Mr. SELTZER. Debit fees are substantially more expensive. And debit is not guaranteed at the end of the day. We take chargebacks on debit.

Mr. SCOTT. Thank you, sir.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Royce, from California?

Mr. ROYCE. Thank you, Madam Chairwoman.

I was going to ask Mr. Kemper—you are with Commerce Bank, right, Mr. Kemper?

Mr. KEMPER. Yes, that is right.

Mr. ROYCE. Which, as I remember, never got into the toxic mortgage mess that a lot of financial institutions did get into.

Mr. KEMPER. I am proud of that.

Mr. ROYCE. I read your testimony here. And I was going to ask you, do you expect the ability of the system as it exists now to combat fraud to be weakened if the proposed rule goes through? And walk us through the logic as to why, if so.

Mr. KEMPER. In the previous testimony with Governor Raskin—and I think we were talking about the incentives on fraud preven-

tion and fraud, if you can't recover the cost of fraud, you are going to have to put different restrictions.

First of all, I think you are not going to guarantee payments on larger items, so that is really going to cripple the debit system for everybody, for the consumer and for merchants. And if you don't continue to invest, as we talked about before, it is part of a rapidly evolving battle, and so the card operators, the banks, we have to continually put a lot of money into doing what we must to outwit the crooks.

So if you can't recover your cost and if you cut your fees by 85 percent, there is no question that you are not going to invest to cover fraud. And if you are not allowed to recover fraud cost, you are going to have to put a lot of restrictions on that so you don't take the losses on fraud. And that would be devastating.

Mr. ROYCE. Let me ask Mr. Floum, too, on that front. I spoke earlier when we had the representative of the Fed here just about their concerns with the way in which fraud in our society continues to evolve, the innovative ways in which people keep trying to hack into the system and, also, the evolution of this system where we are informed as consumers, where it is found in advance of us finding it, in most cases by the current system. But that system has cost billions and billions of dollars to develop.

And I was going to ask you how often is your network hacked?

Mr. FLOUM. Congressman, there are efforts to hack our network multiples times every day. And, fortunately, up till now there has never been a successful breach of our network, not one, and we are proud of that. But that takes a lot of investment. We invest at Visa alone $800 million a year in preventing fraud and cyber attacks. The banks, our issuers invest billions each year.

And if there is not an incentive and an economic return to continue to invest and to safeguard the data security of our payment network and our digital currency, that is a very serious policy concern. I would respectfully submit we need to keep ahead of the cyber criminals. It is not enough to be on par with them. That takes a very sophisticated technology, thinking ahead and significant investment.

Mr. ROYCE. Let me ask you then, do you think the system will be less safe as a result of this rule if it is implemented as is, without change or without study?

Mr. FLOUM. Whatever the regulatory environment, we will always strive to make the system as secure as possible. And I am sure the issuers will do the same. But without a return, and if issuers have to operate at a loss, it makes it very problematic and much harder to do so. And I fear that competitors overseas, other networks will have an edge because they are not constrained by artificial price controls.

Mr. KANTOR. Congressman, could I have a word about this fraud question—

Chairwoman CAPITO. Yes.

Mr. KANTOR. —because it is an important one, and I think it is helpful to recognize first that Visa's fees as a network are not regulated by the Fed under the law or the Fed's proposal, so if their investments are not affected, they can continue to charge merchants, which they do, whatever they desire to charge them.

But Mr. Hensarling made a very important observation during the first panel that you don't want to create that incentive by paying banks for their fraud losses—then they don't have the incentive to get rid of those fraud losses. And so that shouldn't be part of the analysis and in our view isn't what is, is fraud prevention. And if in fact there are systems that demonstrably prevent fraud, our view is—and we believe the law says this and the Fed's rule accounts for them in the options they put forward—those fraud prevention cost can be recovered if they demonstrably reduce fraud.

Mr. ROYCE. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Mr. Meeks?

Mr. MEEKS. Thank you, Madam Chairwoman.

It is a very good hearing. And, I can recall when we started this, I wish we would have had the time before we passed the bill to have this kind of an intensive kind of debate and conversation and it might have cleared it up and—because, ultimately, what we are concerned about is the consumers and all of you, whether it is merchant or whether it is bank group or the person who is going to a bank or credit union and our constituents. We want to make sure that they get the benefit.

There is one question, that before I get into the main question, I want to ask. And I don't know—backing off to Mr. Scott. I didn't get quite the understanding because I know usually, there is a lot of tax. How much does it cost or who pays the cost if a check was bounced? If you gave the check, what is the cost of the, you know—maybe, I don't know if someone could answer that for me, Mr. Floum or someone from the credit union or anybody. How much or what is the cost for a bounced check?

Mr. FLOUM. The cost annually to merchants from bounced checks far exceeds the total amount that they pay in debit interchange. And as volume increases on debit cards, those bounced check losses come down. So, again, this idea that debit fees have gone up, I have said that is not true. The rate hasn't gone up. The overall expense has gone up because more debit cards are being used. That means merchants are saving money because it costs them more to bounce checks, to pay for bounced checks.

If you want to guarantee a check, you can go to a check guarantee type of service. And the rate they are going to charge you is 1.3, 1.4, 1.5 percent. So with that guarantee and with the additional expense, and as Mr. Kemper said, it is not just us who are saying this. Everyone would acknowledge who studied it that the cost of checks far exceeds the cost of debit cards per merchant.

Mr. MEEKS. Quickly, please because—

Mr. KEMPER. Sure. We are happy to bring in the numbers from merchants. It is the case because, often, with the bounced checks the merchant does get the money. There is—or otherwise, and there are fees put on there just like the bank's $38 billion in overdraft fees. Merchants do put a fee, so it is not the fact that merchants lose more money than they pay on—

Mr. MEEKS. Let me just—this is another reason why, in my viewpoint, we need to dig into this more because, too, I was watching. That is what it meant. The first panel is watching the Senate Banking hearing today. And there were two statements that were made—one by Chairman Bair—that said that the Durbin Amend-

ment might not be helpful to consumers and has unintended consequences and really needs to be fixed. He further stated that the full policy ramifications might not have been dealt with as thoroughly as they should have been. So we kind of rushed it through.

And then there was also a statement—because I was particularly concerned at that time with the effect that for a small—for credit unions and for the smaller institutions, the community banks—and so we put in an exemption what we felt would protect them. So my question then is—and I think Chairman Bernanke said that the exemption may not work.

So my question—and Mr. Floum, I will ask you, especially with this network, because I heard you testified about network exclusivity provision. How does that affect, if it does, small issuers?

Mr. FLOUM. Thank you for the question, Congressman Meeks. It affects small issuers greatly because although they were exempted from the direct price regulation on the debit rate, they are square in the crosshairs and exclusivity and routing provisions. Those were put in during conference by RILA, the large retail association, for one reason and one reason only—and that was to suppress interchange rates and issuer revenue.

So what they do is they say that it is not enough that the networks can't compete to have cards, but that there had to be two networks on one card. Whether the cardholder wants two networks or the issuer wants two networks or not, the choice is taken away. And the choice is taken away from the consumer to route the transaction. So someone is asking about thin pads and merchants trying to steer— at least consumers had a choice before, but with the Durbin Amendment the choice is taken from the consumers and merchants' route and with two networks they want to set up a situation where they drive the interchange rate down.

That was the reason. That was the intent. That will be the effect. And, unfortunately, the credit unions and community banks are not exempt from that provision.

Mr. MEEKS. Do you have any comments?

Mr. KANTOR. If I could, it is important to recognize a couple of things here. One is that there is robust competition in one place here—that is to drive interchange fees up. The networks drive interchange fees up to get issuers to put them on the card. That won't change even with the network non-exclusivity and that will protect the small banks so that they won't have to worry about their fees.

Visa has already said they will have a two-tiered system. And there have been commentators like Christopher Leonard of the American Banker, who said, "This will allow the small banks to win and have their cake and it eat, too."

Chairwoman CAPITO. Mr. Renacci?

Mr. RENACCI. Thank you, Madam Chairwoman.

And thank you all for being here.

Mr. Prentzas, Mr. Kantor, and Mr. Seltzer, there was a day just very recently that I was a retailer. And Mr. Michael, Mr. Kemper, and Mr. Floum, there was a day very recently that I was on a bank board. So I see both sides of your story. The only concern I have is in the long run, who is going to win and who is going to lose?

If I was sitting on the retailer side, and even if prices were able to come down, I know that the bankers have to make these dollars up somewhere and those fees will wind up going to the consumer. And, today, I am sitting on the side of the consumer and wondering who really wins in all of this.

The other thing that I think we need to be very, very careful of is that any time the government gets involved and sets a price or a standard or a fix, whatever you want to call it, it is a very dangerous precedent especially for the retailers. So I am concerned about that and not comfortable at all. But I do know that, from a retailer's standpoint, these cards do allow you the opportunity to sell more. And I do know, from a banking perspective, these cards do allow you to make money.

The issue again is going to be, how does it affect the consumer? My biggest concern today, though, goes back to all of the testimony.

And, Mr. Kantor, I want to—two things you did say in your testimony. You said that interchange rates should be based in many cases with the foreign markets charge. I think you need to be extremely careful there, too, because I am sure your retailers would not want to have to charge with the foreign—with some of the foreign market for selling things for. I will give you a chance to speak.

And you also mentioned—the word early on in your testimony—fixing fees and you said that the banks are fixing fees. I am not too sure you want the government to fix fees. So, again, let's be careful while we are talking about all of these numbers.

But here is the question I have. After all of this testimony, we are still getting down to we now have an interchange fee that the Federal Reserve is saying should be at a certain amount. And they put that amount inside of a specific box. We didn't give through a statute the Federal Reserve any opportunity to pick up all of the costs that are available.

You heard the testimony earlier that it could be an issue. And for the retailers sitting on the panel, I am sure that if you were stuck with a certain retail cost that was set by somebody else and all you were told was you would want your cost, you would want to make sure it is a fair fee and a fair cost. So I am going to ask this primarily to the retailers.

Hearing the testimony earlier and hearing that you know that this interchange fee is really—it is flawed in my opinion. It doesn't take into consideration all of the cost. And as I asked the previous person who testified, what do you need to get this cost, I really didn't get an answer, so what do you need?

But for your purposes, do you really want the Federal Reserve to set a cost, a standard, as you called it, or do you want it to be fair and reasonable? And are you willing to allow there to be more time given to the Federal Reserve to have all the details available so that they can come up with a fair standard, as they call it?

Mr. KANTOR. Congressman, I appreciate that. And thank you for looking at this question so closely. What is helpful to recognize here, as I said in my testimony again, is if banks would compete rather than fixing the fees and set their own costs, charge whatever you want and have a market system, that is great with us, do it.

If they are going to fix the fees, we think frankly they should not be allowed to charge anything by fixing the fees. The Fed has been more generous than that in spite of the fact that we advocated that they not do that and, instead, here you can recover this cost plus a rather large rate of return on those costs.

And so, here, I have gone through in my testimony the banks have argued for a great many other costs to be included here. Now, some of those are costs of the network, which, as I said, aren't regulated. Some of those are the costs of the credit program—

Mr. RENACCI. I am going to run out of time, so I just want to make sure are you willing to let more time to be allowed from a retailer's standpoint so that actual reasonable cost can be determined, or you are going to stand here or sit here today and say, no, I don't want to waste any more time to have a reasonable cost?

Mr. KANTOR. The Fed has done a good job here so far. Merchants have been—

Mr. RENACCI. The Fed has said today that they did not take into consideration all of the costs. So my question is pretty specific—are you willing to allow that there will be more time for the Fed to get all the costs outside of the box so that they can come up with a fair interchange fee?

Mr. KANTOR. We have waited more than 10 years too long already.

Mr. RENACCI. You are not answering my question.

Mr. KANTOR. The Fed is getting it right. It should go forward. If anything, the fees should be lower.

Chairwoman CAPITO. Mr. Carney?

Mr. CARNEY. Thanks, Madam Chairwoman.

First, let me apologize for not being here in the last—when you made your opening statements. You may have heard the questions that I asked the Governor earlier about the cost—and we have been having some discussion about that.

I am just glancing through the testimony that was provided in writing. I am interested in the banker's view of those costs and if there are things that you don't take into consideration or allowed allowable cost because presumably that will be in the—part of the comment record and maybe you have already submitted that, but could you summarize that for me, I guess, Mr. Kemper?

Mr. KEMPER. Yes. I would be glad to comment on that. First of all, when you step back—and I said that in my testimony, when you look at all of the social costs, debit is lower than any other form of payment. And so, we talked about facts. There are facts on that.

I mentioned in my opening statement that—and we talked about with Governor Raskin that the Feds have really been putting a box on this because of the language in Dodd-Frank on how narrowly they can interpret what the costs are. It is basically just the marginal electronic and clearing costs.

The other cost, we talked about fraud, and we paid millions of dollars in fraud cost. That is a real cost. Our call center, our 24/7 call center where we have 120 people, we have people call up all the time about entries on their checking accounts. They are doing far more debit transactions. And they are checks or other forms of payments. So how do you allocate that? We have to have systems

for their payment system. Periodic statements were required and we spend millions of dollars sending our customers statements every month.

It is very difficult. And I think the whole—and there are a lot of frauds. First of all, price fixing on an unprecedented scale is very scary to me. But, secondly, telling businesses that they can only price a product, our most popular consumer product, at marginal cost just doesn't make any sense. And it was very narrowly defined by the Fed.

So they are hamstrung on this. And so if we talk about it, then it gets very important that we step back from this and have a full debate like we are having today and really get the cost right because I think—I have a lot of merchants who are very good customers of mine. We want a fair deal just like the merchants want a fair deal.

Mr. CARNEY. The second question I had this morning was the effect on consumers. I didn't really have enough time to pursue it. Could you outline what you think the effects will be on your customers, I guess, and other fees that you might otherwise have to—and you might now have to charge?

Mr. KANTOR. In aggregate, it is $14 billion. As I mentioned, it is 16 percent of bank—

Mr. CARNEY. $14 billion is—

Mr. KANTOR. $14 billion is just taking that $0.44. And cutting it—I think Josh mentioned 12, but it is somewhere in between that. I am going from $0.44 to $0.07 and $0.12 cents. And, basically, that is the transfer from the banks to the retailers. Now, whether or not they lower cost, who knows?

Mr. CARNEY. But that is in a nutshell what we are talking about in terms of—

Mr. KANTOR. Yes. And as I mentioned in my opening testimony, that would move our basic checking account where we have a full cost of profit of maybe 13 percent to a loss of probably 10 or 12 percent on every checking account and so we are going to have to recapture. And, also, we really haven't talked about it today.

But, certainly, people are going to fall out of the banking system on this. And I have talked to Congressman Clay, who is my Congressman from St. Louis. There are big issues on this about the banking system has worked very well and you don't—you want to keep people in the banking system because the alternative is not good.

Mr. CARNEY. One of the things we have tried to look hard to do in Delaware, and I am sure others have as well, is to try to get people who aren't banks, if you will, to go to the banks and checking the account fees and all that kind of stuff is a barrier there. And I would not want to see that obviously happen.

I mentioned this morning that some of the regulations with the court act have had taken away some other revenue sources for—on the credit card side. And so it is just really a question of what the ultimate impact is going to be on the consumer with this.

Again, I apologize for not being here earlier to hear your testimony. I had to go out. And I will read it carefully. Thanks very much for—

Mr. MICHAEL. Representative, may I say something?

Mr. CARNEY. Yes, you may, please.

Mr. MICHAEL. On the credit union side, just to let you know, our consumers are our members. And as interchange rates are dropped, this is going to be a direct transfer from our members to the merchants. So that will—they will have to make that up some way through some other sources—

Mr. CARNEY. What is the estimated loss for the credit unions?

Mr. MICHAEL. Again, what we are figuring right now that it is going to be fairly substantial, about $1.1 billion a year. They will be transferred to merchants. And I don't have a guarantee that the merchants are going to take and give that money back to my members.

Mr. CARNEY. Thank you.

Mr. KANTOR. Yes, if I could?

Mr. CARNEY. No, you can't.

[laughter]

Sorry, I am just a freshman. I don't mess with the Chair.

Chairwoman CAPITO. You are a good man.

Mr. Canseco?

Mr. CANSECO. Thank you, Madam Chairwoman.

The Federal Reserve Board has proposed these regulations in an effort to implement the interchange fee provisions of the Dodd-Frank Act.

Let me ask a simple question, starting with Mr. Kemper. How did the Federal Reserve do in writing this rule, in your opinion?

Mr. KEMPER. I think the Federal Reserve, as I mentioned, was hamstrung with some very specific language on what they can do on incremental costs, and I think they narrowed. And I have talked to—Missouri is the only State with two Federal Reserve districts. And I know both persons very well and I have talked with them.

I think there are a lot of questions on how they came up with what they did and why they didn't include fraud and why it was so narrow. But I think it took a very bad law and made it worse and narrowed it down. And that is—and I think—I listened to Governor Raskin, and I think you asked a lot of good questions about what are the costs that should be in there. And they are not in there.

Mr. CANSECO. So you don't think that the Federal Reserve did a good job in writing?

Mr. KEMPER. I think they did a very thorough job, but I think the outcome was not good. And I don't think it is right, either.

Mr. CANSECO. Thank you, Mr. Kemper.

Mr. Kantor?

Mr. KANTOR. Thank you for that. I think that the Federal Reserve has done a good job and a credible job of writing this rule. It is not everything that we would like it to be, as you heard. I think they have the room and should not have centrally fixed interchange fees, whatsoever, allowed anymore by the banks.

But they did a good, credible job going through it. And it is substantial progress that will benefit everyone, in particular, the consumer. And I would know, just with respect to Mr. Carney's comment before, too, it is helpful to look the—in Europe, they took a look at this question when they moved to a 0.2 percent debit interchange, which is a little bit lower than what the Fed proposed, and

they found that there is no relationship between the fees that banks charge their customers checking and otherwise in the interchange fee.

In fact, if there were, had interchange fees tripled in this country over the last decade, we would have seen bank fees on the consumers fall dramatically. In fact, they didn't—those increased dramatically to the $38 billion in overdraft just to take one example.

Mr. CANSECO. So they did well, Mr. Kantor?

Mr. KANTOR. But I think they did well.

Mr. CANSECO. And, Mr. Michael?

Mr. MICHAEL. I think that, again, they have been hamstrung. And they had some options where they could have—have made some decisions, for example, enforcing—or requiring an enforcement of the two-tier system could be something they could have done, but they have decided not to do that.

I think there are issues in the definition of the cost. It is not an incremental cost. It is really an operational cost and it all has to be allocated out. But my operational costs are not being surged for the process.

The final thing I am going to say is they have acknowledged that the small—the exempt institutions will be dragged in. They said that is a reality of what is going to happen. But they haven't surveyed it. They haven't determined what our costs are and included those as part of their determination.

Mr. CANSECO. Thank you.

And, Mr. Floum?

Mr. FLOUM. Congressman, I think the Fed did not have enough time and so it could not and did not do a thorough enough job. They didn't consider all of the costs. They didn't survey the small financial institutions. And they didn't include all of the costs that even the narrow statute should have allowed them to include such as fraud cost, such as network fees, such as fixed costs, the investment cost to keep the infrastructure safe, sound, and secure.

Mr. CANSECO. Thank you, sir.

Mr. Prentzas?

Mr. PRENTZAS. I believe that the Federal Reserve is now doing a proper job. Like I said, there might be more that has to be done, but we are heading in the right direction.

The only comment I just want to make so maybe we could get a down-curve grasp on this problem coming from a small business. If you have 2 flower shops within a 50-mile radius, those 2 flower shops could basically set their own prices. But, now, if you allow four other flower shops to come into that area, there is going to be competition. Who benefits at the end of the day? The consumer.

This is what could happen here. If they allow the competition to exist, where not two banks decide what these interchange fees are, that, at the end of the day, it is the consumer and the retailer who will benefit, including the banks.

Mr. CANSECO. Thank you, Mr. Prentzas.

Mr. Seltzer—because we are running out of time.

Mr. SELTZER. Sure. I think the Fed has, from our perspective, gone through a very thorough process. I know that we have spent considerable time answering their questions in the fall as did

banks and other institutions. So from our perspective, they have done a very thorough job.

And there were things that—we think the actual cost of the transaction is a bit lower than where the Fed came out. So we think the rates could be lower, but at the end of the day, we will trust the process and, in any event, we think that the merchants and consumers in particular will benefit from their actions.

Mr. CANSECO. And just a very short follow-up question, if I may, Madam Chairwoman?

If the Dodd-Frank bill was presumably inactive or cobbled together in order to try to and pull back our economy from the brink, were interchange fees a root cause of the financial crisis?

Mr. FLOUM. No. No, they weren't, Congressman. They had nothing to do with the financial crisis. And, in fact, they are an engine for growth.

Mr. CANSECO. Yes. Dodd-Frank was supposed to be about protecting consumers. And the Durbin Amendment, unfortunately, will have the opposite effect by harming consumers. So it really was rushed and has no place as a part of a consumer protection bill.

Mr. KANTOR. And we would not surprisingly perhaps disagree. The interchange fees in fact said some—lacks the underwriting standards on credit cards system that will in fact be a terrible problem.

Mr. CANSECO. Thank you, gentlemen, very much.

Chairwoman CAPITO. Thank you.

Mr. Watt?

Mr. WATT. Thank you, Madam Chairwoman.

And I am going to confess to being old school. I don't use debit cards. Just a fact of life—I am behind the times.

I want to ask a couple of questions here about—Mr. Michael, let me start with you because I met with local credit union people last week. I think only two, Credit Unions National—exempt. Is that correct?

Mr. MICHAEL. Yes, that is correct.

Mr. WATT. Okay, but the argument was that, ultimately, even being non-exempt was not necessarily a good thing because the fees get set so low for the exempt institutions, for the ones who are covered, then the folks will flock to them because of those lower fees. And so they seem to be now rethinking the proposition and thinking that they may be ought to have been covered.

What is your—this is not a trick question. I am just trying to find out.

Mr. MICHAEL. Yes. Basically, the intent of Congress—and we thank you for trying to keep us out of this battle to begin with—was to keep small institutions out of this interchange.

Mr. WATT. I understand that.

Mr. MICHAEL. But the reality is because of the routing provisions that are in there and market forces, it will drive costs down to the lowest common denominator—

Mr. WATT. Okay.

Mr. MICHAEL. —and yank them up on the other side. So I am going to see what I received on interchange income drop to what the largest institutions have.

Mr. WATT. Okay. I want to go to Mr. Floum because I couldn't figure out why Visa is here. Visa doesn't issue debit cards. And so I have to stay—you have the network, I understand, or one of the networks. Is that your Visa's involvement in this debate?

Mr. FLOUM. Yes, Congressman. We are the technology platforms, so we operate the network that makes the banks able to talk to one another.

Mr. WATT. Okay. And how many competitors are there in that space?

Mr. FLOUM. There are many competitors in that space.

Mr. WATT. Okay. And how do you get paid for providing that service to banks and whomever uses it?

Mr. FLOUM. We charge fees to the issuing banks and to the merchant banks. We do not charge fees to merchants or cardholders.

Mr. WATT. So your network is a convenience to them also, is it not? It is a convenience to the banks, but it is not a convenience to the cardholders—

Mr. FLOUM. Yes, it is.

Mr. WATT. —and to the merchants?

Mr. FLOUM. It is, sir. The merchants and the cardholders are end users of the platform that we provide. And this is an important point. I have heard a lot about the uniform interchange fee being—

Mr. WATT. I don't mean to disturb you. I am just trying to—in short, I am trying to understand how this works. As you provide a network, what part of this fee are you getting for providing the network as opposed to the financial institution that ultimately has the account and the debit is being debited against? What part of it goes to them?

Mr. FLOUM. Of the interchange fee, which is the subject of the Durbin Amendment, the networks get nothing, no part of it. Separately, we do charge a fraction of a percent fee to the issuing bank and the acquiring bank. That is how we make our revenue.

But, obviously, we are very interested in the health of the debit card program because we are in the business of facilitating that program.

Mr. WATT. And if somebody defrauds the system, is it the network that is defrauded or is it the financial institution that is defrauded? If somebody hacks into the system—

Mr. FLOUM. Let me give you some examples.

Mr. WATT. No. No, I am just trying to find out, who loses?

Mr. FLOUM. The issuers lose. They would bear the financial responsibility, unfortunately. The breaches have occurred at merchants—T.J. Maxx, Hannaford, and others who have stored data in ways that could have been more secure. So there is fraud directed at Visa, but it has never penetrated our network.

The problem has been with third parties, but the issuers bear the responsibility. And that is part of—

Mr. FLOUM. They are compensated by interchange.

Mr. WATT. Okay. So that is the fraud costs that the Fed should be taking into account, is that what you are saying?

Mr. FLOUM. Correct. Fraud losses and fraud prevention costs.

Mr. WATT. Even though it didn't go to your network? It goes to them?

Mr. FLOUM. Yes. And the interchange fee we are talking about is a revenue to issuers, correct?

Mr. WATT. Thank you.

Mr. FLOUM. Thank you.

Chairwoman CAPITO. Thank you.

Mr. Luetkemeyer?

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

Mr. Kemper, I know a while ago Mr. Kantor made statements to the effect that there is no correlation between bank fees and interchange fees. Would you like to jump in on that discussion to represent the banks, on how you structure your fees and how you charge interchange fees?

Mr. KEMPER. We look at our payment system and our payment account as one account that we priced. And there are a lot of different components in that. People write checks. People use credit cards. People use their debit cards. And so we take all of those into account and we look at what—just like any business would look at—we would look at what our revenue is and what our cost is and we will price that accordingly.

The system has worked brilliantly. And I think that is what—everybody has benefited from this. When you go to a fast food place now, they take debit cards, they take credit cards. That wasn't true 5 years ago. When you were on an airplane, they wouldn't accept credit and debit cards. The merchants want to take it, the airlines want to take it because they don't want to handle checks and they don't want to handle cash. We see that.

So we like—the idea that you can strip out this marginal cost on one component of payment systems to me just doesn't make any sense because it is all wrapped together. We have to support all of the—we have to support our call center. We have to work with Visa. We have to support security. All of those things flow together for our payment accounts. So we factor all of that together in trying to carve out one area and price it at marginal cost. It is just not the way business is done in this country.

Mr. LUETKEMEYER. If this price structure goes forward, what are you going to do? What are you going to reprice? How are you going to reprice your products or all of your products or just the debit cards to make up for lost income, to continue to provide the service? Are you going to continue to provide the service?

Mr. KEMPER. It is a very competitive world out there. And there is PayPal, there are all kinds of non-bank kinds of accounts. So the market will dictate how we can price up. But there are 7500 banks in this country and they compete very vigorously. So, sure, if we are going to lose tens of millions of dollars of revenue and we are going to start losing as I mentioned on every checking as a whole, we will price that up. So costs go up to consumers.

But the debit card now is paid for by users. And, in fact, as you use it, it is a user fee as opposed to spreading it out. I think it is a very fair way to do it. But I guess the bottom line answer is fees will go up significantly to consumers to—the market will allow us. That is the way a free market system works.

Mr. LUETKEMEYER. Mr. Michael, you indicated that all of your members are consumers?

Mr. MICHAEL. That is correct.

Mr. LUETKEMEYER. And, therefore, this is going to be a direct charge back to them. Have you looked at your model yet to see what is—how much it is going to cost? Or how you are going to approach this? Are you going to continue to provide debit card service? Are you going to pull it out of the system of services you provider? How are you going to approach this?

Mr. MICHAEL. First off, I need to, again, let you know that we don't cover our cost with interchange. I have to charge—currently $0.25 in these transactions to help cover the cost of processes and transactions, and I still lose money.

Going forward, the issue is going to be I will have to either adjust that price or find other locations and my financial institution to do that. But I have a narrow range of products, and larger financial institutions could take that cost and past it off to another area. I can only basically add it back into my deposit products such as my checking accounts either through fees or through incremental fees on the debit card transactions or checking account fees. Other institutions will be able to go other directions with it.

Ultimately, in the end, if my fees get to be too high, I will not be competitive in the marketplace and I will lose members who will go to other financial institutions because they will be able to get those products cheaper.

Mr. LUETKEMEYER. Okay. A while ago, Mr. Floum, you indicated that you had some data with regards to the cost per transaction of cash, credit cards, and debit cards. Off the top of your head, do you have the information just roughly which one of those cost would be what your research shows?

Mr. FLOUM. I would be happy to provide that. I believe that one bank executive has said that cost of cash ranges 79, 80 basis points. The cost of verified checks is 1.35 basis points. But we can get you that information. And that doesn't include fully-loaded cost, as Mr. Kemper said. If you look at the—cost to all participants, cash and checks have even higher cost.

Mr. SELTZER. And I could tell you for 7-Eleven, the cash costs are about 20 or 25 basis points. So the debit is on the order of 8 times more expensive for us than accepting cash, including the bank service charge that we incur on depositing cash—

Mr. LUETKEMEYER. What is your—on checks, etc.? What is your cost on checks?

Mr. SELTZER. I don't know that one—

Mr. LUETKEMEYER. And, now, and when—those checks, I am not talking about the cost just to handle checks. I am talking about the losses you incur on taking bad checks as well.

Mr. SELTZER. Less than 1 percent.

Mr. LUETKEMEYER. One percent of the cost of the transaction?

Mr. SELTZER. Of the transaction as compared to 2 percent plus on a debit transaction.

Mr. LUETKEMEYER. Okay, very good.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Clay?

Mr. CLAY. Thank you, Madam Chairwoman. Let me thank you and the ranking member for allowing me to sit in on this hearing today. I find it quite interesting.

And I also want to take this opportunity to welcome my constituent, Mr. David Kemper, here who is a pillar of our community. He has been in business for a long time. And in the interest of full disclosure, I am a customer of the bank.

Let me also say that there are other benefits to debit cards. In my case, I have a 16-year-old daughter, and I utilize the card to teach her the principles of banking. It is very important for young people, especially those who think money grows on trees. So it helps me with that.

And all of you appear to be a reasonable business group. I know that this is driven by profit margins. But starting on this end of the table, have you all—have the opposing sides attempted to sit down outside of the Federal Reserve to try to resolve this issue, and then be able to come forward with a reasonable solution to offer up to the Federal Reserve? Has anyone? I will start with you, Mr. Prentzas. Go ahead.

Mr. PRENTZAS. Okay. Thank you for the question. On my level, at the small business level, no, the only thing I could tell you is when I did call my local bank that handles my accounts, they basically told me that they don't control the interchange fees. They really can't do anything about that.

Mr. CLAY. Mr. Michael?

Mr. MICHAEL. I am certain that there are conversations that have occurred. But I have to be honest with you; I wouldn't have been privy to those. I am just too small to be included.

Mr. CLAY. Mr. Kemper?

Mr. KEMPER. I think you want to have the market determine the price. I think we would all agree on that. I think we would debate about whether or not there is enough competition, but I just go back to—I have a lot of merchants who are very good customers. Everybody has benefited from the program and we have a real danger here if we don't do something, that the train is going to go off the track here.

So I would just urge Congress to step back and really examine a lot of the issues that have been brought up today.

Mr. CLAY. Mr. Kantor, would you be willing to go outside of the Federal Reserve and be able to offer up a solution that both sides could agree to?

Mr. KANTOR. We have many merchants in our coalition who have tried to do that and then rejected both on fees on different legislative and policy proposals in the past and unfortunately, we have been rebuffed in any case. We are always open to talking about good policy proposals here because we see this as a broken market demonstrably so, that needs fixing and the debit card piece is just the first step. Credit card fees are even higher and much needs to be done there as well. We are quite open to those conversations at any time.

Mr. CLAY. Mr. Floum, any position on—

Mr. FLOUM. Actually, we are very happy to negotiate. In fact, we have negotiated customized agreements with thousands of merchants. We tried with 7-Eleven. We were unable to get to an agreement, but that is the way it ought to work, though negotiation, through free market rather than through government intervention and price controls.

Mr. CLAY. Thank you for your response.

Mr. Seltzer?

Mr. SELTZER. Sure. We have great relationships with a lot of banks that we do business with in many other areas of our business. We have gone to all the major banks before that we do business with and we have asked them, can we have the discussion with them regarding interchange.

The banks that are the beneficiaries, the direct beneficiaries of interchange, say they can't talk to us about it, that all of that goes through Visa and MasterCard. So the banks won't have the dialogue about it. With Visa and MasterCard, our experience has been that we have not been able to have a meaningful, constructive dialogue with them regarding these fees.

Mr. CLAY. We know that fee increases will be passed on to consumers ultimately. Mr. Michael and Mr. Kemper, what do you estimate will happen to your customers as far those who still want to use debit cards?

Mr. KEMPER. Estimates and a number of people have said this is that perhaps 5 percent of banking customers will fall out of the system as banks raise prices. I don't know. It probably won't be that magnitude to us—it would be tens of thousands because we have 700,000 checking accounts.

And the cost of going outside the banking system, there is an article I will send you that was done by Candice Troy who is an A.P. personal financial writer and she said, "What would it cost me if I couldn't work with the banks?" So she wrote this article last October and she did it for a month and it cost her $93, primarily cashing checks, getting prepaid debit cards which they charge per item $1. And $93, that is $1,100 a year—$1,100 and we figure that our cost, we are making about $260, so it is a real danger when people go outside the banking systems.

Mr. CLAY. Thank you all so much. I yield back.

Chairwoman CAPITO. Thank you.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Madam Chairwoman.

To the panel, I heard your testimony. I had to step out for much of the Q&A, so I may be plowing some old ground here. I apologize about that.

Like many other members, I have heard from a number of financial institutions in my State and in my district, particularly dealing with the small financial institution exclusion. I have heard from the First Financial Bank in Hartford, Texas, and they tell me economic forces are going to force their institution to adapt the same price level as the large institutions.

And since the proposal doesn't permit their bank to cover the cost of providing debit card transactions, they will be forced to implement new service charges and other fees on checking accounts.

I hear from First State Bank of Athens, Texas, who say that if the formula applied to their bank caused the result in revenues, it would not even cover switch and transaction cost, much less cost to issue the cards, administer them, and cover fraud losses.

I heard from Austin Bank, also in my district, "We expect a 70 percent reduction in our interchange fees which will reduce our in-

come by 14.74 percent. If net income is reduced, so is our capital growth. That leads to less lending by banks."

So, Mr. Kemper, you are representing a number of the banks here today. Why aren't these small financial institutions convinced that they are going to be protected? And they certainly don't seem to believe the consumer is going to be protected.

Mr. KEMPER. As I mentioned in my opening remarks, and I think Mr. Michael has mentioned it too, that whenever you have a low-cost alternative, they are going to take market share. I think that is why the small banks don't think exemption will work their way.

Chairman Bernanke commented on that this morning. I think that this will hasten the consolidation in the industry and of the community banks that are most at risk. And we see this all the time. I said, we are a Main Street bank. We have banks in Poplar Buff, Missouri; Hannibal, Missouri—Illinois. And our profitability relates directly to how big the community is. The smaller the community, the less profitable it is. It is a simpler kind of model, the community bank model. They are much more dependent on this kind of payment stream. So they are going to suffer proportionally more because they are not in other businesses.

Mr. HENSARLING. Mr. Seltzer, in your testimony, you said there was a "lack of a properly functioning market mechanism", speaking of the payment card network. Do you view there to be a legal barrier to entry in the payment card network market?

Mr. SELTZER. By that, I meant that—we have never seen another product like this.

Mr. HENSARLING. But, no, I am just asking the question. Does your firm believe there is a legal barrier to entry into this market? Yes, no, maybe?

Mr. SELTZER. No. There is a practical barrier.

Mr. HENSARLING. Okay, a practical barrier. Do you view it as a natural monopoly? Do you have an opinion on the matter?

Mr. SELTZER. No.

Mr. HENSARLING. We now have a rule, okay, so if we don't necessarily have a natural monopoly, if we don't have legal barriers to entry, I am not totally unsympathetic here. I take you at your word as your testimony. This is very high cost for you. I understand that, but I happen to patronize one of your establishments in Lakewood, Texas. I have two small children. They are thirsty. They drink a lot of milk.

So my first question is, we hear to some extent about the benefits that can be derived here. If Congress does not act to delay this for further study, when the Federal Reserve rule is implemented, if I go to the 7-Eleven in Lakewood, Texas, in the Lakewood neighborhood of Dallas, Texas, can I expect a gallon of milk to drop in price? Can I expect a gallon of gas to drop in price? Is the DVD from the Redbox machine you have in front of your store going to drop in price?

Mr. SELTZER. I think when this goes forward, you are going to see competition in every retail merchant. We compete every day on gas prices. You mentioned gas prices. So my competitor across the street—

Mr. HENSARLING. So maybe, maybe not.

Mr. SELTZER. I either have to drop the price—

Mr. HENSARLING. I expect you don't know the answer to the question, but I want to make a point here. The question is, do you know what the incremental cost is of producing a Slurpee?

Mr. SELTZER. Yes.

Mr. HENSARLING. What is it?

Mr. SELTZER. I don't know specifically—

Mr. HENSARLING. I just wonder how 7-Eleven would feel if the Federal Reserve came in with a rule that said you can only recover the incremental cost of selling a Slurpee. My guess is, the ice and the fruit flavor don't cost a whole lot, but you have a lot of fixed cost. My time has expired, but I think you get the point.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Mr. Welch?

Mr. WELCH. Thank you very much.

It has been informative for me to listen to everybody because I go back to the basic proposition that the debit cards and the credit cards are really essential for commerce. They are incredibly important to the merchants. They are incredibly important for the customers. I have a Rewards Card and I am very happy that the cost of my trip to Disneyworld is paid for by the merchants of America because that does get passed on to them.

But here is the question, there are impacts of this legislation. Cost will be shifted. But what might be good, it is good if we have banks making solid returns so that they can do the work that they do that is so important in our communities. But it is not great if you have this uncontrollable expense and you are a merchant. You have a floral shop. You have a 7-Eleven.

And the question really is about what is fair and how do we get fair pricing in this? Let me ask you, Mr. Kemper. Your bank does have a tremendous reputation. You have done a lot of great work in the community and you have a Congressman for a customer who is not complaining. But if the Fed did take the time you think they need to take, and they included what you fairly thought was a fair consideration of the cost, would you accept their authority to then make this recommendation as to what was reasonable and proportionate?

Mr. KEMPER. I wish I had Ayn Rand up here. But I would say that the idea of government fixing prices is not the way the system works.

Mr. WELCH. Right. So, no, I can understand it. Mr. Hensarling made that point, in fact, I think, quite effectively. But so, what I am trying to find out is whether this call for delay is really just another polite way of saying you just don't want it done.

Mr. KEMPER. No. I don't think it is good public policy.

Mr. WELCH. Right.

Mr. KEMPER. But having said that, I think the box that the last Congress put the Fed in is a very tight, little box and I think the Fed made it even smaller.

Mr. WELCH. Right.

Mr. KEMPER. And I think that the idea—if you are really going to price based on marginal cost which you shouldn't, you have to look at all the costs.

Mr. WELCH. No. I am sorry. I hear you on that.

Mr. KEMPER. Okay.

Mr. WELCH. And whether it is a Slurpee or a debit charge, you are going to be concerned about it. But the dispute that we have here is whether there really is the market setting the price on the debit and on the credit card transactions. That is really the question.

If Mr. Prentzas wanted to get a better deal on his Visa charges, Mr. Floum, could he call you up and do it? He is right here.

Mr. FLOUM. Yes. In fact, the last hearing when that Rotten Robbie was here from the gas stations, I told him that we would be happy to negotiate with any merchant.

Mr. WELCH. Okay. I have talked to literally hundreds of merchants in Vermont and they tell me that is not the case. Mr. Prentzas, tell me. He is offering a good deal here.

Mr. FLOUM. I am happy to give you my card and I would invite you to call me after the hearing.

Mr. WELCH. Let's get real here. That sounds good, to maybe—with Wal-Mart, but Mr. Prentzas, have you had any success trying to get—

Mr. PRENTZAS. I shop around to get the best rates out there. And basically, every time I turn to a bank, they just—the bank tells me that interchange fees are set. They have no control over them. It is something that Visa and MasterCard control.

Mr. KANTOR. If I could—

Mr. WELCH. Mr. Kantor?

Mr. KANTOR. Congressman, thank you, and thank you for your tireless work on this issue over time. That has been tremendous in terms of advocacy for small businesses. What we have heard from businesses all across the country is in fact that the answer is "no." They can't negotiate with the banks because the banks all charge the same thing and won't depart from that. And, no, they can't negotiate with the card networks either.

And, in fact, Mr. Floum made his offer to Tom Robinson when he was here a few years ago. Tom Robinson followed up on that and he was presented with a gag order that he had to sign which would have prevented him from talking to Members of Congress about this issue in the future if—as a first step before he could ever negotiate.

A similar thing happened before when Senator Arlen Specter's office had this conversation and folks from MasterCard made a similar offer to folks from Giant Eagle. And Giant Eagle—

Mr. WELCH. I get the point.

Mr. KANTOR. I answered them with "no."

Mr. WELCH. If you could sit down and work something out, that would be great. There is a lot at stake for American businesses despite of—I have had great relations with my credit unions, but we don't see to eye-to-eye on this one.

And I would say this to the community bankers, if you guys were in charge, we never would have had the Wall Street meltdown.

Mr. MICHAEL. Can I make a quick comment here on this?

Mr. WELCH. Sure.

Mr. MICHAEL. I think that this law is bad public policy, and I think the rules are bad public policy. And, the rules are going to go in effect unless you as Congress go stand up and say, "We need

to intervene and stop this for the time being. We need to delay. We need to go back and take a look at this rule.''

Mr. WELCH. But I will ask the same question I asked Mr. Kemper.

Thank you.

Chairwoman CAPITO. Mr. Duffy?

Mr. DUFFY. Thank you, Madam Chairwoman.

I appreciate you all coming in and testifying and sitting so nicely together.

I understand the concerns. I have heard from—as every district—we have a lot of merchants in my district and my community and I understand the problem that they convey to me that they face with the interchange fees. But I do have this overwhelming concern about the government stepping in and fixing prices.

And, I guess, Mr. Floum, to you, with regard to Visa, was this debit card philosophy developed by Visa?

Mr. FLOUM. We had a great hand in pioneering the debit category and growing that category including the technology platforms needed to deliver instantaneous guaranteed transactions.

Mr. DUFFY. And what did it cost Visa, $100,000, $200,00?

Mr. FLOUM. Congressman, over the years, billions and billions and if you include the—tens of billions.

Mr. DUFFY. Okay, fair enough.

Are you familiar with Mr. Kantor's organization?

Mr. FLOUM. Yes, very well.

Mr. DUFFY. Okay, part of a lawsuit, challenging—

Mr. FLOUM. Sure.

Mr. DUFFY. Okay. And were his clients investors in those billions of dollars that Visa spent to develop this technology?

Mr. FLOUM. No, they were not.

Mr. DUFFY. So you took the risk. You innovated the product. And now, Mr. Kantor's clients enjoy that product. Is that right?

Mr. FLOUM. Yes, sir.

Mr. DUFFY. And is it fair to say by way of Visa that sales have gone up for merchants who use this Visa product?

Mr. FLOUM. Without a doubt.

Mr. DUFFY. So they sell more, is that right?

Mr. FLOUM. Yes, sir.

Mr. DUFFY. Which would mean they would probably make more money.

Mr. FLOUM. They make more money out of it.

Mr. DUFFY. Okay. Mr. Kantor, you and your folks say there is not enough competition in this market. Is that right?

Mr. KANTOR. That is correct. There is price fixing now.

Mr. DUFFY. But is it fair to say that your clients can use cash?

Mr. KANTOR. Can they use cash? Sure.

Mr. DUFFY. Yes. And they can use checks as well, right?

Mr. KANTOR. Sure.

Mr. DUFFY. So there are three methods of payment that your clients can choose to use if they so wish, right?

Mr. KANTOR. There are many methods of payment, yes. The problem is—

Mr. DUFFY. —these are the Visa products, yes?

Mr. KANTOR. Visa is one product, they have credit and debit, but there is no competition among different cards and—

Mr. DUFFY. But there is competition with the payment method, right? You can accept checks, you can accept cash, or you can accept Visa.

Mr. KANTOR. Right. Thankfully, that was part of the Durbin Amendment that we could discount based on those differential prices.

Mr. DUFFY. And so, we are talking about, what is the appropriate charge here, right? Why don't your clients just pass that cost onto the consumers? We will give you a 1.5—we will give you a 2 percent discount if you use cash or check.

Mr. KANTOR. There are two things. One, consumers are paying these fees right now in the form of higher prices.

Mr. DUFFY. But they don't see them, right?

Mr. KANTOR. They don't see them, which is—

Mr. DUFFY. So why don't you let them see the fees, pass it on to them?

Mr. KANTOR. We have started doing that. Since the Durbin Amendment passed, there has been actually a large uptick in cash discount, particularly, at gasoline stations and some restaurants.

Mr. DUFFY. And then—

Mr. KANTOR. Visa has been quite aggressive about pushing them not to do that—

Mr. DUFFY. But what exactly is the answer to say, "Listen. Let's expose these fees and let the consumer decide whether they want to use a credit card, check or cash."

Mr. KANTOR. It would not though engender competition among different kinds of cards—Visa versus MasterCard versus—

Mr. DUFFY. But why is that your concern? You have competition of payment.

Mr. KANTOR. Because if they don't compete with each other, their only incentive is to keep driving fees up as it has been.

Mr. DUFFY. But at what point do we say, this is the appropriate role of government. I traveled in a campaign for a very long time, and I like the example of Slurpees, but—and I am a big fan of McDonald's. I ate a lot of it. But, I get a super-sized Coke and what is the cost of a Coke? The water and the sugar and the ice in the cup, $0.20? And they charge $1.50 or $1.80.

We should get involved and regulate the price of McDonald's Coke. Is that how far we are going to go?

Mr. KANTOR. If McDonald has fixed their prices with their competitors, the government not only should, but would get in trouble.

Mr. DUFFY. I go to Burger King and I go to Taco Bell and they are all the same price.

Mr. KANTOR. They are competing. They are competing that price down.

Mr. DUFFY. I don't know.

Mr. KANTOR. We fixed this. Trust me. Their profit margins wouldn't be 1 percent to 3 percent. They are very well.

Mr. DUFFY. But it is fair to say, if we look behind the curtain, there are other expenses and costs that feed into the $1.50 or $1.80 supersized Coke that I get.

With that, Mr. Kantor, do you think that the Fed has analyzed all the costs that go into the fees that the banks charge or interchange fees that are charged?

Mr. KANTOR. I think they actually have not because there are a lot of other costs ranging all the way from marginal to semi-fixed that are part of that product.

Mr. DUFFY. And thank you—one other question. Quickly, Mr. Seltzer. You indicated that with the check guarantee service—okay, that—what do you guys pay on average for a transaction to your Visa, $0.44, $0.50?

Mr. SELTZER. The average debit transaction is about $0.29—

Mr. DUFFY. $0.29. And you testified earlier that if you have a check guarantee, you pay about half of that. Is that right?

Mr. SELTZER. Sure.

Mr. DUFFY. So you pay about 14.50 cents if you are going to get a guarantee for a check.

Mr. SELTZER. Something on that order.

Mr. DUFFY. And right now, the maximum you are going to pay with Visa with this new rule is $0.12. Is that right?

I yield back.

Chairwoman CAPITO. Thank you for making all of us hungry—

Mr. DUFFY. Congressman?

Chairwoman CAPITO. And I would like to go to Mr. Prentzas because he is one of the weigh in on this and he is our bona fide merchant on the panel. So if you could, in 30 seconds, respond to Mr. Duffy.

Mr. PRENTZAS. Yes. Mr. Congressman, you made a comment that let's leave it to the consumer to decide their form of payment. I understand that my type of business, for example, is basically by phone orders and also by the Internet. There is no way I could accept the check or cash. My business depends on somebody using that credit card and debit card.

On the other hand, you tell me it is not the place of the government, the Federal Reserve—the government to oversee that this is a billion dollar industry. It affects every single one in this country. And when it doesn't affect everybody and thus cause a billion dollar industry, I believe that the government should be able to oversee what is going on. It has been done in the past and it should be done today.

Chairwoman CAPITO. Thank you.

Mr. McHenry?

Mr. MCHENRY. Thank you, Madam Chairwoman, and thank you for your leadership on this subcommittee and congratulations on your subcommittee chairmanship.

Most of the great questions have been already asked. And it is tough for me to follow Sean Duffy on anything.

Do you want my time, Sean?

But in all seriousness, this is a major issue, and Congress was legislating when a lawsuit was ongoing and some of us had some questions about that. But price fixing, this was—Mr. Kantor, to your question here—to your comment, rather.

What Sean was saying in terms of $0.99 Cokes at all the fast food restaurants, you could call that price fixing, that is to be litigated by the courts. So in terms of representing your coalition, do

you conceptually think that the government setting prices is the right path?

Mr. KANTOR. What the government should do is get rid of price fixing here and get rid of these fees and that is what this amendment says exactly, if I may—

Mr. MCHENRY. Reclaiming my time, so in order to eliminate price fixing, we need to have a regulator set the price. Yes or no?

Mr. KANTOR. Here, we need to have the regulator do something. And we thought they should say no more price fixing zero fees. Set them on your own. They have instead been more generous to the banks and said, "Oh, charge more than that." Okay.

Mr. MCHENRY. We just had testimony from Mr. Seltzer that it costs, in essence, $0.14 for a check and $0.12 for the Fed's regulation for debit. Is that a fair assessment, Mr. Kantor?

Mr. KANTOR. It is. Unfortunately, that price difference doesn't make up for the fact that Dave Seltzer, Gus Prentzas and merchants like them get charged back for fraud transactions and don't get a payment guarantee. He has bought one on the checks and paid extra for that, debit cards don't give—

Mr. MCHENRY. Okay.

Mr. KANTOR. The Fed found that in our numbers—

Mr. MCHENRY. Let's continue on this question here. And I have had merchants tell me prior to this debate going back a number of years that the cost of cash is a burden on small businesses. If you are—especially 7-Eleven or during a lot of transactions and so sticky fingers, taking money out of the till is—and loss prevention is a cost and so there is a cash cost.

And so I just want to better understand that cash cost. This is a complicated issue, but it is hard to get an accurate comparison. Mr. Seltzer, can you discuss that cash cost?

Mr. SELTZER. Sure. We calculated this, within the last year or so. And as we calculate the cost of cash, we include all of the bank service charges we incur for depositing that cash and currency.

Mr. MCHENRY. What about losses?

Mr. SELTZER. We include losses.

Mr. MCHENRY. —okay. Yes.

Mr. SELTZER. And labor and everything else that goes into it. And so at the end of the day, we see our cost of cash being somewhere in the 0.2 percent to 0.25 percent range as we looked at it.

Mr. MCHENRY. Okay—everything. Okay.

Mr. SELTZER. That is probably an eighth of what we see for debit cards.

Mr. MCHENRY. So as a merchant, you don't like the deal you are getting with debit, with credit. Okay. Why not simply say no to credit and debit?

Mr. SELTZER. We are happy to pay a competitive fee for debit or credit. The challenge we see is that every time we had discussions with any of the networks, the answer we get back—

Mr. MCHENRY. No. No.

Mr. SELTZER. —change rate because we have to compete with the other network.

Mr. MCHENRY. I know. I understand. But, why not simply say no?

Mr. SELTZER. We would be out of business.

Mr. MCHENRY. You would be out of business. So there is—the current value that they are producing for your business, debit and credit is providing some value for you and your business.

Mr. SELTZER. That is right and if there were a competitive market for this—

Mr. MCHENRY. Okay.

Mr. SELTZER. —and prices were set accordingly with—

Mr. MCHENRY. True. Okay. Mr. Kantor, are you going to answer?

Mr. KANTOR. I am very eager. There is a benefit. There are also benefits to the banks because they save on the check processing. What the courts have found is that Visa and MasterCard have market power. And they found that there is not an ability for merchants to say no, because of that market power.

Mr. MCHENRY. Okay. Then, why not come to Congress and look for a legislative fix in order to reduce that market power? It is an untoward market power. Why not get a remedy in courts? It appears that you just didn't like the remedy the courts were offering. And the simple way to do this is to simply have a regulator fix the price.

Mr. Floum—yes, my time is wrapping up, so I mean—

Mr. FLOUM. Yes. They have gone to the courts time and again with this argument that a uniform interchange is price fixing and every time the court has said no, you need to have interchange, a uniform rate. That is what keeps the small merchants, the small banks and low-income individuals in the system.

If the banks set the rates themselves, then, sure, some banks and some merchants would do fine, but the little guy would drop out of the system. So let's not confuse the benefits of a uniform interchange rate which the courts have found every single time to be lawful with the kind of price fixing that the government would impose under the Durbin Amendment.

Chairwoman CAPITO. I want to thank everybody on the panel and the visitors for their attention. I think you raised some interesting points. And I will go back to my original statement, a lot of questions at the same time.

So I will dismiss this panel and again, thank you, and I apologize for the late start. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record. This hearing is adjourned.

[Whereupon, at 3:40 p.m., the hearing was adjourned.]

A P P E N D I X

February 17, 2011

One of the most important roles of this subcommittee will be to monitor the consequences – both intended and unintended – of provisions of the Dodd-Frank Act on the financial services industry. Not only was Dodd-Frank a mammoth piece of legislation at 2,300 pages, it was unique because it left a tremendous amount of discretion up to the regulatory agencies.

Of the 300 or so rules expected to be made as a result of Dodd-Frank, few have been as contentious so far as the interchange rule, proposed by the Federal Reserve back in December. To me, this hearing is important because it pits against one another two important groups in our economy: Retailers, who are a large source of employment - especially part time employment; and banks, the source of credit and the engine of growth for our overall economy.

In order for us to form a useful understanding of this issue, we must get beyond the dollar and cents arguments that have been laid out by both

sides. We must look at the rule itself – its origin, the data used to create it, and its potential effect on consumer behavior.

The question will be whether this rule really creates a fair playing field, or whether it is a rigid price control that in and of itself will create further unintended consequences.

That is the heart of the matter, and I hope this hearing will be a step towards a better understanding for this committee.

2° Francisco Canseco.
TX 23.

Hon. Kenny Marchant
February 17, 2011
Opening Statement

Subcommittee on Financial Institutions and Consumer Credit Hearing on Interchange Fees

Madam Chair, thank you for holding this important hearing on the Fed's proposed rule on debt interchange. I look forward to hearing the testimony of the witnesses.

To this end, I am very concerned that the Fed has insufficient time to issue a rule without a thorough investigation into the unintended consequences. All parties should know what they are getting with this proposed rule before it is finalized. It is my hope that the Fed will shed light on some of these potential unintended consequences so that Congress can truly study this issue before it does irreparably harm to financial institutions and consumers. I am afraid that many do no fully realize the impact that this proposed rule will have on consumers who currently receive many financial services at little or no cost. Moreover, I am greatly concerned that this proposed rule will more adversely affect

smaller financial institutions than larger ones. Congress should not be picking winners and losers amongst our financial institutions and I look forward to hearing the testimony from the witnesses on how we can ensure fair treatment.

Thank you Madam Chair.

I would like to ask unanimous consent to insert a letter from the Texas Credit Union League in to the hearing record.

Statement of the Honorable Jim Renacci (OH-16)

Subcommittee on Financial Institutions Hearing

2.17.2011

Thank you, Mrs. Capito. The issue of interchange fees is one to which I feel I bring a unique perspective, so I am thankful for the opportunity to sit on this subcommittee as we attempt to sort out exactly what has been done by the Federal Reserve, and what steps we can take going forward.

Before I came to Congress, I actually had the opportunity to deal on both sides of the debit card transaction. I have sat on the board of a regional bank, analyzing its revenues and income streams, AND I have been a retailer, making the cost-benefit analyses as to whether or not to accept debit and credit cards. As we dig into this debate about the costs of a transaction, however, it is relevant to remember that I also am a CPA, so my interpretation of something's true cost will dig a little deeper and include many more line items than that of many of my colleagues.

In my 28 years as a businessman, I have learned both to love and understand the free market and its effect on the price of goods and services. With that deep affinity for free-market principles, I wish the previous Congress did not pass such a hastily-conceived provision which sets the price for a service totally independent of market forces. In a perfect world, we would repeal this particular provision and get out of the way to let banks and merchants negotiate a fair price for debit card services. I think that many of us understand that profit is not a bad word and banks are not all bad actors.

I am, however, a realist, and understand the powerful forces behind this provision and the seemingly insurmountable hurdles we would face in the other Chamber if we undertook a repeal effort. With that, we must play with the hand we are dealt, and figure out a way to evaluate the true costs of the debit transaction before we let the Federal Reserve's proposed rule to become final.

I regret that Senator Durbin is not with us today to answer some questions as to the motivation behind his amendment, whether he thinks that he properly directed the Federal Reserve to examine everything that actually goes into a debit transaction, and whether or not he believes the Fed's proposal to be fair to all parties involved.

I would, on the other hand, like to welcome and thank Governor Raskin from the Federal Reserve for being here today. I do not envy the task that Congress has directed her and her

team to undertake, especially with the passion on both sides of this issue. I think that, with the limited parameters that they were given, her team has done an admirable job of determining the costs that exist within the box that Congress directed her to examine. My worry, however, is how we best identify, evaluate, and price the costs that fall *outside* that box.

STATEMENT

OF

JOSHUA R. FLOUM

ON BEHALF OF

VISA INC.

BEFORE THE

SUBCOMMITTEE ON

FINANCIAL INSTITUTIONS

AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment

February 17, 2011

Chairman Capito, Ranking Member Maloney and Members of the Subcommittee, my name is Joshua R. Floum. I am the General Counsel of Visa Inc. ("Visa"). Visa appreciates the opportunity to address the important issues raised by today's hearing on the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") provisions related to debit interchange and the exclusivity and routing of debit transactions, as well as the corresponding regulatory proposal issued by the Federal Reserve Board ("Board") to implement these provisions.

Visa is a leading consumer payments system, and plays a pivotal role in advancing new payment products and technologies worldwide to benefit its more than 15,000 participating financial institutions, tens of millions of merchant outlets that accept Visa-branded cards, and the tens of millions of consumers who use over 1.8 billion Visa-branded cards.

Visa commends the Subcommittee for focusing on the potential negative impact of this debit regulation affecting all U.S. debit transactions. The Dodd-Frank Act amendments to the Electronic Fund Transfer Act (the so-called "Durbin Amendment") to implement government-mandated price controls, as well as changes to the structure of the payment industry, were enacted in haste and with little or no open discussion and debate in Congress. The Durbin Amendment was enacted through an extraordinary process in which there was no consideration in any Congressional committee, no vote on the Durbin Amendment in the House of Representatives, and only scant discussion of select provisions in the Senate. We believe that changes of this magnitude should not be imposed without serious and careful consideration, analysis and study. The Amendment could have significant, long-term consequences for American consumers, our financial and payment systems, and the U.S. economy as a whole. These changes are so fundamental and far-reaching that the extent of the consequences cannot be

fully determined today. As a result, we believe it is critical for Congress to suspend implementation of the Durbin Amendment and the Board's related regulatory proposal and request an impact study of the unintended consequences on participants in debit transactions, particularly consumers, small businesses, community banks, credit unions and other financial institutions. Although the GAO has completed studies that address certain topics dealing with interchange fees, those studies were conducted prior to the Board's interchange proposal and do not focus on the fundamental issues raised by the Durbin Amendment and in my testimony. In fact, only one of the studies addressed debit cards at all, and it narrowly focused on interchange for federal government entities.

President Obama recently challenged this country in his State of the Union Address to "out-innovate, out-educate, and out-build the rest of the world" in order to secure America's future.[1] As the President succinctly noted, "[t]he first step in winning the future is encouraging American innovation," and it is "[o]ur free enterprise system [that] drives [this] innovation." American ingenuity created electronic benefits, which have been enthusiastically adopted globally. And we continue to be a leader in developing digital currency and the great benefits that accrue to all as a result. The Durbin Amendment, and the Board's related regulatory proposal to implement the Amendment, however, stands in stark contrast to the President's call for innovation and his recognition of the importance of America's free enterprise system. The Durbin Amendment and the Board's proposal would supplant free market pricing in favor of government price controls, and could single-handedly remove all incentives for debit card issuers and payment card networks to innovate in debit card payments. Similarly, the Durbin Amendment and Board proposal send a clear signal to financial institutions that innovation and development of new services will not be encouraged. The very purpose of the Dodd-Frank Act

[1] *Available at* http://www.npr.org/2011/01/26/133224933/transcript-obamas-state-of-union-address.

as a whole was to bolster and strengthen this country's financial system and to protect American consumers. Yet, the Durbin Amendment and the Board's proposal represent a direct attack on American consumers and this nation's financial institutions, and their combined efforts to recover from the worst economic conditions this country has faced since the Great Depression.

In fact, debit cards themselves represent the very type of innovation called for by President Obama. Designed to replace single-purpose ATM cards and give consumers a non-credit point-of-sale payment option, debit cards are valued and used extensively by consumers as a replacement for cash and checks. Retailer acceptance of debit cards also has increased substantially as retailers recognize the efficiencies and savings of debit cards over cash and checks and the value of guaranteed payments. But instead of acknowledging the risks and investments that led to this innovation, now that this innovative product has taken root, the retailers are asking issuers through government-mandated price controls to give them access to the debit payment system for next to nothing in return. Retailers would have us believe that debit transactions are nothing more than "electronic checks" and should be priced like paper checks that clear at par. To the contrary, debit cards are not "electronic checks;" they are a form of payment that delivers significantly more value to all parties than paper checks do. Debit cards provide consumers and retailers with the ability to make and receive instantaneous payments. Unlike checks, Visa's debit card payments are generally accompanied by a guarantee to retailers. According to the 2010 Federal Reserve Payments Study, in 2009 there were $103 billion worth of checks returned unpaid, a decrease from 2006 when $182.5 billion worth of checks were returned unpaid. This reduction corresponds to an increase in debit card use over that same period and the guaranteed payment feature of debit cards.

Unlike checks, debit card payments are processed over state-of-the-art networks that provide consumers and retailers with robust security for transactions and secure access to funds anytime and anywhere these debit cards are accepted. Although consumers and retailers are not required to use or accept debit cards, their choice to do so is a clear recognition that debit cards provide both consumers and retailers with substantial value. Today's consumer has many payment options at her disposal. She frequently carries cash, checks, a debit card and one or more credit cards, as well as stored value or prepaid cards—all within one purse or wallet. Nonetheless, she continues to reach for her debit card on a more frequent basis for an increasingly broad selection of transactions. Each time she selects her debit card, that card serves as an engine for growth in this country's consumer-driven economy.

The Debit Interchange Price Controls

The debit interchange fee is commonly misunderstood and misinterpreted. The debit interchange fee represents a payment or value transfer made by a retailer's acquiring bank to the bank that issued the debit card, often based on the type of card used and the type of transaction or merchant category involved. This transfer of value between banks is necessary because the debit card cannot be used without participation of the consumer using the card from her issuing bank, and the retailer accepting the card with its acquiring bank.

For debit transactions, Visa has undertaken to provide extremely low rates, as well as certainty, in many merchant segments -- interchange rates on supermarket transactions are capped at only 35 cents, regardless of whether the purchase is for $50, $200 or any other amount. Similarly, interchange for utilities payment transactions is capped at 75 cents, and in the fuel segment, interchange is capped at 95 cents. On smaller ticket transactions, retailers may see interchange as low as five or six cents for small dollar purchases. And, the diversity of rates in

the Visa system reflects the wide range of retailers and merchant segments, sales channels and ticket sizes that Visa seeks to serve and make available to the consumer. The Board itself reports that average debit interchange across the industry is 44 cents per transaction—or 1.14% of the average transaction amount. Overall, Visa's effective debit interchange rate has remained flat, with only a minimal rate of change in interchange rates over the past ten years. In fact, retailer claims of "cost increases" overwhelmingly are driven by increased acceptance and usage of debit cards, rather than increases in the interchange rates themselves. But earning more revenue by offering more efficient and innovative products, at pricing that leads to more and more use by both consumers and retailers, is not unlawful or the exercise of "market power" as the retailers claim: it is the essence of market based competition.

Products and services in this economy should be fairly priced based on the value provided, not some limited concept of cost, and certainly not on some artificially selected portion of those costs. Instead, however, the Durbin Amendment would place an arbitrary, government-mandated price cap on the amount of debit interchange fees. This price cap would be dramatically below a debit card issuer's variable costs for those transactions and far more restrictive than the limitations placed on public utilities, since utilities are uniformly permitted to recover all costs of providing their services, plus a reasonable rate of return on their investments. In fact, the Board's debit interchange proposal not only takes an extraordinarily narrow reading of an already narrow statute, but also arbitrarily reduces the level of debit interchange fees by excluding costs that are clearly provided for under the statute. For example, the Board's proposal would not permit issuers to recover either the processing fees they pay to networks or fraud management expenses that are clearly related to the authorization, clearance and settlement of debit card transactions.

Essentially, the Durbin Amendment, together with the Board's related regulatory proposal, would force a transfer of approximately $12 billion per year from debit card issuers to retailers, with the largest retail chains being the primary beneficiaries of this government-mandated transfer. In fact, the very largest merchants would capture the vast majority of the interchange reductions, despite the extraordinary value that these merchants receive from the acceptance of debit cards, including driving increased, faster, and more efficient incremental merchant sales and profits.

Ironically, it's these same big box retailers who claim that Visa and MasterCard are "cartels" engaged in unlawful price fixing, and that this somehow justifies Congressional intervention. In fact, the claim that setting interchange equates to price fixing has been litigated—and lost—by the retailers on numerous occasions, and instead interchange has been found to be necessary, lawful and pro consumer. *See Nat'l Bancard Corp. v. Visa U.S.A., Inc.*, 596 F. Supp. 1231 (S.D. Fla. 1984), *aff'd*, 779 F.2d 592, 605 (11th Cir. 1986) (affirming the trial court's findings that interchange is pro-competitive "because it was necessary to achieve stability and thus ensure the one element vital to the survival of the V[isa] system—universality of acceptance"); *Kendall v. Visa U.S.A., Inc.*, No. C 04-04276 JSW, 2005 U.S. Dist. LEXIS 21449 (N.D. Cal. July 25, 2005), *aff'd*, 518 F.3d 1042, 1049 (9th Cir. 2008) (concluding that it was not unlawful for the networks to set interchange fees and that the acquiring banks' conduct was suggestive of "a rational business decision, not a conspiracy"); *Reyn's Pasta Bella, LLC v. Visa U.S.A., Inc.*, 259 F. Supp. 2d 992, 1000 (N.D. Cal. 2003) (quoting *State Oil Co. v. Kahn*, 522 U.S. 3, 10 (1997)) (holding that the rule of reason should apply because "the uniform interchange fee does *not* appear to be one of the few types of restraints exhibiting a 'predictable and pernicious anticompetitive effect' without potential for pro-competitive benefit") (emphasis

added), *aff'd on other grounds*, 442 F.3d 741 (9th Cir. 2006). And, these Court decisions were delivered when Visa and MasterCard were bank associations owned and governed by the banks. Now, of course, both are independent public companies, and the big box retailers' claims ring even more hollow. Nonetheless, the big box retailers continue to litigate the same claim in private class actions lawsuits. Of course, any remedy for so-called price fixing lies in the Courts, not in rushed legislation.

Before the Durbin Amendment, price control legislation understandably had not been enacted in this country for decades. Not only is the Durbin Amendment inconsistent with basic American free enterprise principles, but price controls in general have proven to be a failure, producing unintended consequences, stifling innovation and competition, and harming the very consumers the legislation was designed to protect. But here, the Durbin Amendment makes not even the slightest pretense about protecting or helping consumers. In fact, the Durbin Amendment has nothing to do with helping consumers. Its only focus is rewarding the big box retailers that successfully lobbied for this legislation. Ultimately, it is the consumer who will suffer.

1. *Consumers will pay more.* Already many banks have announced new programs to restructure pricing for checking and debit programs because the Durbin Amendment and the Board's related regulatory proposal would permit debit card issuers to recover only a small fraction of their debit card costs. The Board itself, in discussing its interchange proposal, acknowledges that issuers would not be permitted to recover their costs, but explains that "issuers have sources of revenue in addition to interchange fees, such as cardholder fees, to help cover their costs."[2] So, the Board itself recognizes that as a result of its proposal, consumers ultimately will pay for this

[2] 75 Fed. Reg. 81,722, 81,737 (Dec. 28, 2010).

value transfer to retailers, by paying for many services that today they get for free, including free debit cards, free online banking and free bill payment. In fact, a recent Independent Community Bankers of America survey found that 93 percent of its members will be required to charge their customers for services that are currently offered for free and 72 percent of its members will no longer offer free checking because of the new law and Federal Reserve rule. The decline or end of "free checking" will disproportionately hurt people at lower income levels, potentially moving them outside the banking system completely and back to corner "check cashers," and making it far harder for the unbanked or under banked to open or maintain debit accounts, and enjoy the mainstream benefits of electronic payments.

2. *Consumers will get less.* Because issuers will only be permitted to recover a small fraction of their debit card costs through interchange fees, many issuers will be forced to cut the costs associated with their debit card programs. As a result, it is likely that many issuers will limit, or eliminate altogether, a number of important consumer benefits, including transaction alerts, innovative loyalty programs and potentially, fraud protections that exceed what is legally required. Similarly, many issuers will be forced to limit investments in their debit card programs, including investments in technology that could lead to new ways of conducting even faster, more secure and reliable transactions for consumers.
3. *Retailers won't pass savings on to consumers.* There is no requirement in the Durbin Amendment (or even the faintest expectation) that retailers will pass along to consumers even a portion of the annual $12 billion windfall they will receive by reducing the prices that they charge for their goods and services. This was the case in

Australia after that government imposed price controls on interchange fees; consumers in that country saw no meaningful reduction in the cost of goods and services. The reality that consumers will not share in this government-mandated transfer of value is clear from statements by retail representatives themselves. Mallory Duncan, the National Retail Federation's general counsel said, that retailers "might offer free shipping or free gift-wrapping."[3] And when asked whether a reduction in interchange fees would lead to a reduction in consumer prices, Tom Robinson, the owner of "Rotten Robbie's" fuel stations and food stores, testified before the House Judiciary Committee that "there is not a businessman that doesn't attempt to keep the margin."[4]

It is important to keep in mind that the "primary objective" of the Electronic Fund Transfer Act, which regulates consumer electronic fund transfers and of which the Durbin Amendment is now a part, is "the provision of individual consumer rights."[5] The Durbin Amendment, however, is anti-consumer, representing instead only a dramatic windfall to the largest retailers in this country. Because of the manner in which the Amendment was inserted—at the last minute without notice or debate—into the broader Dodd-Frank Act, Members of Congress who voted for the Act overall were not given an accurate or complete picture of the full scope and impact of this legislation, nor the appropriate time to consider these complex issues. As a result, ordinary consumers will be harmed by this law and the primary beneficiaries will be a small number of powerful big box retailers.

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[3] Changes in Bank, Debit Card Fees May Have Limited Impact, *USA Today*, May 25, 2010. (attached)
[4] Credit Card Fair Fee Act of 2008: Hearing on H.R. 5546 Before the H. Comm. On the Judiciary, 110th Cong., Serial No. 110-179, at 161-162, May 15, 2008. (attached)
[5] 15 U.S.C. § 1693(b).

The Exclusivity and Routing Provisions

After the initial Senate vote on the Durbin Amendment, two more harmful provisions were added during the conference committee process, again with no meaningful discussion or debate. The first is an "exclusivity" provision requiring that issuers must do business with two unaffiliated debit networks, essentially compelling issuers to contract with networks that are unnecessary, and completely redundant to services they already contract for—and probably more costly to work with or less secure—than the networks they already chose to do business with. One egregious option under the Board's proposal would go even further and require two unaffiliated networks per authentication method for use of the debit card – meaning an issuer might be forced to pay the extra costs of putting four redundant networks on every card.

The second is a "routing" provision under which retailers, not cardholders, get to direct how transactions are routed at the point of sale. Similar to the government-mandated price controls on interchange fees, the network exclusivity and routing provisions will essentially mandate how debit card transactions are handled in this country. The network exclusivity and routing provisions, like their interchange counterpart, will have harmful intended and unintended consequences, many of which cannot be fully known at this time. And unlike the debit interchange provisions, no banks, financial institutions, or government programs are "carved out" or exempted from the network exclusivity and routing provisions.

The Exclusivity and Routing Controls Eliminate Consumer Choice

The Durbin Amendment and the Board's related regulatory proposal eliminate the consumer's choice in how her debit transaction is handled. If the transaction initiated by the consumer is changed, at the sole direction of the retailer to route through a different payment network, then a completely different set of rules applies to the transaction to which the consumer

would now be bound without her knowledge or consent. When dealing with a subject as sensitive as how people want their own money stored and accessed, consumers have a number of reasons for having a preference for how their transactions are processed (*e.g.*, speed, reliability and security) and the rules and protections that apply to those transactions. In many circumstances, a consumer will only receive certain benefits or protections associated with her card when a transaction is routed through a specific network. As a result, if a retailer steers the consumer's transaction to a different network, the consumer will lose access to certain features and protections associated with her account. For example, Visa's Zero Liability policy does not apply if transactions are processed on non-Visa networks; so, a retailer's choice to route a transaction through any network on the card can expose the consumer to fraud losses from which she otherwise would be protected. In addition, some consumers absolutely refuse to enter a PIN at a retail location because of understandable concerns about the security of that sensitive information being used "in public." Although other consumers may be comfortable entering PINs, the government should not be in the business of taking away the consumer's choice of how she will complete a debit transaction.

Ultimately, the routing provision gives retailers, rather than consumers or issuers, control over the debit payment system. It will now be the retailers—not consumers, not issuers, not networks—who make decisions for how the system operates, even though it is the consumer's money and checking account being accessed and used. These retailers are, for the most part, unregulated by financial regulators and lack financial prudence requirements. It would be unprecedented to leave the welfare of America's payment systems in the hands of unregulated entities. In fact, it is this very issue of control over those affecting our financial system that drove a number of the Dodd-Frank Act provisions designed to increase financial stability within

this country. As retailers make the routing decisions, not only are they depriving consumers of choices today, they are also depriving consumers of future choices. Networks and issuers, deprived of their ability to "win" the consumers, have less incentive to innovate and offer new products and services. Consumers will lose their option to use a mobile phone or newly designed technology to make their payments, and if new technology becomes available, retailers will control if and when it gets used, not consumers.

Retailers are also paving the way to drive transactions to networks, even retailer-owned or affiliated networks, that may offer a cheaper option but only because they have not made the necessary investments in security, error-free processing, or consumer protections. If the network used by the retailer is less secure, the consumer's financial information could be more exposed to theft or compromise—and the cardholder would have been given no say. In fact, consumers may ultimately feel misled because they will have expected their transactions to be handled by a safe and trusted network like Visa (or MasterCard) and the retailer will send it through some other, less reliable network. Moreover, one of the most serious consequences of both the routing and exclusivity provisions is that they deprive issuers of the ability to tailor unique products and fraud protection measures most suitable to their business goals and the needs of consumers. Instead, the Durbin Amendment, and the Board's related regulatory proposal, would commoditize debit payments for the sole purpose of driving down retailer costs and issuer revenue.

The Exclusivity and Routing Controls Will Compromise Security and Fraud Prevention

The exclusivity and routing controls also will compromise the security of debit transactions and compromise fraud prevention—not only because retailers will choose the cheapest (and likely least protected) network, but also because each issuer will need to interface

with additional payment network fraud detection services, thereby degrading the value of each fraud detection service. As issuers are required to spread their volume over multiple networks, issuers will not be able to tailor programs that identify fraud and other risk patterns. Many consumers, for example, have received calls from issuers asking them to confirm that they actually engaged in a particular transaction, rather than a fraudster. This antifraud service is made possible because the issuer and the network can see many of the consumer's transactions. If the retailer has the sole discretion to determine how the transaction will be processed, this antifraud tool may no longer be available or will be much less effective. Some special innovative services, like immediate "alerts" on transactions sent to the consumer's cell phone or email, simply will not be available unless the transaction is handled by the network offering that service. As a result, the ability of an issuer or a network to protect their customers and themselves will be materially reduced. Such a result is especially troubling given the recent instances of identity theft and cyber attacks, which demonstrate the critical need for robust systems and data security, and the related need for ongoing vigilance and continued investment in this area. Investments in new types of data security and fraud prevention can only be made, however, if there are sufficient economic incentives to do so, and there are opportunities to recover the costs of these investments. The combination of the interchange limitations and the exclusivity and routing requirements drastically limit these incentives and, therefore, materially compromise both security and fraud prevention.

The Exclusivity and Routing Controls Will Limit Interchange Rates

The debit interchange limitations and the exclusivity and routing requirements are inextricably linked. Retailers support the exclusivity and routing provisions because these provisions would further limit interchange fees. By requiring that issuers include multiple

networks on debit cards and by giving the retailer the routing choice over which network to process transactions, retailers will force a "race to the bottom" on the features and protections offered with debit cards. When a consumer pays by debit card, a retailer can aggressively route the transaction toward the network with the lowest interchange fee regardless of whether that network is the most secure, or provides unique benefits that the cardholder may value. As a result, in order to compete for the retailer's routing decision, some networks would be incentivized to provide fewer protections or fewer features for the transaction in order to win the retailer's routing choice. Ultimately, this will allow retailers to put pressure on issuer revenue by ensuring that all rates fall to the lowest possible government-mandated price controls, if not further, and potentially degrade consumer protections on transactions, since any network that invests in consumer protections may cost more and, therefore, not be selected by the retailer for routing. The incentive for issuers or networks to invest in new innovations or consumer features will be undermined.

This routing race to the bottom will have a particularly significant impact on community banks and credit unions, and on the government and prepaid programs that rely in part on debit interchange to fund their operations. Although Congress purposely exempted smaller community banks and credit unions and government-sponsored and prepaid debit programs from direct interchange price regulation, these small financial institutions and government and prepaid programs are nonetheless subject to the same exclusivity and routing provisions. This may have the effect of undoing the statute's small financial institution, government and prepaid exemptions by indirectly leading to the very interchange limitations that they were to be exempted from. Economic pressures could drive interchange on "exempt" volume toward the level established by the price controls, thereby degrading the operating revenue of all financial institutions, including

community banks and credit unions. This was precisely the intent of the big box retailers who surreptitiously put the provision in the bill during the conference committee process.

The Non-Exclusivity and Routing Controls Add Additional Complexity and Cost

As discussed above, the Durbin interchange limitations would permit an issuer to recover only a small fraction of its incremental costs. In addition, the exclusivity and routing provisions represent government-mandated increases in issuer costs coupled with an already drastic reduction in revenue. The non-exclusivity requirement for multiple networks introduces unnecessary complexity and cost to payment networks, issuers and acquirers. Issuers will be forced to enter into additional contracts, build new system connections and maintain network relationships they may not want and that may not be profitable for them. In fact, given current industry-wide processing systems and requirements, a number of specialized prepaid products such as healthcare reimbursement-type cards may not work if they have to comply with the exclusivity and routing controls. This will result despite statements on both the House and Senate floors that members of Congress thought healthcare related cards were excluded since they are valued by consumers and drive widely recognized efficiencies in health care management.

All of the contracts, systems and relationships required to meet the exclusivity and routing controls will be duplicative of the same services they already pay for, simply adding government-mandated cost and inefficiency, all against the backdrop of a price control regime that does not even permit the recovery of all such costs of providing valuable debit card services to retailers. This problem would be exponentially magnified by the untenable alternative in the Board's proposal that multiple networks should be provided for each authentication method established for a debit card. As complexity and costs increase, consumers face the real

possibility of reduced access to their funds, higher fees and fewer benefits from their debit products, and likely degraded consumer protections.

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We urge Congress to extend the effective date of the Board's interchange rule and request an impact study conducted by appropriate federal agencies of the unintended consequences of the Durbin Amendment and recommendations on the legislative or regulatory steps that might be taken to address the unintended consequences, particularly those affecting consumers and small financial institutions.

Thank you, again, for the opportunity to present this testimony today. I would be happy to answer any questions.

TESTIMONY OF DOUG KANTOR

COUNSEL

MERCHANTS PAYMENTS COALITION (MPC)

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES FINANCIAL SERVICES SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

HEARING ON

"UNDERSTANDING THE FEDERAL RESERVE'S PROPOSED RULE ON INTERCHANGE FEES: IMPLICATIONS AND CONSEQUENCES OF THE DURBIN AMENDMENT"

FEBRUARY 17, 2011

Chairwoman Capito, Ranking Member Maloney and Members of the Subcommittee, I am honored to appear before you today and appreciate the opportunity to share my views on debit card regulations. My name is Doug Kantor. I am a partner in a private law firm and am counsel to the National Association of Convenience Stores ("NACS"), the Society of Independent Gasoline Marketers of America ("SIGMA"), and the Merchants Payments Coalition ("MPC").

NACS is an international trade association representing the convenience store industry. The industry as a whole includes about 145,000 stores in the United States, sells nearly 80 percent of the gasoline in the nation, and employs about 1.7 million workers. It is truly an industry for small businesses; more than 60 percent of convenience stores are owned by one-store operators.

NACS and SIGMA are both members of the MPC. The MPC is a group of more than 20 national and 80 state trade associations representing retailers, restaurants, supermarkets, drug stores, convenience stores, gasoline stations, theater owners, on-line merchants and other businesses that accept debit and credit cards. MPC 's sole mission is securing a more competitive and transparent card system that works better for consumers and merchants alike. The coalition's member associations collectively represent about 2.7 million locations and 50 million employees. These merchant associations account for more than 60 percent of the non-automotive card based transaction volume in the United States.

The Durbin amendment which became law last year as part of the Dodd-Frank Wall Street Reform Act represents a dramatic improvement over the centralized price-fixing among competing banks that has characterized the debit card swipe fee market to date. The Federal Reserve's proposed rules to implement the amendment have the potential to move us significantly in the direction of the MPC's mission of a more competitive and transparent card system.

In my testimony today, I would like to cover a few areas: first, the background on clearance and fees associated with checks and debit cards; second, the problems with debit card swipe fees for businesses and consumers; third, how the Durbin amendment addresses these problems and fosters competition; fourth, how the amendment and the Fed's rule will level the playing field for small and large banks; and fifth, I will address some of the arguments being thrown around in this debate that are not supported by the facts.

I. Background on Checks and Debit Cards

In order to properly evaluate debit card policies, it is important to understand the history of the products that we are considering and the policy in this area. It should be recognized that neither checks nor debit cards are products in and of themselves. The relevant product is the demand deposit account that a consumer has at a bank. This is a point of agreement in this discussion. Bill Cooper, for example, CEO of TCF Bank which has sued to block implementation of the Durbin amendment described the situation in just this way late last year

saying, "Debit cards are not a product in and of itself. It's a delivery system for the checking account in a similar way that the checks are."[1]

The deposit account is a vehicle by which consumers give their own money to banks. Those banks hold the money for consumers' future use. Demand deposit accounts were traditionally a central part of banks' business model because it provided the bank with capital that it could use to make loans. By lending money at a higher interest rate than it paid to accountholders, banks made money. And by moving that money to uses that produced economic value, this system benefited everyone.

Checks, withdrawal slips and debit cards are simply access devices. They give accountholders a way to get their own money out of the bank so that they can use it. For centuries, checks were a very efficient way for people to have the use of their own money without having to actually get cash from a financial institution prior to entering into a transaction. One hundred years ago in this country there were exchange fees on checks – just like interchange or swipe fees – by which the bank receiving a check paid a fee to the bank on which the check was written. But this fee added inefficiency to our transactions because the recipient of the check, whether a merchant or an individual, did not get the full value of what was paid. The idea of currency is that it should reduce the costs of transactions to make them more efficient and easy. The exchange fee on checks worked in the opposite direction. As Tim Kelly, attorney for TCF Bank, put it during an ABA panel last year: "And the truth of the matter is that checks clear at par bank to bank, and if you think about it, it can't work any other way. Banks can't be charging each other for checks, and it would -- to add friction to this system would be a bad thing."[2]

So, the Federal Reserve, acting on the authority that Congress provided in the Federal Reserve Act of 1913, abolished exchange fees on checks. This made checks an even more efficient mechanism for consumers to access their own money that they kept in banks. It is worth noting, however, that this did not make the checking system completely free. Merchants, banks and consumers have faced costs relating to checks throughout the last hundred years. Merchants often pay their bank a flat fee – today it is often about a nickel – for each check they deposit. There is a cost to banks for handling a check. Likewise, consumers have had a number of fees associated with checks and their accounts. But all of these fees were determined transparently in direct business relationships between merchants or consumers and their own banks with which they chose to do business. That competition kept the fees as low as possible.

The first debit cards appeared in the United States in the late 1970s. For most consumers, these first cards weren't referred to as debit cards. They were "ATM cards." These cards could

[1] William Cooper, Comments, TCF National Bank Financial Earnings Conference Call, Transcript, Oct. 12, 2010, at 5.

[2] Timothy Kelly, Comments, *A Challenge to the Durbin Amendment: Is the Fed's Power to Write Rules Regarding Interchange Fees Unconstitutional?*, American Bar Association Section of Antitrust Law Insurance and Financial Services Committee, Conference Call Transcript, Dec. 14, 2010, at 38.

not be used at a point of sale to purchase goods. Instead, they allowed consumers to go to an automated teller machine and withdraw cash from their own accounts that those consumers, in turn, could use to make purchases. The cards were introduced because they created tremendous efficiencies for banks. When ATMs were used to make withdrawals, banks saved money on tellers and the extended hours and convenience allowed people to leave their funds in the bank longer – giving the banks greater use of those funds. And, processing these transactions electronically was much cheaper than processing checks, so the banks saved on those processing costs as well.

Banks and networks realized that the benefits of electronic banking would be multiplied if merchants would accept the cards at their establishments. This would further reduce the reliance on tellers, would give the banks control over accountholders' money longer (because they would only spend it when needed and not withdraw it in advance of expected purchases), and would begin to replace checks and save on processing costs. Initially, the interchange fee system mirrored ATMs. Fees were paid by banks to merchants to compensate them for the cost of deploying a PIN debit machine. PIN debit transactions were more secure and prompt than checks and the banks also realized merchants were saving them money by deploying PIN pads. For the most part, there were no swipe fees associated with debit cards at the point of sale. By sharing the savings of debit, everyone benefited. Consumers had a more convenient way to spend, banks saved on every transaction and had use of consumers' money longer, and merchants had some revenue, knew the transaction was good and another way for their customers to choose to pay.

The ATM comparison is interesting. It is widely recognized that ATMs provide value to banks by allowing the banks' accountholders to access their funds. ATM owners spend money to do this – and collect money from accountholders' banks to make up for it. Similarly, merchants invest funds in PIN pads and other hardware and software to allow consumers to use debit cards in their stores and access their money in the banks. And at first it operated in a similar way to ATMs with some merchants getting funds back on each transaction.

Somewhere along the way, however, that situation changed. That change and the repercussions of it are central to the hearing today. The New York Times chronicled much of this change in January of 2010.[3] During the 1980s and 1990s, ATM and debit transactions were handled by a number of different regional networks such as Star, Pulse, NYCE, and Shazam. In the early 1990s, Visa acquired its own debit network, Interlink, and began to change the equation.

Visa and its member banks recognized that as debit cards were becoming more prevalent in the early 1990s, so were credit cards. And Visa decided that debit cards weren't competing with checks – they were competing with credit cards. The banks controlling Visa collectively set interchange fees in order to maximize their revenue. Rather than gaining market share by cutting prices as happens in other markets, Visa and its banks were able to get more banks to issue its cards by raising fees; not the fees it charged, but the fees its bank issuers charged. Visa (again,

[3] Andrew Martin, *The Card Game; How Visa, Using Card Fees, Dominates a Market*, N.Y. TIMES, Jan. 5, 2010, at A1.

along with its banks) applied this logic to the debit card market and began aggressively raising interchange fees. In turn, more and more banks chose to use Visa and Interlink on their cards in order to collect this extra revenue. Interlink also created incentives to try to push banks to withdraw from the lower cost regional networks. That drove more transactions to Visa's Interlink network, increased its revenue and dramatically cut into the market share of the other networks.

As noted by the New York Times, by 1999, Visa's debit interchange fees reached $1.35 on a $100 transaction while the interchange on Maestro and other debit networks was less than 10 cents on the same transaction.[4] As Visa gained market share, its rivals eventually copied its strategy. MasterCard followed suit with its Maestro debit network, and the trend of aggressive debit interchange increases continues today. Fees continue to rise at a rapid rate and Visa/Interlink and MasterCard/Maestro have an ever-increasing stranglehold on the debit market. The former chief executive of the Star network summed up this history well when he said, "What we witnessed was truly a perverse form of competition. They competed on the basis of raising prices. What other industry do you know that gets away with that?"[5]

It is important to remember that debit cards are essentially plastic checks. That means the banks aren't extending credit to anyone. People are simply using the cards to access their own money that they have given to the banks. The history is telling here because it shows that there is no need for interchange. Banks need to attract consumers to give them money. It is a way for banks to get capital so they can lend – and make money on their loans. Of course, these banks would have a very difficult time convincing consumers to give them money if they didn't allow those consumers to get access to their money. Debit cards save the banks money every time they are used because they are cheaper than other ways that consumers get their funds. The economics work without interchange. That has been proven as at least eight countries around the world, including Canada, operate very efficient debit systems without interchange.[6]

This doesn't mean, however, that merchants would pay nothing with interchange reform any more than merchants pay nothing when they accept checks. Merchants still pay their banks for every transaction. But centrally set interchange is not necessary to return customers' own money to them and is inefficient. The debit system in the United States didn't have interchange for years and there are debit systems in a number of other countries that do not have interchange and operate extremely well.

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[4] *Id.*

[5] *Id.*

[6] Dennis W. Carlton, *Externalities in Payment Card Networks: Theory and Evidence*, Federal Reserve Bank of Kansas City, 2010, at 130.

II. The Problem with Swipe Fees for Businesses and Consumers

A. The Impact on Business

Having interchange causes a number of problems. The fact that the card networks and their banks centrally set prices and that banks which should be competing against one another agree to charge the same fees results in dramatically inflated fee levels. We know that anytime competitors agree on a set price it is set high. The American economic system, however, depends upon businesses competing with each other on the basis of price and quality. The swipe fee system, unfortunately, does not allow that to happen. Huge banks such as Citi, Chase, Bank of America, Wells Fargo and others all agree to charge the same schedule of swipe fees when they offer cards under the Visa umbrella, for example. There is no price competition. These banks compete on price in every other aspect of their businesses – from interest they pay on customers' accounts, to rates on loans and many fees – but not on swipe fees.

The fees, not surprisingly, have been rising rapidly. In less than a decade between 2001 and 2010 the fees more than tripled from $16 billion to $50 billion per year. On debit alone, the fees grew 234 percent from 1998 to 2006.[7] For most merchants these fees are now the second highest operating cost they have – less than labor but more than items like rent and utilities. And this is the fastest-growing cost these businesses face. Interchange has risen far faster than, for example, health care.

What is particularly troubling for many businesses, however, is that they are powerless to plan for or deal with these rising costs. They can take measures to keep other costs in check – installing more energy-efficient equipment, using a different supplier, and the like. But there is no dealing with interchange because all of the thousands of banks under the Visa umbrella (or, separately, the MasterCard umbrella) charge precisely the same schedule of fees. And the increases are unpredictable. Businesses don't know how much they will go up. Even after new rates are announced it is difficult to predict how those rates will impact a merchant's fees because the card networks have made the system so complex. GAO reported that Visa and MasterCard each had four credit card rate categories in 1991, but by 2009 Visa had 60 rate categories and MasterCard had 243. That complexity helps obscure the consistent, large fee increases that merchants must bear.

Merchants small and large have reported that these unpredictable, uncontrollable cost increases have stopped them from hiring new employees and opening new locations. In some cases, the fees have contributed to merchants closing stores and laying off employees.

These fees are stunting business growth and hurting efforts to hire more workers and expand operations. Robert Shapiro, former UnderSecretary of Commerce for Economic Development, issued a study last year of this impact and concluded that without the higher prices

[7] Stephen Mott, *Industry Facts Concerning Debit Card Regulation Under Section 920*, Oct. 27, 2010, at 14, *available at* http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf.

caused by fees above and beyond costs plus a reasonable rate of return, consumers would have an additional $26.9 billion to spend and the economy could add 242,000 jobs.[8] That study took into account both debit and credit interchange. Debit accounts for about 40 percent of interchange in the United States. So, according to Shapiro's findings, the Fed's rule may result in more than 95,000 jobs as consumers spend the more than $10 billion in additional money in their pockets each year.

Retail profit margins are very, very narrow. The retail sector of the economy is highly competitive and if costs go down for those businesses, then their prices go down. Exhibit 1 to this testimony includes charts from Fortune magazine comparing the profitability of different U.S. industries for each year from 2006 through 2009. There isn't a single category for retail, but they have numbers for "Specialty retail," "Food and Drug Stores" and "Automotive retailing" -- these cover large parts of the retail industry. The numbers show that each of these retail categories consistently rank near the bottom of all industries in terms of profitability and have very stable profit margins each year (many other industries are lower in particular years but fluctuate more). Specialty retail, for example, is between 3.2 and 4.0 percent profitability every year since '06. Specialty retail is about the most profitable sector of the retail industry. Food and drug stores are between 1.5 and 2.6 percent profitability each year. Automotive is less than that. This means that regardless of conditions in the economy the competition across retail businesses is such that revenues can never exceed costs by much – whether costs are rising or falling.

The inability of merchants to go to a competitor bank to get a better deal on swipe fees is simply devastating. In fact, economists with the Kansas City Federal Reserve have found that merchants cannot realistically refuse to accept Visa and MasterCard even though interchange costs far exceed any benefits those merchants receive by accepting cards.[9] While the card companies sometimes argue that merchants could stop accepting cards, the cards are so dominant now that that is not realistic. Visa, in fact, is promoting itself as "currency" in its marketing. Telling merchants they don't have to take cards, then, is like telling them they can refuse to take cash. While theoretically possible in some niche businesses, it is generally not a realistic option.

The dramatic jump in card rates – both in dollar terms and in terms of the rates charged – takes its toll on merchants. According to the GAO this is not just due to more people using cards but is the result of Visa and MasterCard increasing their fees. GAO wrote, "Visa and MasterCard officials told us that their average effective interchange rates applied to transactions have remained fairly constant in recent years when transactions on debit cards, which have lower interchange fee rates, are included. **However, our own analysis of Visa and MasterCard interchange rate schedules shows that the interchange rates for credit cards have been increasing and their structures have become more complex,** as hundreds of different

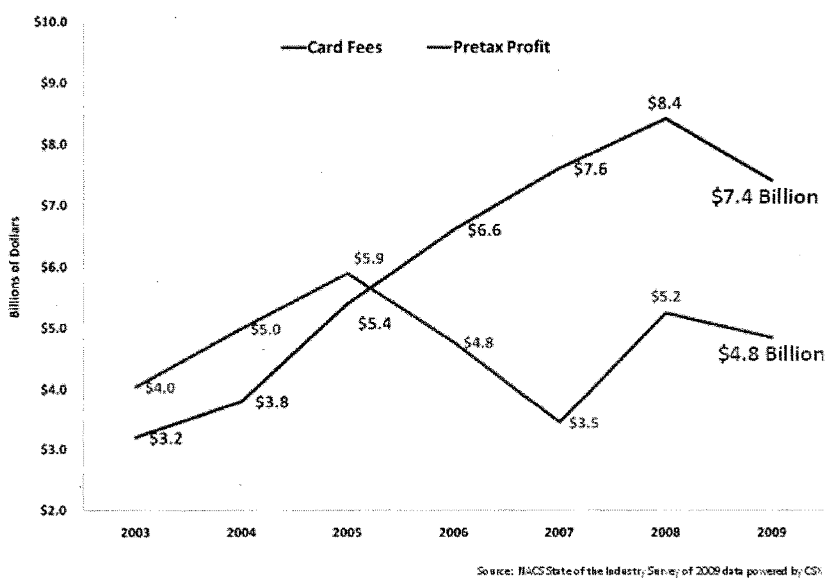
[8] Robert J. Shapiro and Jiwon Vellucci, *The Costs of Charging It in America: Assessing the Economic Impact of Interchange Fees for Credit Card and Debit Card Transactions*, Feb. 2010, at 2.

[9] Fumiko Hayashi, *A Puzzle of Card Payment Pricing: Why are Merchants Still Accepting Card Payments?*, Federal Reserve Bank of Kansas City, Dec. 2004.

interchange fee rate categories for accepting credit cards now exist."[10] Let's be clear about this, GAO concluded that what Visa and MasterCard told them about their rates remaining flat was false.

The increases in the rates set by Visa, MasterCard and their banks, along with increased card usage, has led to a huge increase in fees paid by merchants. The chart below shows how those fees have grown over time for the convenience store industry and shows industry profits per year as well. It is not a coincidence that as the amount of card fees jumped past the amount of profits the industry made, industry profits fell. The fact that fees exceeded profits for 4 years in a row demonstrates the difficulties these fees cause for businesses. With the recession there was also a shift to more debit usage. The card companies must have seen that shift, because on April 16 of last year, they put into effect a 30 percent increase in debit fees. While we don't have final numbers for 2010 yet, our preliminary data, which covers most of the year, indicates that interchange fees paid by the industry jumped 20 percent.

Card Fees and Pre-Tax Profits in the Convenience Store



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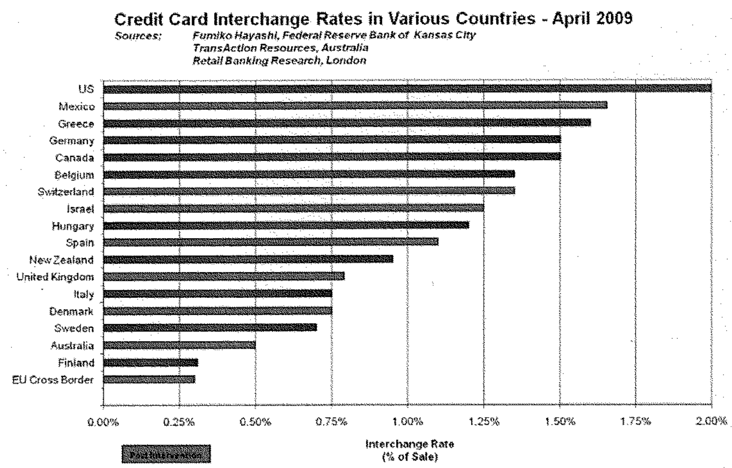
[10] *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges*, GAO-10-45, Nov. 19, 2009, at 14 (emphasis added).

And these fees hit small businesses the hardest.[11] That simply should not be. Unlike situations in which product needs to be manufactured and delivered to stores, there are no cost savings that justify better deals for large merchants.

These out of control fees disadvantage the U.S. economy. Interchange fees in this country are among the highest in the industrialized world, as shown by the chart below.



No one could contend that the U.S. card system is less efficient, has lower economies of scale, or is more fraud prone than systems in Italy, Hungary and other nations paying far lower fees. And it is worth noting that while some countries with lower interchange rates have taken action to deal with these fees, several countries that have done nothing pay lower rates than Americans do. The reason for that is straightforward. The two major card companies have such dominant market power here that they can engage in the anticompetitive practices that I have described without fear of too many merchants leaving the network.

B. The Impact on Consumers

The impact of anticompetitive swipe fees and the card industry's calculated lack of transparency on consumers is dramatic. American consumers pay inflated prices for virtually everything they buy because of these fees. And they pay these funds without even knowing it. Consumers never get a disclosure from their bank telling them any swipe fees are charged – not to mention how much they are. This is the card companies' model. By hiding their fees they can keep charging more and consumers won't notice. In 2009, the Hispanic Institute studied this phenomenon. They found that the business model by which fees are embedded in retail prices

[11] *Id.* at 10.

without disclosure, combined with the rewards that some affluent cardholders get, leads to a regressive transfer of wealth from low income consumers to high income consumers. This regressive wealth transfer is more than $1 billion every year.[12] The study did not even take into account the 27 percent of U.S. families who do not have credit cards – but are still paying inflated prices due to interchange.[13] The Boston Federal Reserve performed a similar study last year and found the same regressive result.[14] They concluded, "What most consumers do not know is that their decision to pay by credit card involves merchant fees, retail price increases, a nontrivial transfer of income from cash to card payers, and consequently a transfer from low-income to high-income consumers."[15]

Retailers are not the only ones who have come to the conclusion that swipe fees hurt consumers. John Blum, who testified on behalf of the National Association of Federal Credit Unions (NAFCU) before the House Judiciary Committee last year and in 2008 said in his previous written testimony, "Further, interchange is a cost that retailers can and do pass onto their customers in the final price of the goods and services they sell."[16] It appears then that NAFCU agrees with the Boston Federal Reserve and the Hispanic Institute – consumers are paying interchange fees right now, but the fees are hidden in the price of goods and services those consumers buy.

The card companies have strenuously argued that if anything at all happens to reduce swipe fees, then other fees paid by consumers will increase and consumers will be in a worse position than they are today. This is false. In fact, the European Commission's Directorates for Competition and Financial Services jointly conducted a comprehensive study into the European payment card industry in general, and Visa and MasterCard in particular. The Commission found no evidence to support the card systems' arguments that the high fee levels associated with the existing interchange system benefit consumers. In particular, the Commission rejected arguments that lower interchange fees to merchants would result in higher fees to consumers:

> There is no economic evidence for such a claim. Firstly, the inquiry's data suggests that in most cases card issuers would remain profitable with very low levels of interchange fees or

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[12] Efraim Berkovich, *Trickle-Up Wealth Transfer: Cross-Subsidization in the payment card market*, The Hispanic Institute, Nov. 19, 2009, at 5.

[13] *Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances*, Federal Reserve Bulletin, Feb. 2009, at 46.

[14] Scott Schuh, Oz Shy, and Joanna Stavins, *Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations*, Federal Reserve Bank of Boston, Public Policy Discussion Paper No. 10-03, Aug. 31, 2010.

[15] *Id.* at 1.

[16] John Blum, Hearing before the Task Force on Competition Policy and Antitrust Laws, House Judiciary Committee, May 15, 2008, House Report No. 110-179, at 89.

> even without any interchange fees at all. Secondly, the international card networks have failed to substantiate the argument that lower interchange fee would have to be compensated with higher cardholder fees. The evidence gathered during the inquiry rather suggests that the pass-through of higher interchange fees to lower cardholder fees is small. Consumers already pay the cost of the interchange fee without knowing it. This cost is now hidden in the final retail price and is therefore non-transparent.[17]

Similarly, the Australian experience has refuted claims that decreases in interchange fees would undercut the viability of card systems. In fact, after several years' experience with reduced interchange fees, the Australian central bank has concluded that card issuers have responded to lower merchant fees by offering consumers a choice: Low cost cards with low interest rates, low fees and no rewards, or rewards cards with higher interest rates and annual fees.

Indeed, this resulting *price competition* is precisely the outcome the card systems feared: For example, MasterCard had complained to the Australian Reserve Bank about having its members forced to compete on price:

> MasterCard does not disagree that there is, at present, strong competition amongst issuers of credit cards. Such competition has been enhanced by the fact that, at present, issuers have been able to recover eligible costs.... One distinct characteristic of the product offerings in recent times, however, has been the increase in the number of "low cost" credit card offerings. While MasterCard believes that it is beneficial for there to be "low cost" credit card products being offered, it also believes that, with the common benchmark interchange fee, in the future there will be fewer "fully featured" credit card offerings and the competition between issuers will be based on increasingly homogeneous "low cost" credit card offerings.

That is precisely the result that would be best for consumers. Once the card companies in Australia stopped competing for market share by raising the fees their banks would earn (which the bank could in some small measure plow back into enticing rewards for consumers), they had to compete on interest rates in order to attract consumers directly. That is what Australian consumers really wanted and what they have been getting since their system was reformed. Interest rates on credit cards fell precipitously after the reforms and even though the overall rates in that country have fluctuated over time, the spread between their benchmark rates and the rates consumers get on their credit cards is consistently narrower than it was prior to Australia's reforms. U.S. PIRG and other consumers groups educate consumers that the most important thing to look at when evaluating cards is the interest rate. Once Australia took some of the confusing subterfuge out of the system by reducing the hidden fee-reward cycle, consumers there were able to focus on interest rates and get better rates.

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[17] European Commission, Directorates on Competition and Financial Services, *Competition: Final report on retail banking inquiry – frequently asked questions*, Jan. 31, 2007, *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/40&format=HTML&aged=0&language=EN&guiLanguage=en.

The number of times that banks have tried to end free checking, raise fees and put the blame elsewhere should raise real questions about their veracity today. Exhibit 2 to this testimony is simply a list of news articles on this subject. It shows that banks proclaimed the end of free checking and increased consumer fees in 2008. At that time they blamed it on the financial crisis. Then, the banks said the same thing in 2009, but they started blaming the Credit CARD Act for their fee increases. Later in 2009, the banks apparently ended free checking for the third time and decided to claim that they were increasing consumer fees due to overdraft regulations. That continued into 2010. Following passage of the Durbin amendment, however, the banks had a new source of blame for their fees – ignoring, of course, that even today the Durbin amendment is not in effect and hasn't yet reduced a single swipe fee. We can only wonder what they will blame next.

What this history of casting blame demonstrates is that whether the Durbin amendment had ever been conceived or not, the banks would do whatever they could to raise fees on their customers. The only thing that holds them back is competition. They need consumers to put money in their banks. If they raise fees too much then consumers might go to another bank. It is that simple. There is no magic revenue number at which the banks stop trying to find ways to make more money. They will keep trying regardless of what happens on the issue before the Committee today.

The last decade proved this point beyond any doubt. Interchange tripled. Consumer fees were not cut to a third of their previous level. In fact, they weren't cut at all – they went up. Greg McBride, a senior analyst at Bankrate.com noted in 2008, "[B]ank fees have been going up consistently for 10 years." [18] Consumer fees for overdrafts and a host of other charges on their checking accounts exploded right along with swipe fees. Overdraft fees, for example, hit a record $38 billion in 2009 which was double what they were in 2000. [19] It is simply false that allowing high interchange results in lower consumer fees.

What is clear is that consumers are paying interchange fees now in the form of higher prices and they are paying high fees directly to their banks – as high as those banks can charge without losing business. Swipe fee reform can't do anything about the direct consumer fees and won't change them either way, but it can reduce the hidden fees that inflate prices, and that is a win for consumers.

III. The Durbin Amendment and Federal Reserve Rule

A. Putting Limits on Price-Fixing by the Card Industry

The Durbin amendment and the Federal Reserve's proposed rule to implement it are properly directed toward the heart of the problem with debit swipe fees. The law is narrowly

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[18] Kathy Chu, *Rising Bank Fees Are Setting Records,* USA TODAY, Oct. 27, 2008.

[19] Saskia Scholtes and Francesco Guerrera, *Banks Make $38bn from Overdraft Fees,* FINANCIAL TIMES, Aug. 9, 2009.

targeted to apply only to centrally fixed fees on which the banks do not compete. This is done through the definitions set forth in the law. The Durbin amendment defines an interchange fee to be "any fee established, charged or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction."[20] If banks would simply set their own fees and compete with one another, then, the Durbin amendment would not apply to those fees at all and banks would be completely free to choose how much they charge. If all banks did this, then the Durbin amendment and the Fed's rule would be dead letters – adding only a cautionary limitation should the banks decide to centrally fix fees again.

It is unfortunate that banks have been unwilling to do this. Centralized price-fixing undercuts the basis of our free market system which relies upon price competition. The scope of the Durbin amendment demonstrates the hollowness of the arguments against it. While banks and card companies are eager to insist that the law results in price controls, it does not. It allows the banks full discretion to charge anything they wish – as long as they compete with one another. If the banks continue to insist on fixing prices, however, the law puts some reasonable limits on the prices that can be fixed.

The comparison to the paper check system is telling. As noted earlier, exchange fees on checks (the equivalent of interchange) were prohibited by the Federal Reserve in the early part of the last century. This change helped the checking system thrive as an efficient way for people to make purchases. Debit cards were an innovation to save banks the money it costs to process paper checks. Every time someone uses a debit card, the bank makes money because the use of that card is cheaper for the bank than it would be for that consumer to use a check or go to a teller to withdraw cash. That is true even if there are no swipe fees and no consumer fees associated with use of the card.

The Federal Reserve's rule, in fact, is more generous to the banks than it ought to be. The Fed had discretion to do just what it did for checks – prohibit these fees altogether. Instead, the Fed has written a rule that allows the banks to charge for the costs of authorizing, clearing and settling debit transactions, plus a rate of return. While this is more money than the MPC believes makes economic or policy sense, it is still movement in the right direction. The banks, however, have made a series of strident claims about the additional costs that they think ought to be recovered through debit interchange. It may be helpful to examine each of these claims to determine whether the fees taken into account by the Fed are sufficient.

The Financial Services Roundtable sent to Congressional offices a list of additional costs it believes should be included in the Fed's analysis. The Roundtable wrote, "The proposal does not take into account funding costs, overdraft losses, billing and collection, customer service, data processing, protection of customer data and fraud losses that relate to supporting debit services – nor does it take into account the investment and development costs borne by financial institutions to create these electronic payment networks."

Why shouldn't funding costs be included in the Fed's analysis? Because those aren't debit costs. Debit cards are used when people want to access their own money. While that is

[20] Pub. L. No. 111-203, § 1075(c)(8), 124 Stat. 2068, 2074 (2010).

money customers have given the banks to hold for them, it is still the customers' money. The banks should not be able to claim a cost for letting people get their own money.

Why shouldn't overdraft losses be included? Because banks make money on overdrafts. The fees banks charge for overdrafts are so high that this is a profit center for banks, not a cost. In 2009, banks made $38.5 billion in overdraft fees and more than $20 billion of that was from debit overdrafts alone. The banks simply cannot credibly claim that a profit center is a cost, allowing them to double-dip and charge both consumers and merchants for overdrafts.

Why shouldn't billing and collection costs be included? Because these aren't debit costs. Consumers accessing their own money aren't billed and nothing needs to be collected. There are costs like these for credit cards, but credit interchange isn't touched by the Fed's rule.

Why shouldn't customer service costs be included? Because these aren't costs of debit, these are costs of having customers. If banks want to have customers who give them money, then they need to provide some service to those customers. The money the banks get on deposit allows the banks to make loans and earn money. The deposit accounts provide multiple revenue streams for banks as noted by TCF Chief Executive Bill Cooper when he said last year, "There are a lot of revenues associated with retail banking. There's the checking fees, there's the debit card fees, et cetera. There's a lot of revenues, plus the margin we collect from the money that we bring in from checking accounts and so forth."[21] There is no reason for banks to charge merchants for what every other business provides as a consequence of having customers without charging a third party for it.

Why doesn't the Fed rule take data processing costs into account? Well, as a matter of fact, it does. The costs of processing data through the system, checking that sufficient funds are in an account, and transferring those funds are precisely the costs contemplated and used by the Fed in coming up with its rule.

Why didn't the Fed include the protection of customer data and fraud losses in its analysis? Fraud losses weren't included because paying banks for having fraud losses creates a perverse incentive for banks to allow fraud-prone systems to proliferate. In fact, that is why "signature" debit – which is seven times more prone to fraud than PIN debit – has been able to grow even though it is far worse for consumers and the economy to have more fraud. Rather than compounding these problems, the law and the rule properly provide for ways that interchange can be adjusted when banks make expenditures that prevent fraud. This may include expenditures to protect data – which the Roundtable complains about without noting that this may be contemplated by the fraud prevention provisions in the rule.

The Roundtable also conveniently ignores that merchants spend billions of dollars on fraud prevention and data protection for the debit and credit systems. Just one subset of these expenditures by merchants (those necessary to comply with the network's PCI requirements) are

[21] William Cooper, Comments, TCF National Bank Financial Earnings Conference Call, Transcript, Oct. 12, 2010, at 16.

estimated to be $10 billion to date.[22] Many of these expenditures are necessary because banks have pushed signature debit transactions which are far more fraud-prone than PIN debit transactions. Given that banks are already pushing higher fraud prevention costs onto merchants through their behavior, the fed should cast a skeptical eye on bank attempts to recover their own, similar costs.

The magnitude of these costs may be surprising to people not familiar with how the payments system works. An average convenience store, for example, loses $930 each year to chargebacks and 86 percent of those chargebacks are in the category of "fraud" chargebacks. That means the store, not the bank, is picking up the tab for fraud. An average store also pays $9,200 each year to secure the payments system and protect data. That amounts to $1.3 billion for the industry as a whole – or 25 percent of the entire industry's pre-tax profits. The size of those numbers should make clear that merchants are more than paying their own share for fraud and data security and should not be paying more to subsidize the banks.

The card industry likes to claim that debit cards give merchants a payment guarantee. That is simply false. A merchant can do everything right to ensure a transaction is properly authorized and still be stuck with the loss if the transaction turns out to be fraud. I have included another all-too-common example at Exhibit 3 to my testimony. It is a letter from the owner of the Catch Seafood Tavern in New York. The letter explains how the banks refused to give him the money for five transactions amounting to $78. The claim was that they were duplicate transactions. After fighting his way through a lengthy dispute resolution process, the owner established that the transactions were legitimate and simply a case of the same cardholder ordering the same round of drinks more than once – a common occurrence in his establishment. He managed to win his dispute, but was charged a dispute resolution fee by the network of $15.50 per transaction. The fees came to $77.50 and he walked away from the abusive process with 50 cents for his efforts. Many merchants have simply given up challenging unfair decisions like this because the networks find other ways to discourage them from doing it – such as with this fee. And remember, his transactions weren't even fraudulent. But he lost the money anyway.

This happens with depressing frequency. The card industry comes up with any excuse it can to push fraud losses onto merchants. The Federal Reserve study found that 43 percent of the time on signature debit transactions merchants footed the bill for fraud. Other analyses show merchants absorb more of the fraud losses than banks. In 2009, merchants suffered debit fraud losses of $689 million while bank issuers had debit fraud losses of $499 million.[23]

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[22] Stephen Mott, *Industry Facts Concerning Debit Card Regulation Under Section 920*, Oct. 27, 2010, at 28, *available at* http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf.

[23] *Id.* at 25.

If you include credit cards and look at the numbers, merchants pay an even higher majority of fraud losses.[24] The card industry simply cannot legitimately maintain that it should be able to make merchants pay for fraud whenever it wants, not guarantee payment, and make merchants pay more interchange for fraud. As Mr. Prentzas said in his testimony, this would not only be wrong, it would be offensive. The real question is whether banks should be reducing swipe fees by the amount of fraud that merchants are forced to take.

Why shouldn't the costs to create the payment networks be included in the rule? There are many reasons for this. First, current network costs are borne by the networks – and their fees are not regulated by the Durbin amendment or Fed rule. Second, any initial capital costs that were spent by banks to start the networks have been recovered many, many times over through decades of inflated interchange fees and the huge investment gains the banks made when the major networks had initial public offerings of stock. The banks made investments and those investments paid off as Visa and MasterCard became very valuable. The banks should not be paid by merchants when they already made a killing off of these investments. Third, credit swipe fees are still vastly over-inflated and more than cover any and all costs that the banks might have put into the networks. There is simply no reason for banks to get debit swipe fees for investments that are borne by others, on which the banks have already recovered and for which the banks continue to receive an outsize revenue stream with huge profit margins.

In short, none of the costs that banks claim should be part of the Fed's analysis belong there. The costs of authorizing, clearing and settling transactions are more than banks receive on check transactions and the Fed built in a rate of return on these costs. The Fed's survey of banks found that these costs amounted to 4 cents per transaction, but the Fed's rule allows for either 7 or 12 cents to be charged. That makes for average profit margins of 75 to 300 percent. Those are margins that no retailer would dare dream of making.

B. Introducing Competition

While most of the attention to date has been on the fees that banks will charge, the Durbin amendment made changes to help promote competition in important ways that should not be overlooked. First, the amendment allows merchants to give customers discounts. These discounts can be based upon the form of payment that a customer chooses so they could be discounts for the use of cash, checks, debit cards or credit cards. These discounts would not differentiate between the type of debit or credit card – they would just be for that generic type of payment. The Justice Department has taken action to add an additional layer of competition to this mix. They settled antitrust claims against Visa and MasterCard that allow merchants to give customers discounts based upon the brand of card they use (Visa/MasterCard/Discover). Unfortunately, this added competition is being held up by American Express which has chosen to litigate against the Justice Department. Until that matter is resolved, American Express is preventing customers at the vast majority of stores across the country from getting discounts when they use cheaper card brands.

[24] Javelin Strategy and Research, *True Cost of Fraud Study*, Lexis Nexis (2009).

While discounts for cash have technically been allowed for years under federal law, the card networks have made it very hard for merchants to offer them. Since passage of the Durbin amendment, however, we have seen merchants become more emboldened and cash discounts have proliferated at the gas pump in particular. This is a very beneficial change from the recent past when Visa was aggressive in fighting against cash discounts. Exhibit 4 includes just one news story demonstrating the types of tactics that Visa used to intimidate merchants.

Giving consumers discounts for using cheaper payment methods is a win for everyone. Consumers and merchants save money on the transaction. And, the discounts allow for consumers to see the cost implications of their payment choices. That brings market pressure to bear on swipe fees that are normally hidden and isolated from such pressures. Transparency and choice are essential ingredients to price competition and the Durbin amendment is a key first step toward that competition.

The Durbin amendment also includes a provision to facilitate competition among the networks. As noted earlier, Visa used its strategy of aggressively raising swipe fees to gain a dominant share in the debit market. Some of this backwards price competition can be avoided through the provision of the new law that gives merchants the ability to select the network over which debit transactions are processed.

Merchants have a role in network routing decisions today but are limited in what they can do. Visa and MasterCard have entered into a number of exclusive deals with banks to prevent those banks from allowing their cards to be processed over other networks. It used to be commonplace for debit cards to be interoperable with four, five or more debit networks. But now smaller networks like Star, PULSE, NYCE, Shazam and others are being shut out of large parts of the market. That hurts competition and should not happen.

But Visa and MasterCard have kept the smaller networks completely barred from so-called "signature" debit transactions. These transactions traditionally have been those initiated by someone signing a receipt rather then entering a PIN number. The name, however, is a misnomer. Today a large volume of "signature" transactions take place in which no one signs anything. This happens, for example, on Internet transactions, pay-at-the-pump transactions, and low dollar amount transactions. There are also PIN transactions in which no one enters a PIN number. Despite this blurring of the lines, Visa and MasterCard do not allow "signature" transactions to be run across any other network. That is anti-competitive and unfair.

The result of Visa and MasterCard restricting the networks that can carry "signature" transactions is that they control growing pieces of the market and have been able to raise their network fees without concern about competition. These network fees are fees that merchants pay in addition to interchange. While interchange is the majority of merchants' costs, the network fees have become a real issue as well and should not be ignored. The fees went up 30 percent last year alone. The Durbin amendment does not regulate network fees. In order to ensure that they do not continue to grow out of control, the amendment requires that every transaction – whether initiated by a PIN, a signature, or neither – should have the option of running over at least two unaffiliated networks. Then merchants can make a competitive choice

among networks based on price and quality – the way that purchasers of other goods and services do in a market economy.

This happens in Australia and New Zealand today. PIN debit networks in those countries are able to carry signature debit transactions, allowing for competition and choice. And, contrary to the card industry's protestations, the change to allow this to happen was easy, fast and cheap. The only reason it hasn't yet happened here is that Visa and MasterCard won't let it happen. Why would they when they have been able to exclude competitors from that part of the market?

IV. Leveling the Playing Field for Small Banks and Credit Unions

Currently, the way that swipe fees are fixed disadvantages small banks and credit unions. Those institutions typically have higher costs than do large institutions. Witnesses in hearings on this topic last year confirmed this. John Blum, for example, told the House Judiciary Committee: "Credit unions have a higher per-transaction cost for processing card payments."[25] Community banks have similar disadvantages because of their relatively small size resulting, in many instances, in the need to outsource card operations.[26] By fixing fees for all banks at the same level, however, large banks have for years been guaranteed higher profit margins than their smaller competitors. Those large banks have used their advantage to aggressively market themselves to consumers. That is one of the reasons why the credit card market is more concentrated than the debit card market. Many consumers who have accounts and debit cards at small banks and credit unions receive credit card and other offers from large banks. The large banks take the small banks customers in this way on a regular basis – paid for by their excess interchange earnings. The result is that large banks have a bigger share of both the credit and debit card markets than their share of deposits.[27]

The Durbin amendment, however, will level the playing field. It exempts banks with less than $10 billion in assets from its restrictions on swipe fees. As Georgetown Law Professor Adam Levitin has noted, "Credit unions are already at a disadvantage when attempting to compete with large banks and finance companies on business models that require economies of scale, and this disadvantage is likely to become more pronounced. . . . If a two- tiered interchange structure emerges from the Durbin Amendment's implementation, it will help make credit unions more competitive in the card issuance market."[28]

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[25] John Blum, Hearing before the Task Force on Competition Policy and Antitrust Laws, House Judiciary Committee, May 15, 2008, House Report No. 110-179, at 80.

[26] Dave Carpenter, Hearing before the House Judiciary Committee on the Credit Card Fair Fee Act of 2009, Apr. 28, 2010.

[27] *See* Adam J. Levitin, *Interchange Regulation: Implications for Credit Unions*, 2010, at 39 (noting that 10 banks alone account for almost 90 percent of the credit card market and 51 percent of the debit card market, even though those 10 banks hold only 36 percent of insured deposits), *available at* http://www.federalreserve.gov/newsevents/files/levitin_filene_paper.pdf.

[28] *Id.* at 39-40.

Visa has already publicly announced that it will allow unregulated banks to charge higher swipe fees than regulated banks. MasterCard will surely follow suit. Why is that? Because the only competition in this market is that between the networks as they try to convince banks to issue their cards rather than the other network's cards. That dynamic has driven up swipe fees for years. If MasterCard does not allow unregulated banks to charge higher fees than the Federal Reserve allows, those banks will do business with Visa. The opposite is true as well – which is why Visa finally confirmed that they would allow small banks to charge more. The same dynamic exists for other networks. All of them need to make themselves attractive to issuing banks so that those banks make it possible to use their networks. The result over time has been that networks compete to raise interchange and, unfortunately, that won't change.

This simple truth is clear to close observers of the industry. Eric Grover, who has a payments consulting firm, said that higher interchange for small banks and credit unions "makes total sense." While initially some were saying that a two-tiered system wasn't possible, Grover identified these claims for what they were and said, "That was simply intended to scare credit unions and small banks to keep them lobbying."[29]

Christopher Leonard, a consultant who works with banks on payments strategies recently authored an article in the American Banker in which he concluded that banks with less than $10 billion in assets are "winners" under the Durbin amendment.[30] Leonard wrote that the amendment may allow these institutions to "have their cake and eat it too."

It is odd, then, that small banks and credit unions continue to lobby against the Fed's rules. Perhaps the scare tactics noted by Grover were effective enough to continue to cloud the issue. The small banks have argued that market forces will force them to reduce their swipe fees to match the fees of larger banks. Unfortunately, there are no such market forces. Consumers don't see the fees and the network rules prohibit merchants from differentiating between different bank issuers. Neither the Durbin amendment nor the Justice Department's settlement with Visa and MasterCard altered that aspect of the rules. Merchants cannot refuse to accept a card based on which bank issued it, nor can they set different prices based on which bank issued a card. In fact, even if the rules allowed it, there is no practical way for merchants to make these distinctions. There are no electronic markers to inform the merchant as to who the issuer is – which would be required in many settings like self-checkout, pay-at-the-pump, and Internet transactions – and making distinctions manually by store clerks at the point of sale simply isn't feasible. Market forces do not exist to push interchange for unregulated banks down to the level of regulated banks.

Frankly, the irony of the banks making this argument is remarkable. They have claimed countless times that market forces don't exist for merchants to lower their own prices in spite of

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[29] Sean Sposito, *Visa Plans Two-Tiered Interchange Rates After Fed Rules*, AMERICAN BANKER, Jan. 10, 2011.

[30] Christopher J. Leonard, *Durbin Amendment Winners and Losers*, AMERICAN BANKER, Feb. 4, 2011.

a large body of evidence that there is robust price competition in retail markets. But when it comes to a market that demonstrably does not have market forces to reduce prices and which has led to policy interventions in countries around the world, the banks suddenly believe in the principals of economics enough to overcome clear market failures. Their arguments ignore the facts.

V. Setting the Record Straight

A. Consumers Will Save

Consumers pay swipe fees right now. They are simply hidden in the price of goods. As noted previously, NAFCU's representatives have agreed with this in past testimony.[31] Advocates for consumers understand this and that is why they have advocated for swipe fee reform. Exhibit 5 to this testimony is a letter from Americans for Financial Reform in support of the Durbin amendment. They and groups including U.S. PIRG and the Hispanic Institute wrote a joint statement for this hearing supporting the Fed's rule because it will benefit consumers.

In spite of these clear statements from people whose job it is to advocate for consumers' interests, some banks claim that merchants will have a mysterious way of keeping savings from consumers who are paying these fees today. That just isn't consistent with the facts.

It may be instructive to look at how fees flow through this system to understand how wrong – and cynical – the banks' arguments are. Swipe fees are paid from a bank at which a merchant has an account (the acquiring bank) to the bank that gave a consumer a debit card (the issuing bank). In order for merchants to see a single penny of savings from reduced interchange, acquiring banks must pass these savings through to merchants. Recognize that merchants don't complain about this and claim that acquiring banks will pocket the savings. The acquiring market is a competitive one and merchants believe that competitive market economics work – they live it every day. Oddly, we don't hear banks arguing that consumers and merchants won't save because acquiring banks will simply pocket the savings and pad their profits. But if market economics did not work – as the banks contend they don't work at retail – then that is precisely what would happen and the only result of the Durbin amendment would be to redistribute funds among the banks.

That will not happen because merchants can take their business to another acquiring bank and get a better deal. The result is that acquirers will compete with each other to reduce prices to merchants and merchants will save. The same will be true in retail markets, which will result in consumer savings. In fact, retail may be the most price competitive sector of the U.S. economy. Retail profit margins are consistently and notoriously thin – even as business costs go up and down those profit margins remain thin. That means merchants are cutting prices to compete when they save costs. As noted previously, Exhibit 1 demonstrates the profit margins for retailers during the past few years. Regardless of conditions in the economy the competition

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[31] John Blum, Hearing before the Task Force on Competition Policy and Antitrust Laws, House Judiciary Committee, May 15, 2008, House Report No. 110-179, at 89.

across retail businesses is such that revenues can never exceed costs by much – whether costs are rising or falling.

The Hispanic Institute, along with a University of Pennsylvania economist, studied swipe fees in late 2009. The study not only found that consumers pay swipe fees today, but it concluded that lower interchange translates into lower retail costs and higher interchange translates to higher retail costs.[32]

This is consistent with other studies. The Department of Energy, for example, has studied how retailers that sell gasoline do or do not pass through costs into retail prices. They found that for both cost increases and cost decreases there is 100 percent pass through of costs into retail prices.[33] That means, without question, whether interchange fees increase or decrease, those changes are reflected in the cost of gasoline paid at the pump by consumers – and that has been true for years.

In fact, consumers are already saving due to the Durbin amendment. The provision allowing for cash discounts helped embolden merchants to offer them in spite of the aggressive restraints that the card networks had put on them in the past. We have seen such discounts multiply at the gas pump and at restaurants as merchants begin to experiment more with trying to incentivize their customers this way.[34] Discounts for cash and other forms of payment means more freedom, choices and transparency for consumers – which is just what the card companies have fought against for years as they try to keep their fees hidden.

B. The Durbin Amendment Will Not Increase Checking Fees

Banks have for years looked to find excuses for raising checking fees on consumers. Today it just happens to be the Durbin amendment's turn to join this hit parade. Exhibit 2 to this testimony lists dozens of news articles proclaiming that banks are ending free checking and charging consumers more fees. Of course, the list starts in 2008 when no one had conceived of or proposed the Durbin amendment. At first, banks blamed the financial crisis and said free checking was ending. Then, in 2009, banks blamed the Credit CARD Act and said free checking was ending. Then, the banks blamed overdraft regulations for their plans to end free checking for the third time in two years. Now the banks tell us that they will end free checking for the fourth time due to the Durbin amendment. They are no longer credible on this question.

And in spite of the banks' hysteria about raising checking fees, there is ample evidence that they will do no such thing because they want to attract consumers to give them money to

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[32] Efraim Berkovich, *Trickle-Up Wealth Transfer: Cross-Subsidization in the payment card market*, The Hispanic Institute, Nov. 19, 2009.

[33] Michael Burdette and John Zyren, *Gasoline Price Pass-through*, U.S. Department of Energy, Jan. 2003.

[34] *See* Eric Dash, *Fed Proposes Rules to Cut Debit Card Fees*, NY TIMES, Dec. 16, 2010, at B1; Tom Sietsema, Review of Noodles on 11, *Going Out Guide*, WA POST, Jan. 26, 2011.

lend. Just this week, the Wall Street Journal reported that "Historically low interest rates, tough new capital requirements and heightened competition from brokerage firms are prompting banks to dangle juicy incentives to a group of customers that not long ago were considered wallflowers: depositors."[35] What the Journal story shows is that checking fees depend on the competitive dynamics of luring deposits to the bank – not on the separate revenue stream associate with a device for customers to access their funds.

The Banks claims about the relationship between checking fees and swipe fees don't have factual support. As noted previously, the European Commission's Directorates for Competition and Financial Services looked at the banks' claims and found no evidence to support the banks' arguments that consumers benefit from the existing high interchange fee levels. In Europe, the card networks have agreed to reduce debit interchange to 0.2 percent. The Fed's rules would reach about the same result (though it would be a bit more generous to the banks).

The evidence in the United States is consistent with this. If the banks were right that reducing interchange would result in higher bank fees on consumers, then the dramatic increases which led to a tripling in interchange over the past decade would have reduced consumer fees charged by banks. That has not happened. Banks have increased consumer fees over the last decade as well. Overdraft fees alone, for example, doubled from $19 billion to $38 billion from 2000 to 2009.[36] Clearly, increased interchange fees had no impact on keeping banks from charging their customers higher fees.

Bank of America spokesperson Anne Pace was at least honest in her comment to the Christian Science Monitor last October when she said, "Customers never had free checking accounts. They always paid for it in other ways, sometimes with penalty fees."[37] Banks are constantly trying to find new ways to generate fee revenue from their customers. If the Durbin amendment magically disappeared tomorrow, that wouldn't change. Banks would still be looking to charge more fees – they would just find another scapegoat to blame for it.

It should be recognized that the drive for more fees is a relatively recent change to banks' business models. For decades, the way that banks made money was by attracting deposits from their customers. Recall, for example, the days of the free toaster when people opened accounts. The bank would take those deposits and lend that money. Banks then made money on the spread between the interest rates they charged on loans and the interest rates they paid to accountholders. It was a model that worked and it tied the success of the bank to the success of

[35] Jessica Silver-Greenberg and Mary Pilon, *The Great Customer Courtship*, WALL STREET JOURNAL, Feb. 14, 2011.

[36] Julianne Pepitone, *Bank Overdraft Fees to Total $38.5 Billion*, CNNMoney.com, Aug. 10, 2009, *available at* http://money.cnn.com/2009/08/10/news/companies/bank_overdraft_fees_Moebs/index.htm.

[37] Associated Press, *Bank Accounts: Free Checking Fading Fast*, CHRISTIAN SCIENCE MONITOR, Oct. 19, 2010.

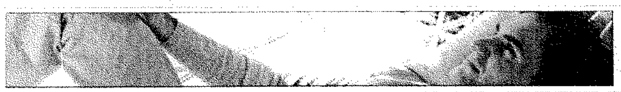
their customers. As long as customers did well they paid back their loans and put more money into the bank.

A little over a decade ago, however, that model changed as banks and their consultants decided fees could be a source of major revenue. Banks have aggressively raised fees ever since. That includes everything from overdraft fees to fees imposed based on the way that customers pay the bank. The aggressive drive for fees has been true when the banks deal with both individual consumers and merchants. Charging fees doesn't benefit everyone in the way that the loan model did. In fact, the fee grabs by banks often hurt the finances of customers and erode their ability to pay back loans and put more money into the bank. The interests of banks and their customers are no longer aligned in the way they once were. Members of this Committee have raised concerns that banks aren't lending money as often as they should. Part of the reason for this is that loans have diminished in importance under the banks' fee-driven business model. The larger percentage of banks' revenues that come from fees as compared to interest on loans, the less important it is for banks to make loans. This is a negative cycle. We would all be better off if banks made more loans and charged fewer fees.

VI. Conclusion

Debit card swipe fees as they exist today cannot be justified. Banks benefit every time a debit card is used. Banks benefit by getting consumers' money so the bank can lend it. Merchants and consumers benefit too, and when debit cards were introduced without swipe fees (or with payments to merchants), everyone was better off. Now, the way that banks agree to charge the same fees and the networks restrain competition undercuts any semblance of a competitive market and merchants and consumers lose. The Durbin amendment and the Federal Reserve's rule will help. The choice these new policies present to banks is straightforward – compete on your fees or they will be limited. Whichever choice the banks make, the rest of us will be better off for it.

Exhibit 1



FORTUNE 500 2006

Our annual ranking of America's largest corporations

Top industries

Most Profitable Industries: Return on Revenues

Industry Rank	Industry	2005 Profits as % of Revenues
1	Mining, Crude-Oil Production	29.9
2	Internet Services and Retailing	23.8
3	Commercial Banks	18.3
4	Network and Other Communications Equipment	15.8
5	Pharmaceuticals	15.7
6	Medical Products & Equipment	13.2
7	Securities	12.7
8	Railroads	12.5
9	Diversified Financials	12.4
10	Publishing, Printing	11.8
11	Household and Personal Products	11.1
12	Insurance: Life, Health (stock)	10.3
13	Homebuilders	9.9
14	Insurance: P & C (stock)	9.0
15	Oil and Gas Equipment, Services	8.7
16	Entertainment	8.4
17	Food Consumer Products	8.4
18	Electronics, Electrical Equipment	8.2
19	Food Services	8.0
20	Computers, Office Equipment	7.5
21	Health Care: Insurance & Managed Care	7.1
22	Hotels, Casinos, Resorts	6.8
23	Industrial & Farm Equipment	6.6
24	Apparel	6.5
25	Petroleum Refining	6.1
26	Utilities: Gas & Electric	6.0
27	Chemicals	5.8
28	Metals	5.6
29	Beverages	5.3
30	Information Technology Services	5.1

More Company News

Starbucks coming to 500,000 hotel rooms

Best business decision of decade: Kindle app?

Home Depot to hire 60,000 seasonal workers

How the states stack up

State	Number of FORTUNE 500 Companies
Texas	56
New York	55
California	52

See FORTUNE 500 Companies in Your State

Best employers

These companies appear on both the FORTUNE 500 and our 2006 ranking of the Best Companies to Work For.

31	Aerospace and Defense	4.9
32	Health Care: Medical Facilities	4.6
33	Telecommunications	4.2
34	General Merchandisers	4.1
35	Specialty Retailers	4.0
36	Semiconductors and Other Electronic Components	3.9
37	Energy	3.0
38	Food Production	2.8
39	Health Care: Pharmacy and Other Services	2.8
40	Wholesalers: Diversified	2.3
41	Engineering, Construction	2.2
42	Wholesalers: Food and Grocery	2.1
43	Food & Drug Stores	1.6
44	Pipelines	1.4
45	Wholesalers: Electronics and Office Equipment	1.4
46	Wholesalers: Health Care	1.3
47	Automotive Retailing, Services	1.1
48	Motor Vehicles & Parts	1.1
49	Packaging, Containers	0.4
50	Airlines	-10.6

From the April 17th, 2006 issue

Company	Number of Employees
FedEx	212,241
Intel	48,655
Starbucks	91,056

See the rest

Most profitable companies

Company	2005 Profits ($ millions)
Exxon Mobil	36,130.0
Citigroup	24,589.0
Bank of America Corp.	16,465.0

See the rest

Women CEOs of FORTUNE 500 companies

There are more women running FORTUNE 500 companies this year than there were last year. Currently, 10 FORTUNE 500 companies are run by women (up from 9 last year), and a total of 20 FORTUNE 1000 companies have women in the top job (up from 19). (more)

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Our annual ranking of America's largest corporations

Full list	Companies	States	Industries	CEOs
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Arrivals	Exits	Losers	50/50	FAQ

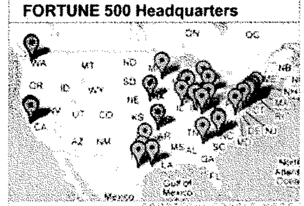
Top industries

Most Profitable Industries: Return on Revenues

Revenues Assets Shareholder equity

Industry Rank	Industry	2006 Profits as % of Revenues
1	Mining, Crude-Oil Production	26.6
2	Pharmaceuticals	19.6
3	Commercial Banks	16.2
4	Financial Data Services	15.2
5	Network and Other Communications Equipment	14.0
6	Medical Products & Equipment	13.5
7	Railroads	13.1
8	Securities	12.4
9	Publishing, Printing	12.4
10	Insurance: P & C (stock)	11.8
11	Diversified Financials	10.9
12	Insurance: Life, Health (stock)	10.7
13	Entertainment	10.7
14	Internet Services and Retailing	10.5
15	Oil and Gas Equipment, Services	10.4
16	Household and Personal Products	9.2
17	Metals	8.0
18	Food Services	7.9
19	Semiconductors and Other Electronic Components	7.7
20	Petroleum Refining	7.3
21	Industrial & Farm Equipment	7.2
22	Homebuilders	7.1
23	Hotels, Casinos, Resorts	7.0
24	Utilities: Gas & Electric	6.8
25	Beverages	6.6

FORTUNE 500 Headquarters



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- For those who have commented on Sam Walton's philosophy being...
- Now, consider this. WalMart no longer has Sam Walton running it.The...

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GALLERY

Top 50

Wal-Mart retakes the No. 1 slot on the Fortune 500 this year. See where America's largest companies rank, and why.

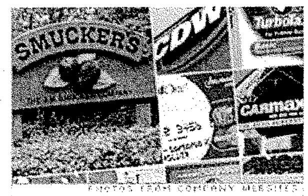
See them all

GALLERY

26	Chemicals	6.6
27	Computers, Office Equipment	6.5
28	Electronics, Electrical Equipment	6.4
29	Apparel	6.3
30	Telecommunications	6.2
31	Food Consumer Products	5.9
32	Aerospace and Defense	5.9
33	Health Care: Insurance & Managed Care	5.8
34	Packaging, Containers	4.3
35	Wholesalers: Diversified	4.1
36	Health Care: Medical Facilities	3.9
37	Specialty Retailers	3.6
38	General Merchandisers	3.3
39	Health Care: Pharmacy and Other Services	2.8
40	Food & Drug Stores	2.6
41	Airlines	2.6
42	Energy	2.6
43	Information Technology Services	2.2
44	Engineering, Construction	1.7
45	Pipelines	1.7
46	Wholesalers: Food and Grocery	1.7
47	Wholesalers: Electronics and Office Equipment	1.4
48	Automotive Retailing, Services	1.2
49	Wholesalers: Health Care	0.9
50	Food Production	-0.7
51	Motor Vehicles & Parts	-1.4

From the April 30th, 2007 issue

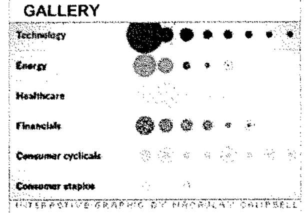
Note:
Due to slight differences in rounding, industry data online may not exactly match the FORTUNE 500 magazine version.



Best employers

More than 35 companies are on both the 2007 Fortune 1000 and 100 Best Companies to Work For lists.
See them all

GALLERY



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Last year saw the biggest buyout frenzy since 2000, as 42 Fortune 1,000 corporations were acquired. Who was part of the buyout binge?
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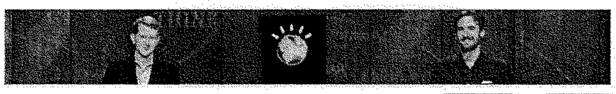

FORTUNE 500 *Our annual ranking of America's largest corporations* 2008

Top industries: Most profitable

RETURN ON REVENUES | RETURN ON ASSETS | RETURN ON SHAREHOLDERS' EQUITY

Industry Rank	Industry	2007 Profits as % of Revenues
1	Network and Other Communications Equipment	28.8
2	Mining, Crude-Oil Production	23.8
3	Pharmaceuticals	15.8
4	Medical Products and Equipment	15.2
5	Oil and Gas Equipment, Services	13.7
6	Commercial Banks	12.6
7	Railroads	12.4
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10	Household and Personal Products	10.2
11	Securities	10.1
12	Insurance: Property and Casualty (stock)	9.9
13	Real Estate	9.9
14	Scientific, Photographic, and Control Equipment	9.8
15	Financial Data Services	8.7
16	Food Services	7.9
17	Publishing, Printing	7.9
18	Utilities: Gas and Electric	7.9
19	Industrial and Farm Equipment	7.6
20	Electronics, Electrical Equipment	7.6
21	Hotels, Casinos, Resorts	7.3
22	Aerospace and Defense	7.2
23	Beverages	7.2
24	Chemicals	7.0
25	Internet Services and Retailing	7.0
26	Food Consumer Products	6.5

Top 50 Headquarters

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- High return to investors
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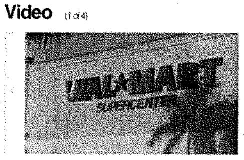

27	Telecommunications	6.4
28	Health Care: Insurance and Managed Care	6.2
29	Petroleum Refining	6.2
30	Computers, Office Equipment	6.0
31	Metals	5.5
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43	Health Care: Pharmacy and Other Services	2.6
44	Food and Drug Stores	2.1
45	Wholesalers: Electronics and Office Equipment	1.6
46	Automotive Retailing, Services	1.1
47	Wholesalers: Health Care	1.1
48	Motor Vehicles and Parts	1.1
49	Food Production	1.0
50	Semiconductors and Other Electronic Components	0.6
51	Diversified Financials	-0.9
52	Homebuilders	-9.5

From the May 5, 2008 issue

Wal-Mart by the numbers
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AES's powerful comeback
Fortune 500's top stock: Freddie Mac
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Pfizer's home remedy

Today's top stories

Top 3

HOW STATES STACK UP | BEST EMPLOYERS

Rank	# of Fortune 500 Companies
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California	52

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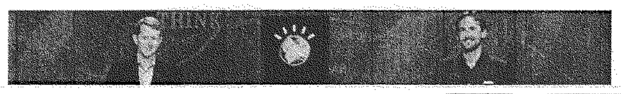


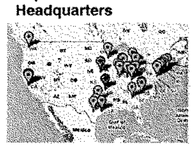
FORTUNE 500 *Our annual ranking of America's largest corporations* 2009

Top industries: Most profitable

RETURN ON REVENUES | RETURN ON ASSETS | RETURN ON SHAREHOLDERS' EQUITY

Industry Rank	Industry	2009 Profits as % of Revenues
1	Network and Other Communications Equipment	20.4
2	Internet Services and Retailing	19.4
3	Pharmaceuticals	19.3
4	Medical Products and Equipment	16.3
5	Railroads	12.6
6	Financial Data Services	11.7
7	Mining, Crude-Oil production	11.5
8	Securities	10.7
9	Oil and Gas Equipment, Services	10.2
10	Scientific, Photographic, and Control Equipment	9.9
11	Household and Personal Products	8.7
12	Utilities: Gas and Electric	8.7
13	Aerospace and Defense	7.6
14	Food Services	7.1
15	Industrial Machinery	6.9
16	Food Consumer Products	6.7
17	Electronics, Electrical Equipment	6.5
18	Commercial Banks	5.2
19	Telecommunications	5.1
20	Chemicals	5.0
21	Construction and Farm Machinery	5.0
22	Insurance: Life, Health (stock)	4.6
23	Information Technology Services	4.5
24	Computers, Office Equipment	4.3
25	Metals	3.9
26	Wholesalers: Diversified	3.5

Top 50 Headquarters



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After the sound, in the air, with the voice of a clarinet, I he...

I just don't understand how the oil companies can make so much in p...

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- High profit growth
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- High return to investors
- Top 5 in its industry
- Best company to work for

27	Insurance: Property and Casualty (stock)	3.3
28	Specialty Retailers	3.2
29	General Merchandisers	3.2
30	Health Care: Pharmacy and Other Services	3.0
31	Packaging, Containers	3.0
32	Beverages	2.9
33	Engineering, Construction	2.7
34	Health Care: Medical Facilities	2.4
35	Health Care: Insurance and Managed Care	2.2
36	Petroleum Refining	2.1
37	Food and Drug Stores	1.5
38	Pipelines	1.5
39	Wholesalers: Health Care	1.3
40	Semiconductors and Other Electronic Components	1.0
41	Energy	0.9
42	Home Equipment, Furnishings	0.7
43	Food Production	0.6
44	Wholesalers: Electronics and Office Equipment	-0.3
45	Diversified Financials	-0.6
46	Motor Vehicles and Parts	-0.7
47	Insurance: Life, Health (mutual)	-3.0
48	Hotels, Casinos, Resorts	-4.5
49	Automotive Retailing, Services	-7.9
50	Forest and Paper Products	-9.6
51	Entertainment	-10.0
52	Real Estate	-13.4
53	Airlines	-13.5

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Big employer Small employer

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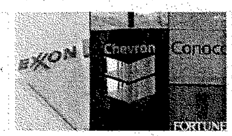

Big oil tops the 500
Exxon Mobil shoved aside Wal-Mart to retake the No. 1 slot. But the Fortune 500 had its worst slump ever.
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Top 3

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Rank	# of Fortune 500 Companies
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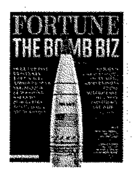

America's hottest export: Weapons

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Exhibit 2

Banks' Excuses for Adding Checking Fees

Banks have been determined to kill free checking for years. During the past few years alone, banks have seized upon one excuse after another for adding fees. This document simply lays out the articles showing these excuses and how they have changed over time. The inevitable conclusion must be that banks will increase fees whenever they can and find any convenient reason to blame someone or something else for their actions.

Articles

Rising Bank Fees are Setting Records, USA Today (Oct. 27, 2008), available at http://www.usatoday.com/money/industries/banking/2008-10-26-atms-fees-checks-banks_N.htm.

- "The high fees come at a time when banks are struggling to unload bad mortgage loans."

Banks Boost Customer Fees to Record Highs, Wall Street Journal (Nov. 12, 2008), available at http://online.wsj.com/article/SB122645109077719219.html:

- "Banks are responding to the troubled economy by jacking up fees on their checking accounts to record amounts."
- "[A]nother factor prompting banks to cut costs and raise fees and loan rates is a Federal Deposit Insurance Corp. proposal to increase the rates banks pay for deposit insurance starting next year."
- "Industry consolidation is also likely to result in higher fees."
- "[A]ll banks have to be looking for ways to meet the requirements of shareholders. . . . That naturally has them looking for alternative sources of revenue." – Thomas Dyck, Executive VP at TD Bank

Banks Find Ways to Boost Fees; Checking Accounts Latest Target, USA Today (May 28, 2009), available at http://www.usatoday.com/money/industries/banking/2009-05-27-checks-fees-banks_N.htm:

- "Banks defend their policies, saying that as unemployment rises, consumers have become riskier, and the higher fees reflect that risk. Banks may also be raising some account fees to compensate for higher borrowing costs and to keep prices in line with other financial institutions, says Scott Talbott of the Financial Services Roundtable, which represents the nation's largest banks."

Bank Fees Rise as Lenders Try to Offset Losses, New York Times (July 2, 2009), available at http://www.nytimes.com/2009/07/02/business/02fees.html?_r=1:

- "Scott E. Talbott, a lobbyist for the Financial Services Roundtable, said that the banks' fees reflect the cost of providing those services and the rise in overdraft charges reflects increased risk. 'There is an increased riskiness around repayment because of the recession, he added.'"

- "We've never seen a price increase during a recession. . . . What the bankers are saying is that I want to maintain my revenue." - Micheal Moebs, economist

Is Free Checking on its Way Out? CNNMoney.com (July 2, 2009), available at http://moremoney.blogs.money.cnn.com/2009/07/02/is-free-checking-on-its-way-out/.

- "Bank customers used to the perks of free checking accounts -- unlimited check writing, online banking, debit card use and ATM access, to name a few -- might have to recalibrate their expectations soon. That's because overdraft fees, which banks use to subsidize the expense of free checking accounts, have been under fire by consumer advocacy groups."

Banking Expert: Free Checking Accounts aren't Long for this World, WalletPop.com (Aug. 31, 2009), available at http://www.walletpop.com/2009/08/31/banking-expert-free-checking-accounts-arent-long-for-this-worl/:

- Following the Credit Card Accountability Responsibility and Disclosure Act and overdraft regulations, "banks are already trying to think of new ways to make their profits."

Is this the End of Free Checking? SmartMoney (Aug. 31, 2009), available at http://www.smartmoney.com/spending/deals/is-this-the-end-of-free-checking/.

- "Changes to federal regulations have triggered the cascade of new fees. Already cash-strapped banks anticipate declining revenue from credit cards as rules from the CARD Act take effect . . ."

The End of Free Checking? FierceFinance (Sep. 20, 2009), available at http://www.fiercefinance.com/story/end-free-checking/2009-09-02.

- "We noted recently that some banks, in the face of credit card legislation, were toying with the idea of hiking fees somehow. At many places, there's discussion of whether free checking has come to the end."

Banks' Struggle May Mean End of Free Checking, msnbc.com (Nov. 10, 2009), available at http://www.msnbc.msn.com/id/33840681/ns/business-consumer_news/.

- "The change by Citi comes as Congress considers legislation that would limit banks' ability to levy overdraft fees on checking accounts."

Checking Account Fees are Making a Comeback, SmartMoney (Nov. 19, 2009), available at http://www.smartmoney.com/personal-finance/debt/checking-account-fees-are-making-a-comeback/:

- "Account maintenance fees increased by 15% between the first and third quarter of 2009, according to Money-Rates.com."

The End of Free Checking? MoneyTalksNews.com (Dec. 30, 2009), available at http://www.moneytalksnews.com/2009/12/30/the-end-of-free-checking/.

- "[N]ew Congressional regulations like the CARD Act have limited the amount of money banks can make from credit cards. The Federal Reserve also has plans to address the highly lucrative "overdraft fee industry", estimated to be worth $38.5 billion in 2009 by industry consultants Moebs Services. In other words, free checking accounts may soon be going the way of the dinosaur."

End is Seen to Free Checking, WSJ (June 16, 2010), available at http://online.wsj.com/article/SB10001424052748703513604575311093932315142.html

- "Bank of America Corp. and other banks are preparing new fees on basic banking services as they try to replace revenue lost to regulatory rules, in a push that is expected to spell an end to free checking accounts for many Americans."

Biz Brief: The End of Free Checking? AOL Daily Finance (June 17, 2010), available at http://www.dailyfinance.com/story/investing/free-checking/19519855/.

- "Free checking accounts have been around so long they have become an American institution. The financial reform act that is now making its way through Congress includes some consumer provisions that may cut some bank fees. In order to make up for lost income, banks could cut free checking on many accounts."

The End of Free Checking, NPR Planet Money (June 17, 2010), available at http://www.npr.org/blogs/money/2010/06/17/127899418/you-may-have-to-pay-for-that-checking-account.

- "It costs banks a few hundred bucks a year to maintain a customer's checking account. Banks have been able to make that up (and more) largely by charging overdraft fees. But new federal rules mean banks can only charge those fees to customers who sign up for overdraft protection."

The End of Free Checking? Not at Credit Unions! Credit Unions Online (June 17, 2010), available at http://www.creditunionsonline.com/news/2010/The-End-of-Free-Checking-Not-at-Credit-Unions.html.

- "Since banks can no longer charge many credit card fees of the past and high risk (high fee) mortgages are gone, banks are finding themselves short of revenue. . . . Now the banks are coming after your checking account to make up the difference."

The End of Free Checking, The Atlantic (June 21, 2010), available at http://www.theatlantic.com/business/archive/2010/06/the-end-of-free-checking/58444/.

- "Free checking is on life support. . . . The main reason why, of course, is the imminent prohibition of overdraft fees, which had been a boon for banks."

End of Free Checking a Financial Squeeze: How Employers Can Help, The Huffington Post (June 28, 2010), available at http://www.huffingtonpost.com/clare-j-morgan/end-of-free-checking-a-fi_b_627540.html.

- "The free checking accounts many Americans enjoy will soon be a thing of the past as banks scramble to find new ways to recoup overdraft charges and other fees they're no longer allowed to impose."

U.S. Banks May End Free Checking, Reuters (June 17, 2010), available at http://in.reuters.com/article/idUSTRE65G0I920100617.

- "Bank of America Corp and other U.S. banks may introduce new fees on basic services and eliminate free checking to replace revenue lost to new banking regulations . . . ."

Free Checking: Will it Survive New Bank Regulations? iStockAnalyst.com (July 5, 2010), available at http://www.istockanalyst.com/article/viewiStockNews/articleid/4278660.

- "The free checking account, a common and widely available quirk of the 21st Century banker, could be in limbo. New regulations that are costing banks revenue may lead to new fees on basic services as new rules have been created after sub-prime lending in the U.S. real estate market resulted in mass foreclosures."

Pandit Says Citigroup Can Absorb Curbs on Fees, New York Times (July 16, 2010), available at http://dealbook.nytimes.com/2010/07/16/pandit-says-citigroup-can-absorb-curbs-on-fees/:

- "Mr. Pandit said Citigroup, which is one of the top issuers of debit and credit cards in the nation, would not experience such a big drop in its revenue due to the new rules on the debit interchange. 'Debit purchase is not a significant business for us,' Mr. Pandit said."

Overdraft Fee Rule May End Free Checking, Augusta Chronicle (Aug. 16, 2010), available at http://chronicle.augusta.com/news/business/2010-08-16/overdraft-fee-rule-may-end-free-checking.

- In the future, your free checking account might not be free anymore. Some banks are considering charging fees on their free checking accounts. One local banker said these fees result from changes in rules by the Federal Reserve Board.

Bank Accounts: Free Checking Fading Fast, The Christian Science Monitor (Oct. 19, 2010), available at http://www.csmonitor.com/Business/Latest-News-Wires/2010/1019/Bank-accounts-Free-checking-fading-fast:

- "Customers never had free checking accounts. They always paid for it in other ways, sometimes with penalty fees." - Bank of America spokeswoman, Anne Pace

Free Checking is Disappearing, The Huffington Post (Oct. 19, 2010), available at http://www.huffingtonpost.com/2010/10/20/free-checking-is-disappea_n_769298.html.

- "Almost all of the largest U.S. banks are either already making free checking much more difficult to get or expected to do so soon, with fees on even basic banking services. It's happening because a raft of new laws enacted in the past year, including the financial overhaul package, have led to an acute shrinking of revenue for the banks. So they are scraping together money however they can."

Another Sign of the End of Free Checking, New York Times (Oct. 26, 2010), available at http://bucks.blogs.nytimes.com/2010/10/26/another-sign-of-the-end-of-free-checking/.

- "A new study released by Bankrate.com on Monday offers another sign that many banks are turning away from free checking as they seek to make up for the end of lucrative automatic overdraft fees and the upcoming limits on the fees that merchants pay for debit card transactions."

Region Banks Refrain from Raising Checking Account Fees, Nwi.com (Nov. 9, 2010), available at http://www.nwitimes.com/business/local/article_337b378b-3f74-5a00-9d86-b9e6b3d58799.html:

- "Bucking a national trend, the region's community banks aren't raising fees or putting the breaks on free, non-minimum-balance checking accounts, yet. A recent Bankrate.com national survey on checking accounts indicates the percentage of checking accounts with no monthly service charges and no minimum balance fell to 65 percent in 2010 from 76 percent in the 2009 study."

Is the End of Free Checking Overblown? GoBankingRates.com (Nov. 19, 2010), available at http://www.gobankingrates.com/banking/checking-accounts/end-of-free-checking-overblown/.

- "With the financial crisis of 2007 hammering banks and increased regulations in the industry hampering their revenue streams, banks are readjusting their strategies and free checking accounts may soon come to an end."

U.S. Bancorp Ends Its Waiting Game with Durbin Debit Rule, American Banker (Jan. 20, 2011), available at http://www.americanbanker.com/issues/176_13/us-bancorp-1031521-1.html:

- "U.S. Bancorp no longer plans to bide its time as competitors figure out how to recoup fee income regulated away by the Durbin amendment. Now it will be piling on with everyone else."

- Jamie Dimon, Chairman and CEO of JPMorgan Chase, "said the company wants to recoup some of the cost of the new regulations in a way that is 'consumer-friendly and fair, but of course the consumer has got to pay, and they weren't paying for debit before.'"

Free Checking Accounts Falling by Wayside, Yakima Herald-Republic (Jan. 23, 2011), available at http://www.yakima-herald.com/stories/2011/01/23/free-checking-accounts-falling-by-wayside:

- "As of Feb. 8, JPMorgan Chase will begin charging most of its new checking account customers."

- "We're taking a fresh look at our checking accounts as a result of changes in our competition, regulations and customer behavior. ...We want to offer customers the best accounts in our industry, while at the same time run a sustainable business." - Darcy Donahoe-Wilmot, a spokeswoman for JPMorgan Chase in Seattle

- "We don't want to raise fees for our customers, but unfortunately, with new regulations, we're losing money on debit card transactions." - Darcy Donahoe-Wilmot, a spokeswoman for JPMorgan Chase in Seattle

U.S. Bank May End Free Checking, CNNMoney.com (Jan. 24, 2011), available at http://chicagobreakingbusiness.com/2011/01/u-s-bank-may-end-free-checking.html.

- "U.S. Bank is one of the last of the megabanks to offer free checking. But that may be about to end. The Minneapolis-based bank recently hinted that it will add fees to its checking accounts — and even possibly to its debit cards — as it attempts to recoup revenue lost under new regulations. "We're not going to be a late follower anymore, we're going to be right in the game ... we no longer have the luxury of waiting," said U.S. Bank CEO Richard Davis..."

Exhibit 3

Catch

January 15, 2010

The Honorable Charles Schumer
The Honorable Kirsten Gillibrand
The Honorable Tim Bishop

To my Representatives in Congress:

I'm writing as a small business owner who has an opinion on almost everything. But, to avoid writing a book, the subject today is credit card fees being charged by the big banks to the small merchant. I know there's legislation pending on this issue. And I know there is a lot of negative consumer sentiment regarding banks. Perhaps my situation will help sway a few votes to the side of right.

In the past month there have been five occasions where banks have initiated charge backs against my account. Three of the incidents were because the cardholder claimed the card was stolen. The other two were initiated by the Bank of America because they *suspected* fraud... two transactions of identical amounts on the same day. (Not unusual in a bar when a customer orders the same round of drinks.) In all five transactions the money was deducted from my account before I had any communication from my card processor requesting verification of the charges. *The big banks took the money of the small merchant assuming guilt before innocence.*

Since I check my account on a daily basis, I notice the debits. I called to ask about the deductions and was told of the claims against me. In all cases, I immediately faxed the proof that all five transactions were approved by the banks and that I did nothing wrong. I have so far been credited for the first three; I'm waiting for the last two. They're very fast to take my funds, very slow to return them. I should also note that had I not called I would have to wait until I got the letters requesting my response. In three cases the letters arrived on December 24th requiring a response by December 23rd. Even I'm not that good that I can respond 24 hours ago to a request.

Now, you'd think it couldn't get any worse... but it does. I've lost the use of the money for a period of time. I've proved that I did nothing wrong and that all the charges were legitimate. I've been credited the money for three of the five transactions and am waiting for the last two. I am now charged $15.50 for each charge back as a fee. A total of $77.50 in fees for $78.00 in charges that I processed correctly and within the letter of agreement with the card processors!!! Mr. Schumer, Ms. Gillibrand, Mr. Bishop – this is ridiculous. I lose the use of my money for weeks, then I have to pay a fee of 100% to get it back.

I write to you today in the hopes that you can appreciate both my frustration with the situation and that you can see just how ludicrous it is. I am a small merchant who is trying to get by, trying to provide employment, trying to pay my bills. I feel that I'm being nickel and dimed and $77.50'd by companies that are trying to shore up their revenues before the new credit card legislation takes effect. I ask your help if you too see the inherent wrong in this situation.

Sincerely,

Marc Miller
Owner

111 West Broadway Port Jefferson, NY 11777 631.642.2824 info@thecatchtavern.com

Exhibit 4

State won't intervene in dispute between Visa and marketers

Visa to marketers: If you don't like our rules, don't offer discount-for-cash

State regulators in California won't come to the rescue of marketers caught between obeying state standards on discount-for-cash pricing and demands by Visa that they drop the word 'credit' from price signs.

"As far as we're concerned, putting the word 'credit' on a price sign is appropriate, but as far as Visa telling marketers they can't do it, that's a civil matter between Visa and the marketers," says Dennis Johannes, the state's Weights and Measures director. "We have no authority to regulate Visa."

The state's posture leaves marketers in a Catch 22 situation. If they use the word 'credit,' Visa has said it may fine them and strip them of their right to take Visa cards. But if they adopt some of Visa's suggestions, such as leaving the 'credit' sign blank, they will be violating state standards, says Johannes.

Johannes believes that Visa is being "a little heavy-handed" on the issue. "They probably don't want dual pricing because it discourages the use of their credit card," he says. His only suggestion for marketers is that they seek a legislative change that will specifically require the use of the word 'credit' on signage.

Johannes is not alone in his suspicions of Visa's motives.

"Visa's goal is to get everyone to pay the higher, credit card price for fuel and they will twist and torture their rules if necessary to force consumers to do so," says Mallory Duncan, chairman of the Merchants Payments Coalition, a business group dedicated to fighting for lower card interchange rates.

Visa is not particularly sympathetic to the plight of marketers – the credit card giant says it is the marketers' fault for offering discount-for-cash in the first place.

"If the merchant wants to steer the consumer to discount for cash, then they have to do it within the context of Visa's rules," said Visa spokeswoman Rhonda Bentz. "It's great if they have a contract with the state, but they don't. They have a contract with Visa and if they don't want to abide by that contract, they shouldn't have signed it," she said.

"These merchants clearly want the consumer to pay with cash. Okay, then, they should just accept cash and not credit cards. But they want access to our 1 billion cardholders, and they want the reduced risk that comes with taking Visa, and they want the guaranteed payments. They just don't want to pay for it."

Visa threatened to fine Mom and Pop operator Mike Gharib's credit card processor $5,000 because he was using the word 'credit' on his price sign, as exclusively reported (OE 04/16). The processor, Petroleum Card Services, planned to pass the fine through to Gharib. Visa withdrew the threat after Oil Express raised questions on the issue. The company says Gharib is now "compliant" with its rules. Gharib has removed the word 'credit' and that part of his price sign is now blank, Oil Express sources say.

Visa's position is that the higher price next to the word 'credit' on signs implies that the customer is paying a surcharge for credit, which is against Visa rules. It wants marketers to substitute other terms, such as 'regular' or 'standard,' or just leave that part of the sign blank. Additionally, Visa says the word 'credit' does not take into account debit cards, which must be treated the same as cash sales under state regulations. Therefore, the signs are misleading to debit customers, too, says Bentz.

Asked why Visa should start objecting to the word 'credit' after its use on station signs for 26 years, Bentz says Visa received complaints from consumers who thought they were being surcharged for credit.

Johannes says consumers know debit transactions are the same as cash, and that the difference between the two forms of payment – cash and credit – is well-understood. Using the term 'standard' or 'regular' would confuse customers, and leaving the sign blank would violate state rules. Visa's other suggestions – 'non-cash' and 'base price' – would have to be studied, he says.

"'Non-cash' is probably something we would not pursue as being illegal but there are a lot of other enforcement people in this state, such as the district attorney, county officials, and state attorney general's office, and we don't speak for them."

Visa has also objected to the way some marketers handle debit card sales at the pump and there is a suspicion among some marketer groups that the company would like to force consumers to go into the station to sign for a debit card transaction. Visa receives higher fees for debit signature sales than it does for Personal Identification Number transactions, sources say.

Visa has told Auburn, Calif.-based marketer Nella Oil that its debit card sales at the pump violate Visa rules because those customers are not getting the cash or discount price.

When customers use a Visa debit card at the pump, they are required to enter a PIN. If they do not do so, the card processor treats the sale as a credit card transaction and the customer will pay the higher, credit price for fuel. Likewise, the marketer will pay the higher fees associated with credit card transactions, although the money will ultimately be debited from the customer's bank account.

Nella has decals on its pumps clearly warning customers that they must key in their PIN to get the debit price, and the state has approved that decal, a Nella exec says. Visa says that's not enough to ensure that customers receive their cash discounts. Nella had hoped to get its bank to segregate PIN debit purchases and block them at the pump, but has been told that is not possible. "So, we're back to square one," says Nella.

Actually, not quite – under the landmark Wal-Mart-Visa lawsuit settlement, Visa and MasterCard were barred from bundling their debit and credit cards together, so forcing merchants to accept debit cards whether they wanted to or not.

Nella can write to its card processor or bank and tell them that it no longer wishes to accept Visa debit cards, says an industry lawyer. This will cause the bank to shut off Nella's access to the Visa debit network. As a result, when a customer swipes his debit card the sale will be routed automatically to the regional debit network whose logo appears on the back of the Visa card – the Star network would be one such example. The Star system will not process the customer's sale until he inputs his PIN, so avoiding charging him the credit card price for fuel.

"What's so frustrating is that Visa and MasterCard have a duopoly in the market place and they're trying to put retailers in an untenable position in order to increase their leverage and revenues," says Duncan, with the Merchants Payments Coalition.

Exhibit 5

AMERICANS
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ACCOUNTABILITY • FAIRNESS • SECURITY

Americans for Financial Reform
1825 K St NW, Suite 210, Washington, DC, 20006
202.263.4533

SUPPORT DURBIN REASONABLE FEES AND RULES FOR PAYMENT CARD TRANSACTIONS AMENDMENT #3989

Senator Durbin
United States Senate
Washington, DC 20510

May 13, 2010

Dear Senator Durbin:

We write on behalf of Americans for Financial Reform, an unprecedented coalition of over 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups as well as Nobel Prize-winning economists. We support a strong Consumer Financial Protection Bureau and oppose weakening amendments to the Restoring American Financial Stability Act, S. 3217.

Durbin Amendment #3989 is a move towards helping Main Street.

Americans for Financial Reform supports the Durbin Reasonable Fees and Rules for Payment Card Transactions Amendment #3989 because it is good for merchants and good for consumers. The bank payment networks, Visa and MC, impose high, non-negotiable interchange fees for accepting credit and debit cards and use other unfair contractual practices that mean all consumers pay more at the store and more at the pump, whether they pay with cash or plastic. The bulk of the $48 billion estimated yearly take from interchange fees flows to the largest Goliath banks. Giving merchants more flexibility against unfair bank and card network practices will result in more payment choices for consumers and lower merchant costs.

For information, please contact Ed Mierzwinski, edm@pirg.org 202-546-9707 ext. 314

Sincerely,

Americans for Financial Reform
Our 250 member groups: http://ourfinancialsecurity.org/about/our-coalition/

February 17, 2011

Testimony of

David W. Kemper

on behalf of the

American Bankers Association
and the
Consumer Bankers Association

Before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

United States House of Representatives

American Bankers Association

CBA CONSUMER BANKERS ASSOCIATION

Testimony of David W. Kemper
On behalf of the
American Bankers Association
and the
Consumer Bankers Association
before the
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
United States House of Representatives
February 17, 2011

Chairwoman Capito, Ranking Member Maloney, and members of the Subcommittee, my name is David Kemper, Chairman and Chief Executive Officer, Commerce Bancshares. I am pleased to represent Commerce Bank, the American Bankers Association and the Consumer Bankers Association at this hearing today.[1] Thank you for the opportunity to provide the Subcommittee with the banking industry's perspectives on the serious implications and negative consequences of the Durbin Amendment and the proposed Federal Reserve rule implementing it.

Commerce is a mid-sized, "main street" bank founded in Kansas City in 1865. Our strong Midwestern culture and engaged workforce of 5,000 serves our customers from 214 branches in five states – Missouri, Kansas, Illinois, Oklahoma and Colorado. We use a super-community banking model, which allows us to balance small bank customer service and deep market knowledge with large bank product offerings and pricing.

Commerce Bank is counted among the best capitalized banks in the country and we did not contribute to the economic crisis by originating ***any*** sub-prime products. Commerce Bank is only one of three banks in the country to hold Moody's highest bank financial strength rating. And last year, we were honored by Congressman Emanuel Cleaver and former Financial Services Committee Chairman Barney Frank on the floor of the House for ranking third in Forbes Magazine's list of America's Best Banks. Chairman Frank flew to Kansas City and

[1]The **American Bankers Association** (ABA) represents banks of all sizes and charters and is the voice of the nation's $13 trillion banking industry and its two million employees.
The **Consumer Bankers Association** (CBA) is the only national financial trade group focused exclusively on the retail banking industry as it strives to fulfill the financial needs of the American consumer.

presented us with a framed page from the Congressional Record recognizing Commerce's achievement.

The Durbin amendment and the Federal Reserve's proposed rule to implement it will cause great harm to consumers, and to financial institutions of all sizes and their ability to revitalize local economies. There are four key points that I would like to make today:

- ***Consumers will be severely affected by the price-controls of the Fed's proposal***
  The government-mandated price control elements in the Federal Reserve's proposed rule will severely affect consumers everywhere, causing new consumer fees, including checking account fees, and pushing low-income customers out of the banking system. Debit cards have been widely embraced by both consumers and merchants in this country. They are faster at checkout, accepted worldwide, and provide a payment guarantee for the merchant ***and*** protect the consumer from fraud. Debit cards reduce the need for cash and check-writing and the cost of handling this paper. The Durbin Amendment moves the payment system backwards, taking a highly efficient debit card system where costs are shared by all who benefit to one where merchants are largely excluded from contributing and, instead, are presented with a multi-billion dollar windfall.

- ***Price-controls will mean a loss on every debit card account***
  The proposed rule dictates that my bank – and financial institutions throughout the country – ***must*** lose money on every debit card transaction we process *unless* we charge consumers more. Artificial price controls are bad enough in a free market economy. Dictating that we may recover substantially less than the cost of providing the debit card service, while also restricting us from obtaining a reasonable return on capital, is bad policy and a recipe for serious problems.

- ***The small-bank exemption will not work in practice***
  The exemption for small banks added to the Durbin Amendment will ultimately be ineffective. Every community banker that I speak with strongly believes they will be severely impacted by the interchange price controls imposed on larger banks. The economics are simple: market share will always flow to the lowest priced product, even

if those lower prices are mandated. The result for small banks is either a loss of market share, a loss of revenue that supports low-cost accounts and other valuable services, or both.

- ***A policy decision of such importance deserves more thorough consideration***
  The process by which the Congress addressed this important issue was deeply flawed. The amendment was added on the Senate Floor as a last minute addition to the Dodd-Frank legislation. It was never the subject of any hearings in either the House or Senate, never voted on by this or any other standing Committee of the House or Senate, and never subject to informed debate. Completely missing was any thoughtful consideration of the impact on consumers, banks, and the economy. As such, the result is a deeply flawed measure that must be revisited.

Commerce Bank, and indeed the banking industry, supported many of the key principles embodied in the Dodd Frank Act – we are all for sound banks, strong capital and consumer transparency. However, the Durbin Amendment had nothing to do with these principles. It has never received the necessary consideration for something so important and with such far reaching consequences. It will devastate retail bank profitability, stifle innovation, lower productivity in our economy and force a number of our customers out of the protection of the banking system.

Therefore, the American Bankers Association and the Consumer Bankers Association, and the thousands of banking institutions we represent, respectfully request that the Congress take immediate action to stop the proposed Federal Reserve interchange rule from being implemented.

In the remainder of my testimony I would like to expand on the above points.

Mandating Prices Below Cost is a Recipe for Serious Problems

Under the current Federal Reserve's proposal, it is estimated that banks will be penalized $14 billion in revenue, a number equivalent to 16 percent of last year's industry pre-tax profits. In essence, this amounts to a government mandated revenue transfer from banks to merchants. It may be worthwhile to note that last year, according to SEC filings; ***the largest retailers enjoyed***

a return on equity at an average of 19 percent, almost three times the financial returns in the banking industry.

It is important to understand the economics of the banking business and the real impact revenue reductions have on our ability to serve consumers and our local communities. It is quite clear that the significant cuts in interchange fees envisioned by the Federal Reserve's proposed rule will lead to a direct harm to consumers, be it in the form of higher costs, lost services, or a smaller banking industry able to serve local needs. And, as explained later, this has an exponential effect on economic growth, as every dollar lost means as much as ten times that amount cannot be loaned to small businesses, manufactures and others.

It is a simple fact that for any business to remain viable, revenue has to exceed costs. If the Federal Reserve's interchange proposal is allowed to move forward, banks will likely see a 70 percent to 85 percent cut in debit card revenues. This means that the income earned on the service will be ***significantly*** less than it costs a bank to provide it.

To illustrate, it costs Commerce Bank about $230 per year to maintain a consumer checking account, including branch costs, administrative, data processing, and issuing statements among other costs. Our overall profit margin for that checking account is 13 percent, or about $35. The Federal Reserve's proposal would cut our debit card revenues by about 85 percent, or $62 per account. This means that our profit on a typical checking account goes from $35 to a ***negative*** $27 and would leave our bank in the unfortunate position of losing money, on average, for each account. Our experience is no different than large and small banks around this country.

Durbin Interchange Price Controls Will Severely Impact Consumers Who Use Debit Cards

The debit card is one of the most successful and widely accepted products we have ever offered. The reality is that checking accounts have become debit accounts. This is because consumers enjoy the convenience of a seamless worldwide payments system available 24 hours a day, seven days a week, 365 days a year, coupled with a near complete protection from fraud. The evidence of how much consumers rely on their debit cards is startling. Our debit card users on average perform 26 debit card transactions a month compared to writing 5 checks.

Local communities also benefit with these added services, and merchants see operating efficiencies and higher sales generating from the confidence consumers have in our highly functioning payments system.

The Federal Reserve's proposed rule, however, will cause such a significant decline in revenue that banks will be forced to seek ways of making up that revenue. For example, without interchange revenue, many banks will be forced to begin charging higher fees on what previously were low and no-cost checking for our customers. Thus, as a direct result of the Federal Reserve rule, in many cases, free checking may very well be a thing of the past. It also may result in new or higher debit card fees and other account-related fees and even not issuing debit cards to some individuals.

As the cost of using a debit card shifts from the merchants to customers, some individuals will not be able or willing to pay the higher cost even though they value the use, safety and convenience of using their debit card to buy goods and services. For example, the loss of revenue will hurt the ability of banks to provide basic banking accounts that enable low-income people to access to the banking system. These individuals may well be forced out of the mainstream banking system, and will end up with more expensive and less regulated check cashers and other non-bank financial service providers.

The loss of revenue and the need to absorb the costs of providing debit card services may have to come by dramatically reducing other bank expenses, such as closing branches, laying off employees, or limiting other services that customers have come to expect. The bottom line is the cost of providing customers with debit cards does not disappear with the Durbin Amendment. It has to be covered somehow and that ultimately means higher costs and even less access to debit cards for consumers, and reduced services and even employment opportunities in community banks.

Interchange Price Controls Will Limit Banks' Ability to Serve Local Communities

If net income is reduced, so is capital growth as most community-based banks raise capital through retained earnings. This means that there are fewer resources to make job-producing small business loans in our community. In short, community banks and the customers they serve will be greatly harmed. The consequences are significant, since $1 worth of capital supports up to $10 in lending. Just to illustrate, for the industry as a whole, a 70 percent loss of interchange income would mean that lending could fall by as much as $100 billion each year.

The Fed Proposal Misses Significant Important Costs of Running the Debit Card System

The interchange amendment sets price controls by directing the Federal Reserve to establish standards for assessing whether the transaction fee paid by merchants to card issuers to use the debit card payment network is "reasonable and proportional" to cost. While this could be viewed more consistently with long-standing legislative and judicial precedents to recover costs and have a reasonable return on investment, the fact is that it is being interpreted very narrowly. As bad as the Durbin Amendment is, the Federal Reserve has made things worse by proposing an extremely restrictive rule that sets caps that do not account for important costs related to ensuring the reliability and security of the vast debit card system that customers enjoy today. The Durbin Amendment even permitted the Federal Reserve to explicitly consider fraud, which the agency acknowledged as important but stated it did not have the time to fully consider it.

Specifically, the Federal Reserve did not include a number of costs related to a transaction, such as: fraud losses; fraud prevention costs; fees banks pay networks to process transactions; costs of handling customer inquiries about the transaction and other customer services; card production and issuance costs; the cost of periodic statements required by Federal Reserve Board Regulation E (and other various costs of federal laws that we must comply with); capital costs for development, improvement, and expansion of the infrastructure to handle volume growth; staff time; and a reasonable rate of return, among others.

Covering just some variable costs and ignoring all the other costs of providing the product will certainly lead to disaster for any business. It is a false premise that in a fixed-cost business, a business could price at variable cost and survive. In the long-run, price needs to cover both variable and fixed costs. No business in the world can survive if it only covers variable costs.

The Federal Reserve Proposal Fails to Compensate Issuers for Fraud Expenses

A primary shortcoming of the Federal Reserve's proposal is it fails to compensate issuers for their fraud losses or fraud prevention costs, even though the Durbin Amendment clearly requires that fraud ***prevention*** costs be included in this rule, and certainly permits ***actual*** fraud losses to be included as well. Under card network rules, if a merchant obtains authorization for an in-person debit card transaction and there is fraud – which often stems from data breaches at

the retailer – ***my bank ends up covering the fraud losses, not the retailer***.[2] It is also the case that for some community banks, the annual fraud losses alone can wipe out all the revenue from interchange for that year. If I lose most of the interchange fee, the primary source of revenue from debit card use, how can I cover my related fraud risks, losses, and fraud prevention costs?

Because of their liability for fraud, card issuers have invested billions in fraud prevention. This includes, for example, neural networks that detect and stop unusual activity that suggests fraud, constant upgrades of card security features and systems, and working with law enforcement to capture and prosecute criminals. And these efforts are never ending. Fraud is dynamic. Eventually, the criminals figure out how to circumvent fraud filters, so issuers must stay one step ahead of the criminals and anticipate the next scam through additional investments, research, and imagination. My staff works 24 hours a day, 7 days a week, 365 days a year to thwart the attacks on our part of the payment system. We discover fraud before the consumer does in over 7 out of 10 fraud cases. We stand between the crooks and our consumers every single day and we offered our customers a zero liability guarantee long before the networks offered it nationwide. We believe we deserve to be compensated for this service.

As noted, current interchange fees help to pay for this investment in fraud prevention and the issuers' fraud losses. The Federal Reserve's proposed rule, however, fails to make any adjustment for these factors.[3] Failure to compensate issuers for fraud losses and fraud prevention will have a significant impact on fraud and change the dynamic of the card system and consumers' experience. Without interchange fees, there is less bank incentive and fewer resources to spend on fraud prevention. Even now we are hesitating over the release of a new fraud-fighting process as we prepare for the profound reduction in revenue that the amendment will impose. Will we be compensated for our investment? It appears not.

Investment in fraud prevention is also an investment in protecting the confidence that consumers have in the payment system. If we are forced to forgo investment opportunities to fight fraud because we cannot be adequately compensated, everyone suffers: banks, consumers, merchants and the economy.

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[2] Section 7.0, *Visa International Operating Regulations Core Principles*: "Issuers are financially responsible for transactions that are accepted by the merchant as defined in the Visa Operating Regulations, and properly processed by the acquirer."

[3] The Durbin Amendment directed the Federal Reserve to consider, as part of its rulemaking, fraud prevention costs. While the Federal Reserve has indicated its intention to do so, it has not done so in the proposed rule and has indicated it will not likely be able to do so by the July 21st effective date for the final rule. We view this as a glaring omission. We would likewise note that the Fed has declined to include actual fraud losses as part of its calculations.

Debit v. Cash/Checks – the Enormous Benefits of Guaranteed Payment

Sophisticated payment card systems ***provide merchants and businesses huge benefits compared with cash or checks***. They allow retail merchants and businesses to instantly confirm that the account and card are valid and the customer has sufficient funds in the account to make a debit card purchase.

In contrast, checks may be returned for any reason – insufficient funds in the account, account closed or nonexistent, counterfeit check, stop payment by the customer – and the business is on the hook for the loss. If the merchant wants to avoid that loss he can refuse to accept checks or he can agree to pay a check guarantee fee similar to, and in many cases higher, than interchange. For that reason, most retailers do not want to take checks, restaurants are a good example, and have seen their profits increase by accepting debit cards rather than checks.

Debit cards also allow the payment to transfer electronically from the customer's bank to the business's account for their almost immediate use without the merchant leaving the store. In contrast, most merchants have to drive to the bank to deposit checks and in some cases may also have to wait for the checks to clear to use the money from checks. Of course, debit cards also speed up the check-out, leading to more sales for the business, and saving time for both the merchant and the customer.

Debit cards also have huge advantages over cash, which can be lost or stolen, for both businesses and consumers. Cash has to be counted, recounted, sorted, transported, and protected. Thus, cash has the largest transaction costs of any payment instrument, and is one of the reasons why some businesses no longer accept cash (e.g., some airlines now accept only cards for in-flight food and beverages purchases). Also, customers' purchases are not limited to the amount of cash in their wallet. Businesses sell more, and customers do not have to carry large amounts of cash which can make them targets for criminals.

It is also important to keep in mind that cash and checks are not free to businesses. Businesses pay banks directly or indirectly for check deposits and services through their general account agreement with the bank. They pay for the cost of delivering checks to the bank, either electronically or physically and for their employee's time in accepting checks. They pay their employees and banks for the costs of handling, managing, and protecting cash, as described above.

The following table provides details on the relative social marginal costs of different payment instruments when considering ***all the parties*** that are involved in the transaction: the merchant, consumer, bank, and the central bank (which clears final payment).[4] These numbers show quite dramatically that debit card acceptance – including the interchange fee – is still the lowest cost.

Payment Type	Social Marginal Cost
Cash	$2.66
Non-verifiable Check	**$1.40**
Verifiable Check	$1.08
Credit	$1.22
Signature Debit	**$1.01**
PIN Debit	$1.08

It is also important to point out that merchants and businesses can simply provide ***discounts*** to customers for non-card transactions such as cash and checks.[5] This way, consumers decide whether they want to pay extra for the convenience of paying with cards or receive the discount for other types of payments. Some gas stations have done just this. It allows the merchant to recoup the interchange fee if they believe that providing that discount option is in their financial interest. ***Any business that believes that the cost of accepting checks and cash is less expensive for them than debit cards, can – under current rules – provide incentives for customers to use those payment options.***

[4] *The Economics of a Cashless Society: An Analysis of the Costs and Benefits of Payment Instruments.* Daniel D. Garcia Swartz, Robert W. Hahn, and Anne Layne-Farrar, AEI-Brookings Joint Center for Regulatory Studies, September 2004.

[5] "Merchants may steer customers to an alternative method of payment such as providing discounts for cash, but may not do so in a confusing manner that denies consumer choice." (Section 6.0 *Visa International Operating Regulations Core Principles*.) "The Merchant may request or encourage a Cardholder to use a means of payment other than a Visa Card." (*Visa International Operating Regulations*, 15 October 2010 p.406. "A U.S. Merchant may offer a non-monetary benefit to a Cardholder as an inducement for the Cardholder to use a means of payment other than a Visa Card. A merchant may offer a monetary benefit in the form of a discount, as provided in "Discount Offer – U.S. Region," as an inducement for the Cardholder to use a means of payment other than a Visa Card." (Visa International Operating Regulations, 15 October 2010, p. 407.)

Interchange Price Controls Moves the Payment System Backwards

Every participant in the debit interchange system—every issuer, network, merchant, and consumer—has entered into the system ***voluntarily***. And more and more join every day. The acceptance of the system demonstrates dramatically just how important this system is to all participants. It is no wonder that even retail businesses that deal in small dollar sales, such as fast food restaurants and coffee shops, are accepting card payment services. These businesses had a ***choice*** to make regarding how best to increase sales and enhance the customers' need for convenient and fast service. They have realized the significant value of the service and made an economic decision that it is in their best interest to be a part of the system.

To illustrate, we know a hair salon owner located just a few blocks from our St. Louis headquarters who recently came to this conclusion. The owner tells us that he began accepting debit cards last year because he knows that his customers prefer them. He feels that his business has grown because he has begun to accept debit and now he doesn't need to worry about any delays in check clearance and the headache of returned checks. He sees debit interchange as just another cost of doing business for which the benefits exceed the cost.

Every participant must bear the large-scale network infrastructure costs required to build, maintain, and protect debit card services. Yet now, merchants want all the benefits of accepting card payments, but they do not want to pay their fair share to receive those benefits. ***It is the big-box retailers in this country that stand to receive a large windfall profit, as only a very small percent of merchants will receive the vast majority of benefit from this change.***

Instead, merchants want the government to fix prices and shift the cost of doing business off their books. While merchants say that they will lower their prices and pass on the savings to consumers, no reasonable person expects that they will be lowering the price of a soda or bag of chips. Congress did not mandate that such a result occur.

Moreover, rather than encouraging the continuing development of the interchange system and the use of debit cards, the Federal Reserve's Proposed Rule would take a fully functioning market and disrupt it by imposing a hard price cap on all debit interchange fees of no more than 7-12 cents. The severity of the cuts under this rule will discourage issuers from investing in the security, innovation, improvement, and maintenance of the debit interchange payment system, because those issuers are unlikely to recoup the costs of such investments, let alone make any return on capital. Accordingly, the natural result of the Federal Reserve's price controls will be

the gradual degradation of the reliability and confidence in the payment system (including system failures and security breaches).

The concern about the Durbin Amendment goes far beyond the impact on my bank, my customers, and the economy. It sets a dangerous precedent, suggesting that financial institutions may be subject to future, unknowable price controls on other financial products and services, undermining important free-market principles. We have always accepted the operational, reputational, and financial risk associated with developing new products and services and making them available to millions of consumers. Now financial institutions risk losing their investments of billions of dollars into improvements of existing products and services, and the creation of new ones, through government price controls. Why would any business invest in an innovative product knowing the government *ex post facto* will interfere and completely dismantle its free-market business model by imposing price controls? The Durbin Amendment serves as a strong disincentive for innovation and investment by financial institutions in other emerging payment systems and financial products and services. In the end, it is the American public who suffers.

Interchange Price Controls Provide No Effective Protection for Small Banks

The retailers will say that small banks and credit unions are protected because the legislation exempts small depository institutions from the Federal Reserve Board's interchange rate setting. Community bankers do not believe that such an exemption will work in practice. It is simply unsustainable for two firms to offer the same product at radically different prices. As with any price controls, there are inevitable unintended consequences, market distortions, and higher costs for others, including consumers.

Under the Federal Reserve rule, the differential between the very low fee that large bank debit card issuers will have to accept and the current fee that small banks receive is so large that there are enormous incentives for merchants to steer customers away from using debit cards issued by small banks. Large retailers will provide additional rewards and perks to customers that use large bank cards. Merchants will see significant reductions in costs if they drive business away from higher-cost debit card alternatives to lower-cost ones. The economics are simple: market share will always flow to the lowest priced product, even if those lower prices

are mandated. The result for small banks is either a loss of market share, a loss of revenue that supports low-cost transactions and other valuable services, or both.

It is likely that merchants will begin a new campaign to have price controls put in across the board on debit cards and on credit cards as well. Such efforts will only magnify the severe unintended consequences of the price controls on debit cards if the Federal Reserve rule goes forward.

Conclusion

The Durbin Amendment was passed as a ***last minute*** addition to the Dodd-Frank legislation on the Senate Floor. This was done ***without any Congressional hearings*** on the amendment. It was done without any consideration for the consequences on consumers or community-based institutions like mine. And it was done without any consideration of the economic impact on communities like mine and those of other banks around our country.

This flawed process and the quick adoption of this amendment will lead to significant unintended consequences if not addressed. It will have profound adverse consequences on consumers (particularly low-income Americans), the banking system (particularly the nation's smaller banks and credit unions), and the United States payments system and economy as a whole.

On behalf of all the member banks of both the ABA and CBA, I urge you to immediately take all necessary congressional action to stop the Federal Reserve from implementing the proposed interchange rule.

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Testimony of
Frank Michael
President and CEO
Allied Credit Union

On behalf of the Credit Union National Association

Before the
House Financial Services Committee
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Hearing on

"Understanding the Federal Reserve's Proposed Rule on Interchange Fees:
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Chairman Capito, Ranking Member Maloney, Members of the Subcommittee, thank you very much for the opportunity to testify at today's hearing. Credit unions appreciate your having called this hearing today on the most significant regulatory issue facing the 95% of credit union members who belong to credit unions that offer debit card services. We believe it would not have been necessary for us to be here today if the Durbin Amendment to the Dodd-Frank Act (Section 1075 of the Act) had been reviewed and considered by any Congressional standing committee prior to its passage.

My name is Frank Michael, and I am President and Chief Executive Officer of Allied Credit Union[1] in Stockton, California. I am testifying today on behalf of the Credit Union National Association (CUNA)[2], and I am Chairman of CUNA's Small Credit Union Committee.

Allied Credit union is not Bank of America. We're not Visa. We're not 7-11. We're small. And we strive to fulfill our mission to serve our members every day. Our members find value in conducting their financial services with us, and one of the things that our members want is convenient access to their checking account. Today, that means the ability to use a debit card.

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[1] Allied Credit Union is a federally insured state chartered credit union headquartered in Stockton, California, with 2,300 members and total assets of approximately $18 million. Allied Credit Union issues approximately 1,100 debits cards.

[2] CUNA is the largest credit union advocacy organization in the United States, representing approximately 90% of America's 7,700 state and federally chartered credit unions and their 93 million credit union members.

As discussed below, Section 1075 will make it more expensive for my members to access their checking account, and I know that this is **not** what Congress intended because Congress included an exemption for institutions like Allied Credit Union.

My testimony focuses on six areas:

1. The benefit that the payment system brings to all parties – consumers, merchants and financial institutions;
2. The flaws of the statute and the Federal Reserve Board's (the "Board") proposed implementing regulation;
3. How the proposed implementing regulation renders the statutory small issuer exemption essentially meaningless;
4. The routing and exclusivity provisions which represent an unreasonable and costly burden on credit unions and will drive interchange revenue down for issuers of all size;
5. The impact that the Board's debit interchange proposal will have on credit unions like the one that I run; and,
6. The statutory and regulatory remedies we believe are necessary to prevent these regulations from having a devastating impact on consumers.

The Benefit of Interchange to All Parties

The interchange fee is just one part of what is referred to as the "merchant discount fee," which has been described by the Government Accountability Office (GAO) in the following manner:

> The majority of the costs associated with accepting cards are the "merchant discount fees" paid to the banks that merchants use to process their transactions. Generally, for each Visa or MasterCard transaction, a portion of the merchant discount fee is paid from the merchant's bank—called the acquiring bank—to the bank that issued the card. **This portion, called the interchange fee, reimburses card issuers for a portion of the costs they incur in providing card services.**[3] [Emphasis Added]

Interchange is an agreed upon condition of accepting debit cards. Payment of interchange is the responsibility of the merchant and the merchant's bank (the acquiring bank). Card issuers, like

[3]Government Accountability Office. "Credit and Debit Cards: Federal Entities Are Taking Actions to Limit Their Interchange Fees, but Additional Revenue Collection Cost Savings May Exist." GAO-08-558. May 15, 2008. 1.

my credit union, who assume the risks of guaranteeing payment, fraud, and the costs of supporting a debit card program, receive interchange as compensation for those costs and the significant benefits that accrue to merchants for accepting debit cards.

Merchants benefit greatly as a result of the interchange fees they pay. Merchants receive guaranteed and expedited payment when a debit card is presented and accepted. Further, a consumer's use of a payment card – whether it is a credit card or a debit card – eliminates the risks that merchants would otherwise have to assume if the transaction were paid for with cash (theft risk, handling and security costs) or a check (bounce risk, which includes non-payment and collection expenses). Merchants also may benefit from "streamlined accounting, reduced credit risk, faster check-out and increased purchase amounts compared to checks or cash."[4]

On the other side of the market, the card issuer – my credit union – assumes all of the risk and guarantees the merchant will receive payment. In the process, the consumer receives a very important service: an efficient, convenient, seamless, and universally-accepted transaction. That very consumer service redounds to the benefit of merchants. The easier it is for a consumer to access his or her funds at the point of sale, the more likely he or she is to spend them on the goods or services the merchant is offering. There is tremendous benefit and value attached to the debit card, as evidenced by the significant increase in its acceptance by merchants and its use by consumers over the last decade.

Between merchants and card issuers, merchants are the primary beneficiaries of debit cards. This is why the merchant-paid interchange model developed in the first place. Accordingly, it is only fair that if merchants receive benefits from debit cards payments that they should have to pay the costs of the provision of debit card services. Under Section 1075, however, the Board would set the price of debit card services below cost, forcing financial institutions such as credit unions and community banks to lose money on each transaction; thereby subsidizing payment services for merchants. Whatever real or perceived problems may exist with the current interchange system, forcing credit unions—and by extension, their members—to subsidize big retailers like Wal-Mart, Home Depot, and 7-11, cannot possibly be the right solution. Indeed,

[4]Adam J. Levitin. "Interchange Regulation: Implications for Credit Unions." Filene Research Institute. 6.

big retailers will be the primary beneficiary of any reduction in interchange, since a recent study found that approximately 80% of all debit card volume is conducted at only 1.5% of merchants.[5]

The Statute and the Proposed Rule Are Flawed

Despite the good intentions of its framers and consumer proponents, Section 1075 will disrupt the debit interchange market that has benefited merchants, card issuers—like my credit union—and consumers—like my members. Section 1075 adds a new Section 920 to the Electronic Fund Transfer Act (EFTA), which requires the Board to set standards for assessing whether debit interchange transaction fees are "reasonable and proportional" to the issuers' costs associated with a debit card transaction and to issue regulations on debit card transaction routing.

When considering the costs incurred by the issuer, Congress directed the Board to distinguish between the incremental costs incurred by the issuer as a result of authorization, clearance, or settlement of a particular electronic debit transaction (which the Board is permitted to consider when issuing its rule) and other operational costs incurred by the issuer which are not specific to a particular electronic debit transaction but which are essential to the operation of a debit card program. The Board is also permitted to make an adjustment to the interchange transaction fees for fraud prevention costs.

Unfortunately, the Board's interpretation of the statute is that Congress directed the Board to disregard many of the most significant costs associated with operating a debit card program. As a result, the Board has proposed a debit interchange rate that is well below the cost of operating a debit card program. The Board's proposed rule changes the nature of the debit interchange fee from a proportional rate based on the amount of the transaction to a hard per transaction cap that does not distinguish between the type of debit transaction (PIN or Signature) or take into consideration the risk assumed by the card-issuing credit union or bank for accepting the transaction. To make matters worse, the Board has selectively chosen to exclude clearly permissible incremental costs associated with authorizing clearing and settling a transaction. These costs include, at minimum, network fees and adjustments for fraud prevention costs.

[5] Peter Schroeder. "Financial industry hits back on debit card fees," The Hill. February 16, 2011.

At its most basic level, the Board's rule tells financial institutions that seek to meet the debit card demands of their customers that if they want to do this business, they must do so under a set of government imposed restrictions that require them to do it for less than it costs them to operate the program. Even for not-for-profit credit unions, the idea of the government requiring the operation of a program at a loss is abhorrent; it flies in the face of safety and soundness and certainly is not reasonable and proportional to credit unions' cost of providing debit card programs.

While we urge Congress generally to repeal the Section 1075 or delay its implementation, in the alternative, we urge Congress to amend Section 1075 to direct the Board to consider all costs incurred in the operation of debit card programs by all issuers, even those which were exempt from the regulation.

The Proposed Rule Renders the Small Issuer Exemption Essentially Meaningless

Congress exempted issuers with less than $10 billion in total assets from the rate-setting part of the rule.[6] Simply being exempt from the language of the regulation does not guarantee that credit unions with under $10 billion in assets are unaffected by the regulation. We are deeply concerned that the carve-out may be rendered essentially meaningless by the Board's proposed rule. If this proposed regulation is implemented, it will adversely affect all financial institutions that offer debit cards, as well as their members or customers who use debit cards. That simply cannot be the result that Congress intended when this law was enacted and as evidenced by the statements of the provision's sponsor, Senator Richard Durbin.

There is extraordinarily little legislative history regarding Section 1075, as Congress held no hearings on the specific provisions of the amendment, and which was subject to only a very brief debate in the United States Senate. In the scant legislative history, however, Senator Durbin, stated of the small issuer exemption:

> "...the requirement that debit fees be reasonable does not apply to debit cards issued by institutions with assets under $10 billion. This means that Visa and MasterCard **can**

[6]This exemption currently covers all but three credit unions: Pentagon Federal Credit Union, Navy Federal Credit Union, and State Employees Credit Union of North Carolina.

> continue to set the same debit interchange rates that they do today for small banks and credit unions. **Those institutions would not lose any interchange revenue that they currently receive**."[7] [Emphasis added].

Unfortunately, under the Board's proposal, this will almost certainly not be the case, for two reasons. First, it is uncertain whether—and for how long—the various payment networks will be willing and/or able to maintain separate pricing schemes for small and large institutions (the so-called "two-tier system"), because there is no requirement for them to do so. Second, even if the payment card networks operate a two-tiered system, with the passage of time, market forces, including the routing and exclusivity provisions which apply to all issuers, will cause convergence of prices between the two tiers. Absent enforcement by the Board of the small issuer exemption intended by Congress, the exemption is meaningless.

Approximately 80% of debit transactions involve cards issued by institutions with assets over $10 billion.[8] Therefore, the debit card networks will likely devote most of their attention to serving the providers of the vast majority of their business. Indeed, large financial institutions frequently receive individually negotiated volume based "incentives" from the networks in addition to interchange fees. The current pricing mechanism was no doubt designed to meet the needs of larger institutions and grow network volumes. Once larger institutions no longer benefit from that structure, it is far from certain that the networks will continue to devote the resources necessary to continue to maintain the complex, existing structure. It is also possible that larger institutions would prefer that the debit interchange system not provide a competitive advantage to smaller institutions by paying higher interchange rates than the large issuers receive. Networks are likely to be sensitive to the small number of issuers who drive the majority of their volume. Therefore, the long-term future availability of a two-tiered structure is far from certain.

Even if a two-tiered system were maintained, merchants would have a clear preference for the lower fee debit cards issued by large institutions. They would therefore have a significant incentive to induce consumers to present cards from larger institutions. An extremely important

[7] http://durbin.senate.gov/issues/leg_wallstreet_swipe.cfm
[8] Mercator Advisory Group. "The Durbin Amendment Impact Analysis." Maynard MA: June 7, 2010. 7.

feature of the convenience of a debit card from the consumer's point of view is its seamless acceptability. Even subtle steering techniques to lower cost may create substantial consumer concerns, especially to avoid the embarrassment of having a card rejected in front of other customers. Consumers will want their small-issuer cards to be just as accessible as large-issuer cards, which may require lowering the fees on small-issuer cards. In addition, the routing and exclusivity provisions will tend to push interchange fees downward.[9] The result of these pressures will be the convergence of interchange fees toward the capped rate to be set by the Federal Reserve. The amount of convergence may not be large initially, but over time it is likely to be substantial, if not complete.

Board staff acknowledged this result in the December 16th meeting of the Board of Governors:

> Both the statute and our proposed rule permit, but do not require, the networks to establish higher interchange fees for the exempt issuers than for the covered issuers. The networks may decide that it's simply too costly or too complicated to maintain two separate interchange fee schedules and they may therefore say that everybody is going to operate on the same interchange fee scheduled which complies with our standards. In that case, obviously, the exempt issuers would face a similar reduction in their interchange fees, as would the covered issuer.[10]

By not including a mechanism to require the payment card networks to operate a two-tier system and by not enforcing the current pricing mechanism for small issuers, the Board has not undertaken its responsibility to protect small issuers from being adversely affected by its proposal. This is a severe misinterpretation of the small issuer exemption, which renders the exemption and intended protection for small issuers essentially meaningless. In fact, the Board's proposal with respect to the small issuer exemption (or rather, the lack thereof) reflects the exact opposite of what the plain language of the law provides and what Congress clearly intended.

The Routing and Exclusivity Provisions Represent an Unreasonable and Costly Regulatory Burden on Credit Unions and Also Will Undermine the Small Issuer Exemption.

Under Section 920(b) of the EFTA, the Board is directed to write rules to provide that an issuer or payment card network cannot restrict the number of payment card networks on which an

[9]Levitin. 35.
[10]Federal Reserve Board of Governors. December 16, 2010. http://www.youtube.com/FedReserveBoard#p/u/1/IaJqZMfqXNY at 31:35.

electronic debit transaction may be processed to just one network or two affiliated networks. The Board is also required to write rules that allow the merchant to direct the routing of debit transactions over any network that is authorized to process the transaction. These proposed provisions would apply to all issuers, not just those with assets of $10 billion and above.

The Board proposes two alternatives to fulfill the prohibition on exclusive arrangements. Alternative *A* would require an issuer to provide debit cards that could be processed on one of two unaffiliated networks, such as one PIN debit network and one unaffiliated signature debit network. A card could also be authorized to be processed on two unaffiliated PIN networks or two unaffiliated signature networks.

Alternative *B* would require a credit union to issue debit cards that could be processed on at least two unaffiliated PIN networks and also on at least two unaffiliated signature networks. Although, even the Federal Reserve has indicated this is technically infeasible at this time.

The first part of Section 1075 intentionally carved out small credit unions and banks in recognition of the importance of interchange to these institutions. However, by giving merchants the final authority to decide how to route each debit transaction – regardless of size -- these institutions and programs will be denied interchange revenue as merchants send transactions to the lower cost networks. So, on the one hand, the interchange provision recognizes the importance of interchange to small financial institutions, and on the other hand it then severely compromises the carve-out by giving merchants the power to route transactions to networks that effectively lower their revenue.

While the uncertainty regarding these provisions extends to large and small issuers, the implications of these provisions may be even greater for small issuers. During the Board's meeting on December 16, 2010 Board staff stated:

> If the networks do decide to establish two separate interchange fee schedules and allow higher interchange fees for the small issuer, it is possible that merchants would discriminate against those issuers by declining to accept their cards because there are higher fees associated with accepting those cards...The merchant routing provisions

> would tend to put downward pressure on interchange fees, in general, because now the merchants can steer transactions toward lower cost networks.[11]

While CUNA shares these concerns generally, we do not think the Board is excused in any way from implementing the exemption for small issuers. The first step toward ensuring small issuers receive the protection that Congress intended is for the Board to implement the exemption.

However, in recognition of the fact that Board has acknowledged the routing and exclusivity provisions may be particularly problematic for small issuers, and may undermine the protection Congress provided, we urge the Board to make changes in these provisions.

The Impact of the Debit Interchange Rule on Credit Unions and Their Members

What does Section 1075 mean to credit unions, and specifically to Allied Credit Union, and our members? It does not require an MBA to realize that if a regulation requires a credit union to operate a program below cost—or if market forces drive the price of a product lower than the cost of offering the product—the credit union is going to lose money. The proposed interchange regulation will significantly reduce the amount of debit interchange income credit unions earn, despite the exemption and Congressional pledges to the contrary. The only real question is how much.

At one extreme, through some combination of an ineffective dual pricing system or merchant steering in favor of large issuer cards, credit unions' interchange fees could converge on the rate set for very large institutions, or 7 to 12 cents per transaction. In that case, even at the higher 12 cent level, based on 2010 estimated volumes, credit unions would find their net income reduced by $1.6 billion. That would represent approximately 17 basis points (bp) of average assets and would amount to a third of credit unions' recent net income of around 50 bp.

Even if net income recovers to pre-recession levels, the lost interchange income would represent about a fifth of total net income. Absent any alternate price or fee increases by credit unions, such a reduction in income would lower capital at debit card issuing credit unions by 10% after six years. For those credit unions currently under regulatory Prompt Corrective Action (PCA)

[11]Federal Reserve Board of Governors. December 16, 2010.
http://www.youtube.com/FedReserveBoard#p/u/1/IaJqZMfqXNY at 32:20

restrictions due to low capitalization levels, or close to PCA thresholds, such a reduction of net income would seriously impair their ability to restore capital, since earnings retention is the only source of credit union capital.[12]

Even if we conservatively estimate that after the passage of a few years the effect of the debit interchange regulation is only half the reduction to be experienced by larger institutions, the effect would still be substantial. At 2010 volumes, net income would fall by about $800 million or 9 bp. As a proportion of total net income, the loss would be almost 20% at current net income rates, and almost 10% if and when net income reaches pre-recession levels.

However, that is not where the story ends, certainly not for credit unions. The harmful effects of this law and regulation will not just be the loss of revenue to financial institutions, but the inevitable result will be its adverse impact on consumers.

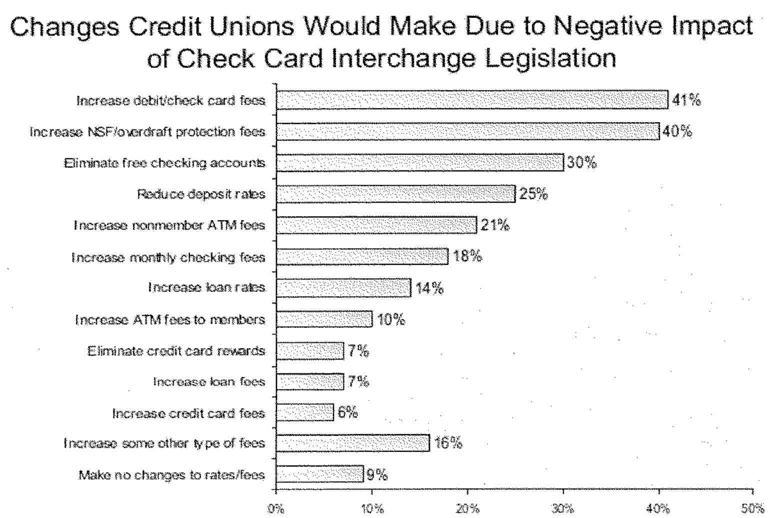
If credit unions experience the significant reduction in debit interchange revenue that is expected as a result of this rule, the National Credit Union Administration (NCUA), which oversees the National Credit Union Share Insurance Fund, will nonetheless expect credit unions to maintain current net income levels and replace the lost revenue. This means that credit unions will have to take steps to cover their losses to ensure that they continue to operate in a safe and sound manner.

Unlike the big banks, which can recover lost revenue by reducing shareholder profits, credit unions have but one choice -- to pass the costs on to our members. Credit union members will lose as a result of these rules when credit unions are forced to reduce dividends, recover fees from members for debit related or other services, or refrain from offering checking account services if they do not already do so. The choices facing the boards of directors and management of credit unions are relatively straightforward and carry a consistent theme: charge more to consumers for services or reduce the services offered to consumers. Either way it is a bad deal for consumers.

[12]By law – not regulation, as is the case for other insured depositories – credit unions must maintain a 7% net worth (or leverage) ratio in order to be considered "well capitalized." The law also specifies that only retained earnings constitute net worth for credit unions. If credit unions fall below the 6% adequately capitalized threshold, a variety of sanctions apply. (See Section 216 of the Federal Credit Union Act.)

According to CUNA's 2010-2011 Fee Survey, 91% of credit unions offering debit cards anticipate making some sort of change to their rates, fees, and/or services as a result of the negative impact of the regulation. The most common changes credit unions anticipate making will be to introduce or increase debit card fees and to increase nonsufficient funds (NSF)/overdraft protection fees. About 40% of credit unions cite these potential changes as shown in the following graphic. Beyond this, 25% to 30% of credit unions say they might eliminate free checking accounts and/or lower deposit rates as a result of the regulation.[13]

If the exemption for small issuers proved completely ineffective, the Board's proposed 12 cent fixed fee could require credit unions to impose an annual fee in the range of $35-$55 per debit card, a fee in the range of 25 – 35 cents per transaction, or some combination of the two in order to maintain pre-reform revenue. These would be new fees to our members.



Note: Limited to credit unions that offer the account/service.

[13]Credit Union National Association. "Credit Union Fees Survey For Strategic Planning 2010-2011." Washington DC: 2010. 4-4.

Remedies

We recognize that the proposal under discussion today is subject to an open comment period. However, the timeline for finalization and implementation is very short, and the consequences are potentially devastating for small financial institutions and consumers. There are problems with the rule that the Board can and should address, but there are also significant statutory problems that Congress needs to fix.

We urge Congress to **stop, study and start over.**

Enacting a significant moratorium against implementation of the Board's interchange rule will provide Congress the necessary time to study the impact of this proposal; time which neither the House nor the Senate were afforded when this measure was hastily approved last year.

Congress should direct the Treasury Department, in consultation with the NCUA, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, to thoroughly analyze the impact of debit interchange regulation on (1) consumers, (2) debit card issuers of all size, (3) the safety and soundness of depository institutions, and (4) future debit card innovation.

Congress should then direct the Board to start its rulemaking process over again, taking into consideration the results of the Treasury study, and the operational impact of the regulation on all issuers; and to set standards for a rate which is reasonable and proportional to the full costs and risks of the transaction.

Conclusion

The consequences of this rule, and the statutory provisions it seeks to implement, have not been adequately or fully considered by the Board. However, credit unions strongly believe that the Board's rule in its current form would cause harm to the small issuers Congress intended to protect, and to consumers that use debit cards issued by credit unions and banks of all sizes. It is important for Congress and the Board to get this right. Otherwise, consumers face higher costs for financial services with no assurance that any savings will be passed on by the merchants. We urge Congress and the Board to stop, study and start over.

Chairwoman Capito, Ranking Member Maloney, Members of the Subcommittee, thank you very much for the opportunity to testify at today's hearing. I am pleased to answer any questions you may have.

STATEMENT OF

CONSTANTINO (GUS) PRENTZAS
OWNER, PAVILION FLORALS; LIFE & HEALTH FITNESS

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

HEARING ON "UNDERSTANDING THE FEDERAL RESERVE'S PROPOSED RULE ON INTERCHANGE FEES: IMPLICATIONS AND CONSEQUENCES OF THE DURBIN AMENDMENT"

FEBRUARY 17, 2011

Chairwoman Capito, Ranking Member Maloney, and Members of the Subcommittee, thank you for inviting me to share my views regarding payment card "swipe" fees. My observations are based on my experience as a small business owner. I own a florist shop and a health club, both located in Astoria, New York. From my perspective, these fees, for both credit and debit cards, have long been out of control. In fact, they have grown so large, so quickly, that when it came to making a choice between paying these fees or laying off an employee recently, I had to lay off the employee. While I understand that the Durbin Amendment only addresses debit card and not credit card fees, I believe this is at least one step in the right direction. Therefore, I fully support the debit card rules proposed by the Federal Reserve and any other efforts to help rein in swipe fees.

Overview

I am owner of two small businesses in Astoria, New York. Pavilion Florals is florist shop I have owned since 1998. Life & Health Fitness is a health club I have owned for four years. Both businesses accept credit and debit cards as payment. The health club is particularly dependent on credit and debit cards as a form of payment, because we charge monthly membership fees and allow our members to set up automatic payment plans via credit or debit

card for their convenience. For the health club, approximately 78% of payments we receive are by credit or debit cards.

As the owner of two small businesses, I have a thorough understanding of the effect that runaway card fees have on small business, and my statement will discuss the impact that swipe fees are having on my businesses.

The Impact of Runaway Payment Card Fees on My Businesses

Both of my businesses accept debit and credit cards for payment. At the health club, I pay monthly interchange fees of approximately $380 for card transactions which include automatic monthly memberships and other payments. I pay roughly the same amount in monthly interchange fees for the floral shop, even though it earns about half the amount of revenue that the health club does. And I note that the interchange I pay is based not only on revenues I get but I also pay a percentage on the sales taxes I collect: money that we don't get to keep.

These fees have grown at an incredible rate; indeed, they have doubled in the last two or three years alone. Our prices certainly have not doubled over this time period, so there is no question that it is the fees themselves that are out of control.

In fact, these fees have increased so much, so quickly, that I was recently faced with an unfortunate choice at my floral shop: I could pay these fees, or lay off an employee. I was forced to lay off the employee because there are no realistic alternatives to accepting credit and debit cards. Our customers expect us to accept these cards, and all of our competitors accept them, so we do not get more business by accepting cards – there simply is no business without accepting cards. Visa and MasterCard are another form of currency and we must accept them like we must take cash. That is one reason why I believe that the debit card fee limit is a step in the right direction: policymakers need to begin to see payment cards for what they really are – a

new form of currency. Approximately 60% of the florist shop's sales are paid by credit and debit cards, and 78% at the health club. We expect that percentage to increase as more young people patronize our stores. So at 60% of sales and growing, "currency" is what payment cards have become and will be in the future.

At this volume, we can pay reasonable fees for interchange and processing, and it is not my position that card processing should be free. What I and other retailers, especially small businesses, cannot continue to do, however, is pay exorbitant fees that continue to climb because banks won't compete with each other on these charges.

Overall for my small businesses, interchange fees have grown more rapidly and significantly than all of our other expenses. And the fact that I cannot control interchange fees the way I can control other expenses is a huge problem for me. For example, we could change employee schedules if we needed to reduce labor costs; we could invest in new technology to reduce utility expenses; and we put our business and health insurance needs out for competitive bid yearly to help keep those expenses down.

But our interchange fees are what they are, and we have absolutely no ability to change them or take our business elsewhere. As a result, my businesses have been hurt and I even resorted to a lay-off, as I mentioned, when I would have liked to invest in more employee time to better serve customers.

I have tried to deal with these fees by offering customers cash discounts. Sometimes that has worked and helped save money for me and my customers. But this alone isn't enough. I look forward to reduced debit card interchange so that I will have the opportunity to offer discounts for those cards and give my customers and my business a bit of a break.

Finally, I want to share my experience dealing with card company charge-backs to make clear that merchants like me are on the hook when problems like fraud come up. My floral shop deals with a high volume of charge-backs. A charge-back is when the card companies don't give me the money for a sale even though it was properly authorized.

The charge-backs I get at the florist shop are about one-third of the amount of the interchange I pay. That is a big loss of funds on top of what I'm already paying and it offends me when the card companies claim that I get "guaranteed payment." Nothing is guaranteed. I can do everything right and still lose a sale long after a customer has left my store with flowers that I will never see again.

I can tell you from personal experience that there have been times when I have checked an ID, obtained a security code and checked a zip code to make sure everything was authorized and in order. When a card turned out to have been stolen, however, I have still been charged back for the sale and lost the money and the goods. This is blatantly unfair and losing an entire sale takes a big bite out of my business.

I'm not alone in this either. Other businesses in my community get the same treatment. The "guarantee" that the card companies brag about only exists in their own minds. If a merchant gave the kind of "guarantee" that credit card companies give, he'd be sued for false advertising.

Not only that, I have to pay interchange fees on the charge-back amounts. Once again, I'm paying fees on money I don't get.

Much of this is far too complex for a small business person like me to follow. I pay quite a few fees other than interchange including a "NABU" fee, Assessment Transaction Fee, Partial

Authorization Fee, and Zero Floor Limit Fee. I'm not even sure what these fees are, but I have to pay them and they keep going up too.

Conclusion

I feel fortunate to be able to serve my community as owner of two small businesses in Astoria, and I see the effects of card fees from this perspective. The increases that I am seeing in credit and debit card fees are unreasonable. If interchange fees – even debit card fees alone – were reduced to more reasonable levels, I would have revenue that I could use to hire more people, offer discounts, and cut prices. And lower prices mean more sales.

At the end of the day, I am completely at the mercy of the credit card industry. They can charge more fees and take my sales by snapping their fingers. I ask you to bring some common sense to this situation. That industry shouldn't be able to all work together to take so much money out of my business this way. Please support the Federal Reserve's proposal and turn your attention to ways to bring some needed changes to credit cards as well.

For release on delivery
10:00 a.m. EST
February 17, 2011

Statement by

Sarah Bloom Raskin

Governor

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

February 17, 2011

Chairman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for the opportunity to discuss the Board's proposed Regulation II, which implements the interchange fee provisions of section 1075 of the Dodd-Frank Act. The proposed rule has two main components. First, the proposal implements the statutory prohibition on network exclusivity arrangements and merchant routing restrictions. Second, as required by the statute, the proposal establishes standards for determining the maximum permissible level of debit card interchange fees that issuing banks covered by this portion of the statute may receive.

These provisions of the Dodd-Frank Act and the Board's implementing regulations may result in significant market changes. The nature of these changes is subject to debate, and the banking industry, the retail community, and consumers have very different perspectives regarding the expected effects and their desirability. I will provide some context regarding the role of interchange fees and other restrictions in the debit card system, describe the Board's proposed interchange rule and alternative approaches that we considered, and discuss some of the concerns that have been raised regarding the effect of the statutory requirements on various parties.

Overview of Debit Card Market

To put these provisions of the Dodd-Frank Act and our proposed rule in context, debit cards now play a prominent role in our payments system. For millions of consumers, debit cards provide a convenient means of payment to merchants for goods and services. These cards access balances that are held in the cardholder's transaction account at a depository institution or have been loaded on a gift card or other form of prepaid card. The results of a recent Federal Reserve survey show that debit cards are now used in 35 percent of noncash payment transactions, and

have eclipsed checks as the most frequently used noncash payment method.[1] Debit card payments have grown more than any other form of noncash payment over the past decade, increasing from slightly more than 8 billion payments in 2000 to almost 38 billion payments in 2009. Debit cards are accepted at roughly 8 million merchant locations in the United States.

Interchange fees are a controversial feature of the debit card system. Most consumers are not aware of these fees. Interchange fees are fees paid by a merchant's bank, also known as the acquirer, to a cardholder's bank, also known as the issuer, for each debit card transaction. The interchange fee schedules are determined by card networks and are generally the same for all issuing banks participating in a network. Merchants' banks generally pass the costs associated with interchange fees through to merchants. In recent years, increases in debit card interchange fee rates, together with the significant growth in the volume of debit card transactions, have led to a substantial rise in the total value of interchange fees paid by merchants. This increase in the aggregate value of interchange fees has precipitated a national and international debate about the appropriate level of those fees.

Supporters of the current interchange system contend that payment cards provide substantial value to both consumers and merchants, and that interchange fees are essential for the proper operation of the card networks. Interchange proponents believe that interchange fees play an economically important role in influencing the incentives of merchants to accept cards, card issuers to issue cards, and consumers to hold and use them. Interchange proponents argue that, when setting its fees, a card network must recognize the need to attract consumers and merchants, both of whom are necessary for the card network to exist. In this view, the resulting fees attempt to balance the two sides of the payment card market to maximize the value of the network, including the value of card services for both consumers and merchants.

[1] See http://www.federalreserve.gov/newsevents/press/other/20101208a.htm.

Critics of interchange fees focus on their level and even their very existence. They argue that merchants have limited ability to drop a network's card brand once their customers have come to expect acceptance of those cards. Moreover, critics contend that merchants are constrained from charging customers different prices for different payment methods. They also argue that networks and issuers impose restrictions that eliminate merchants' choice of network over which to route transactions. They assert that, because of these characteristics of the debit card market, merchants generally do not have the leverage to control the costs of accepting debit cards and that network competition tends to result in higher interchange fees as networks strive to attract issuers (the recipients of interchange fee revenue) and cardholders (who are beneficiaries of attractive account terms, such as rewards programs, funded by interchange fee revenues).

Proposed Regulation II

The statute addresses transaction routing flexibility for merchants and debit card pricing in several ways. As discussed in more detail below, the statute provides for a minimum number of networks per debit card and establishes the ability of merchants to direct the routing of debit card transactions over those networks. The statute also contains provisions, not subject to implementing rules by the Board, that protect the merchant's ability to provide pricing incentives for customers to use different forms of payment.[2] In addition, the statute provides overall limitations on interchange fees through standards to be set by the Board.

Input to the rulemaking. As input to the development of our proposed rule, Board staff held numerous meetings with card issuers, networks, merchants, consumer advocates, and others to deepen our understanding of the debit card industry. These discussions provided information

[2] The statute prohibits payment card networks from inhibiting merchants from providing a discount or other incentive for any particular form of payment, as long as any discount for card use is clearly disclosed and does not differentiate on the basis of issuer or payment card network.

about the structure and mechanics of the debit card system, fraud losses and fraud-mitigation activities, and fees and costs associated with debit card transactions. Staff also reviewed written submissions by interested parties that highlighted issues to be considered in implementing the statute.[3]

To obtain further input, last fall the Board surveyed debit card issuers that would be subject to the interchange fee standards, payment card networks, and large merchant acquirers. We requested information about the volume, costs, fees, fraud-prevention activities, and fraud losses associated with different types of debit card transactions. We also asked about network exclusivity arrangements and routing restrictions. The information gathered through these surveys informed our development of the proposed rule.

Based on this information, we published a proposed rule for public comment in December. The comment period closes next Tuesday, February 22. We will carefully review all the comments we receive before we adopt a final rule.

Let me turn now to the substance of our proposed rule. I will summarize each major statutory requirement, and then describe how the proposed rule implements it, including alternative approaches we considered.

Prohibition on network exclusivity and routing restrictions. 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 inhibiting the ability of merchants to route debit card transactions over any network that may process such

[3] The meeting summaries and written submissions are posted on the Board's public website at http://www.federalreserve.gov/newsevents/reform_interchange.htm.

transactions. Together, these provisions appear designed to give merchants a choice of networks over which a debit card transaction may be routed. The statute applies these provisions to all issuers, including the small issuers and government-administered payment and other prepaid programs that are exempt from the interchange fee standards.

The Board requested comment on two alternative interpretations of the prohibition on network exclusivity arrangements. The first possible interpretation would require issuers and networks to allow a debit card transaction to be routed over at least two unaffiliated payment card networks. Under this approach, an issuer could, for example, enable a debit transaction to be routed over one signature-based network and one unaffiliated personal identification number or PIN-based network. The second possible interpretation would require a debit card to have at least two unaffiliated payment card networks for each method of authorization available to the cardholder. For example, under the second interpretation, a debit card that can be used for both signature and PIN debit transactions would have to be able to be routed over at least two unaffiliated signature debit networks and two unaffiliated PIN debit networks. This latter approach would provide more merchants with routing choice,[4] but would entail far more substantial operational changes by debit card networks, issuers, merchant acquirers, merchants, and their processors.[5]

As noted above, the law also requires rules that prohibit issuers and networks from inhibiting merchant routing choice. The proposed rule includes examples of issuer or network

[4] This approach would provide routing choice to merchants that only accept signature debit. About 6 million of the 8 million merchant locations in the United States that accept debit cards do not have PIN debit capability and only have the capability to accept signature debit transactions. In addition, there are currently operational or market impediments to using PIN debit for certain types of transactions, such as most online transactions.

[5] This approach would require issuers to have multiple signature debit networks, such as Visa and MasterCard, on their cards (unless a card had only PIN functionality). The signature debit network over which a transaction is routed is determined by the first digit of the card number; therefore, the industry currently does not have the capability to enable transactions using a particular debit card to be routed over either of two signature networks.

actions that would impede merchant routing flexibility, such as issuer or network rules that require routing of a transaction over a particular network when multiple networks are available.

These proposed network exclusivity and routing rules, along with the statutory provisions that provide merchants more flexibility to set differential prices based on method of payment used, could promote competition among networks and place downward pressure on interchange fees.

Interchange fee standards. In addition to these market approaches to constraining interchange fees, the law also limits the amount of any interchange fee that an issuer receives for a debit card transaction to an amount that is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[6] The Board is required by law to establish standards for assessing whether an interchange fee meets the reasonable-and-proportional requirement; the statute directs the Board to adopt these standards by April 21. In developing these standards, the statute explicitly requires the Board to consider certain factors and not to consider other factors. In particular, the statute instructs the Board to consider the functional similarity between debit card transactions and checks, which clear at par (i.e., with no interchange fees).[7] The statute also directs the Board to distinguish between the issuer's incremental cost to authorize, clear, and settle a particular transaction, which the Board must consider, and other costs that are not specific to a particular electronic debit transaction, which the Board may not consider.[8] These are the directives that Congress provided in the law.

The statute exempts certain issuers and cards from the restrictions on interchange fees. In particular, the law states that the interchange fee standards do not apply to issuers that, together

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[6] EFTA § 920(a)(2), 12 USC § 1693o-2(a)(2).
[7] EFTA § 920(a)(4)(A), 12 USC § 1693o-2(a)(4)(A).
[8] EFTA § 920(a)(4)(B), 12 USC § 1693o-2(a)(4)(B).

with affiliates, have assets of less than $10 billion.[9] In addition, the law states that the standards do not apply to debit cards used in government-administered payment programs and certain reloadable, general-use prepaid cards.[10]

As stated above, the statute requires the Board to consider "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement" of a particular transaction. We considered limiting the allowable costs to only those costs associated with authorizing a debit card transaction. This approach would reflect a key distinction between debit card and check transactions: the fact that debit card transactions are authorized by the issuer, whereas check transactions are not (although merchants may purchase a third-party check guarantee service). However, because the statute explicitly instructs the Board to consider clearing and settlement costs, in addition to authorization costs, the proposal includes those costs, rather than limiting allowable costs only to authorization costs.

We also considered including other costs that are associated with a particular transaction but that are not directly associated with authorizing, clearing, and settling the transaction. Such costs might include, for example, the cost of providing cardholder rewards and the cost of responding to cardholder inquiries regarding specific transactions. However, given the statute's mandate to consider the functional similarities between debit card and check transactions, and the fact that these costs are not charged to merchants in check transactions, our proposal limits allowable costs to those costs that the statute explicitly directs the Board to consider. We specifically requested comment on whether other costs of a particular transaction should be included as allowable costs and what criteria should be used to determine the costs to be included.

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[9] EFTA § 920(a)(6), 12 USC § 1693o-2(a)(6).
[10] EFTA § 920(a)(7), 12 USC § 1693o-2(a)(7).

As I mentioned earlier, the statute directs us to consider the incremental cost of a particular transaction. There is no single, generally accepted definition of the term "incremental cost," as it applies to a particular transaction, so arriving at a definition was challenging. The incremental cost of a particular transaction could be interpreted to be the same as the marginal cost of that transaction. This approach of interpreting incremental cost would be impractical, in part because marginal cost cannot be identified from cost accounting data and can differ for each transaction.

The proposed rule interprets the incremental cost as average variable cost. This interpretation of incremental cost excludes fixed costs, such as network connectivity costs, and common or overhead costs, based on the premise that these categories of costs generally cannot be attributed to any particular transaction, given that they could not be avoided if any particular transaction did not occur. Under this view, the exclusion of fixed costs is required by the statute's explicit directive that the Board may not consider costs that are not specific to a particular transaction. If marginal cost does not vary materially over the relevant volume range, then average variable cost will provide a close approximation of marginal cost. Hence, average variable cost appears to be the closest approximation of what the statute requires when it directs the Board to set standards for "incremental costs."

In addition to requesting comment on using the average variable cost of authorizing, clearing, and settling a debit card transaction as the standard for determining whether an interchange fee is reasonable and proportional to the issuer's incremental cost, the Board also requested comment on two alternative approaches for implementing that standard. The first approach is based on each issuer's allowable costs with a safe harbor and a cap. The second approach adopts a cap that is applicable to all covered issuers.

We developed these approaches for implementing the standard after analyzing the data collected in our surveys and considering the economic incentives and burdens associated with various approaches to implementation.[11] Under the first alternative, an issuer would comply with the standard if it received an interchange fee that did not exceed the lesser of its allowable average variable cost and a cap, which we proposed initially be set at 12 cents per transaction. Eighty percent of issuers that responded to the survey and provided the necessary information reported average variable costs of authorizing, clearing, and settling a debit card transaction that were below the proposed 12 cent cap. This alternative would also permit an issuer to comply with the standard by receiving an interchange fee that does not exceed the level of a safe harbor. If the interchange fee is at or below the safe harbor, the issuer would not need to determine its maximum interchange fee based on allowable costs. The proposed rule initially sets the safe harbor at 7 cents per transaction, which represents the median average variable cost of authorizing, clearing, and settling a debit card transaction reported by issuers that responded to our survey and provided that information. Under the second alternative, an issuer would comply with the interchange fee standard as long as it does not receive an interchange fee above the cap. The proposed rule provides the same initial cap of 12 cents per transaction.

The statute requires the Board to collect data from card issuers or payment card networks as necessary to carry out the provisions of the statute (and to publish aggregate data on a biannual basis). The Board expects that it would adjust the cap or safe harbor amounts in the future, if warranted by future data collections.

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[11] We believe that both alternatives provide better economic incentives for covered issuers to improve the efficiency of their card operations than would be provided by an approach based solely on each issuer's allowable costs. The safe harbor in the first alternative and the cap in the second alternative are also intended to reduce the administrative compliance burden on industry participants and would improve the consistency and ease of enforcement by supervisors.

Fraud-prevention adjustment. The statute permits, but does not require, 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 relating to fraud-prevention activities.[12] The statute excludes fraud losses as a category of costs that may be recovered through the fraud-prevention adjustment. The proposed rule does not currently include a specific adjustment to the amount of interchange fees for an issuer's fraud-prevention costs because at the time the proposed rule was issued, the Board had insufficient information upon which to propose a specific adjustment and the standards an issuer must meet to qualify to receive it. Instead, the Board requested comment on two general approaches and posed a number of questions related to those alternatives.

Under the first approach, the fraud adjustment would allow issuers to recover costs incurred for implementing major innovations that would likely result in substantial reductions in total, industry-wide fraud losses. Under the second approach, the fraud adjustment would reimburse the issuer for reasonably necessary steps it takes to maintain an effective fraud-prevention program. The second approach would not prescribe specific technologies that must be employed as part of the program. After considering the comments we receive, the Board plans to issue a specific proposal on the fraud-prevention adjustment for public comment.

Prohibition against circumvention or evasion. The statute grants the Board authority to address circumvention or evasion of the interchange fee restrictions. Under the proposed rule, a finding of circumvention or evasion will generally depend on the facts and circumstances. The proposed rule, however, specifically provides that circumvention or evasion occurs when an issuer receives compensation from a payment card network (for example, in the form of incentive payments) that exceeds the total amount of fees that the issuer pays to the network.

[12] EFTA § 920(a)(5), 12 USC § 1693o-2(a)(5).

Under these circumstances, the net compensation from the network would effectively serve as a transfer to an issuer in excess of the amount allowed under the interchange fee standard. The proposal requests comment on other forms of circumvention or evasion that should be addressed in the rule.

Consideration of key issues. The public comment period is still open on the Board's proposal. The Board has already received thousands of comments raising a variety of issues, and we expect to receive many more in the next several days. In addition, one issuing bank has already initiated a court challenge to the constitutionality of the statute. In light of the novelty and unusual complexity of the issues raised in this rulemaking effort, my colleagues and I are very interested in reviewing the full range of comments offered on our proposed rule and are reserving judgment on the terms of the final rule until we have the opportunity to benefit from these comments.

A common theme among many commenters and the court challenge is concern about the effect that the statute may have on debit card issuers, including small issuers. As I noted earlier, the statute exempts small issuers from the interchange fee standards. Community banks and credit unions are concerned that the interchange revenue they currently receive will decline to the extent networks do not implement a two-tier interchange fee system that retains the current interchange fee levels for exempt issuers. They are also concerned that even if the networks did differentiate between covered and exempt issuers, some merchants would steer their customers to use lower-cost payment options.

Another concern expressed by small issuers is that the statute does not exempt them from the prohibitions on network exclusivity and routing restrictions. Small issuers are concerned that they will incur additional costs to participate in additional debit card networks. Small issuers are

also concerned that these provisions may provide an incentive to networks to lower their interchange fees to encourage merchants to route their debit card transactions through that network, thus lowering interchange revenue to all issuers, including small issuers.

The plaintiff in the suit against the Board on this rulemaking, on the other hand, is a debit card issuer that does not qualify for the small issuer exemption and is concerned this exemption will effectively put large issuers at a competitive disadvantage vis-à-vis small issuers, which are not subject to the interchange fee restrictions. It contends that small issuers will be able to continue to fund their debit card operations through interchange fees charged to merchants while larger issuers will either be unable to recoup their total costs or will be forced to increase fees to their customers, and thus risk losing the account relationships.

Commenters also have differing perspectives on the potential effect of the statute and the proposed rule on consumers. The magnitude of the ultimate effect is not clear and will depend on the behavior of various participants in the debit card networks. For example, card issuers may choose to make up their lost interchange fee revenue by imposing higher fees, or reducing rewards programs, for debit card use or for deposit accounts in general. On the other hand, consumers will benefit to the extent merchants pass on their interchange fee savings in the form of lower prices.

Conclusion

The provisions of section 1075 of the Dodd-Frank Act raise a number of complex issues. The Board is devoting substantial resources to understanding and addressing these issues within the parameters established by the statute. We welcome input from the public and from members of the Committee in this effort.

I would be happy to answer any questions you may have.

Testimony of David Seltzer before the Financial Institutions and Consumer Credit Subcommittee of the Financial Institutions Committee of US House of Representatives.
Thursday, February 17, 2011

Good Morning. First, I would like to thank Chairwoman Capito, Ranking Member Maloney and the Members of the Committee for inviting me to testify before the Subcommittee today on an issue that is vitally important to the thousands of small business franchisees that own and operate 7-Eleven stores. My name is David Seltzer, and I am Vice President and Treasurer of 7-Eleven Inc. I am responsible for all treasury functions in the company, including capital-raising, bank and rating agency relationships, cash management and payment acceptance. I am also responsible for overseeing corporate insurance and risk management activities.

I am also testifying today on behalf of the Retail Industry Leaders Association. RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs and more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

By way of providing an overview of our company, there are currently more than 6,700 7-Eleven convenience stores operating in 32 states nationwide. More than 5,000 of these stores are operated by small business franchisees. In fact, sitting behind me today is Dennis Lane who has operated a 7-Eleven in Quincy Massachusetts for over 30 years. I welcome this opportunity to share the perspective of 7-Eleven and more importantly the

perspective of small business owners like Dennis on interchange reform and the Federal Reserve's Notice of Proposed Rulemaking.

I would like to put this issue and its importance to 7-Eleven in perspective. A typical 7-Eleven franchisee owns a single store, employs 8 to 10 people, and works 60 to 70 hours per week in the business. Outside of employee wages and benefits, interchange is the largest single cost for the franchisees. And it is the only cost the franchisees have no control over. The proposed rule is important to our franchisees as it will provide them with relief and greater visibility on interchange fees in running their business.

Before I explain how the current system is broken, I will begin by acknowledging the fact that credit and debit cards are important to 7-Eleven. In essence, credit and debit cards are replacing paper as the nation's currency. **At 7-Eleven, 49% of our sales are paid using plastic; 73% of these transactions are on a Visa / MasterCard.** Credit and debit sales currently make up 70% of our fuel sales, and we believe credit/debit transactions will continue to rise over the next five years. Given that cards have become ubiquitous in our society, 7-Eleven and other merchants simply cannot operate our businesses without accepting credit and debit cards.

We are willing to pay fair and reasonable fees so our customers can use these cards for payment. Unlike virtually all other business expenses, fees associated with these cards are not determined in a competitive manner. The lack of a properly functioning market mechanism spurred Congress to include the Durbin amendment in the Dodd-Frank financial services reform bill last year.

Unfortunately, interchange fees are the fastest growing expense for 7-Eleven and our franchisees. Over the past eight years, 7-Eleven's credit and debit fees have quadrupled from a little less than $40 million in 2002 to $177 million per year in 2010 --- that's a 21% average annual increase. **Debit cards are now used for over 80 percent of our card transactions. Average debit card interchange rates have risen 500% over the past 10 years, and without some form of intervention, we see rate increases continuing. In October of 2009, MasterCard increased the interchange rate of one of its most popular debit products by 98%. On small ticket transactions the fee can be more than 20% of the sale. Debit rates imposed by Visa/MasterCard are often above levels charged for credit card transactions, despite the fact that debit transactions do not involve credit risk.** Dennis often says that it's cheaper for him to give away a Boston Globe than it is for him to sell one to a customer using a debit card. On this transaction he actually loses money.

Given the dramatic increases in this expense category, we and many others in the business community decided that we had to take action. Over many years, 7-Eleven attempted to negotiate reductions in interchange rates, without success. The October 2009 MasterCard rate increase of 98% is a great example of what we have experienced over the years. Without advanced notice or consultation, MasterCard published and implemented the new rate. When we spoke with MasterCard executives regarding the change, we were told that interchange rates were non-negotiable. Further, we were advised that MasterCard views banks rather than merchants as their customer and rates are set at levels needed to entice banks to issue MasterCard rather than Visa products. In other words, competition among the card networks translates into higher interchange

fees. This conversation illustrates the fact that interchange rates are not set to cover the reasonable costs of running the clearing system. Rather, they are a tool to encourage banks to issue more and different card products at the expense of our franchisees and our customers. Representatives from other payment networks have cited the same rationale in explaining the need to increase their interchange rates. As the Federal Reserve observed, the financial incentives in the debit clearing services market work to encourage higher costs and more risky debit transactions --- in short, this market is fundamentally broken.

After a decade of continuous rate increases and a refusal by Visa and MasterCard to engage in meaningful negotiations, we recognized that controlling this expense was beyond our control. In 2009, we joined with our franchisees and decided to petition Congress to address this issue. We asked our customers to sign a petition calling for Congress to stop credit card companies from charging unfair transaction fees to businesses in their communities. We were delighted to find that our customers responded with great enthusiasm and nearly 1.7 million signed our petition. In October of 2009, we delivered petition pads to 285 Members of the House of Representatives. (Present the map). Since our petition drive, over 3 million more Americans added their names to similar petitions sponsored by members of the National Association of Convenience Stores and their franchisees from around the country. In total, over 5 million Americans signed petitions calling on Congress to reform interchange fees. Fast forward to May of last year, when at the urging of millions of consumers and small businesses, Senator Durbin offered the first iteration of his amendment to the Senate's version of the Financial Reform package: 64 Senators voted in favor of the amendment including 18

Republicans. Several members of this Subcommittee participated in the comprehensive effort to develop the final package of reforms that became part of the Dodd-Frank Bill. The amendment was examined and compromises were included to provide exemptions for community banks and credit unions, additional safeguards for state-issued debit cards and other changes. It is important to note that the bill does not address the abusive rates charged on credit cards, a significant compromise. Fortunately, a compromise version of the amendment made it into the final bill that passed both Houses and went to the President last July for his signature. Dennis, as a representative of small business, was invited by the White House to attend the signing ceremony on behalf of small business franchisees that will benefit from this change.

In December, the Federal Reserve proposed regulations implementing the Durbin amendment. Most importantly, the proposed regulations included a cap on the interchange fees charged by the largest debit card issuers in the country. If this cap remains in the final regulation, it will lead to tremendous savings for hundreds of thousands of small businesses. These savings will translate into more hiring, more development and more economic activity in communities throughout America. In fact, Dennis has already hired a new employee in anticipation of the savings from the debit interchange language. In contrast to large financial institutions, 7-Eleven and most retailers operate on low single-digit profit margins. These tight profit margins are the result of the intense price competition that retailers engage in on a daily basis. There is no doubt that competitive market forces will also allow consumers to directly benefit from this reduction in debit card rates.

Today, there will be talk of delaying implementation of the proposed Rule. From our point of view such a delay permits the top 100 banks to "double dip." Many of these giant banks are using the possibility of lower debit rates as an excuse to impose new fees on or reduce services to their customers. **At the same time, they are reaping the benefits of the highest interchange rates in history.** I want to reiterate this point – the debit interchange amendment only affects about 100 banks (and only 2 credit unions) – all others are exempt from the language. According to a recent article in the American Banker, some analyst believe that community banks and credit unions will benefit from this change as it will provide them with a competitive advantage against the large banks. Madam Chairwoman, the facts are clear. First, the credit and debit card clearing system is critical to the U.S. economy and vital to our success as a retailer. As the Federal Reserve concluded, the pricing mechanism for this clearing system is broken. Debit interchange fees have increased by more than 500% over the last decade. Anyone who accepts credit and debit cards, whether small or large businesses, and the more than 5 million consumers that have signed petitions, agree that interchange reform is necessary. Last year, Congress responded to this situation by passing the Durbin amendment to the Dodd-Frank Bill. After careful consideration and significant modification by the conference committee, modest interchange reform became law in July 2010. Now the Federal Reserve has proposed a rate, having received substantial input from card networks, banks, credit unions, and merchants. We believe the data submitted to the Federal Reserve supports a lower rate than what has been proposed, however, the proposed rates still represent a significant savings to anyone that accepts debit cards. **In fact, every day that passes with the current rates in force, American businesses lose**

another $33 million. We ask that you ensure that the Federal Reserve can complete its work to provide some common sense to debit fees for businesses, large and small, and most importantly their customers across the nation.

Thank you for the opportunity to appear before the Subcommittee this morning. I would be happy to respond to any questions that the Members may have on this issue.

February 16, 2011

The Honorable Spencer T. Bachus, III
Chairman
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

On behalf of the undersigned higher education associations, we are writing regarding your planed February 17th hearing on critically important swipe fee reforms enacted by Congress last July. We welcome the opportunity to express our support for these needed reforms which will provide real relief to students, their families, and colleges and universities across the country.

Debit card swipe fees have been a hidden expense for students and families paying for college for which they received no benefit. As a result of the law enacted last year and the Federal Reserve's proposed rule, we believe that colleges and universities will see reduced debit card costs which they will be able to pass on to students and their families through lower costs as well as increased resources for institutional grant aid and student services. In addition, implementing this reform will create an opportunity for colleges and universities to offer discounts to students and their families for payments made with checks and debit cards."

During this time of economic insecurity, steps like those undertaken in swipe fee reform will help students and their families to manage the costs of attendance in increasingly strained budgets.

We urge the Committee and Members of Congress to stand up for students and colleges and universities by ensuring these debit card fee reforms are fully implemented in a timely manner.

Sincerely,

Association of American Universities
American Council on Education
Association of Student Conduct Administration
The Council for Christian Colleges & Universities
Hispanic Association of Colleges and Universities
National Association of College Stores

ELECTRONIC
PAYMENTS COALITION

Written Statement
of the
Electronic Payments Coalition
submitted to the
House Financial Services Committee
Subcommittee on Financial Institutions and
Consumer Credit
On
"Understanding the Federal Reserve's Proposed Rule
on Interchange Fees: Implications and
Consequences of the Durbin Amendment"

February 17, 2011

ELECTRONIC
PAYMENTS COALITION

The Electronic Payments Coalition's goal is to protect the value, innovation, convenience and competition in today's growing electronic payments system. In that capacity, we thank Chairman Capito and the Subcommittee for holding this hearing to review a new proposed Federal Reserve rule that will, if adopted, have a dramatic and harmful impact on consumers, financial institutions, the economy, and the payment systems.

The proposed Federal Reserve rule on debit card interchange fees is government price fixing at its worst. It sets the interchange rate 70 to 90 percent below the current free market rate, providing the largest two percent of the nation's retailers with $12 billion in windfall profits. Consumers will be the ones left to face the consequences.

Put simply, the proposed rate for debit card interchange does not come close to covering all of the costs that a debit card issuer incurs, much less the value the issuer provides in performing the services from which merchants directly benefit. The Fed rule permits issuers to recover only a fraction of the costs associated with authorizing, clearing, and settling debit card transactions. It does not include any variable costs, such as funding costs, overdraft losses, fraud prevention costs, fraud losses, billing and collection, customer service, data processing, protection of consumer data, compliance costs, card production costs, or statement production and mailing. And it certainly does not include any fixed costs of maintaining debit card services. No business would continue to offer a service at a loss, and banks will be forced to turn elsewhere to generate revenue to ensure they can continue offering debit programs to their customers.

To recoup this lost revenue, all issuers, regardless of size, will be forced to increase fees, reduce benefits, charge for services that are now free, and limit ways consumers may use their debit cards.[1] Customers could see the loss of services like free checking and free online banking. Many lower-

[1] "Debit Card Fee Cap Could Mean Higher Banking Costs," Associated Press, December 17, 2010: http://finance.yahoo.com/news/Debit-card-fee-cap-could-mean-apf-868404449.html?x=0&.v=2

ELECTRONIC
PAYMENTS COALITION

income customers who are not able to afford additional fees could be forced to drop out of traditional banking entirely.[2]

Contrary to giant retailers' claims, there is absolutely no evidence that consumers will see any difference in prices at the register. Neither the Fed rule nor the Durbin Amendment makes a single mention of retailers passing any savings on to their customers. Consumers will end up paying more than their share, just so merchants can take home billions of dollars in windfall profits.

Small financial institutions and their customers will also be severely affected by the Fed's rule. Although these smaller banks and credit unions are supposedly exempted from the Fed's set rate, this so-called "carve-out" simply will not work. With different rate levels within the systems, cards from these "exempt" institutions will be significantly more expensive for merchants, who will then discriminate against customers using those cards, and steer them towards the use of cards from issuers fully covered by the proposed rule. Market pressure will ultimately force small issuers to lower their rates to match those of larger banks, resulting in a crippling loss of interchange revenue and leading to further negative consequences for the customers who depend on these institutions for their banking services.

A recent survey conducted by the Independent Community Bankers of America confirmed that small institutions and their customers would face severe consequences as a result of this rule. Nine out of ten community bankers surveyed said that the rule would force them to charge customers for services that are currently free, and 50 percent said they would charge customers a fee each time they use a debit card.[3]

These widespread unintended consequences are the result of an amendment that was passed without a single hearing, study or review. The only discussion on the Senate floor came from the amendment's sponsor, Senator Richard Durbin, and last-minute, hand-written changes

[2] "New fees could drive millions to join the 'unbanked,'" *The Minneapolis Star-Tribune*, February 12, 2011: http://www.startribune.com/business/115948854.html
[3] "Swipe Fee Caps May Force Fees, Job Cuts, Bankers Say," Bloomberg, February 14, 2011: http://www.bloomberg.com/news/2011-02-14/-swipe-fee-cap-would-force-new-fees-job-cuts-bank-group-says.html

ELECTRONIC PAYMENTS COALITION

to the text of the amendment failed to address any of the serious concerns about its impact. In fact, 13 senators signed a letter to Federal Reserve Chairman Ben Bernanke in December 2010 stating that they felt they were misled about the Durbin Amendment's true impact for consumers and small financial institutions.[4] Rep. Barney Frank and former Senator Chris Dodd, the two lead cosponsors of the Dodd-Frank Act, have publicly stated that the Durbin Amendment should be fixed to prevent harm to consumers.[5]

The truth is clear: the Federal Reserve draft rule on debit card interchange will cause serious harm to consumers and small financial institutions. It is imperative that Congress act now to stop the implementation of this harmful rule.

Thank you again for convening this hearing. We would be happy to provide any additional information that you would find helpful.

[4] Letter to Fed Chairman Bernanke from 13 United States Senators; full letter available here: http://www.electronicpaymentscoalition.org/downloads/letter_SenateDebitInterchangeLettertoChairmanBernanke.pdf

[5] "Rep. Frank Critical of Debit Card Fee Rule," Reuters, December 17, 2010: http://www.reuters.com/article/2010/12/17/financial-regulation-debit-idUSN1714384120101217; "Chris Dodd Ruminates on Dodd-Frank, GSEs," *The Wall Street Journal*, December 20, 2010: http://blogs.wsj.com/washwire/2010/12/20/chris-dodds-exit-interview/

U.S. PIRG

THE HISPANIC INSTITUTE

PUBLIC CITIZEN Protecting Health, Safety and Democracy

February 17, 2011

Dear Chairwoman Capito, Ranking Member Maloney, and Members of the Subcommittee,

US PIRG, Public Citizen, and the Hispanic Institute, representing the interests of the public in advocating for a fair and competitive marketplace, submit this written testimony and ask that it be entered into the record for the House Financial Services Subcommittee on Financial Institutions and Consumer Credit hearing on "Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment." We strongly support the efforts of the Federal Reserve Board of Governors to regulate debit card swipe fees pursuant to the Durbin Amendment of the Dodd-Frank Wall Street Reform Act.

Our groups, other groups, including Americans for Financial Reform, and consumers at large supported the need to regulate these fees. In the last session of Congress, U.S. PIRG testified about the broken debit card market and over 5 million consumers signed petitions seeking reform of the swipe fee system. During the Federal Reserve Board regulatory process we submitted comments about why regulation of debit card swipe fees was necessary. We strongly support the proposed regulations for several reasons:

- **The current swipe fee market is broken and all consumers pay more for less because of escalating swipe fees;**
- **Sixteen countries and the European Union regulate swipe fees and their experience demonstrates that regulation benefits consumers in lower fees and lower costs of goods;**
- **There is no evidence that swipe fee regulation will lead to an increase in consumer fees; and**
- **Reductions in swipe fees should result in substantially lower prices for all consumers.**

We now discuss each of these points.

I. The current swipe fee market is broken and all consumers pay more for less because of escalating swipe fees.

In the past decade credit and debit card swipe fees have increased over three-fold, reaching over $48 billion. Debit card swipe fees have dramatically increased almost four-fold over the past decade from an average of 12 cents to 44 cents per transaction, totaling more than $16 billion annually. These are direct costs incurred by merchants and consumers. The purpose of swipe fees was to compensate card-issuers for costs such as fraud, risk of loss, float and processing (much of which is not even applicable to debit cards). Yet, while all these costs have decreased in the past 15 years, swipe fees have continued to increase. In competitive markets prices decrease as costs decrease – in this market the exact opposite occurs – clearly demonstrating a broken market.

Swipe fees raise the costs of goods for all consumers and disproportionately harm the unbanked. Swipe fees are hidden charges paid by all Americans, regardless of whether they use credit, debit, checks or cash. Put another way, all consumers pay more at the store and more at the pump because of the non-transparent, non-negotiable, non-competitive swipe fee system. These fees impose the greatest hardship on the most vulnerable consumers, the millions of American consumers without access to payment cards or banking relationships -- over 25% of the population.

Recent studies have demonstrated that swipe fees are a regressive penalty on the unbanked and underbanked. Some modest portion of swipe fees may benefit a small segment of consumers through rewards programs. (Only a small portion of debit cards have rewards programs). Yet while unbanked Americans receive no benefit from these programs, they pay in excess of $1 billion annually to subsidize those regressive rewards.[1] The Federal Reserve Bank of Boston has found that each credit-card using household receives a cross-subsidy of $1,133 from cash users every year.[2] The Hispanic Institute has reported that the bottom 50 percent of income earners pay at least $669 million more in higher prices to subsidize at least $354 million in payment card rewards.[3]

The regressive nature of this charge is exacerbated because swipe fees are assessed as a percentage of overall sales. For example, when gas prices averaged $1.87 per gallon in 2004, swipe fees totaled about $12.5 million per day. In 2005, gas prices averaged about $2.75 per gallon nationally and fees equaled $18.4 million a day. The networks and banks made an additional $2.2 billion dollars per year simply because of rising gas prices. It is difficult for low and moderate-income consumers to afford skyrocketing gasoline prices without having to pay additional fees that are passed on to them.[4]

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[1] Testimony of Edmund Mierzwinski, US PIRG, before the Subcommittee on Financial Services and General Government of the U.S. Senate Appropriations Committee, Hearing on Interchange Fees (June 16, 2010).
[2] Scott Schuh, Oz Shy, and Joanna Stavins, *Who Gains and Who Loses From Credit Card Payments? Theory and Collaborations*, Federal Reserve Bank of Boston Public Policy Discussion Paper No. 10-3, August 2010.
[3] The Hispanic Institute, *Trickle-Up Wealth Transfer: Cross-Subsidization of Consumers in the Payment Card Market,* November 2009.
[4] Testimony of Ed Mierzwinski (June 16, 2010).

The current swipe fee system provides perverse incentives for financial institutions to issue more fraud prone signature debit cards. Signature-based cards are far less safe from fraud since they do not require the use of a personal identification number ("PIN") and the debit from the account is not instantaneous. **Not surprisingly signature-based cards have seven and a half times the rate of fraud as PIN-based cards.**[5] Signature-based cards have higher swipe fees, so banks use a variety of tactics to force consumers to use the less safe signature cards either by providing rewards for signature transactions, or assessing surcharges on PIN debit transactions, or both. A system that promotes the less secure and more costly product for consumers makes no economic sense and is a sign of a broken market.

Not surprisingly, outside the United States, where debit card fees are regulated, the fraud prone signature cards are rarely found. PIN debit is a far safer and more secure product, with a much lower incidence of fraud than signature debit. Where market forces are not restrained and consumers can make fully informed choices, the lower-priced, more efficient product prevails.

A debit card is simply an electronic check. Billions of checks clear each year without any type of swipe fees. As the Federal Reserve recognized in its proposed rule, "for checks there is nothing analogous to an interchange fee to reimburse the issuer for the cost of clearing and settling a transaction."[6] Moreover, the Federal Reserve has prohibited the equivalent of swipe fees on paper checks for nearly one hundred years. That has made the U.S. check system more efficient and ensured that the fees that are charged are transparent and competitive. There is simply no economic basis for swipe fees for electronic checks.

II. Sixteen countries and the European Union regulate swipe fees and their experience demonstrates that regulation benefits consumers in lower fees and lower costs of goods.

Many of the world's largest economies, including the European Union, Canada, Australia, New Zealand, Israel, Spain, and Switzerland regulate swipe fees. Regulators in those and other countries have found the swipe fee system to be broken and regulation necessary to protect consumers from abusive, anticompetitive conduct. In seven of the eight countries with the highest debit card usage per capita there are no swipe fees. Those countries are Canada, New Zealand, Iceland, Norway, Finland, Denmark, and the Netherlands.[7] The results of the regulation in these countries are lower fees to consumers, greater innovation and choice, and greater debit card usage.[8] We provide three examples.

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[5] "Debit Card Interchange Fees and Routing; Notice of proposed rulemaking," 75 Federal Register 248, at 81740-41 (of the $1.36 billion in debit card fraud losses, $1.15 billion arose from signature debit card transactions, and $200 million arose from PIN debit card transactions).

[6] 75 Federal Register 248, at 81735.

[7] Dennis w. Carlton, "Externalities in Payment Card Networks: Theories and Evidence, Commentary," The Changing Retail Payments Landscape: What Role for Central Banks, proceedings of a conference held at the Federal Reserve Bank of Kansas City, November 9-10, 2009, at 129-130.

[8] In addition to the above listed consumer benefits, a number of countries with swipe fee regulations have a lower population of unbanked individuals compared to the United States. For example, in Canada -- the country with the highest debit card usage and zero swipe fees -- only 4% of the population is unbanked. *See* the Alliance for Financial Inclusion, *available at* http://www2.rznet.com/afi/index.php?option=com_

First, the European Union carefully considered the issues surrounding debit card competition in a recent enforcement action against Visa. The EU Competition Commission reduced Visa Europe's debit swipe fees by 60% to 0.2% of a transaction (less than the proposed Fed regulation). Joaquin Almunia, the EU's competition commissioner said "Lower inter-bank fees will trigger real benefits for merchants and consumers whilst more transparent rules will also improve competition in the cards market."[9] If the 0.2% rate is profitable for European banks, then it stands to reason that higher proposed Fed rate must be profitable for U.S. banks.

Second, when the credit card swipe reforms in Australia were implemented and the card companies ceased competing for market share by raising the fees their banks would earn, the banks had to compete on interest rates to compete for customers. This competition sharply reduced interest rates on credit cards and there was greater overall competition for credit cards.[10]

Finally, Canada has one of the highest rates of debit card usage in the world, and it has zero debit swipe fees. In many respects PIN debit in Canada is far superior to debit in the U.S. Fraud rates are far lower. There is a lower rate of unbanked consumers. The at-par swipe fee system has fostered much innovation in Canada and this innovation surpasses the degree of innovation in the U.S. For example, the Interac network offers an Internet payment service enabling over 500 merchants to offer their customers a secure internet payment option using PIN debit cards. Moreover, the system incentivizes issuers to create stronger fraud controls through Chip & PIN systems, which will be complete by 2015.[11]

III. There is no evidence that swipe fee regulation will lead to an increase in consumer fees.

Some banks have claimed that reductions in debit card swipe fees will force banks to increase other fees on demand deposit accounts. The facts simply do not support this argument.

First, there is simply no demonstrated relationship between debit card swipe fees and other consumer charges. Although debit card swipe fees increased almost four-fold over the past decade, there was no related decrease in other charges to consumers -- in fact, consumer costs have been going up consistently for 10 years."[12] For example, overdraft fees hit a record $38 billion in 2009 which was double what they were in 2000.[13] Simply, swipe fees have been another source of income for the banks.

Some banks have raised the specter that free checking would be lost if swipe fees declined. First, for many consumers, free checking was a front-end come-on for punitive back-

content&view=article&id=41&Itemid=111&lang=en.

[9] Aoife White, "Visa Europe Settles EU Antitrust Case, Reduces Fees," Bloomberg News (Dec. 8, 2010).

[10] Testimony of Ed Mierzwinski (June 16, 2010).

[11] Interac has set a deadline for complete migration to chip debit cards of December 31, 2012 for ATMs, and December 31, 2015 for point-of-sale. *See* http://www.interac.ca/merchants/chip.php.

[12] Kathy Chu, "Rising Bank Fees are Setting Records," USA Today (October 27, 2008).

[13] Saskia Scholtes and Francesco Guerra, "Banks Make 38bn from Overdraft Fees," Financial Times (August 9, 2009).

end overdraft fees (which have since been strictly regulated due to abuses). But "free" checking existed as far back as the 1980s, when some cards carried negative swipe fees or had swipe fees far lower and even less than the level of the proposed, regulated fees. Moreover, there is significant free checking in Canada even with a zero swipe fee rate. Simply, the relationship between swipe fees and free checking is dubious.

Second, even if regulated, debit cards will be profitable under the proposed swipe fee regulations. Prior to issuing the proposed rule the Fed conducted surveys of the issuers to determine their real costs of electronic payment processing. Based on the survey results, the Fed determined the costs for issuers to be 4 cents, yet the proposed rule allows for swipe fees higher than 4 cents; it allows for 7 to 12 cents per transaction. **Moreover, the proposed rule merely reduces the swipe fee to approximately the level it was about a decade ago. Since then debit card costs to issuers have fallen. If the cards were profitable at that rate ten years ago they should be profitable today.**

Third, banks admit that swipe fees are just one of many revenue streams that banks get on checking accounts. It is not necessary for banks to cover every cost they have for their entire business through swipe fees any more than grocery stores have to cover every cost they have for their entire business through selling milk.

Finally, this argument about increased consumer charges is a line consumers have heard many times before. Nearly 100 years ago banks said the same thing about the death of checks if the Fed eliminated the system of exchange fees. Checks did not disappear, but rather their use grew very rapidly. They, like debit cards, are important tools to promote the demand deposit account, which is very valuable to banks. Banks will compete over these charges as they compete over other aspects of the demand deposit account. That is a far greater amount of competition than in the swipe fee market. The bottom line is that banks would move consumer fees up as much as they can to maximize profits based on market conditions even if this rule disappeared tomorrow. The proof of that is the fact that swipe fees on merchants have tripled just since 2001 while the banks have continued to raise consumer fees too.

IV. Reductions in swipe fees should result in substantially lower prices for all consumers.

The claim that merchants will not pass savings from reduced swipe fees on to consumers is inconsistent with both sound economic policy and recent history in other countries. The reduction in debit swipe fees will result in substantial benefits to <u>all consumers</u>, including the 25% of Americans who are unbanked.

First, economic theory teaches that in competitive markets, lower costs will lead to lower prices to consumers. The staff of the Federal Reserve Board echoed that point in their presentation of the proposed rules and stated that "given reductions in interchange fees and in overall debit card acceptance cost, merchants could choose to pass the savings through which could benefit both the consumers that primarily pay with cash or checks, as well as debit card

users. We expect this would be most likely to happen, that is, lower costs would be most likely passed on to consumers, in those markets with lower margins and intense price competition."[14]

Second, in Australia, the Reserve Bank found in 2005 that "the most notable impact of the reforms [on credit card swipe fees] has been a marked reduction in merchants' costs of accepting credit cards, which in turn, is flowing through into lower prices of goods and services for all consumers."[15] Moreover, in 2008, the Reserve Bank reported that reduced swipe fees resulted in lower prices and the fact that merchants passed savings from lower swipe fees on to the consumer "is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge."[16] And in its 2007/2008 review, the Reserve Bank found consumer savings of $1.1 billion Australian in one year.[17]

Further, in conjunction with the University of Pennsylvania, in 2009 the Hispanic Institute studied the impact of anticompetitive swipe fees on consumers. The study found that "lower interchange fees result in lower prices for consumers and higher interchange fees result in higher prices for consumers."[18] Moreover, a recent EU enforcement action found that "there is no economic evidence" to support the claim that reduced swipe fees would lead to higher charges to consumers. After carefully examining the claims of the card networks, the EU concluded that debit cards would be profitable even absent a swipe fee and there was little evidence that higher swipe fees had led to lower cardholder fees. "The evidence gathered during the inquiry rather suggests that the pass-through of higher interchange fees to lower cardholder fees is small."[19] The EU concluded that: "Consumers already pay the cost of the interchange fee without knowing it. This cost is now hidden in the final retail price and is therefore non-transparent. Our objective is to improve transparency, so that consumers know how much and when they are paying for a card."[20]

Congress recognized the importance of transparency and choice in enacting the Durbin Amendment. These regulations are likely to have substantial benefits and result in saving in everyday goods for consumers. As Governor Warsh recognized in the December 16, 2010 presentation of the proposed Fed rules, "it's not [the Fed's] job to substitute our judgment for the judgment of Congress, and Congress has given us some clarity on rules on what our regulations should suggest."[21]

[14] Federal Reserve Open Board Meeting, December 16, 2010.
[15] Payments Systems Board Annual Report, *Reserve Banks of Australia*, 2005 at 10.
[16] Reform of Australia's Payments System Preliminary Conclusions of the 2007/08 Review (April 2008).
[17] *Id.* It should be noted that proponents of swipe fees often site a MasterCard funded study, which found no benefit to consumers from the reduction of swipe fees in Australia. However, the Reserve Bank of Australia vigorously disputes this study's findings.
[18] The Hispanic Institute, *Trickle-Up Wealth Transfer: Cross-Subsidization of Consumers in the Payment Card Market*, November 2009.
[19] EU Competition Commission, *Competition: Final Report on Retail Banking Inquiry - Frequently Asked Questions* (January 31, 2007).
[20] *Id.*
[21] Governor Kevin M. Warsh, Federal Reserve Open Board Meeting, December 16, 2010.

We strongly support the efforts of the Board and hope Congress will continue to support the efforts to regulate swipe fees.

US PIRG, the federation of state Public Interest Research Groups ("U.S. PIRG"), serves as the non-profit, non-partisan federal lobbying office and federation of state Public Interest Research Groups. PIRGs take on powerful interests on behalf of their members. See U.S. PIRG on the web at http://uspirg.org.

Public Citizen is a national, nonprofit consumer advocacy organization founded in 1971 to represent the people's interests in Congress the executive branch and courts. Public Citizen champions the public interest and counter corporate power, using data-driven research and the voices of its 150,000 members and supporters to effect change.

The Hispanic Institute is a 501(c)3 dedicated nonprofit organization. Its mission is to provide an effective educational forum for an informed and empowered Hispanic America through consumer outreach projects focused on consumer fraud protection, media monitoring, study of Hispanic economic contributions, citizenship education, and technology and telecommunications research.

For questions or comments, please contact Ed Mierzwinski, U.S. PIRG, edm@pirg.org or 202-461-3821 (direct).

The 60 Plus Association

515 King Street • Suite 315 • Alexandria, VA 22314
Phone 703.807.2070 • Fax 703.807.2073 • www.60Plus.org

Kill the Death Tax. Protect Social Security. Energy Security.

February 17, 2011

The Honorable Shelley Moore Capito
2232 Rayburn HOB
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney
2443 Rayburn HOB
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Capito and Ranking Member Maloney:

Founded in 1992, the 60 Plus Association is a non-partisan seniors advocacy group with a free enterprise, less government, less taxes approach to seniors issues. We believe that seniors, and society at large, are best served when minimal government intrusion and competition combine to create an environment of more choice and better services.

On behalf of over 7 million senior citizen activists of the 60 Plus Association, we oppose arbitrary price controls in any sector of the economy. The wallets and well-being of seniors are especially sensitive to regulations that push costs onto consumers. We do not believe that it is the role or responsibility of the government to intervene in private contractual relationships between retailers and banks and that is why we urge you to remove Senator Durbin's "interchange fee" provisions from the Dodd-Frank Wall Street Reform and Consumer Protection Act.

60 Plus voiced its concerns in a June 17, 2010 letter to Congressional leaders, but these provisions nonetheless were forced through conference committee without the benefit of a hearing or careful examination of what effect this type of regulation will have on consumers. There is no mandate for retailers to share any savings resulting from this regulation with consumers, and the Fed-proposed caps do not allow debit card issuers to recover their costs, let alone realize any profit. If implemented, consumers will be forced to pay the price as fees for banking services will surely increase. Consumers and seniors alike will lose out.

Policy that is this comprehensive should not be forced through without serious deliberation and with no regard for the impact on consumers. Therefore, we urge you and your colleagues to repeal these provisions which will hurt American consumers, especially seniors, most of whom live on fixed incomes.

Sincerely,

Jim Martin

James L. Martin

The 60 Plus Association is a 19-year-old nonpartisan organization working for death tax repeal, saving Social Security, affordable prescription drugs, lowering energy costs and other issues featuring a less government, less taxes approach as well as a strict adherence to the Constitution. 60 Plus calls on support from over 7 million activists. 60 Plus publishes a newsletter, SENIOR VOICE, and a Scorecard, bestowing awards on lawmakers of both parties who vote "pro-senior." 60 Plus has been called, "an increasingly influential senior citizen's group."

ASSOCIATION OF KENTUCKY FRIED CHICKEN FRANCHISEES, INC.

9520 Poplar Hill Drive • Crestwood, KY 40014

February 15, 2011

The Honorable Spencer Bachus
Chairman, Financial Services Committee
U.S. House of Representatives
2246 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus:

We are writing this letter on behalf of the 696 Kentucky Fried Chicken franchisees representing 4,182 restaurants in the United States.

Last year, one of the provisions included in the Dodd-Frank Wall Street Reform Act required reform of interchange fees that banks charge when customers use a debit card at my stores. That provision, called the Durbin amendment, passed overwhelmingly and will provide meaningful relief to both our small businesses and our customers during these challenging economic times.

As I'm sure you are aware, the quick service restaurant business is extremely competitive, and given our low average ticket (<$15), we operate at thin margins, so these fees are a significant cost to our business. Additionally, we've seen a HUGE increase in the use of debit cards at KFC restaurants over the past few years and they continue to grow. With the growth of these transactions and continued price increases by card associations, our cost for merely accepting debit cards has risen substantially. As we look forward to 2011, we are facing many challenges in our business, including a fragile economic environment, as well as commodity and food price increases. ***This legislation, and its timely implementation, is extremely important to our small businesses during this challenging economic period.***

As you review how best to implement this important legislation, please consider the following:

1. We support the comparison of debit cards to checks. In fact, we also believe that debit cards are not only similar to checks; they are also similar to ACH transactions. Both checks and ACH transactions are significantly cheaper than debit cards. Debit fees, especially the variable portion, are out of control. It doesn't cost the bank any more for a $1,000 transaction or a $1 transaction. So why do we, as franchisees, pay a percentage to the bank on every debit

Page Two

sale? We would think that debit card transaction costs should be approximately the same as what we pay for check clearing and ACH transactions – it's nearly the same transaction. In fact it is actually cheaper for the banks to process debit transaction than checks due to the labor and additional costs associated with handling the paper checks, and as we read the proposed rules by the Federal Reserve Board it is apparent that they feel the same.

2. Please consider the impact of your maximum charges to small ticket merchants, like our business. We have a significant number of transactions under $5, where the fees could actually become more expensive under your current proposed cap of $0.12 per item. We urge you to introduce LOWER caps on fees to less than $0.12. And, by the way, if we accept debit cards, we must accept ALL debit cards, even if the transaction is only a $1. We may now be allowed to put a minimum on the use of credit, but not debit. However the reality is that if we impose limits on these types of transactions it angers our customers and in these economic times we cannot afford nor can any small business afford to do anything that might potentially cause a customer to stop trading with them. Therefore it makes more sense to have a reasonable cost associated with processing small ticket Debit and Credit transactions. As our economy continues to move away from cash it is imperative that we accept all forms of payment for all transactions.

3. We often hear from banks that the reason debit fees are so expensive is that the "cost of fraud is so high". We are in the restaurant business. We sell chicken. We have very little fraud in our business (<0.01% of sales) and yet, we must pay higher fees like everyone else. Therefore, we do not support the implementation of a fraud adjustment.

4. Additionally, please note that we do not use PIN pads in our restaurants because they are so expensive. All of our transactions are processed as a signature based debit transaction, and again we do not have any fraud. We believe that you correctly made NO distinction between the variable cost for a PIN based or a signature based transaction.

5. Today, we are restricted by network rules to route our transactions in a specified sequence based on which networks are able to process and clear the transaction. This prevents healthy competition by requiring us to use specific networks. We believe that competition is encouraged best through choice and we support Alternative 2 which requires multiple networks on debit cards. We are not able to competitively source debit card processing services, so from our perspective it is "like" a monopoly market, justifying Federal Reserve Board regulation of rates.

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This legislation, and its potential impact, is extremely important to our small businesses. We want to thank you for your fine work on this matter. We know that the Federal Reserve Board's proposal has been met with strong resistance from the banks and big card companies, but we urge you to stand strong on this issue so that these rules can be implemented in a timely manner. Our small businesses are counting on it.

Sincerely,

Terry Rogers
President
Association of Kentucky Fried Chicken Franchisees, Inc.

Dale E Black

Dale Black
First Vice President
Association of Kentucky Fried Chicken Franchisees, Inc.

Brandon Robertson

Brandon Robertson
Chairman
AKFCF Government Affairs Committee

cc: The Honorable Barney Frank

INDEPENDENT COMMUNITY
BANKERS of AMERICA

Statement for the Record

By the

Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

Hearing on

"Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment"

February 17, 2011
Washington, D.C.

On behalf of its nearly 5,000 member banks, ICBA is pleased to submit this statement for the record for this hearing on "Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment."

Stopping the Federal Reserve proposal and preserving the consumer benefits of the debit interchange system is ICBA's highest priority. We are deeply concerned by the impact of the new law and the proposed implementing rule. The Federal Reserve proposal goes even further than required by statute and, if implemented, would fundamentally change the economics of retail banking at the expense of consumers. ICBA is confident that this hearing will substantiate our concerns, and we are grateful to Chairman Capito for convening it.

Small Issuer "Carve-Out" Will Not Work

Before describing in detail the impact of the law and Federal Reserve proposal on community banks, it is essential that we dispel any notion that the statutory exemption for debit cards issued by institutions with less than $10 billion in assets would work as billed in shielding small issuers and their customers. ICBA vigorously opposed the interchange amendment during consideration of the Dodd-Frank Act because we recognized that the carve-out would not work. Visa's planned two-tiered pricing system, however well intentioned, also will not work. The credit union industry, represented at this hearing today by the Credit Union National Association, shares this conviction. Small issuers will feel the full impact of the Durbin amendment over time. ICBA encourages you to discuss this with the community bankers in your districts. It's too easy to focus on the large issuers and lose sight of the thousands of community bank issuers who would be harmed if the Federal Reserve proposal is implemented. Not only are small issuers not carved out, they would be disadvantaged relative to large issuers, and a likely consequence of the Federal Reserve's proposed rule, if implemented, is further industry consolidation and higher fees and fewer choices for consumers.

Why won't the carve-out work? The reasons are twofold. First, in addition to the interchange price-fixing provisions of the law and the Federal Reserve proposal, other less-discussed provisions shift control of transaction routing from the card issuer to the merchant. These provisions apply to all financial institutions, regardless of size, and negate the benefit, if any, small financial institutions would gain from the interchange price-fixing exemption. Granting retailers the ability to route debit card transactions over the network of their choice – where the card issuer currently designates the network on which its card is routed – will allow retailers to bypass the two-tier system. Further, large retailers will be able to incentivize customers to use the rate-controlled cards issued by the largest financial institutions, discriminating against community banks and their customers.

Community bank cards will either be subject to the lower rate or their cards will be neglected by retailers.

There's a second way in which the carve-out fails to shield small issuers. In any two-tier system, the small issuer interchange rate, to the extent that small issuers actually receive it, will surely be lower than the current interchange rate. The payment card networks will be under considerable pressure from their clients with more than $10 billion in assets to narrow the gap between the two tiers.

For these reasons, a tiered system will not protect community banks. Over time, community bank interchange revenue will drop sharply with a direct impact on community bank customers.

Description of the Federal Reserve Proposal

The Federal Reserve proposal would set debit interchange rates at $.07 to $.12 per transaction. These rates are well below cost to a community bank, representing a drop of 80 percent from the current interchange rates, which are competitively set in the market place. The proposal would create a windfall for large merchants, shifting $12 billion in revenue from card issuers to the top 1.5% of merchants in the United States.

A fair interchange rate is important to community banks because interchange offsets the cost of processing transactions, maintaining highly-complex systems, guaranteeing payment and assuming risk. Retailers accept the current interchange rates as a cost of doing business because they get tremendous benefit from the card payments system. Acceptance of debit cards is not mandated. Among these benefits are more efficient check out times, reduced cash and check costs (e.g., theft of cash, bounced checks), increased sales and profits, and, significantly, the ability to make sales without assuming any credit risk. By accepting card payments, merchants also shift the costs of debt collection, regulatory compliance, billing, customer service and transaction processing onto others. Merchants get guaranteed funds in their accounts right away, the ability to accept payment cards carried by millions of customers, and do not have to worry about bounced checks. All parties to a transaction – merchants, card holders, and card issuers – benefit from state of the art fraud detection systems.

However, providing these services is not free, and the costs are primarily imposed on the bank that issued the payment card. Card networks generally charge an interchange fee, paid by merchants, to compensate the card issuers for the services they provide which ultimately benefit merchants. As the recipient of these benefits, it is wholly appropriate

that the merchant pay its fair share. The rates set by the Federal Reserve proposal are simply not adequate to support the system delivering these benefits.

The Federal Reserve Proposal Would Alter the Economics of Community Banking

What would happen if the Federal Reserve proposal were implemented? We don't have to speculate about the effects of the proposal. ICBA just completed a survey of its members, and the results demonstrate that the Federal Reserve proposal would alter the economics of community banking and fundamentally and adversely change the nature of the relationship between a community bank and its customers. Among the survey results:

- Ninety-three percent of community bank survey respondents said that they would be forced to charge their customer 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, free checking, online or 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.

The ICBA survey results clarify what is at stake.

The Current Interchange System Allows Community Banks to Compete

Our global payments system works so well that thousands of small community banks are able to stand toe-to-toe and offer services to consumers in direct competition with banks like Citigroup and Bank of America, while providing the quality of relationship service that only a community banker can give. The new law and the Federal Reserve proposal threaten the ability of community banks to compete with large issuers and would bring about further industry consolidation, to the detriment of consumers and small businesses in small town and rural America.

Closing

Debit cards have become a way of life for most Americans because they are vastly more convenient than carrying cash or a checkbook. Banking customers have come to expect

debit cards in connection with their checking accounts. Community banks play a vital role in meeting that demand, and should not be disadvantaged because large retailers want to shift their reasonable costs to consumers and tilt the electronic payments system drastically in their favor and against consumers. The new law and the Federal Reserve proposal are an unwarranted intervention in a functioning market that will have far reaching consequences. ICBA urges this committee to prevent the Federal Reserve proposal from going into effect.

Statement of Senator Richard J. Durbin
Hearing before the House Financial Services Subcommittee on Financial Institutions & Consumer Credit on
"Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment."
February 17, 2011

Chairman Capito, Ranking Member Maloney, and members of the subcommittee, I appreciate the opportunity to submit this statement today.

Last year, Congress passed landmark legislation to reform the interchange fee system in America. This bipartisan effort came after years of Congressional hearings and Government Accountability Office studies that made clear that the interchange system was on an unsustainable course. While many in the financial services industry have opposed interchange reform, it is clear that this reform is necessary for the sake of America's consumers, businesses and overall economy.

Debit and credit cards are rapidly replacing cash and checks in today's economy. Over half of all retail sales in America are now made with plastic, and that percentage is growing. There are benefits that come from the increasing use of these cards, but there are also concerns that can no longer be ignored.

Visa and MasterCard are the dominant players in the card industry, and their cards are used in around 80% of debit and credit transactions. Every time a sale is made with one of their cards, these card network companies take a cut out of the transaction amount and route it along to the bank that issued the card as an interchange fee. These fees average between 1%- 3% of the transaction amount and have been steadily increasing. Tens of billions of dollars in interchange fees are now collected each year from those who accept cards, including large and small businesses, charities, and government agencies.

There is nothing wrong with card-issuing banks receiving fees for debit transactions as long as the fees are transparent and set in a competitive market environment. But that is not the case with interchange fees. For years card networks like Visa have fixed the interchange fee rates that each issuing bank receives when one of their debit cards is swiped. In other words, each bank that issues Visa cards receives exactly the same network-established fee no matter how efficiently or inefficiently that bank processes transactions or prevents fraud.

It's easy to see why banks and card networks set up this interchange scheme. It is lucrative for the banks, who receive tens of billions per year in high fees that are not tempered by competitive market forces and that are not linked to any particular bank's actual costs. It benefits card networks, because they are paid each time a card is swiped and high interchange means banks will issue more cards. But the system is unfair to consumers, who pay tens of billions per year in hidden fees passed on to them in the form of higher retail prices. And it is unfair to merchants, who cannot negotiate interchange fees and who can no longer realistically refuse to accept the dominant card networks despite constant fee increases.

Many merchants argue that interchange fees should be prohibited in the debit system as they are in the checking system. The new reform law conceded that a network will be allowed to set an interchange rate that uniformly compensates issuers for the minimum costs necessary to authorize, clear and settle a debit transaction over that network's wires. But issuers should be incentivized to manage all other costs of operating a debit card system efficiently. The old unregulated system encouraged networks to set rates at levels that subsidize inefficiency and that massively overcompensate banks at the expense of merchants and their customers. This was simply unsustainable, and the new law corrects these incentives through reasonable regulation.

What the Durbin Amendment Does

The Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act brings reasonable regulation to the $20 billion per year debit interchange fee system which had previously been unregulated. The amendment will bring relief for small businesses, merchants, universities, charities, government agencies, and all others who accept cards for payment, and will help them achieve cost savings and pass those savings on to consumers through discounts and price competition.

The amendment contains two main parts. The first part directs the Federal Reserve to place reasonable constraints on the interchange price fixing that card-issuing banks permit networks like Visa and MasterCard to perform on their behalf. The second part rescinds several anti-competitive restrictions imposed by card networks on other participants in the debit system.

The only fees regulated by the first part of the amendment are those fees that card networks fix on behalf of their issuing banks. The amendment says that for transactions involving debit cards issued by banks with assets over $10 billion, any interchange fee established by a card network for the purpose of compensating the card issuer must be reasonable and proportional to the cost incurred by the issuer in processing the transaction. The amendment permits card-issuing banks to receive debit interchange fee adjustments to cover reasonably necessary fraud prevention costs. However, as opposed to the current system where banks receive a guaranteed level of interchange revenue no matter how effectively they deal with fraud, the amendment will require regulated banks to demonstrate that they have taken effective fraud-prevention steps in order to receive an issuer-specific interchange adjustment.

The second part of the amendment prohibits several anti-competitive card network restrictions. The amendment prevents card networks from penalizing merchants who offer discounts for the use of cash, checks and debit cards as a method of payment, and it prevents networks from penalizing merchants who set a $10 minimum for credit card transactions. The amendment also responds to efforts by dominant networks like Visa to sign banks to exclusive agreements under which Visa becomes the sole network upon which the bank's debit transactions can be routed. This growing trend toward network exclusivity will force smaller debit networks out of business, and the amendment preserves competition by directing the Fed to issue regulations ensuring that a card network cannot limit a debit card to only be allowed to run on one exclusive network.

Response to Financial Industry Arguments

I have heard many arguments against interchange reform presented by the financial services industry. I will respond to those arguments below.

Consumer Impact

Banks and card companies argue that interchange reform will hurt consumers. However, my amendment was supported by consumer groups and millions of individual consumers who signed petitions in support of swipe fee reform. When banks and card networks advise Congress on what is best for consumers, I would urge my colleagues to take that advice with a grain of salt.

Transparency, competition and choice are good for consumers, and the current interchange system is designed specifically to avoid those features. Other nations that have regulated interchange fees have seen significant consumer benefits, and the same will be true here. Note that the Fed met last October 13 with consumer groups about interchange reform, and according to the Fed's public summary of that meeting the groups said they would prefer that debit interchange fees be either de minimis or zero.

Small Banks and Credit Unions

Financial industry trade associations claim that interchange reform will harm community banks despite the amendment's exemption for small banks and credit unions. Neutral observers disagree with this claim. For example, on February 4, an article in the American Banker titled "Durbin Amendment Winners and Losers" said that "[d]espite fear that has run rampant through under-$10-billion banks, we think they are winners" under the Durbin Amendment. A January 7 American Banker article titled "Visa Plans Two-Tiered Interchange Rates After Fed Rules" said the following about Visa's announcement that it would implement different interchange rate schedules for large and small banks: "[a]nalysts say the move will put community banks and credit unions at an advantage over larger institutions."

The financial industry argues that, in the words of the American Bankers Association, "marketplace pressures will force all banks to conform to the artificially lower government mandated rate restrictions to which large banks will be subject." But of course banks do not set their own interchange rates-- networks set them, and networks have a clear financial incentive to keep interchange rates high for unregulated small banks in order to entice those banks to issue the networks' cards.

The argument that merchants will discriminate against small bank debit cards that carry higher interchange fees is also flawed for three reasons: (1) merchants are subject to severe contractual penalties if they refuse to honor all cards within a network; (2) merchants do not want to lose sales by telling customers to put their debit cards away; and (3) if merchants wanted to discriminate against cards that carry higher interchange fees, they could always easily do so by discriminating against rewards cards or corporate cards- but they do not because of the significant deterrent of contractual penalties and lost sales.

Threatened Consumer Fee Increases

Banks argue that if interchange reform is not stopped, they will be forced to raise fees on consumers. But even a quick glance at past headlines reveals that banks have already been raising consumer fees long before Dodd-Frank was enacted last July. I would note for example the following articles:

- October 27, 2008 - "Rising bank fees are setting records" – USA Today
- November 12, 2008 - "Banks Boost Customer Fees to Record Highs" - Wall Street Journal
- May 28, 2009 - "Banks Find Ways To Boost Fees; Checking Accounts Latest Target" - USA Today
- July 1, 2009 - "Bank Fees Rise as Lenders Try to Offset Losses" - New York Times
- July 19, 2009 - "Why Are Banks Raising Fees? As Citigroup and Bank of America Post Huge Profits, Why Are Bank Fees Going Up?" – CBS News
- November 19, 2009 - "Checking Account Fees Are Making a Comeback" - SmartMoney
- January 4, 2010 - "Banks Eye New Fees, Revenue in 2010" - ConsumerAffairs.com
- May 18, 2010 - "Banks return to charging credit card, checking account fees" - USA Today
- June 22, 2010 - "Wells Fargo to boost checking fees" - Business Journal

Banks may have changed their justifications over the years for why they raise consumer fees -- from the financial crisis to loan losses to overdraft regulations to interchange reform-- but they have consistently increased consumer fees as far as the market will allow. Reasonable regulation is needed to ensure competitive markets for the fees banks take from consumers as well as for the fees they take from merchants.

I would further note that consumers are <u>already</u> paying for the debit interchange system in the form of higher retail prices – an estimated $427 per year for each American family according to one study. Currently those fees are hidden and non-negotiable, but under my amendment they will be transparent and subject to competitive market forces. Most retail sectors are highly competitive on price, which will ensure that interchange savings are passed on to consumers.

Preventing Fraud

The banking industry claims that network-established interchange fees are necessary in order to prevent fraud in the debit system. This claim is misleading. As the Fed pointed out in its draft rule, fraud rates are far lower for PIN debit than for signature debit transactions, but banks urge their customers to pay with signature debit since networks give higher interchange rates for signature than for PIN. (See the April 21, 2010, American Banker article "Counterintuitive Pitch for Higher-Fee Debit Category" on JP Morgan Chase's efforts to urge cardholders to stop using PIN.) When fraud occurs on signature debit transactions, the Fed reports that 45 percent of those fraud losses are charged back to merchants.

In contrast to the current system in which all banks receive the same interchange fee rate regardless of how much fraud they allow and in which networks give banks higher interchange for fraud-prone signature debit than for PIN, my amendment will incentivize banks to reduce fraud by allowing higher interchange for those banks that take successful fraud prevention steps.

Congressional Hearings

The financial industry claims that there were no Congressional hearings or informed consideration of interchange reform. Actually, interchange fees have been the focus of two GAO reports and at least seven hearings in the past five years, including hearings before (1) the House Committee on Energy and Commerce, Subcommittee on Commerce, Trade and Consumer Protection, February 15, 2006; (2) the Senate Judiciary Committee, July 19, 2006; (3) the House Judiciary Committee Antitrust Task Force, July 19, 2007; (4) the House Judiciary Committee Antitrust Task Force, May 15, 2008; (5) the House Financial Services Committee, October 8, 2009; (6) the House Judiciary Committee, April 28, 2010; and (7) the Senate Appropriations Committee, Subcommittee on Financial Services and General Government, June 16, 2010.

Of course, previous Congressional hearings and GAO reports on the issue of interchange reform were hampered by the financial industry's unwillingness to share key information about the interchange system. As GAO noted on p. 23 of their November 2009 report, "We were not able to obtain data from the largest card issuers about their revenues, profits, or expenses to compare interchange fee revenues with expenses." The enactment of the Durbin Amendment and its requirement that industry provide key information to the Fed was necessary to bring this information to light, and this information has appropriately guided the Fed's rulemaking process.

The Push for Delay or Repeal

Finally, I would note that many in the financial industry are pushing to stop or delay the Fed from implementing the interchange reform that Congress directed them to implement. They are urging this action before the Fed has even crafted its final rules, and despite the fact that the amendment already provides ample timeframes for implementation between the issuance of the final rules and their effective date.

The record shows that the financial industry has always fiercely opposed interchange reform efforts ever since the introduction of bipartisan reform legislation back in 2008. However, after years of considering the issue, Congress has now recognized that interchange reform is necessary and has passed a reform law that should be given time to work.

Thank you for the opportunity to provide this statement today.

HyVee

February 16, 2011

Chairman Bachus
Ranking Member Frank
Members of the House Financial Services Committee

Re: PIN & Signature Debit Interchange Fees

Debit card interchange swipe fee reforms are a top priority for Hy-Vee, our employees, and our customers. At Hy-Vee we pride ourselves on excellent service and low prices. We are an Employee-Owned company with over 56,000 employees, operating 232 grocery and drugstores in the Midwest.

Hy-Vee is in a unique position in that we also own Midwest Heritage Bank – one of the oldest financial institutions in the state of Iowa. The positive impact debit card interchange reforms will have on our retail business and our customers is far more significant than any impact the reforms could have on our bank.

Hy-Vee has accepted credit and debit cards since the mid 1980's. In the early years of PIN debit, the customer's bank would pay Hy-Vee 10¢ if the customer used a debit card in our stores. Despite increases in volume and improved technology, which would normally result in lower rates, our fees have continued to go up and now PIN and Signature debit fees range from 20¢ to over a $1.00 per transaction.

Interchange fees are the largest cost of accepting credit and debit cards, and the one fee we have no control over. We are continually looking for ways to decrease our payment system costs and make investments to reduce card expenses wherever possible. We have managed to reduce check processing costs to pennies. We have invested millions of dollars in technology to help reduce our transaction processing costs on fees that are totally independent of interchange fees. With interchange, however, there is no competition to go to and no ability to negotiate with banks for better rates and costs have increased despite technological efficiencies.

Over the past decade Hy-Vee's credit and debit card fees have increased 350% and swipe fees cost us tens of millions of dollars each year. In many of our retail stores the cost to accept debit and credit cards is rising faster than healthcare costs and exceeds the cost of health insurance for our employees. Additionally, we have spent millions of dollars to comply with Payment Card Industry Data Security Standards and other initiatives that protect our customers and reduce fraud. Also we spend hundreds of thousands of dollars every year auditing and maintaining compliance with PCI standards.

Nonetheless, we do not receive a payment guarantee on debit cards. Card networks reserve the right to reverse payment due to processing errors or fraudulent use of the card, yet prevent us from checking ID to help prevent fraudulent use of the card. They also incent the customer to use the more fraud-prone, signature debit option, instead of the more secure PIN debit because the signature option can bring them three times the amount of revenue on a single transaction. In either of these chargeback situations, we can end up losing both payment and product.

We, at Hy-Vee, believe the proposed interchange transaction fee and routing reforms will have a positive impact on our business and our customers without having any significant adverse affect on our bank customers, bank business, or the safety and soundness of the financial institution. We applaud the Federal Reserve Board of Governors for the thoughtful considerations that have gone into the proposed rule and would like to convey our support for the important steps they have taken toward finalizing the debit card swipe fee reforms.

I currently serve as Chairman of the Food Marketing Institute Board of Directors and should stress that implementation of debit card swipe fee reforms this summer is not only important to Hy-Vee and our customers, but is a high priority for the entire grocery retail and wholesale industry and will result in benefits to our customers.

Sincerely,

HY-VEE, INC.

Ric Jurgens

Ric Jurgens
Chairman, CEO

RJ/jl

NAFCU
National Association of Federal Credit Unions
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Fred R. Becker, Jr.
President and CEO

February 16, 2011

The Honorable Shelley Moore Capito
Chairman
House Financial Services Subcommittee on
Financial Institutions
and Consumer Credit
United States House of Representatives
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Financial Services Subcommittee on
Financial Institutions
and Consumer Credit
United States House of Representatives
Washington, D.C. 20515

Re: Consequences of the Durbin Amendment on Credit Unions

Dear Chairman Capito and Ranking Member ~~Maloney:~~ Chairman Capito

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the interests of our nation's federal credit unions, I write today in conjunction with the Financial Institutions and Consumer Credit Subcommittee hearing: "Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment."

NAFCU strongly opposes the Federal Reserve's proposed rule that, as prescribed by the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203), would implement burdensome new price caps on debit interchange fees. We are pleased that the subcommittee is holding a hearing on this subject and urge immediate legislative action to stop the Federal Reserve's proposed rule from going into effect later this year.

The Federal Reserve's price cap scheme interjects the government between two industries, and destroys a free market system that has worked successfully for the American public, as evidenced by the continued record use of debit cards during the holiday season. The Durbin Amendment and the proposed rule amounts to a multi-billion dollar give-away to our nation's largest retailers at the expense of our nation's not-for-profit credit unions and their 92 million member-owners. For example, the corporate parent of the one large privately-owned retailer appearing before the subcommittee in this hearing had higher worldwide revenues in 2009 ($57.6 billion)[1] than the entire federally-insured credit union industry ($55.9 billion). The implementation of the Durbin Amendment and the Federal Reserve's proposed rule is sure to expand that margin.

Based on the Federal Reserve's proposed rule, it appears that the worst case scenario is materializing for all issuers including those community institutions under $10 billion in assets. The proposal will lead to job losses, higher costs for consumers, and may even force some small credit unions out of business as

[1]*Breaking New Ground in Retail*, Annual Report 2009, Seven and i Holdings Co., Ltd., p.2; (www.7andi.com)

The Honorable Shelley Moore Capito
The Honorable Carolyn Maloney
February 16, 2011
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small issuers will ultimately be forced to accept the same below market interchange rates the rule imposes on large institutions.

Recent NAFCU surveys of our membership, found that nearly 65% of credit unions are considering eliminating free checking to help mitigate lost revenue from the debit interchange rule, and 67% are considering imposing annual or monthly fees on debit cardholders. Implementation of this rule could also lead to lower dividends and higher costs of credit, as 52% of credit unions may consider reducing rates on deposit accounts and 25% will consider increasing rates on loans. Furthermore, it may lead to job losses, as nearly 19% of credit unions will consider reducing staff at their credit unions and nearly 21% will consider closing existing branches or postponing plans to open new ones if the capped rate becomes the default rate for all issuers.

Implementation of this rule is a clear and present danger to credit unions, regardless of their size, and their ability to serve their 92 million members. Congress must act to stop it. While proponents of this price cap point to a "carve-out" for institutions under $10 billion, the fact remains that it is essentially toothless as written. While there are provisions in the act designed to prevent merchants from steering customers to lower-rate cards, there are no enforcement mechanisms in the act, or the proposed rule, to protect consumers and small institutions from this devious behavior. Furthermore, there are no mechanisms in the act to guarantee the creation of a two-tier payment system (one for those above $10 billion, one for those below $10 billion) to benefit exempt institutions. Even if networks propose one now, there is nothing to stop them from changing their mind at any point in the future. This means that, ultimately, market pressure is likely to force interchange rates for institutions under $10 billion to the "capped" rate.

The flaws of the proposed Federal Reserve rule become even more egregious here, when you consider the fact that the Federal Reserve did not consult and factor in the debit interchange costs for financial institutions under $10 billion in crafting the price cap. Rather, their "capped" rate was based on the larger economies of scale of those institutions above $10 billion. If those institutions under $10 billion are driven to the "capped" rate, the impact on their ability to offer debit products to those they serve will be devastating.

We believe that Congressional action to repeal the Durbin Amendment, and to delay or prevent the Federal Reserve rule from going into effect later this year, is especially warranted given the numerous factors the Federal Reserve failed to take into consideration as part of the rule making process. It is clear that the cost of maintaining a debit card portfolio at a not-for-profit credit union was never taken into account.

First and most significantly, there should have been more consideration given to fraud losses and data security concerns when drafting any regulation limiting interchange fees. Credit unions have suffered steep losses in recent years due to the direct and indirect costs of data breaches. They are often forced to charge-off fraud losses and incur additional expenses in making their members whole again, much of which stem from the failure of merchants to protect sensitive financial information about their customers. Such costs include, but are not limited to, the re-issuance of new cards, creation of new personal identification numbers, and fraud insurance. These were not factored into the Federal Reserve's proposal.

Second, the Federal Reserve should have also taken into consideration all of the significant costs associated with maintaining a debit card portfolio. Network fees, licensing fees, personnel training, regulatory compliance, and the technology (including ongoing improvements to the system) needed to operate a debit card program add up quickly and become a significant burden for small financial institutions. Neither the Durbin Amendment, nor the Federal Reserve's proposed rule, currently account for these considerable costs.

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Furthermore, the destructive price fixing amendment fails to recognize that use of the debit card system provides a significant benefit to merchants, such as by allowing for the immediate transfer of payment at the point of sale. Proponents of this amendment sold it by falsely asserting that debit cards are just like paper checks. Recently, a representative from the National Retail Federation was quoted in the *Financial Times* as saying "A debit card is nothing more than a plastic cheque." *However*, unlike paper checks, the use of plastic cards leaves the onus on the financial institutions to recoup losses incurred by a defrauded customer. If debit cards are to be treated equivalently to checks, then recovering the cost of a fraudulent transaction on a debit card should lie with the merchant, just as it does for a paper check.

Finally, the amendment did not require the Federal Reserve to consult with functional regulators about the impact the proposed rule would have on the safety and soundness of our nation's financial institutions. Thus, they did not do so. This is of paramount importance for not-for-profit, member-owned credit unions, as they are structured and operated differently than large financial institutions that can turn to their shareholders or capital markets to raise funds. The National Credit Union Administration (NCUA), which serves as the regulator for all federally-insured credit unions, can provide a more accurate depiction of how the proposed price caps will negatively impact the credit union industry.

NAFCU urges the subcommittee to focus on the above factors at tomorrow's hearing when considering the credit union perspective with regard to the proposed rule. Make no mistake, if this proposed rule goes into effect, it will have a disastrous impact on credit unions and their 92 million members.

Should you or your staff have any questions or require any additional information please do not hesitate to contact Brad Thaler, NAFCU's Vice President of Legislative Affairs, at 703-842-2204 or me.

Sincerely,

Fred R. Becker, Jr.
President/CEO

cc: Members of the Subcommittee on Financial Institutions and Consumer Credit
The Honorable Spencer Bachus
The Honorable Barney Frank

Network Branded Prepaid Card Association
110 Chestnut Ridge Road, Suite 111
Montvale, NJ 07645-1706
201-746-0725

February 16, 2011

The Honorable Shelley Moore Capito
Chairman
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
2443 Rayburn Building
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
2332 Rayburn Building
Washington, D.C. 20515

Dear Chairwoman Capito and Ranking Member Maloney:

On behalf of the Network Branded Prepaid Card Association (NBPCA),[1] I am writing to express deep concerns with the Federal Reserve's proposed rules on debit interchange fees pursuant to the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The NBPCA is gravely concerned that if implemented in its current form, the Federal Reserve's proposed rules will have a dramatic negative effect on the prepaid card industry and, more importantly, on users of prepaid products including consumers, businesses and governments. We believe the current interpretation of the Durbin Amendment, as reflected in the proposed rules imposes unreasonable and unworkable mandates, does not reflect the intent of Congress, and often goes well beyond the requirements of the Amendment itself.

Because of the significant potential damage of the Federal Reserve's proposed approach to implementing the interchange provisions of the Durbin Amendment, Congress should strongly urge the Federal Reserve to withdraw these proposed rules and reevaluate their approach. Furthermore, any final rule should be delayed until the Federal Reserve has, at the direction of Congress, conducted a thorough and objective study that evaluates the full impact of implementing interchange restrictions on consumers, governments and businesses that rely on prepaid cards , as well as on the development of the young and innovative industry that is providing these popular, effective and efficient payment options. Absent further analysis and deliberation, there is little

[1] The Network Branded Prepaid Card Association is a non-profit trade association representing a diverse group of organizations that deliver network branded prepaid cards to consumers, businesses and governments.

doubt that the Federal Reserve's proposed rule will significantly harm the financial services marketplace and all the constituencies it serves.

Overview of Network Branded Prepaid Cards

Network branded prepaid cards are prepaid debit cards that carry the logo of one of the payment networks (MasterCard, Visa, American Express or Discover.) They offer highly specialized and customized payment options and services. Moreover, they do not require the consumer to have a bank account or credit card to make electronic payments, and therefore are an attractive option for the millions of unbanked and underbanked* consumers.

Unlike bank debit cards for checking or savings accounts, network branded prepaid cards are available for purchase directly by the consumer at retail locations throughout the country and often in communities with no mainstream financial institutions. Businesses, large and small, also often opt to use prepaid cards as a more secure and efficient method to deliver employee pay, while governments are increasingly turning to prepaid cards for the delivery of government payments and benefits.[2]

Because of the direct-to-consumer manner in which a large volume of prepaid cards, and especially gift cards, are delivered and made available via retail locations, prepaid cards have many more variable costs and higher fraud costs compared to debit cards associated with checking accounts. On a product with already very slim margins - especially government benefit prepaid cards and payroll cards -interchange fees are often the only revenue supporting their availability. Reduction of interchange could easily eliminate these products from the marketplace altogether and with them the access to convenience, safety and security provided to millions of consumers.

The Proposed Rule Particularly Challenges Prepaid Card Products

The Federal Reserve's proposed rules fail to adequately account for these notable differences between network branded prepaid cards and bank debit cards. It is quite possible that the Federal Reserve staff has struggled with its interpretation and rulemaking, with respect to prepaid cards (resulting in unworkable requirements), because Sen. Durbin did not originally contemplate their inclusion under the interchange legislation. To wit, exemptions were included in the Durbin Amendment for certain general use and government benefit cards, and this provided a certain, albeit limited, safety net for the industry. Unfortunately, there is a very real risk that these exemptions will be eviscerated by the proposed rules which, as drafted, make enforcement of the exemptions voluntary and discretionary.

Because the prepaid industry is being improperly viewed by the Federal Reserve through the same interchange lens as the broader range of debit products there are several critical aspects of the proposed rules that create real impediments to the industry's ability to continue to provide prepaid products to consumers. Thus, to avoid an unnecessary disruption of the availability of prepaid cards in the marketplace and undue harm to consumers, the following points must be addressed in any final rulemaking:

1. **The cap/price control on interchange must be eliminated and the costs of delivery, innovation and fraud prevention must be covered.** Price controls and caps were not even contemplated in the Durbin Amendment which instructed the Federal Reserve Board

[2] In January, the U.S. Department of the Treasury announced a pilot program to give 600,000 low and moderate income taxpayers the option of receiving their tax refund on a prepaid card.

to "establish standards." Senator Durbin himself stated that "*the Fed would not set debit interchange prices. Instead the Fed would oversee the debit interchange fees set by card networks to ensure that they are 'reasonable and proportional' to cost.*"[3] In addition, the unique costs associated with providing prepaid cards must be accounted for in determining what is "reasonable and proportional."

2. **Network routing restrictions must be reevaluated to account for the operational differences with prepaid cards.** Most bank debit cards (approximately 87%) access both PIN and signature networks however only 25% of prepaid cards do. Therefore, the requirement to offer access to both networks will fall disproportionately on the prepaid card industry. Moreover, requiring a gift card to add a PIN network is illogical, unnecessary and will increase fraud. These are not the cards Senator Durbin was describing when he explained the basis for these routing restrictions.

   > *"Until recently, most cards could be used on multiple networks. You used to see a number of debit network logos on each debit card. In recent years, however, the biggest networks like Visa have begun requiring banks to sign exclusive agreements under which they become the sole network on the banks' cards. This diminishes competition between networks and leads to higher prices. My amendment will restore this competition."*[4]

3. **The time allowed for implementation and compliance by the industry of these proposed changes must fully account for system changes of this scope and magnitude.** The 90 day timeframe in the proposed rule is unreasonably short and is setting the industry up to fail. Implementation of interchange fee requirements and exemptions by July 21, 2011 simply cannot be accomplished. The "Alternative A" routing restrictions will likely take two to three years to implement, and the "Alternative B" approach requiring both two signature network plus two PIN networks will take even longer. There is simply no system existing today that can provide such network routing options. Companies will either operate out of compliance or temporarily cease delivery of prepaid products.

4. **As discussed above, the exemptions for prepaid cards outlined in the Durbin Amendment should be honored.**

Conclusion

For the reasons discussed above, the NBPCA believes the proposed rules must be withdrawn and the Federal Reserve directed to conduct a thorough study and analysis of the full impact of implementation on consumers, businesses and the industry. Failure to reevaluate its rules and address the concerns outlined above will result in unnecessary harm to millions of unbanked and underbanked consumers and severe impairment of an industry that offers an innovative payment tool, at a time when governments and businesses are in need of ways to reduce costs, and consumers need to securely operate in the financial mainstream.

[3] See http://durbin.senate.gov/issues/leg_wallstreet_swipe.cfm

[4] Congressional Record - Senate; Proceedings and Debates of the 111st Congress, Second Session, Wednesday December 22, 2010.

I appreciate that the Financial Institutions Subcommittee is conducting a hearing on this critical issue, and hope that our letter will be made part of the hearing record. NBPCA looks forward to working with you and stands ready to provide additional information or answer any questions you or members of the subcommittee may have.

Sincerely,

Kirsten Trusko
President and Executive Director
Network Branded Prepaid Card Association

Texas Credit Union League
Richard L. Ensweiler, CCUE, CAE
President and Chief Executive Officer

February 15, 2011

The Honorable Kenny Marchant
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Marchant,

We want to thank you for holding an oversight hearing, along with Chairwoman Capito, on the proposed rule by the Federal Reserve Board (Fed) regarding the regulation of debit interchange fee income, as mandated by the Dodd-Frank Act.

By way of background, this provision was added to the Dodd-Frank Act on the Senate floor. The Senate Banking Committee and the House Financial Services Committee never considered this proposal. In fact, the record of hearings on this issue is scant. It is no wonder that the workability of this proposal is difficult, because it was not properly vetted in the Congress.

Further, the Dodd-Frank Act was intended to address the causes of the financial crisis. Debit cards and interchange rates had nothing to do with the financial crisis. This is yet another layer of federal regulation that will drive up costs for financial institutions and consumers alike.

Let me state a few specific concerns about this proposal. First, we believe many Senators were induced to support this, believing that small credit unions and financial institutions under $10 billion would be exempt under the Durbin amendment. As the Congress is now learning, there is no enforcement mechanism for a two tiered pricing structure. The proposal references an exemption for small issuers of $10 billion or less in assets from the interchange fee rate setting but does not include provisions to enforce the exemption. As a result of the lack of enforcement for the exemption, small issuers may be subject to the fees that will be required for large issuers under the proposal.

Second, the Fed should have included fraud prevention and data security costs in determining the rate cap for larger issuers, but it did not. There is a real fear from our institutions that they will be swept up in the pricing structure for large institutions, and that the rate has been set too low to take into account the costs of fraud and security. Financial institutions bear these costs, and make investments to prevent fraud and upgrade security measures. In addition, when merchants fail to protect card data the costs to small institutions like credit unions, can be substantial and should be a factor in setting interchange rates. This proposal will hurt both efforts. There is a promise of yet another rule on fraud costs, but we believe the current proposed rule should not take effect until this issue is settled.

Finally, the proposal *does not* exempt small institutions from aspects of the rule regulating network exclusivity and routing. Credit unions, under the Fed proposal, could conceivably have to join as many as four networks to allow processing of their debit cards. This burden should be reduced in the final rule.

We thank you again for your efforts to examine this statute and proposed rule in depth and its impact on credit unions and consumers. Such an effort was sorely lacking when this was passed in the last Congress. We look forward to working with you in the future on this subject.

Sincerely,

Richard L. Ensweiler

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WILLIAM A. COOPER
Chairman and Chief Executive Officer

February 16, 2011

The Honorable Shelley Moore Capito — Fax No. 202 225-7856
2443 Rayburn House Office Building
Washington, D.C. 20515-4802

The Honorable Carolyn Maloney — Fax No. 202 225-4709
2332 Rayburn House Office Building
Washington, D.C. 20515-3214

Dear Madam Chairwoman Capito and Representative Maloney:

I am writing in regard to the hearing to be held this Thursday in the House Financial Institution and Consumer Credit Subcommittee concerning debit card interchange fees and the repeal of the Durbin Amendment. I had asked to be a witness at the hearing, but I understand and accept that the limitations on the number of witnesses will not permit my testimony.

I would like to submit this letter expressing my views. I would respectively pose the following questions.

<u>First, is it appropriate that Congress limit the fee that banks can charge on debit card transactions to less than the cost of providing the service</u>? The Durbin Amendment clearly states that only incremental processing costs can be recovered, thus requiring banks to provide this service at a loss.

The attached Exhibit 1 which is based on data we submitted to the Federal Reserve on October 12, 2010, clearly shows that TCF and other banks will not be permitted to recover their legitimate and verifiable direct costs (let alone make a profit).

<u>Second, is it appropriate that Congress require banks to provide a service that provides significant value to merchants at below cost</u>? With debit cards, merchants receive payment guarantees from banks, faster payment, reduced labor costs in check out lanes, reduced back office collection and data file costs, reduced cash needs, more efficient customer error resolution, etc. etc. Furthermore, there is evidence that debit card use increases total sales and therefore total profits.

We commissioned economist Anne Layne-Farrar from LECG Consulting to tabulate the dollar benefit of debit services to merchants, looking at the alternative avoided costs of accepting cash and checks (such as bad check losses and extra time at checkout line) and the uptick in sales that debit services generate (see attached Exhibit 2). Ms. Layne-Farrar concluded that the value of debit services fully justifies current interchange rates, and far exceeds the incremental cost only formula of the Durbin Amendment. She also concluded that debit card acceptance had the lowest net cost compared to cash and checks.

The fact that merchants all over the United States freely choose to accept debit cards and continue to do so at today's fee levels clearly demonstrates the economic benefits to the merchant. There are millions of merchants in the United States with signs that say "NO CHECKS". All these merchants take debit cards.

Third, merchants have claimed that current interchange rates are the result of a "market failure", i.e., the result of some sort of monopolistic practices on the part of VISA and MasterCard. Is this claim based on sound economic analysis? To my knowledge, no such study exists.

We commissioned economist Kevin Murphy, George J. Stigler Distinguished Service Professor of Economics in the Booth School of Business and the Department of Economics at the University of Chicago to examine this issue for us. Are current debit interchange rates too high? Do they reflect, as the merchant lobby alleges, an absence of competition between debit networks? Professor Murphy concludes that the pricing and structure of debit networks reflects what economics predicts would emerge in a competitive marketplace. He concludes that the observed structure and pricing facilitate the efficient operation of debit networks. Professor Murphy also concluded that today's interchange rates reflect the appropriate balancing in a two-sided market in which bank customers are linked to merchants, and that current interchange rates are competitively priced and not the result of a market failure or a monopoly.

Fourth, the Federal Reserve Board concluded in its proposed rulemaking that debit services are the functional equivalent of checks. Is that conclusion supportable in view of the numerous fundamental differences between the two? Doesn't this conclusion ignore the fact that debit comes with a bank guarantee while the credit risk for checks remains with the merchant, and the fact that the legal obligations around a check are set by the Uniform Commercial Code and FR rules while those around debit are set by the VISA, MasterCard or other applicable platform rules?

There is a reason that merchant signs "No Checks Please" have been appearing all across America in recent years. Debit is driving out checks in every place where both can be used because debit is superior to, not equal to, checks as a payment method. Checks are not the same as debit – neither functionally nor as a value proposition to the merchants. These merchant signs are evidence that the retail

community recognizes the significant differences between checks and debit, and the greater value of the debit service.

Also, while checks transfer between banks at par, they have never transferred between merchants and banks at par. Banks have always charged merchants for processing deposited checks.

Fifth, does the Constitution permit the federal government to tell a seller of services to sell below cost? We respectfully submit to the Subcommittee that the Durbin Amendment violates the Fifth Amendment's prohibition against taking without just compensation, because it requires banks that offer debit services to change a below-cost price to merchants. The value of debit services to merchants greatly exceeds what the Durbin Amendment allows banks to collect.

In conclusion, I want to thank you for allowing me to submit these comments. I believe the Durbin Amendment will significantly harm our banking system. Taking some $10 billion of capital out of the banking system yearly (80% of which goes to 1.5% of the largest merchants like Wal-Mart, etc.) in these difficult economic times will take countless billions out of lending to American business and families.

Very truly yours,

William A. Cooper

WAC:kml
Encl.

TCF Financial Corporation
Debit Card Expense
Excludes Allocable Account Acquisition Cost

Exhibit 1

Amount per Transaction	Column A Federal Reserve Survey Jan '09 - Dec '09	Column B TCF Calculated Cost Aug '09 - Jul '10	Column C Federal Reserve Allowable Cost - Draft Proposal Jan '09 - Dec '09
Incremental Authorization, Clearance, and Settlement			
1 Visa debit card / gift card processing DPS	$ 0.029	$ 0.035	$ 0.026
2 Visa network fees	0.043	0.039	**0.000**
3 TCF data processing	0.007	0.006	0.007
4 TCF card settlement operations	0.007	0.005	0.007
5 Miles Plus rewards processing expense	0.007	0.006	**0.000**
6 Subtotal	0.093	0.092	0.039
Fraud Prevention			
7 Visa fraud services	0.008	0.008	**0.000**
8 Information security group	0.003	0.003	**0.000**
9 TCF card settlement operations - (fraud analysis)	0.001	0.001	**0.000**
10 Call center (card activation, fraud related calls)	0.002	0.002	**0.000**
11 Subtotal	0.014	0.014	**0.000**
Other Incremental Cost in Relation to Authorization, Clearance, and Settlement			
12 Card plastic and mailing expense amortized over 4 years	0.010	0.008	**0.000**
13 Reg E. claims Department	0.005	0.005	0.005
14 Miles Plus rewards expense	0.013	0.013	**0.000**
15 TCF card system depreciation	0.002	0.001	**0.000**
16 Subtotal	0.029	0.027	0.005
Other costs incurred specifically for debit cards			
17 Deposit fraud losses & other	0.016	0.020	**0.000**
18 TCF card development department	0.003	0.003	**0.000**
19 Call Center - Overdraft handling	0.007	0.007	**0.000**
20 Visa acceptance fee (reported against interchange revenue)	0.013	0.013	**0.000**
21 Account statement generation	0.023	0.022	**0.000**
22 Corporate compliance (non BSA)	0.004	0.003	**0.000**
23 Overdraft handling (collection activities)	0.003	0.003	**0.000**
Other costs not surveyed by the Fed (Excludes $0.08 per transaction allocable acquisition cost)			
24 Net account overdraft losses - card transactions	**0.000**	0.012	**0.000**
25 Bank Secrecy Act	**0.000**	0.025	**0.000**
26 Call Center - Card customer service	**0.000**	0.040	**0.000**
27 Total *	**$ 0.206**	**$ 0.283**	**$ 0.044**
28 At 7¢ permitted charge - loss per transaction	(14¢)	(21¢)	
29 At 12¢ permitted charge - loss per transaction	(9¢)	(16¢)	

* The bank has additional costs related to the debit card that are not listed above

Exhibit 2

Executive Summary: Quantitative Cost-Benefit Study of Accepting Debit Cards for Retailers
By Dr. Anne Layne-Farrar
February 15, 2011

All payment instruments, even cash, involve costs and benefits for merchants handling and processing consumer payments for goods and services. For example, cash must be counted and deposited in a bank for safe keeping, and it can be stolen by employees or by robbers. Checks can bounce or be fraudulently written. And debit cards involve direct per transaction bank charges. It is these last fees that will be affected by the Durbin Amendment. Merchants claim that the transaction fees banks charge for debit cards are "too high", are "hidden" from consumers, and thus lead to higher consumer prices.

The argument that debit card transaction fees represent a "hidden tax" that increases prices to consumers does not make economic sense. The typical merchant incurs a number of costs in bringing its goods and services to consumers, and while all costs affect the merchant's pricing decisions, none is detailed for the customer on the ticket or invoice. For example, when a store receives a cash payment it must hire an armored truck to transport the cash to the bank at the end of the day, but the cash customer's bill does not have a line item for safe cash transport. Proponents of the "hidden tax" argument against debit cards have not explained why card fee expenses should be made transparent to consumers while the equivalent cash expenses should not.

Far more important to the debate over debit card fees, however, is the selective nature of the evidence that has been put forth thus far. Retailers have by and large focused solely on bank card fees and have not acknowledged that other payment instruments incur costs as well, nor have they admitted that cards may provide benefits that offset those bank fees. For instance, card payments can often be processed faster than cash, and are certainly faster than a check, which means retailers save labor time at the checkout station, save consumers time for their own checkout as well as in line behind others. In addition, debit cards do not involve cash in the till and thus lower retailers' risk of employee theft or break in. Unlike checks, debit cards provide merchants (following the prescribed steps) with guaranteed payment. Moreover, debit cards can offer retailers direct benefits, such as increased incremental customer spending as compared to paper payments.

I quantitatively analyze the costs and benefits that retailers incur in accepting cash, check, and debit card payments for goods and services rendered at fast food restaurants (QSRs) and at discount stores. The conclusions of that study are:

- Looking solely at bank fees presents a distorted view of the relative costs that merchants face in accepting debit cards as compared to cash or checks. When other relevant, quantifiable costs are included, bank transaction fees being but one of them, and when benefits are accounted for, debit cards emerge as less costly than paper instruments for both QSRs and discount store retailers.
- At a QSR, a typical transaction paid by debit instead of cash saves retailers 10 – 20 cents. At a discount store, a typical transaction paid by debit instead of cash saves retailers 8 – 13 cents and saves 30 – 35 cents over a check payment.

While all costs are factors in the prices that retailers set, there is no basis for the conclusion that debit card transaction fees lead retailers to charge higher prices to consumers than they would otherwise charge. My quantitative analysis illustrates that debit card transactions are one of the least costly payment methods for fast food and discount retailers to accept and save those retailers the higher costs associated with cash and check payments.

Exhibit 2

LECG

Assessing Retailers' Costs and Benefits from Accepting Debit Cards

Dr. Anne Layne-Farrar

15 February 2011

LECG, LLC
33 West Monroe
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Chicago, IL 60603

Table of contents

Section I Introduction & Executive Summary

1. My name is Anne S. Layne-Farrar. I have a Ph.D. in economics from the University of Chicago, where I also received my M.A. in economics. I received my B.A. in economics from Indiana University, summa cum laude, with honors. I am a Director at LECG, based in the Chicago office. My economic research and writings over the past fourteen years has been primarily quantitative, focused on topics in industrial organization and public policy. I have published numerous articles in peer-reviewed journals, including several papers on the economics of payment cards, and have authored or coauthored several book chapters. My curriculum vita, which lists my publications, is attached as Appendix 1.

2. In the following report I assess – to the extent reasonably possible – the costs and benefits that merchants face in processing payments from consumers for the goods and services they render.[1] Because retailers can differ significantly by the types of goods and services they provide, any study of merchant costs and benefits for payment instrument processing should take into account the specific venue at issue. I intend to study several different merchant types. Thus far, I have analyzed fast food restaurants, known as quick service restaurants (or QSRs) in industry parlance, and "big box" discount stores, like Wal-Mart and Target. This report presents my findings for these two retail venues. The analysis presented here builds on an earlier study I co-authored with Dr. Daniel Garcia-Swartz and Dr. Robert Hahn in 2006, referred to henceforth as GHL (2006).[2]

3. It is important to recognize that all payment instruments, even cash, involve costs and benefits for merchants handling and processing consumer payments for goods and services. For example, cash must be counted and deposited in a bank for safe keeping, and it can be stolen by employees or by robbers. Checks can bounce or be fraudulently written. Debit cards, on the other hand, do not involve deposit preparation expenses, but the cards do involve direct per transaction bank processing charges. It is these fees that will be affected by the Durbin Amendment. Merchants claim that the transaction fees banks charge for debit cards are "too high", are "hidden" from consumers, and thus lead to higher consumer prices.[3]

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[1] This work is part of ongoing research conducted at the behest of TCF National Bank.

[2] Daniel D. Garcia-Swartz, Robert W. Hahn & Anne Layne-Farrar, "The Move Toward a Cashless Society: Calculating the Costs and Benefits," *Review of Network Economics* ,Vol.5 (2): 199-228, (2006).

[3] See, e.g., the following article quoting the National Retail Federation, PYMNTS.com, "NRF Says Federal Reserve Action on Debit Cards Could Lead to Discounts for Consumers", Dec 16, 2010, 4:03pm, available at http://www.pymnts.com/nrf-says-federal-reserve-action-on-debit-cards-could-lead-to-discounts-for-consumers-20101216006715/?nl.

4. As a preliminary matter, the argument that debit card transaction fees (typically referred to as the "merchant discount") represent a "hidden tax" that increases prices to consumers does not make economic sense. The typical merchant incurs a number of costs in bringing its goods and services to consumers, and while all of them affect the merchant's pricing decisions, as a general matter none of them is detailed for the customer on the ticket or invoice. Consider the costs of keeping the lights on in a store, as well as heating or cooling the store, during the time the customer is served. These are incremental costs, but the customer's receipt does not include a line item for lights or temperature control. More directly related to payment instrument costs, when a store receives a cash payment it must hire an armored truck to transport the cash to the bank at the end of the day.[4] Again, the cash customer's bill does not have a line item for safe cash transport. Proponents of the "hidden tax" argument against debit cards have not explained why card transaction fee expenses should be made transparent to consumers while the equivalent cash transaction fees should not.

5. Far more important to the debate over debit card fees, however, is the selective nature of the evidence that has been put forth thus far. It is certainly true that banks charge retailers a per transaction fee for each purchase a customer makes with a debit card, while merchants do not pay a per transaction fee for purchases paid in cash. Because bank transaction fees appear on retailers' monthly profit and loss statements, these fees are highly visible to retailers. A quick review of retailers' P&L statements, however, cannot form the basis of a reasonable inquiry into the full costs associated with any payment instrument. There are other costs pertinent to incremental payment processing, even if these costs do not appear as a clear line item on any accounting document. Equally important, the benefits associated with different payment mechanisms must be assessed before any pronouncement can be made regarding which payment instrument is, on net, the most or least costly for retailers to accept.

6. Thus far in the debate over the Durbin Amendment, to the best of my knowledge, retailers have focused solely on bank card transaction fees and have not acknowledged that cards may provide benefits that offset those bank fees. For instance, card payments can often be processed faster than cash, and are certainly faster than a check, which means retailers save labor time at the checkout station, save consumers time for their own checkout as well as in line behind others. In addition, debit cards do not involve cash in the till and thus lower retailers' risk of employee theft or break in. Unlike checks, debit cards provide merchants (following the prescribed steps) with guaranteed payment. Moreover, debit cards can offer retailers direct benefits, such as increased incremental customer spending.

7. The goal of this report is to provide a balanced view of the costs and the benefits that retailers face in accepting various payment forms from their customers. Section II provides the cost-benefit analysis for QSRs. Cash was the only payment method at fast food restaurants until relatively recently. Starting in the late 1990s and early 2000s, select QSRs began accepting debit and credit cards. Today, there are three

[4] Or, if the retailer is a small one, it must pay for a trusted employee's time in taking the cash deposit to the bank.

types of payment instruments commonly accepted at QSRs: cash, debit and credit.[5] Section III then presents the cost-benefit analysis for discount stores. Unlike QSRs, checks are generally accepted at discount stores and debit cards have been accepted for over twenty years. This retail venue also offers a case study with a much higher average transaction size (around $50 versus around $5 for QSRs), a factor that affects a number of the costs and benefits associated with various payment instruments. Section IV concludes the report with some general comments.

A. Key Findings

8. My quantitative analysis leads me to several conclusions.[6]
    - First, looking solely at bank fees presents a distorted view of the relative costs that merchants face in accepting debit cards as compared to cash or checks.
    - Second, when a variety of relevant, quantifiable costs are considered, bank fees being but one of them, signature/offline debit cards emerge as relatively more competitive with paper instruments than bank fees alone indicate.
    - Third, signature debit cards provide merchants with tangible benefits that can outweigh the bank fees and other costs incurred.
    - At a QSR, a typical transaction paid by debit instead of cash saves retailers 10 – 20 cents.
    - At a discount store, a typical transaction paid by debit instead of cash saves retailers 7 – 12 cents and saves 30 – 35 cents over a check payment.
9. We cannot conclude that debit card transaction fees lead retailers to charge higher prices to consumers than they would otherwise charge if debit cards did not exist. While all retailer costs are factors in the prices that consumers pay, as the quantitative analysis presented below illustrates, debit card transactions are less costly for QSR and discount merchants to accept than paper payment instruments.

[5] While credit cards are accepted at those QSRs that accept debit cards, I do not study credit cards as the key payment instrument comparisons for the Durbin Amendment debate are debit cards with either cash or checks. Checks have never been widely (if at all) accepted at QSRs and thus are omitted in the QSR case study as well.

[6] As I add other retail venues to my case study analysis, these conclusions may change.

Section II QSR Cost-Benefit Analysis

10. In 1998, Sonic Inc., an Oklahoma City based drive-in chain, became one of the first QSRs to accept cards at its 2,200 restaurant locations. According to an article published three years later, in 2001, the increasing relative costs of handling cash as compared to card payments was the primary motivation for Sonic.[7] Technological advances over time have lowered the network and equipment costs of processing card transactions while the costs of handling cash do not appear to have fallen. Sonic subsequently found that customer orders (tickets) paid by card were 80% higher than cash tickets.[8] In other words, although Sonic decided to accept cards in order to lower their payment handling costs, they found direct benefits from card acceptance in the form of dramatically higher sales.

11. KFC began accepting cards in 2001, three years after Sonic. In contrast to Sonic, as its motivation KFC cited specific benefits expected from cards, rather than solely the savings derived from reduced cash handling. Specifically, KFC began accepting payment cards as a way to sell its higher priced group meals, such as large buckets of chicken with side dish containers and packages of biscuits.[9]

12. Sonic, KFC, and the other "first movers" did not start an immediate mass industry move, however. Estimates indicate that by 2000 only 7% of all QSRs accepted cards, up from 5% in 1999.[10] Instead, other QSRs have taken a cautious approach to card acceptance, beginning with small scale tests prior to broad acceptance. McDonald's began extensive testing of credit and debit card transactions at select restaurants across the nation in 2001. Visa and Burger King began a pilot program to test debit and credit card acceptance at restaurants in the Atlanta area in 2002.[11] Wendy's also began testing card acceptance in 2002.[12]

13. In November 2002, Visa released a study based on tests at various QSRs (Burger King plus several others) that revealed three important results for QSR owners. First, the average credit card transaction was 20-30% higher than cash transactions. While not as dramatic as Sonic's experience, the increase is nonetheless substantial and confirms that card acceptance offers QSRs tangible benefits. Second, card transaction processing speed was reduced significantly by waiving the requirement

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[7] Fredric H. Lowe, "Cards Make the Fast-Food Menu", *Cards and Payments* Vol. 14 (1) March 2001, at 18..

[8] Lowe, supra note7.

[9] Id.

[10] Id.

[11] "Visa U.S.A. and Burger King Corp. Test Payment Cards At Approximately 100 Atlanta Burger King Restaurants," *Business Wire*, June 2002.

[12] Shirley Lueng and Ron Lieber, "The New Menu Option at McDonalds: Plastic – Fast Food Giant Will Allow Customers to Use Credit Cards; Earning Miles With Your Fries," *The Wall Street Journal*, November 26, 2002, at D1.

for signatures on transactions below a pre-specified minimum (usually $25). This change made card transactions as quick as, or even quicker than, cash. Finally, surveys indicated that customer satisfaction from using payment cards at QSRs was extremely high: 96% of customers considered the technology easy to use and were satisfied with the speed of service.[13]

14. Corroborating the Visa study and providing further evidence of the improved ticket sizes associated with payment cards, Subway claimed in 2002 that its average credit transaction had doubled to $9 since it started accepting cards in 1999.[14]

15. The Visa study, and others supporting it, appears to have been a significant factor in subsequent QSR decisions to accept payment cards. After 2002, a number of major QSRs began accepting debit and credit cards. Pizza Hut and Domino's started accepting cards in 2002. Burger King, Wendy's and McDonald's all began accepting cards in 2003.[15] Note however that industry wide card acceptance, while increasing each year, was still relatively low, at around 14.5% of QSRs in 2002.[16]

16. By 2003, the time taken to approve a card transaction had fallen to 4 - 5 seconds, compared with cash transactions which took 8 - 10 seconds.[17] In other words, cards moved from being competitive with cash in terms of transaction time to being twice as fast as cash. This meant that QSRs could serve more customers in the same amount of time, reduce the length of lines at their restaurants, and McDonald's could come closer to its goal of a 90 second customer in-and-out time.[18] Moreover, lowering time at checkout increased QSR throughput: according to one industry estimate, every 10 seconds that could be cut from drive-through service increased sales by $1000.[19] It is likely that these factors played a key role in McDonald's decision to accept cards, a decision which Wall Street welcomed as the restaurant saw a 2.7% increase in its share price after the announcement.[20]

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[13] Visa study, as cited in "Visa Efforts Demonstrate that Payment Card Acceptance Increases Ticket Size, Increases Speed, and Improves Customer Satisfaction," *Business Wire*, Nov 2002.

[14] Lueng and Lieber, supra note 12.

[15] Some McDonald's franchisees had been taking cards before 2003 on their own initiative. In 2003, McDonalds decided to sign a single umbrella agreement with Visa, MasterCard, American Express and Discover to accept their cards. See W. A. Lee, "How Cards Finally Won Reluctant McDonalds Over," *American Banker* Vol. 169 (59), March, 2004.

[16] Id.

[17] Lueng and Lieber, supra note 12.

[18] Lueng and Lieber, supra note 12; "Visa Efforts Demonstrate that Payment Card Acceptance Increases Ticket Size, Increases Speed, and Improves Customer Satisfaction," *Business Wire*, Nov 2002.

[19] Linda Punch and Jeffrey Green, "Fast Food Meets Fast Payment," *Credit Card Management* Vol. 15 (11), January 2003 at 18. Drive-through windows account for between 50 and 65% of an average QSRs sales.

[20] Ari Weinberg, "McDonald's Goes Plastic," http://www.forbes.com/2004/03/25/cx_aw_0325mcd.html ("Investors applauded the move [of increased card acceptance], which was announced late in the trading day, boosting shares 75 cents, or 2.7%, to $28.45.")

17. Debit card networks introduced an additional important pricing change in 2003 that also helped to spur QSR acceptance. The fixed rate interchange fees charged at that time were much harder for QSRs to accept on their relatively smaller tickets of $3 - $6 as compared to merchants with substantially higher average sales per transaction. In recognition of this reality, MasterCard, First Data and NYCE developed QSR specific rates in which the bulk of the interchange fee was derived from a percentage of the ticket value.[21] While Visa and American Express did not implement separate rates for fast-food restaurants, they claimed that processing costs were more than offset by increases in ticket values (of 40-100% depending on the card brand). Moreover, McDonald's negotiated with the card networks to obtain the following special interchange rates:[22]
    - 1.8% for MasterCard
    - 1.65% + 4 cents for Visa
    - 12.5 cents flat fee for First Data Corp
    - Amex and Discover also negotiated lower interchange fees, although these remain confidential.

18. As more and more QSRs began to accept payment cards, cards' share of QSR transactions increased. In 2007, 80% of orders at QSRs were still transacted in cash.[23] Over the course of that year, however, the use of Visa cards at QSRs increased by 31% and the use of debit cards in general increased by 32%.[24] By 2008, cash transactions at QSRs were down to 66%.[25] I do not have data for 2010, but it is possible that the ratio is now closer to 50-50 given the ongoing general trend towards greater debit use. The results confirm that while cash may still be the primary means of payment at QSRs, there is steady growth in card transactions, particularly debit cards, driven by a clear consumer preference for the convenience that cards provide.[26]

19. With this brief history of QSR card acceptance in mind, I turn next to the specific costs entailed in QSR payment handling.

A. The Costs Associated with QSR Payment Processing

20. Table 1 below presents QSR costs associated with processing cash, signature debit, and PIN debit payments, broken down into the constituent per transaction cost elements. Each cost element is explained below. I take a transaction of $5.62 as the

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[21] Punch and Green, supra note 19.

[22] W. A. Lee, supra note 15.

[23] "Payment Cards Make Fast Food Faster," *QSR Magazine*, June 2007 http://www.qsrmagazine.com/news/payment-cards-make-fast-food-faster

[24] Id.

[25] "The Price of Credit," *QSR Magazine*, accessed on Jan 14, 2011, http://www.qsrmagazine.com/articles/operations/128/priceofcredit-1.phtml

[26] For a survey on consumer benefits from card use at QSRs, see "Payment Cards Make Fast Food Faster," *QSR Magazine*, June 2007 http://www.qsrmagazine.com/news/payment-cards-make-fast-food-faster.

basis for the calculations.[27] The tables presented in this report assume a large transaction base which one would associate with a major QSR like McDonald's. A large number of transactions reduces the estimate of per-transaction cash handling costs for variable costs that do not change at the individual transaction level, such as armored car transport. Costs of this sort are "lumpy": as long a QSR takes one cash payment, it must expend resources to safely transport that cash to the bank. As long as one armored car suffices, the total cost does not vary over a large range of transactions, until the threshold is reached where two armored car pickups per day are required. As a result of stepped variable costs of this sort, the number of transactions can affect per transaction calculations.[28]

Table 1: Estimated Costs by Payment Type, Large QSRs

	Costs Per Transaction ($), for $5.62 cash trans		
	Cash	Signature Debit	PIN Debit
POS Time	0.021	0.010	0.010
Back Office	0.003	0.000	0.000
Bank Costs	0.007	0.160	0.161
Float Costs	0.000	0.000	0.000
Theft/Robbery/Fraud	0.001	0.002	0.002
Counterfeit	0.001	0.000	0.000
Fraud Prevention Costs	0.013	0.000	0.000
Other Direct Costs	0.015	0.000	0.000
TOTAL	0.060	0.173	0.174

Note: Figures are independently rounded. See Appendix 2 for details on how these figures are estimated.

21. POS (point of sale) time is computed by calculating the merchant's cost of taking payment for a single transaction. This is given by the time taken to process the transaction (in seconds) – that is, the time from when the amount owed is first displayed on the cash register to the time payment is consummated – times the wage rate of the cashier (in dollars/second). According to industry reports, cash transactions take about 8 - 10 seconds to complete, whereas card transactions take 4 - 5 seconds to complete.[29] To estimate POS costs, I use May 2009 hourly wages for cashiers in food services reported by the BLS.[30]

22. Back office costs cover the expense that merchants face in processing deposits. In this example, debit cards incur no back office costs because the merchant's bank

[27] The average transaction (regardless of payment type) at McDonalds is $6. As explained below and in Appendix 2, we can back out the cash transaction size using other data points. Assuming that card tickets are 20% higher than cash tickets implies the average cash transaction is $5.62.

[28] I have also analyzed smaller, regional QSRs and find the results are qualitatively the same.

[29] Lueng and Lieber, supra note 12.

[30] U.S. Department of Labor, Bureau of Labor Statistics. See national 5-digit NAICS industry-specific estimates available at http://www.bls.gov/oes/oes_dl.htm.

account is credited with payment upon clearance, whereas cash deposits need to be prepared by an accountant or clerk. In the original 2006 GHL study, I relied on a 1997 FMI survey of supermarkets for deposit preparation times. Here, I assume that the time taken to process a cash deposit remains what it was in the FMI survey. The FMI study also reports that 2.7 bank deposits are made each day; in order to adjust this figure for QSRs, I multiply it by the ratio of representative QSR annual sales to supermarket annual sales.[31] For wage data, I use May 2009 hourly wages for bookkeepers, accountants, and auditing clerks in food services reported by the BLS.[32] I divide daily costs by the estimated number of daily cash transactions to estimate the average marginal cost.[33]

23. Bank costs for cash are the fees charged by banks to process cash deposits. I use lower end estimates of fees charged by Wells Fargo Bank to business customers in Illinois, Wisconsin, and Michigan and multiply this by the cash transaction size of $5.62.[34] Bank costs attributable to debit arise from the transaction fees paid on a transaction of $5.62. As of October 2010, the Visa signature debit interchange rate for QSRs is 1.55% + 4 cents.[35] For PIN debit, the relevant Visa Interlink interchange rate is .50% plus a flat fee of $0.10 per transaction, capped at $0.60.[36] Evidence of intense competition amongst merchant acquiring banks leads one to expect that acquirer margins have remained stable over time.[37] Assuming that the ratio of

[31] Weekly average supermarket sales in 2003 are available through the FMI available at http://www.fmi.org/facts_figs/?fuseaction=superfact. I compute this ratio separately for small and large QSRs.

[32] U.S. Department of Labor, Bureau of Labor Statistics. See national 5-digit NAICS industry-specific estimates available at http://www.bls.gov/oes/oes_dl.htm.

[33] See Appendix 2 for details on how this is estimated.

[34] See Wells Fargo Bank business account holder service fees in IL, WI, and MI https://www.wellsfargo.com/downloads/pdf/biz/accounts/fee_information/michigan_wisconsin_illinois.pdf. Cash deposit fees are $0.0012 per dollar deposited; this is the lower of the two fee schedules shown (p. 31 and p. 38).

[35] Visa eliminated the QSR specific interchange rate. Now QSRs pay the "small ticket debit" rate of 1.55% + $0.04 for tickets less than or equal to $15 and they pay the "restaurant debit" rate of 1.19% + $0.10 for tickets greater than $15. See, http://usa.visa.com/download/merchants/october-2010-visa-usa-interchange-rate-sheet.pdf.

[36] See http://usa.visa.com/download/merchants/october-2010-interlink-interchange-rate-sheet.pdf.

[37] Ann Kjos, "The Merchant-Acquiring Side of the Payment Card Industry: Structure, Operations, and Challenges," Federal Reserve Bank of Philadelphia Payment Card Center Discussion Paper, October 2007, p. 17-18. Available at http://www.philadelphiafed.org/payment-cards-center/%5Cpublications/discussion-papers/2007/D2007OctoberMerchantAcquiring.pdf. In fact, a VISA study estimated that the merchant discount was 2.08% in 2004 and had grown by less than 0.5% annually over the previous 10 year period. See VISA, "Driving Value and Innovation: Interchange in Action," Federal Reserve Bank of Chicago, May 2005

interchange rates to merchant transaction fees has remained the same, I compute the current bank transaction fee for QSR's to be 2.85% for both forms of debit.[38]

24. While PIN debit is frequently less expense than signature debit, over time PIN debit fees have risen considerably relative to signature debit.[39] As Table 1 illustrates, the bank transaction fees for two forms of debit are now quite close to one another.

25. Float costs are given by the interest income that merchants could have earned if payments cleared instantaneously. Cash "clears" at the end of the day when the bank account deposit is made and thus incurs no float cost. Likewise, PIN debit transactions typically clear within one day and therefore incur no float costs either.[40] According to a VisaNet report provided to TCF, TCF signature debit transactions take 1.46 days on average to clear. To calculate float costs on the roughly half a day of delay, I assume that merchants would be able to earn the November 2010 Series I U.S. savings bond interest rate of 0.74%.[41]

26. Theft, robbery, and fraud costs vary considerably by payment type. Theft and robbery are not applicable to signature and PIN debit, but fraud is. An FMI survey on loss prevention from 2003 estimates that fraudulent debit transactions cost merchants 0.04% in retail sales.[42] For cash transactions, fraud comes in the guise of counterfeited bills. The Federal Reserve Bank of Chicago estimates that around 1 out of every 10,000 bills is counterfeit.[43] Assuming that QSRs receive no more or less than the average number, their cost of counterfeit currency is simply 1/10,000 multiplied by the transaction size. In addition, losses that arise from employee theft and store robbery are significant. I use data from the 2003 FMI survey on supermarkets to determine estimated losses for QSRs for all cash theft and robbery. Details on these computations, as well as all others, are provided in Appendix 2.

27. Fraud prevention costs are also estimated from data in the FMI 2003 study.[44] A Federal Reserve Bank study observed that "[t]he high costs of preventing payments fraud ... are similar to the estimates of actual losses due to fraud."[45] Expenses

[38] The smaller the transaction size, the less of a base over which to spread the fixed fee portion of the charge. At larger transaction sizes, the fixed fee portion of the interchange fee will matter less, lowering (in percentage terms) retailer transaction fees for debit charges.

[39] Fumiko. Hayashi, Richard Sullivan, and Stuart. Weiner, "A Guide to the ATM and Debit Card Industry, 2006 Update," Federal Reserve Bank of Kansas City, especially pp. 12-13. "The gap between signature and PIN debit interchange fees has narrowed since 2001. (...) partial convergence has been the result of a slight decline in interchange fees for signature debit and a large increase for PIN debit." (p. 12)

[40] See American Credit Card Processing Corp. "Study: PIN Debit Cheaper, Less Fraud-Prone Than Signature," Nov 2005. Available at http://www.accpconline.com/site/754600/page/696144.

[41] See http://www.treasurydirect.gov/news/pressroom/currenteebondratespr.htm.

[42] FMI survey data, "Loss Prevention," 2003, p.8

[43] Ruth Judson and Richard Porter, "Estimating the Volume of U.S. Counterfeit Currency in Circulation Worldwide: Data and Extrapolation", Federal Reserve Bank of Chicago, Financial Markets Group, Policy Discussion Paper Series, March 1, 2010, p. 2.

[44] FMI survey data, "Loss Prevention," 2003, p.20.

[45] Richard J. Sullivan, "Can Smart Cards Reduce Payments Fraud and Identity Theft?", 2008, available at www.KansasCityFed.org.

incurred in association with locksmiths and CCTVs are included within this cost category. For QSRs these costs are typically associated with the costs of preventing cash theft and are therefore considered only under the cash processing cost in Table 1.

28. Finally, I estimate direct costs that can arise from other sources. For example, cash requires armored cars for transport. I update the average annual armored car costs per supermarket estimated in 1997 using the Bureau of Economic Analysis' PCE chain-type price index for "other goods and services." The FMI data for supermarkets indicate that 2.7 deposits are made per day on average. I assume, however, that QSRs deal with lower cash volumes and therefore only make a single cash deposit each day. I therefore divide the annual armored car cost by 2.7. As with all calculations, further details on these figures are provided in Appendix 2.

29. As Table 1 illustrates, if we look just at bank transaction fees, debit "costs" QSRs around 17 cents while cash "costs" QSRs less than 1 cent. However, when we consider other relevant incremental costs, the relative position of debit to cash changes considerably: debit is only around 3 times more "costly" than cash, not 17 times more. Since, as explained in Section I, we cannot consider costs alone, we turn next to estimating benefits.

B. QSR Benefits Associated with Debit Cards

30. Retailers can receive a number of benefits from the payment instruments they choose to accept. Some of these will simply be relative cost savings, such as savings on armored car transport costs when customers pay using a debit card or a reduction in float costs for cash as compared to cards. These "benefits" are already accounted for in the cost table above. Other benefits are important but extremely difficult to quantify. For instance, debit cards provide retailers with information about their customers that cash cannot: the names on the cards can be linked to zip codes and customer lists with demographic factors, which can help retailers improve their inventory and marketing practices. For QSRs, however, two explicit benefits that can be quantified have been identified within the industry: ticket lift and increased throughput.

31. As noted earlier, ticket lift is the increased per transaction sales that QSR merchants have reported when their customers pay with cards instead of cash. Sonic, one of the first QSRs to accept payment cards, found that its order tickets paid by card were 80% higher than cash tickets.[46] Other later adopters have reported more modest, but still sizable gains, on the order of 20-30% higher than cash transactions. This effect is not surprising. If a customer is limited to the cash in his or her wallet, then they may be constrained to purchase less than they would otherwise have at the moment they are ordering their meal.[47] With a debit card, however, an extra dollar or so to

[46] Lowe, supra note 7.

[47] While it might be possible that card tickets are higher because customers use cards to pay when they order more, available evidence suggests that the causality runs in the other direction: customers order more when they use a card. See, e.g., Tamara E. Holmes, "Credit cards can make you fat", Bankrate.com,

add a bag of French fries or a dessert to the order is possible. With small size purchases like those made at QSRs, the ability to purchase more is not a matter of credit availability, as it would be at, say, an electronics store. Instead, the constraint is likely to be limited cash in the customer's wallet, not in their demand deposit account. Debit cards free consumers from the time and expense of having to obtain and carry cash, but do not involve credit or finance fees. In the table below, I assume two different ticket lift amounts for QSRs: 5% and 20%.

32. The second merchant benefit reported by QSRs is increased throughput. The notion here is that for every second a fast food restaurant is able to shave off of the POS time, the more customers that QSR will be able to serve during its peak lunch and dinner rush times. Not only will the restaurant be able to get to the next order faster, lines will be shorter both at the counter and in the drive through, lines that could deter potential customers from ever stopping at the restaurant. I rely on the industry estimate reported above for per transaction throughput improvement.

33. The average transaction, averaged across both cash and card sales, at large QSRs is around $6.00.[48] If we assume that card tickets are 20% larger than cash transactions, that implies an average cash transaction size of $5.62,[49] the amount employed for the cost calculations above. If, on the other hand, cards provide only a 5% ticket lift, this implies the average cash transaction is $5.90. We calculate benefits at each transaction size.

Table 2: Estimated Gains by Payment Type, Large QSRs

	Large QSR Gains Per Transaction ($), $5.62		
	Cash	Signature debit	PIN debit
Ticket Lift (20%)	0.000	0.258	0.258
Throughput Improvement	0.000	0.138	0.138
WEIGHTED TOTAL	0.000	0.311	0.311

	Large QSR Gains Per Transaction ($), $5.90		
	Cash	Signature debit	PIN debit
Ticket Lift (5%)	0.000	0.068	0.068
Throughput Improvement	0.000	0.138	0.138
WEIGHTED TOTAL	0.000	0.121	0.121

Note: Figures are independently rounded. See Appendix 2 for details on how these figures are estimated.

http://www.bankrate.com/brm/news/cc/20070704_credit_cards_fat_a1.asp. ("According to a new survey commissioned by Visa, 82 percent of respondents said fast food purchases made with debit or credit cards are more convenient than dealing with cash. And 68 percent say using payment cards is faster than paying with cash. Importantly, 77 percent say they can buy exactly what they want because they are not limited by the cash they have available.")

[48] Results for McDonald's from a *Fast Food Company Magazine* survey available at http://www.jeremyperson.com/fast-food-per-store-sales-information/

[49] Appendix 2 explains this calculation.

34. The two benefits estimated in the table above result in a merchant benefit of between 12 cents and 31 cents, which are significant amounts in light of the overall costs involved.

Net Effects

35. Recall that cost advantages, like no float and lower bank charges for cash, are incorporated into the total cost figure reported in Table 1; these are repeated below. In the cost section above, we presented only the costs associated with the $5.62 (20% ticket lift) transaction. We therefore need to calculate the costs associated with a 5% ticket lift benefit resulting from cards to combine with the benefits estimated on the basis of 5% ticket lift. This is presented in Table 3 below.

Table 3: Estimated Costs by Payment Type, Large QSRs

	Costs Per Transaction ($), for $5.90 cash trans		
	Cash	Signature Debit	PIN Debit
POS Time	0.021	0.010	0.010
Back Office	0.003	0.000	0.000
Bank Costs	0.007	0.166	0.163
Float Costs	0.000	0.000	0.000
Theft/Robbery/Fraud	0.001	0.002	0.002
Counterfeit	0.001	0.000	0.000
Fraud Prevention Costs	0.013	0.000	0.000
Other Direct Costs	0.015	0.000	0.000
TOTAL	0.062	0.179	0.176

36. We are now ready to combine the cost and benefit estimates for QSRs to obtain the overall, or net, effect. Table 4 below combines the appropriate costs and benefits (holding transaction size and the ticket lift assumption constant) to obtain the net benefit, if any.

Table 4: Aggregate Effects by Payment Type, Large QSRs

	Big QSR Per $5.62 Transaction ($)		
	Cash	Signature debit	PIN debit
Costs	0.060	0.173	0.174
Benefits (20% lift)	0.000	0.311	0.311
NET BENEFITS	-0.060	0.138	0.137

	Big QSR Per $5.90 Transaction ($)		
	Cash	Signature debit	PIN debit
Costs	0.062	0.179	0.176
Benefits (5% lift)	0.000	0.121	0.121
NET BENEFITS	-0.062	-0.057	-0.055

36. As Table 4 makes clear, a 20% ticket lift is sufficient to provide debit (both signature and PIN) transactions with a positive net benefit for merchants, even counting those payment instruments' higher bank transaction fees. Cash, which has no offsetting explicit benefits, is strictly negative. With only a 5% ticket lift for debit cards, all three payment instruments is strictly negative on a net basis and all cost roughly the same – cash is not cheaper than debit.

37. When we step back to consider the history of QSR payment card acceptance, these results are not at all surprising. QSRs had been among the most reticent of merchants to accept debit or credit cards. The first QSR to make the change was Sonic, which began accepting cards in 1998 – 40 years after the first credit card appeared and several years after debit cards entered the mainstream.[50] Thus, had card acceptance not made financial sense, it seems clear that QSRs would to this day still not accept them.

38. Reinforcing that point is the fact that the early card adopters among QSRs were publicly traded firms. It is likely that Sonic and KFC each had to make a compelling case to their respective boards before they could gain approval for the investment required to accept cards. Not only did QSR merchants need to incur capital expenses (e.g., the installation of card readers or the acquisition of cash registers with integrated card readers), they also knew they would face per transaction bank fees. Nor did one of the very first adopters, Sonic, expect the substantial ticket lift that it later discovered.[51] Even knowing they would have upfront investment costs and increased per transaction bank costs, these early adopter QSRs nonetheless decided to move forward with payment cards, indicating that they expected the customer service improvements and cost savings relative to cash to outweigh the costs of taking cards. Once the sizable ticket lift became apparent, the justification for accepting cards was that much more obvious for later adopting QSRs. The calculations presented in Table 4 are consistent with this view.

[50] Sonic began accepting cards in 1998, Lowe, supra note 7; BankAmericard was launched by Bank of America in 1958, http://corporate.visa.com/about-visa/our-business/history-of-visa.shtml; the establishment of a national EFT network and universal ATM access in the early 1990s encouraged rapid growth of debit card use, see Fumiko. Hayashi, Richard Sullivan, and Stuart. Weiner, "A Guide to the ATM and Debit Card Industry," Federal Reserve Bank of Kansas City, 2003, pp. 12-13, available at http://www.ffiec.gov/ffiecinfobase/resources/retail/frb-guide%20to%20the_atm_debit_card_ind.pdf.

[51] Lowe, supra note 7.

Section III Discount Store Cost-Benefit Analysis

39. As noted in the introduction, the costs and benefits associated with transaction payments can differ by retail venue. For instance, a higher average transaction size will drive a higher bank card transaction fee and greater cash sales per store will entail higher theft and counterfeit risks. Some costs and benefits scale in a linear fashion (e.g., employee theft) while others do not (e.g., the debit card interchange fee, which has a percentage portion and a fixed portion), so it is important to calculate the costs and benefits for the transaction size of interest, rather than simply scaling those for another venue and transaction size. As a result of these factors, it is important to estimate payment instrument costs and benefits at a variety of venues to gain a better understanding of how the costs and benefits can differ among retailers.

40. The second case study I consider is a purchase made at a discount store, such as Wal-Mart, Target, or Costco.[52] For the purposes of cost-benefit analysis, there are two key differences between QSRs and discounters. The first is the transaction size. Rather than $5, the average transaction size at discount stores is around $50. The second key difference is the interchange fee, which differs from the QSR rate. According to Visa data, discount store retailers pay a blended interchange rate that combines the rate for grocery stores and retail stores. Finally, discount stores have traditionally accepted personal checks as payment, while QSRs generally do not.

41. The use of checks in the US economy has been declining steadily for years now. A study by First Data Corporation found that in-store check use was 18% in 1999; by 2008 it had fallen to 8%.[53] From the consumer's perspective, checks are time consuming to write and process at the checkout counter and are cumbersome to carry. Because the risks of non-payment are too great, retailers rarely ever accept out-of-state checks, so they are a poor choice for consumers when travelling. Even within the consumer's home town, more and more stores refuse to accept checks today. Debit cards, on the other hand, provide a convenient means to access funds in a demand deposit account regardless of where the consumer is shopping. Thus the First Data study reported that in-store debit card use (signature and PIN combined) rose from 21% in 1999 to 37% in 2008.

42. From the retailer's perspective, checks present a host of problems. According to a Federal Reserve Bank report, check fraud cost retailers $10 billion in 2006.[54] That figure is over five times the fraud cost that debit cards imposed on retailers that same year, as the total cost to POS retailers from both debit and credit cards was only $2 billion in 2006. When a check bounces, the retailer's bank will typically attempt to run

[52] I am in the process of analyzing additional retail venues but these were not far enough along to include in this interim report.

[53] First Data Market Brief, Consumer Payment Preferences for In-Store Purchases. 2008.

[54] Sullivan, supra note 45.

it through a second or third time – charging the retailer a returned deposit item fee each time the check bounces. If the check fails to clear after the second or third try, it is up to the retailer to recover the loss. This typically entails hiring a collection agency. But even with collection attempts, some checks are never paid. Of the funds that are recovered, the collection agency often keeps a substantial percentage as its fee. The costs and risks associated with checks explain why so many merchants now refuse to take checks as payment.

43. In short, checks are not convenient for consumers and are costly and risky for merchants. Thus, despite the government subsidy that comes in the form of bank-to-bank at-par exchange,[55] both check use and check acceptance have been declining steadily within the US.

A. The Costs Associated with Discount Store Payment Processing

44. Table 5 below presents the costs of payment instrument acceptance for a typical "big box" discounter. The analysis is based on an average transaction size of $49.38, the implied cash transaction amount when debit cards provide a 10% ticket lift for discount retailers. As with QSRs, even though credit cards are a popular form of payment at discount stores their use is not relevant for the debit card debate and thus credit card use is again ignored in the analysis presented here. Checks are included.

Table 5: Estimated Costs by Payment Type, Big Box Discount Store

	Costs Per Transaction ($49.38)			
	Cash	Check	Signature Debit	PIN Debit
POS Time	0.041	0.136	0.046	0.043
Back Office	0.037	0.093	0.000	0.000
Bank Costs	0.059	0.080	0.409	0.360
Float Costs	0.000	0.001	0.002	0.000
Theft/Robbery/Fraud	0.033	0.444	0.019	0.019
Counterfeit Losses	0.004	0.000	0.000	0.000
Fraud Prevention Costs	0.085	0.000	0.000	0.000
Other Direct Costs	0.010	0.026	0.000	0.000
TOTAL	0.269	0.780	0.476	0.423

Note: Figures are independently rounded. See Appendix 2 for details on how these figures are estimated.

45. While the cost estimates themselves differ, the methods for estimating the cost elements are the same as employed for the QSR case study. A couple of important differences should be pointed out, however. First, as noted above the interchange

[55] Howard Chang, Marina Danilevsky, David Evans, and Daniel Garcia-Swartz, "The Economics of Market Coordination for the Pre-Fed Check-Clearing System: A Peek into the Bloomington (IL) Node", *Explorations in Economic History* 45:4 (September 2008).

fee for discount stores is different, which leads to a different merchant transaction fee. In particular, big box discount stores typically have a grocery section and a general merchandise section. As such, one of two interchange rates applies depending on the particular items purchased. The grocery store rate for signature debit is 0.62% + $0.13 (capped at $0.35) and is $0.20 for PIN debit.[56] The general merchandise rate for signature debit is 0.62% +$0.13 with no cap and 0.50% + $0.10 (capped at $0.60) for PIN debit.[57] I employ the same method as used for QSRs to estimate the applicable retailer bank transaction fee, which is 0.82% for signature and 0.73% for PIN.

46. The check fraud cost estimate is based on a LexisNexis Report that finds that retailers face an average annual check fraud loss of 0.9% of their total annual revenue.[58] Because this figure is expressed as a percentage of total annual revenue, it will understate the loss that retailers experience as a percentage of check payment revenue, which would be a better measure of the cost to retailers of accepting an incremental check payment. The check fraud cost estimate of 44 cents reported in Table 5 above is therefore conservative.

47. Discount stores also differ significantly from QSRs in that they have to worry about both cash theft from the till and the theft of goods from inventory. Discount store theft prevention expenses are therefore substantial, but only a portion of that expense is relevant for cash payment acceptance. While there are public reports of what retailers expend to prevent theft from employees and thieves, I was unable to find the breakdown of those expenditures for inventory shrinkage/theft versus cash theft. As a conservative estimate, I assume that only 25% of a discount store's theft prevention expenditures are directed toward preventing cash loss (e.g., CCTV aimed at the till to catch employee theft).

48. While the individual costs reported in Table 5 are quite different from those reported for QSRs in Table 1, the qualitative conclusion is the same. Looking just at bank transaction fees presents a highly misleading picture of the relative costs to retailers of accepting the various payment instruments. On the basis of bank charges alone, signature debit cards are around 6 times more costly than cash and around 5 times more costly than checks. However, when the relevant incremental costs are accounted for, signature debit falls to less than 2 times more costly than cash and reverses position entirely with checks, which are over 1.5 times more costly than debit transactions.

[56] See, http://usa.visa.com/download/merchants/october-2010-visa-usa-interchange-rate-sheet.pdf and http://usa.visa.com/download/merchants/october-2010-interlink-interchange-rate-sheet.pdf, respectively.

[57] I do not have the data necessary to parse discount store sales into grocery and general retail so I assume a 50-50 split to calculate the blended PIN debit rate. For the signature debit rate, I use the rates that TCF debit card transactions imply, which account for the split in sales.

[58] 2009 LexisNexis True Cost of Fraud Study.

B. Discount Store Benefits Associated with Debit Cards

49. The benefits that discount stores enjoy from different payment instruments differ from those that QSRs enjoy. In particular, throughput is not, to the best of my knowledge, as important a factor for discount stores. Certainly all retailers would like to maximize their sales while minimizing their customers' waiting in line time, but there is no daily peak lunch or dinner rush in which speeding customers through the checkout line is particularly important. Moreover, shoppers at discount stores are generally there to save money, not time. The large box layout of discount stores is not aimed at shopper convenience, but rather at volume discounts. As a result of these considerations, while it is possible that increased throughput for debit relative to cash and checks benefits discount retailers, I do not quantify that benefit.

50. Ticket lift, however, remains an important benefit for discount stores. The transaction size here is roughly ten times the average at QSRs so ticket lift will be a smaller percentage. Debit cards do not involve access to credit, so ticket lift is, as before with QSRs, based on the convenience of directly accessing funds in the consumer's demand deposit account without having to carry a lot of cash. Indeed, studies continue to find that U.S. consumers are carrying less and less cash over time, as debit card use increases.[59] Thus, discount store shoppers can purchase a magazine or some candy and a drink – items that discount stores tend to stock at the POS counter to catch impulse purchases – whether they have the additional $5 in their pockets or not. This level of purchase (a $4-$6 magazine, for example) implies a ticket lift of 10% on an average transaction of $49.38. As Table 6 illustrates, this translates into a benefit of around 29 cents for all non-cash payment instruments.

Table 6: Estimated Gains by Payment Type, Big Box Discount Store

	Gains Per Transaction ($49.38)			
	Cash	Checks	Signature Debit	PIN Debit
Ticket Lift	0.000	0.287	0.287	0.287
TOTAL	0.000	0.287	0.287	0.287

51. Table 7 below combines the cost and benefit estimates to obtain the next cost/benefit for each payment instrument accepted at a discount store for a transaction of $49.38.

[59] See, e.g., Electronic Banking Options, "U.S. consumer use of cash to decline by nearly $200 billion by 2015, January 15, 2011, http://electronicbankingoptions.com/2011/01/15/u-s-consumer-use-of-cash-to-decline-by-nearly-200-billion-by-2015/ ("United States consumers' use of cash declined 3 percent last year and it will continue to drop at the same rate through 2015, according to a new report by Aite Group LLC, a Boston-based consulting firm.").

Table 7: Aggregate Effects by Payment Type, Big Box Discount Store

	Per Transaction ($49.38)			
	Cash	Checks	Signature Debit	PIN Debit
Benefits	0.000	0.287	0.287	0.287
Costs	0.269	0.780	0.476	0.423
NET BENEFITS	-0.269	-0.494	-0.189	-0.136

52. Each payment instrument is strictly negative, however the debit transactions have the smallest costs of all four payment instruments. Once benefits are included (at least those that can be quantified), checks emerge as over 2 times more costly than debit while cash is almost 2 times more costly. Relative to cash, the use of a debit card saves discount retailers between 8 and 13 cents. Relative to checks, debit saves discount retailers between 30 and 35 cents. Clearly, it is inappropriate to consider just banking transaction fees when assessing retailers' costs of payment processing.

Section IV Conclusions

53. On the basis of the above analysis I conclude that debit cards provide retailers with tangible benefits for typical transactions when compared to paper transactions.

- Looking solely at bank transaction fees is highly misleading and suggests the wrong conclusion: cash and checks are not cheaper than signature debit at the transaction sizes I have studied thus far.
- The benefits that debit cards provide to major QSRs and discount stores appear to justify the higher bank charges that such merchants must pay for signature debit transactions.
- There is no economic basis for concluding that debit card bank transaction fees raise consumer prices any more than the transaction costs associated with cash or check payments do. In fact, debit tends to be less costly to QSR and discount retailers than either paper instrument is.

Section V

Appendix 1

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Summary

Dr. Layne-Farrar specializes in antitrust and intellectual property matters, especially where the two issues are combined. She advises clients on competition, intellectual property, regulation, and policy issues across a broad range of industries, with a particular focus on high-tech. Her client list includes some of the largest information technology, communications, and pharmaceuticals companies in the world.

Her advisory work for industry leading clients has included: analyzing reasonable licensing, including RAND and FRAND; analyzing market definition; assessing economic incentives and firm behavior within standard setting organizations; reviewing the competitive implications of licensing IPR; calculating damages; conducting empirical research on the costs and benefits of policies and regulation, including payment instruments within the United States, labor unions, television ratings, software security, and e-commerce; and assessing the antitrust implications of mergers and acquisitions in a number of industries, including software, telecommunications, pharmaceuticals, airlines, manufacturing, and consumer goods.

Dr. Layne-Farrar received her BA in economics with honors, summa cum laude, from Indiana University (Bloomington), her master's and her PhD in economics from the University of Chicago. She has published articles in magazines including *Antitrust*, *Global Competition Review*, and *Regulation* and has numerous publications in academic journals, including *Antitrust Law Journal*, *Harvard Journal of Law and Public Policy*, and *Journal of Competition Law and Economics*.

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	GTE – TELEPHONE OPERATIONS HEADQUARTERS
1989–1991	Market Researcher (Small Business Customers).
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TESTIMONY (Oral)

Witness, US Senate Committee on Health, Education, Labor, and Pensions Hearing on "Rebuilding Economic Security: Empowering Workers to Restore the Middle Class", March 10, 2009 (webcast online at http://help.senate.gov/Hearings/2009_03_10/2009_03_10.html).

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Section VI

Appendix 2

This appendix provides details on the assumptions and underlying calculations used to compute the merchant costs and benefits. For the QSR case study, ticket size and representative transaction volume provide basic inputs for the cost and benefit computations. We start with these two cost elements and then move on to the other cost measures included in Table 1 in the body of the report.

1. Ticket Size

A Hitachi Consulting study estimated that for QSRs in 2008 payment cards accounted for 34 percent of transactions, with cash accounting for 66 percent.[60] The average transaction at McDonalds in 2009 was $6.00 (regardless of payment type).[61] Finally, a 2002 Visa Study found that card payments at QSRs were accompanied by a 20-30 percent increase in ticket size.[62] While many of the quotes related to "ticket lift" refer to credit cards, given the small transaction sizes it is reasonable to conclude that cards do not so much provide "credit" as they release the consumer from the constraints imposed by the cash currently in the consumer's wallet. I therefore take a conservative range of potential ticket lifts for debit cards, assuming that the use of debit cards provide a ticket lift of 5 to 20 percent. Combining all these pieces of data, we can estimate the range of the average ticket size for cash and card payments at McDonalds (as a representative QSR) by solving the following equations:

$$0.66 \text{ Cash Ticket} + 0.34 \text{ Card Ticket} = 6.00$$

$$\text{Card Ticket} = \text{Ticket Lift Factor} * \text{Cash Ticket (where } 1.05 <= \text{Ticket Lift Factor} <= 1.2)$$

Solving this system of equations with the date reported in the paragraph above gives the following cash ticket range of $5.62 - $5.90 and a card ticket range of $6.19 - $6.74.[63]

An analogous calculation is made for discount stores. We made the calculations on the basis of the top three discount stores: Wal-Mart, Costco, and Target. In the calculations we weighed the three companies by their 2008 total sales. Wal-Mart receives a weight of 74 percent, Target 12 percent, and Costco 14 percent. Their interchange fees for signature debit are 0.65, 0.79, and 0.37 percent, respectively. Thus, the weighted-average interchange fee is 0.63. The cash transaction size is $51.29, $40.55, and $82.50, respectively. Thus, the weighted-average transaction size is $54.32.

[60] "The Price of Credit" QSR Magazine Jan 14, 2011, http://www.qsrmagazine.com/articles/operations/128/priceofcredit-1.phtml
[61] Results from a *Fast Food Company Magazine* survey available at http://www.jeremyperson.com/fast-food-per-store-sales-information/
[62] "Visa Payment Card Acceptance helps the Bottom Line of Quick Service Restaurant Partners," *Business Wire*, Nov 12 2002.
[63] At 5 percent ticket lift, cash transactions are $5.89 while card transactions are $6.19, which, with rounding, provides the correct weighted average transaction of $6. At 20 percent ticket lift, cash transactions are $5.62 while card transactions are $6.74.

2. Transaction Volume

Daily transaction volume at QSRs varies considerably depending on the type of chain and the restaurant's location. Due to limited data availability, I use two estimates of representative QSR transaction volume: the first, McDonalds, represents a large national chain on the higher end of transaction volume; the second, Taco Time Northwest, a local chain in the Pacific Northwest represents a medium sized QSR. McDonald's sales volume per store in 2009 was $2.3 million, and the average transaction size in 2009 was $6. We can therefore infer that the number of transactions processed annually per store was 383,333, which translates to about 1050 transactions per day per store.[64] Using samples of monthly transaction data from various Taco Time Northwest franchises in 2009-10, I estimate that a smaller QSR averages about 10,773 monthly transactions per location,[65] or 359 transactions per day per location. As noted in the main body of the report, scale is important for variable costs that do not vary per individual transaction, but rather vary over tranches of transactions. This follows because the larger the number of transactions, the greater the base over which "lumpy" variable costs are spread, which has an impact on the cost-benefit analysis.

According to industry estimates, the average QSR has 70 transactions per hour during the peak periods of lunch and dinner, each of which lasts an hour, for a total of 140 peak period transactions.[66] Because 140 transactions are made per location in the peak periods, the remaining 219 occur during slack periods, for a total of 359 transactions per day. At a larger restaurant like McDonalds, we assume that the ratio of peak to total transactions remains the same as reported for average QSRs (140/359=38.9%). Applying this ratio to the total transaction volume of 1050 at a McDonald's restaurant results in 409 peak and 641 off peak transactions. Since smaller QSRs have fewer transactions, their aggregate cash processing costs are estimated as being slightly higher. I present tables on costs, benefits, and aggregate effects for smaller QSRs at the end of this appendix. These tables are analogous to the tables presented in the main text which exhibit costs, benefits, and net effects for large QSRs.

The daily number of cash transactions is equal to the share of cash payments (0.66) multiplied by the daily transaction volume. Similarly, the daily number of card transactions is equal to the share of card payments (0.34) times the daily transaction volume.

3. Transaction Costs

For all payment instruments, POS costs per transaction are determined by multiplying the relevant transaction time (at QSRs, 4.5 seconds for cards and 9 seconds for cash[67]) by the cashier's wage rate ($8.37/hour or $0.002/second[68]). Thus, POS cost is measured as a labor cost for handling payments by payment instrument type.

[64] Results for McDonalds from a Fast Food Company Magazine survey available at http://www.jeremyperson.com/fast-food-per-store-sales-information/. While some purchases will be for coffee only, and thus far less than $6, other transactions will be for far more than $6, such as when a family of four purchases dinner. Given the limited data available, using the average transaction size to estimate the number of transactions should provide a reasonable estimate.
[65] Eric A. Finkelstein et al., "Mandatory Menu Labeling in One Fast-Food Chain in King County, Washington," *American Journal of Preventive Medicine* Vol. 40 (2):122-127 (2011), p.124.
[66] Amy Garber, "Quick-Service Leaders Eye Life in the Fast Lane," *Nation's Restaurant News*, Dec 12, 2005.
[67] Lueng and Lieber, supra note 12.

Back office costs for cash are also measured as a labor cost from the 1997 FMI survey of supermarket data. This figure is determined by multiplying average deposit preparation time (36.5minutes) with the accountants wage rate ($14.58/hr or $0.243/min) and the number of deposits prepared each day (2.7).[69] In order to adjust this figure for QSRs, I multiply it by the ratio of representative QSR (or discount store) annual sales to supermarket annual sales.[70] This amount is then divided by the number of daily cash transactions.

For card transactions, bank costs are given by multiplying the relevant merchant discount by the transaction size. Note that merchant discounts are seldom reported directly. We have merchant discount rates (2.08%) from 2004, along with QSR specific interchange rate data from that year (1.65% + 4 cents).[71] As acquiring services have remained competitive among banks, we assume that the relationship between the interchange rate and the merchant discount has remained constant. We therefore multiply the ratio of interchange fee to merchant discount from 2004 by the current interchange fee (1.65% + 4 cents) to obtain an estimate of current merchant discounts. For cash transactions, bank costs are given by multiplying the bank cash deposit fee ($0.0012per dollar deposited) by the transaction size.[72] We do similar calculations for discount stores.

Float costs for debit cards are given by multiplying the transaction amount first by the number of days taken for the transaction to clear (1.46[73]) and then by the interest earned each day (0.74%/365[74]).

Fraud costs for cards are based on the costs reported in the FMI 2003 study on fraud losses in the supermarket industry.[75] For lack of better data, I assume that the QSRs incur payment card related fraud losses of the same scale and proportion as supermarkets. For debit transactions, the study estimates that losses are on the order of 0.04% of revenue. Therefore we multiply the transaction amount by 0.04% to determine losses to fraudulent debit cards on a per transaction basis. As noted in the text, fraud costs for checks at discount stores are based on the LexisNexis report.

For the supermarket industry in 2003, 1 in 15 stores was robbed each year; this is equivalent to a rate of 0.07 robberies per store per year.[76] Annually, the loss to each supermarket chain was estimated at $38,884.35.[77] Multiplying total company wide losses by the robbery rate per store gives us about $2592 in losses per store. In order to adjust

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[68] This is the hourly wage rate for cashiers in the food services industry. U.S. Department of Labor, Bureau of Labor Statistics. See national 5-digit NAICS industry-specific estimates available at http://www.bls.gov/oes/oes_dl.htm

[69] FMI, "A Retailer's Guide to Electronic Payment Systems Costs," 1998.

[70] Weekly average supermarket sales in 2003 are available through the FMI available at http://www.fmi.org/facts_figs/?fuseaction=superfact. I compute this ratio separately for small and large QSRs.

[71] 2004 merchant discount of 2.08% is from VISA, "Driving Value and Innovation: Interchange in Action," Federal Reserve Bank of Chicago, May 2005. In 2004 VISA negotiated QSR specific interchange fees of 1.65% + 4 cents. See W. A. Lee, "How Cards Finally Won Reluctant McDonalds Over," *American Banker* Vol. 169 (59), March, 2004.

[72] See Wells Fargo Bank business account holder service fees in IL, WI, and MI https://www.wellsfargo.com/downloads/pdf/biz/accounts/fee_information/michigan_wisconsin_illinois.pdf. Cash deposit fees are $0.0012 per dollar deposited; this is the lower of the two fee schedules shown (p. 31 and p. 38).

[73] VisaNet report provided to TCF.

[74] See http://www.treasurydirect.gov/news/pressroom/currenteebondratespr.htm

[75] FMI survey data, "Loss Prevention," 2003, p.8

[76] Id.

[77] Id.

this figure for QSRs, I multiply it by the ratio of representative QSR annual sales to supermarket annual sales.[78] Aggregate cash sales per store can be computed by multiplying 365 by the daily cash transaction volume and the cash transaction size, which yield around $485,853 per store for small QSRs and $1,421,020 for McDonalds. Adjusted per store losses to robbery are then divided by annual cash sales to compute the proportion of robbery losses per dollar of cash sales for small and large QSRs respectively. This fraction is then multiplied by the relevant transaction size to give robbery losses per transaction for both small and large QSRs.

Employee theft of cash and merchandise at supermarkets was estimated at 3.47 detected incidents per store in the FMI 2003 study.[79] An average of $450.49 was recovered in each incident (this amount included both cash and merchandise).[80] I assume, however, that QSRs incur only cash losses. In the FMI study it was estimated that 49% of store locations experienced cash theft; I apply this fraction to the recovery per incident to estimate the amount of cash recovered in each detected incident.[81] The FMI study notes that several undetected cases of employee theft occur for each detected case. I assume, conservatively, that there is only one undetected loss for all detected losses. Undetected losses are then given by the product of detected incidents per year, average recovery per incident, and share of cash locations with theft, which yields about $766 per year in employee theft. In order to adjust this figure for QSRs, I multiply it by the ratio of representative QSR annual sales to supermarket annual sales.[82] This amount is then divided by annual cash sales for small and large QSRs respectively to compute the proportion of employee theft losses per dollar of cash sales. This fraction is multiplied by the relevant transaction size to give employee theft losses per transaction for both small and large QSRs.

Loss prevention costs are also estimated from data in the FMI 2003 study. Expenses incurred in association with locksmiths and CCTVs are included within this category. In 2003, each supermarket incurred about $28,356 in loss prevention costs. I update these costs to 2009 levels using the BEA's PCE chain type price index for other goods and services.[83] In order to adjust this figure for QSRs, I multiply it by the ratio of representative QSR annual sales to supermarket annual sales.[84] This amount is divided by annual cash sales for small and large QSRs respectively in order to compute the proportion of loss prevention costs per dollar of cash sales. Finally, this fraction is multiplied by the relevant transaction size to give loss prevention costs per transaction for both small and large QSRs.

Because discount stores must protect against both cash theft and inventory shrinkage/theft, their loss prevention expenditures will be greater than those at QSRs.

[78] Weekly average supermarket sales in 2003 are available through the FMI available at http://www.fmi.org/facts_figs/?fuseaction=superfact. I compute this ratio separately for small and large QSRs.
[79] FMI survey data, "Loss Prevention," 2003, p.8
[80] Id.
[81] Id.
[82] Weekly average supermarket sales in 2003 are available through the FMI available at http://www.fmi.org/facts_figs/?fuseaction=superfact. I compute this ratio separately for small and large QSRs.
[83] U.S. Department of Commerce, Bureau of Economic Analysis, Table 2.5.4 Price Indexes for Personal Consumption Expenditures by Function (A) available at http://www.bea.gov/national/nipaweb/SelectTable.asp.
[84] I Weekly average supermarket sales in 2003 are available through the FMI available at http://www.fmi.org/facts_figs/?fuseaction=superfact. I compute this ratio separately for small and large QSRs.

However, only those prevention measures aimed at stopping cash theft from the till (either by employees or robbers) is relevant for our purposes. For lack of data, I assume that 25% of loss prevention expenditures at discount stores are aimed at cash loss.

Other direct costs for cash transactions are assumed to include only armored car costs. For lack of better data, I assume that the supermarket industry presents a suitable proxy for QSRs. In an FMI 1997 study, it was estimated that armored cars used to transport deposits to the bank cost stores $2357 annually.[85] I update this figure to 2009 price levels using the BEA's PCE chain type price index for other goods and services.[86] The FMI data estimated 2.7 deposits prepared each day for each supermarket store. I assume that less cash is handled at QSRs and therefore only one cash deposit is made each day. I therefore divide estimated annual costs by 2.7 resulting in about $1273 in annual armored car costs. This amount is then divided by annual cash sales to compute the proportion of armored car costs per dollar of cash sales. Finally, the resulting fraction is multiplied by the relevant QSR transaction size.

4. Transaction benefits

According to the assumptions outlined above, ticket lift for QSRs varies from a lower bound of 5% to an upper bound of 20%. The ticket lift benefit per transaction is given by multiplying the profit margin earned by McDonalds (taken as a representative QSR) with the appropriate ticket lift in dollars. We assume a ticket lift of 10% at discount stores.

If we assume a ticket lift of 5%, the dollar difference between card and cash tickets is $6.19 - $5.90 = $0.29. McDonald's had a profit margin of 22.94 percent.[87] Therefore, the benefit provided by ticket lift is $0.29x0.2294 or about $0.07. A similar computation follows for an assumed ticket benefit of 20%. And an analogous calculation is made for discount stores.

We know that card transactions are about 5 seconds faster to process than cash transactions at QSRs.[88] Therefore, replacing a cash transaction with a card transaction frees up 5 seconds of service time. At peak periods, 70 transactions occur each hour per location, which corresponds to a rate of 51 seconds per transaction. 5 seconds of additional service time corresponds to a throughput increase of 0.1 transactions.

The benefits from throughput improvements of 5 seconds depend on whether the additional time is spent serving a card paying customer (probability of 34 percent) or a cash paying customer (probability of 66 percent). Throughput benefits also vary depending on whether ticket lift is assumed to be 5 percent or 20 percent. In general the expected value of throughput benefits is given by the equation below:

(0.10) x (0.66) x cash ticket x profit margin + (0.10) x (0.34) x card ticket x profit margin

If we assume a ticket lift of 5 percent, we use the upper bound cash ticket and the lower bound card ticket in the equation above. If we assume a ticket lift of 20 percent, we use the lower bound cash ticket and the upper bound card ticket in the equation above. In both cases, the expected value of the benefit is estimated to be $0.137.

[85] FMI survey data, "A Retailer's Guide to Electronic Payments Systems Costs," 1997, p.20
[86] U.S. Department of Commerce, Bureau of Economic Analysis, Table 2.5.4 Price Indexes for Personal Consumption Expenditures by Function (A) available at http://www.bea.gov/national/nipaweb/SelectTable.asp.
[87] See McDonald's Annual Report 2009, p.7. I calculate profit margins as operating income divided by total revenues.
[88] Lueng and Lieber, supra note 12.

The benefits of throughput occur only during peak hours and not during slack periods. Ticket lift, however, occurs both during peak and slack periods. We must therefore weight the benefits accrued from ticket lift and throughput accordingly. Since 140 transactions on average occur during peak periods for regional QSRs, while the remaining 219 occur during non-peak periods,[89] the following formula estimates the weighted benefits derived from throughput improvements and ticket lift (lift and throughput benefits both vary depending on the ticket lift assumed):

(proportion of peak) x (lift benefit + throughput benefit) + (proportion of non-peak) x (lift benefit)

If we assume a ticket lift of 5 percent the cumulative weighted benefits are $0.121. If we assume a ticket lift of 20 percent, the cumulative weighted benefits are $0.311.

[89] And I assume that the ratio of peak to non-peak sales is the same for larger, national QSRs as well.

Exhibit 3

Report of Professor Kevin M. Murphy

February 15, 2011

Executive Summary

The Durbin Amendment and its proposed implementation by the Federal Reserve Board are based on a fundamental misunderstanding of how competition works in the debit industry. The debit system is not "broken" – it has proven to be an enormously successful payment method that has substantially displaced checks and cash for many types of transactions. Merchants derive substantial value from accepting debit, as debit's increased adoption in new merchant categories (such as fast-food restaurants) shows.

Debit networks generally impose transaction fees on merchants, not cardholders. This reflects the basic economics of two-sided platforms, and is not unique to debit or to well-established platforms. New two-sided platforms like OpenTable and Groupon have adopted the same pricing model – imposing fees on merchants and not on consumers. Merchant complaints about paying such fees are not evidence of an absence of competition, but rather reflect merchants' collective preference to limit competition for customers.

The Durbin Amendment and the FRB's proposal are an extreme form of price regulation. A vast body of economic literature has shown the harm to efficiency and consumers from price controls that limit price below the level that covers the relevant measure of economic cost, which is what the FRB has proposed. Critics fail to recognize that the price regulation intervention they propose will cause other adjustments which will harm merchants and consumers.

Proponents of debit regulation have not identified any market failure that justifies intervention, because there are none. They wrongly conclude, without appealing to any evidence, that cash and check customers subsidize debit users. In fact, the opposite is more likely to be true given the benefits that merchants obtain from their customers' use of debit. Critics identify no benefits from increased transparency of debit interchange fees, and indeed economics shows that transparency in merchant costs is not common in retailing and thus its absence does not suggest a lack of competition. And there is no evidence that smaller networks or competition among a larger number of debit networks would result in lower merchant fees, and indeed economic theory and available evidence show that this would not result.

The key economic principles to guide future consideration of the wisdom of the Durbin Amendment and the FRB's proposed implementation are whether there is a market failure to solve (and there is not), whether the proposed rule does more good than harm (it does not), and whether there is a likelihood of harmful unintended consequences (there is). Thus, the consequence of the current proposal likely will be substantial loss of efficiency and harm to consumers.

Table of Contents

I. INTRODUCTION AND SUMMARY OF CONCLUSIONS

My name is Kevin M. Murphy. I am the George J. Stigler Distinguished Service Professor of Economics in the Booth School of Business and the Department of Economics at the University of Chicago, where I have taught since 1983. I earned a doctorate degree in economics from the University of Chicago in 1986. I received my bachelor's degree, also in economics, from the University of California, Los Angeles, in 1981.

At the University of Chicago, I teach economics in both the Booth School of Business and the Department of Economics. I teach graduate level courses in microeconomics, price theory, empirical labor economics, and the economics of public policy issues. I cover a wide range of topics in these courses, including the incentives that motivate firms and individuals, the operation of markets, and the impacts of regulation and the legal system. Most of my teaching focuses on two things: how to use the tools of economics to understand the behavior of individuals, firms and markets; and how to apply economic analysis to data. My focus in both research and teaching has been on integrating economic principles and empirical analysis.

I have authored or co-authored more than 65 articles in a variety of areas in economics. Those articles have been published in leading scholarly and professional journals, including the *American Economic Review*, *Journal of Law and Economics*, and the *Journal of Political Economy*.

I am a Fellow of the Econometric Society and a member of the American Academy of Arts and Sciences. In 1997, I was awarded the John Bates Clark Medal, which the American Economic Association awarded once every two years to an outstanding American economist under the age of forty.[1] In 2005, I was named a MacArthur Fellow, an award that provides a five-year fellowship to individuals who show exceptional merit and promise for continued and enhanced creative work.

In addition to my position at the University of Chicago, I am also a Principal at Navigant Economics (formerly Chicago Partners), a consulting firm that specializes in the application of

[1] Although the John Bates Clark Medal was awarded biennially until 2009, it now is awarded annually. *See*, http://www.vanderbilt.edu/AEA/clark_medal.htm.

economics to law and regulatory matters. I have consulted on a variety of antitrust, intellectual property and other matters involving economic and legal issues such as mergers, class certification, damages, labor practices, joint ventures, and allegations of anticompetitive exclusionary conduct, tying, price fixing, and price discrimination. I have submitted testimony in Federal Court, to a committee of the U.S. Senate and to state and federal regulatory bodies, and I have submitted expert reports in numerous cases. Of particular relevance to the issues I address in this submission, I have written on the economics of two-sided markets, I have served as an expert witness in connection with litigation over merchant fees, and I submitted a report to the Federal Reserve Board on behalf of Bank of America in connection with its consideration of implementation of the Durbin Amendment.[2]

In this report, I explain that the Durbin Amendment[3] and its proposed implementation by the Federal Reserve Board[4] are based on a fundamental misunderstanding of how competition works in the debit industry.[5] The Amendment and proposed implementation fail to acknowledge the benefits that merchants receive from widespread adoption of debit and reflect a dangerous overestimation of benefits from imposing regulation and disregard for the adverse consequences to economic efficiency from doing so. My primary conclusion is that proponents of debit regulation have not identified any market failure that justifies intervention, because there are none. Instead, debit's critics adopt a merchant-centric view with blinders – limiting their focus to the amount of bank fees paid by merchants without understanding the competitive forces from which these fees arise and the corresponding benefits to merchants and consumers that would be lost if merchant debit fees were capped as proposed. Importantly, critics fail to recognize that the price regulation intervention they propose will cause other adjustments, many of which will harm merchants and consumers.

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[2] *Economic Analysis to Guide Interpretation of Provisions of the Dodd-Frank Act Regarding Regulation of Debit Interchange Fees, Submission of Professor Kevin M. Murphy on Behalf of Bank of America Corporation*, November 23, 2010.

[3] "Sec. 920. Reasonable Fees and Rules for Payment Card Transactions," Sec. 1075 (a)(2) of U.S. Congress. House. *Dodd-Frank Wall Street Reform and Consumer Protection Act.* H.R. 4173. 111th Cong., 2nd sess. (5 January 2010).

[4] "Regulation II, Debit Card Interchange Fees and Routing – Notice of proposed rulemaking" 12 CFR Part 235. Federal Register Vol. 75, No. 248. December 28, 2010 ("FRB Proposal").

[5] My submission has been prepared at the request of Timothy Kelly, outside counsel for TCF National Bank.

II. THE LEVEL OF DEBIT INTERCHANGE RATES IS NOT UNREASONABLE AND DOES NOT REFLECT AN ABSENCE OF COMPETITION OR "A MARKET THAT IS WORKING LESS THAN COMPETITIVELY"[6]

A. The Debit System is Not Broken – It is a Tremendously Successful Innovation in Payment Systems

It is highly unusual, indeed perhaps unprecedented, to focus regulatory scrutiny and intervention on a segment of the economy that all participants have voluntarily and enthusiastically embraced, and that has grown faster than and substantially displaced competing products or services. The enormous success, expansion and benefits of debit may be the one fact acknowledged and agreed upon by all parties that participated in the Federal Reserve Board's ("FRB's") deliberations that resulted in the proposed *Regulation II, Debit Card Interchange Fees and Routing* ("FRB Proposal") issued for public comment on December 16, 2010. In its request for comments on the Proposal, the FRB noted that, since the mid-1990s, checks and "most likely cash payments" have been replaced by other payment methods, that "[d]ebit card usage, in particular, has increased markedly during that same period," and that "[d]ebit card payments have grown more than any other form of electronic payment over the past decade..."[7] The FRB further noted that today "[d]ebit cards are accepted at about 8 million merchant locations in the United States"[8] and that "beginning in the early 1990s, signature debit networks also began creating separate pricing categories for merchants in certain market segments (*e.g.*, supermarkets and card-not-present transactions) to gain increased acceptance in those markets,"[9] an effort that clearly has succeeded. However, after acknowledging the enormous success of debit card systems, the FRB proposed rules to dramatically reduce interchange rates that will endanger that success.

A fundamental economic principle is that, absent rare circumstances, quantity or "output" provides the clearest and best indication whether economic actors are benefiting from supply of a product or service. The much-discussed "two-sided market" feature of debit cards does not change, indeed perhaps even strengthens, this fundamental economic fact – when customers find

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[6] Transcript of Fed Governors-Staff Colloquy, p. 14.
[7] FRB Proposal, p. 81723.
[8] FRB Proposal, p. 81723.
[9] FRB Proposal, p. 81724.

that a product or service provides value given its price, they demand more of it and its quantity increases. This economic principle applies to both sides of two-sided markets – the adoption and expansion of a product or service occurs only if customers on *both* sides of the platform find it in their interest to "purchase" more. And it is clear that both merchants and cardholders have, in effect, "voted with their feet" by adopting and using debit for more and more transactions.

Despite this incontrovertible evidence of a healthy and growing market for debit services, Congress adopted the Durbin Amendment ("Amendment") to the Dodd-Frank Act ("Act") without identifying any market failure to justify the imposition of price regulation in a highly successful marketplace. The FRB then worsened a bad situation by proposing an interpretation of the Amendment and the FRB's mandate under the Act that would dramatically shift how issuers finance their debit programs from fees paid by merchants to fees paid by cardholders and even (according to the FRB itself) to "other sources, besides interchange fees, from which [issuers] can receive revenue to help cover the costs of debit card operations."[10]

In other words, the FRB proposes to shift the fees that compensate issuers for the costs of operating their debit programs from the merchants that benefit from the availability of debit as an efficient payment method to issuers' unrelated businesses. This recommendation tramples on the fundamental economic principle that economic efficiency is achieved through appropriate price signals and is endangered when products and services are "taxed" to subsidize other operations.

One interpretation of the intent of the Amendment and the FRB's proposed rate regulation is that Congress and regulators view merchants as victims who are forced to pay for a system from which they do not benefit, and that the proposed regulations remedy this inefficiency by shifting how the debit system is financed to cardholders and other bank customers.[11] But this view is contrary to the evidence and to proper economic analysis. Merchants derive substantial value by accepting debit. This is evident from their actions –

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[10] FRB Proposal, p. 81736.

[11] This is consistent with the speech that Senator Durbin gave when he introduced the Amendment, in which he pointed to a complaint by one of his constituents – the CEO of Walgreens – about the size of its interchange fees. Of course, Senator Durbin made no effort to distinguish between fees associated with credit and debit, or to explain why, if these fees were so onerous, Walgreens did not stop accepting debit. I doubt the CEO of Walgreens would deny that he wants to receive the conveniences of debit cards – reduced cash losses, reduced cashier time, convenience to other customers, larger transaction size, etc. – but prefers to obtain these benefits without having to pay for them (or paying 80 percent less).

merchants increasingly accept debit and have voluntarily moved away from other payment methods such as cash and checks. Further, as is evident from the experience of early adopters in new retailing segments (such as the quick-service restaurant segment), merchants derive substantial net benefits from accepting debit at *the prevailing level of debit fees.*[12] While some merchants in markets where the acceptance of debit is widespread might complain that they "must take" debit, this does not imply that those merchants do not receive equal or even greater benefits in exchange. The fact that merchants compete with other merchants by accepting debit cards is no different from the fact that those same merchants must compete on price, service and product quality. The fact that a competitor's lower prices or better service offsets much of the gain that a merchant otherwise receives by lowering its own prices and improving its service is a natural part of the competitive process, and not a rationale for regulatory intervention.

B. Consumers are Choosing Debit over Paper-Based Payment Methods

Consumers recognize that debit offers benefits when compared to checks and cash. A recent consumer survey, the Survey of Consumer Payment Choice ("SCPC"), found that:

> "...[m]ore consumers now have debit cards than credit cards (80.2 percent versus 78.3 percent), and consumers use debit cards more often than cash, credit cards or checks individually."[13]
>
> The move to debit cards occurred while "U.S. consumers have more payment instruments to choose from than ever before (nine)."[14]
>
> "More than half of U.S. consumers (51.6 percent) said they wrote fewer checks in 2008 than they did in 2005. In contrast...49.5 percent of consumers reported an increase in their use of debit cards..."[15]
>
> Non-adopters of ATM or debit cards have higher average cash holdings on their person ($141) and make larger average monthly withdrawals ($462) compared with adopters of ATM/debit ($68 and $313, respectively).[16]

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[12] *Assessing Retailers' Costs and Benefits from Accepting Debit Cards*, Dr. Anne Layne-Farrar, February 15, 2011 ("Layne-Farrar Report").
[13] Kevin Foster, Erik Meijer, Scott Schuh, and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Public Policy Discussion Papers, April 2010 ("Foster et al."), p. 2.
[14] Foster et al., p. 9.
[15] Foster et al., p. 10.
[16] Foster et al., pp. 22 and 23.

Another recent study found that "the share of all noncash payments (by consumers, businesses, and government) made using checks fell from 77% to 36% [from 1995 to 2006], while the shares of three other instruments increased, especially the shares of debit cards [from 2 to 27 percent] and Automated Clearing House (ACH)."[17] This study attributes 34 percent of the decline in check share to a "decrease in relative convenience of checks" and 11 percent to the "increase in relative cost of checks."[18] The study concluded that "[o]ne of the most common substitutions of payment use from checks to another payment instrument has occurred with debit cards… On average, most consumers view debit cards as having better timing than checks..."[19]

Another consumer study found that 88 percent of debit users reported "convenience" as a reason for using debit rather than other payment methods, while only 8.3 percent of non-users of debit reported "convenience" as a reason for using a payment method other than debit. The same study found that debit users who reported "a desire for Time and Convenience" viewed debit as a substitute for cash "and somewhat less strongly, for checks."[20]

Data from the Visa Payment Panel Study ("VPPS") also document the switch from checks to debit, and the increased adoption of electronic payment forms generally. One analyst of the VPPS data commented that "[p]articularly striking is the displacement of checks by debit cards."[21] The data showed that, between 2000 and 2008, "the [monthly] incidence of check use declined from 84 percent to 69 percent."[22] Ownership of debit cards increased from 60 percent in 1997 to 92 percent in 2008, with usage increasing from 17 to 60 percent over this period. "[I]n just a seven-year period, changes in American consumer payment preferences caused a

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[17] Schuh, Scott and Stavins, Joanna, "Why are (some) consumers (finally) writing fewer checks? The role of payment characteristics," *Journal of Banking & Finance,* Vol. 34 (2010) 1745-1758 ("Schuh and Stavins"), pp. 1745-1746.

[18] Schuh and Stavins, p. 1756. The measure of the relative convenience of checks was based on the share of consumers surveyed who reported that checks were convenient (declined from 50 percent in 2001 to 25.7 percent in 2005). *Id.*

[19] Schuh and Stavins, p. 1755.

[20] Ron Borzekowski, Elizabeth K. Kiser and Shaista Ahmed, "Consumers' Use of Debit Cards: Patterns, Preferences, and Price Response," *Journal of Money, Credit and Banking,* Vol. 40, No. 1 (February 2008) ("Borzekowski et al."), p. 158.

[21] Herbst-Murphy, Susan, "Trends and Preferences in Consumer Payments: Lessons from the Visa Payment Panel Study," Payment Cards Center Discussion Paper, May 2010 ("Herbst-Murphy"), p. 1..

[22] Herbst-Murphy, p. 3.

shift in transactions from only $1 of every $14 being made with a debit card to nearly $1 in every $5."[23]

C. Merchants Accept Debit because of the Benefits Debit Provides

Merchant acceptance of debit also has been growing, with debit increasingly accepted by merchants in new business segments (such as fast-food restaurants and in-flight airplane purchases) where transactions typically are small. A study of payment trends in thirteen countries concluded that "[o]ur empirical results suggest that the adoption of POS debit terminals by merchants was the key factor in the explosive growth in debit card usage. This suggests that both consumers and merchants generally prefer debit cards to other payment alternatives for certain types of transactions."[24]

Grocery stores, which typically have extremely low margins, were early adopters of debit cards. Studies have quantified the time and other cost savings to merchants when cardholders purchase using debit rather than checks. One study estimated the "ring time" to transact with debit at a grocery store was about 25 seconds less than with checks.[25] With a wage of $9.61 per hour and an average transaction size of $37, the savings to grocery merchants in labor costs alone would be roughly 0.2 percent of the purchase amount.[26] This is a conservative estimate of merchant benefits, since it does not consider other savings from faster checkout times (such as more efficient use of checkout facilities and spillover effects to other customers from more efficient checkout); nor does it include merchant savings from other features of debit, such as faster settlement, lower fraud losses, etc.

Another study based on a grocery chain's scanner data also found that it took less time to transact with debit than with credit cards, and substantially less (by 50 percent or more) than

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[23] Herbst-Murphy, p. 6.
[24] Gene Amromin and Sujit Chakravorti, *Debit Card and Cash Usage: A Cross-Country Analysis*, March 2007 ("Amromin and Chakravorti"), p. 28.
[25] Elizabeth Klee, "How people pay: Evidence from grocery store data," 55 *Journal of Monetary Economics* (2008) 526-541 ("Klee"), p. 533.
[26] $9.61was the average hourly wage for grocery cashiers in May 2009 according to the Bureau of Labor Statistics. *See*, www.bls.gov/oes/2009/may/oes412011.htm. $37.00 is an average of Signature Debit and PIN Debit average purchase amounts. *See*, Daniel D. Garcia-Swartz, Robert W. Hahn, and Anne Layne-Farrar, "The Move Toward a Cashless Society: Calculating the Costs and Benefits," *Review of Network Economics* 5:2 (2006): 199-228, p. 201.

with checks.[27] It also took less time to give a shopper cash back with debit (0.26 seconds per dollar) than with checks (0.77 seconds per dollar).[28] Authorization and verification costs were lower with debit (9.4 seconds) than with credit (15.1 seconds) and checks (35.5 seconds).[29] From an economic standpoint, the early adoption of debit by grocery stores reflects the fact that grocers recognized that debit offered substantial functional advantages over checks, their traditional mainstay form of payment.[30]

It is possible to quantify some of the value to merchants of other functions provided by debit, but not by checks. In particular, merchants bear the overdraft or fraud risks as to checks, but banks take these risks as to debit. The cost to merchants to purchase a level of payment guarantee equal to that provided by debit for a check transaction is substantial. In many cases, the cost of purchasing check guarantee and verification are high enough that the merchant either declines to accept a check (and thus loses some potential sales) or assumes the risk of non-payment associated with check transactions. In cases where merchants purchase payment guarantee from third-party providers, the fees average about 0.92 basis points.[31]

Taken together, this evidence shows that merchants benefit substantially when consumers use debit rather than checks. Although both checks and debit transfer funds from a customer's demand deposit account to the merchant's account, debit cards are not "electronic checks."[32] The two payment methods do not provide the merchant with the same benefits (which is what is critically relevant from the point of view of evaluating the level of interchange rates).

D. By Choosing to Accept Debit, Merchants Demonstrate that the Value they Receive from Debit Exceeds the Bank Fees they Pay

The benefits realized by a merchant when consumers use debit rather than payment methods such as checks do not disappear once the merchant (and its competitors) transition to

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[27] Klee, p. 533.
[28] Klee, p. 533.
[29] Klee, p. 535.
[30] The growth of self- and automated checkout facilities is evidence of additional cost savings merchants achieve by reducing labor costs associated with checkout. The use of debit rather than checks facilitates the shift to self-checkout, with at least some of these gains attributable to the shift toward debit.
[31] *See*, "Check Authorization – 2009," Nilson Report #953 (July 2010).
[32] According to the Merchant Payment Coalition, it is a "Fact" that "debit cards are simply electronic versions of checks." (*See*, Merchants Payment Coalition Letter to Senator Crapo, December 20, 2010. ("MPC Letter to Senator Crapo")).

accepting debit. Implicitly, merchants acknowledge this when they argue that they must accept debit or they will be at a competitive disadvantage. A merchant easily recognizes debit's advantages when it first introduces debit and can directly measure the associated benefits from reduced checkout times, increased ticket size, reduced losses from bad checks and increased customer satisfaction. Those gains then become part of the status-quo once the merchant and its competitors accept debit; as time goes by, even though debit provides all the same benefits as before, accepting debit becomes part of keeping up with the competition. The same is true of many competitive tools used by merchants, including price discounts, free parking, better service, or the provision of higher quality products – merchants may be unhappy about having to match competitive sales prices, amenities or superior quality, but the essence of competition is firms' efforts to gain an advantage over competitors, and competitors' responses to the challenge.

The complaints from merchants about current debit rates also reflect the different characteristics of debit's costs and benefits. The value received by merchants does not show up as a separate line item on the merchant's profit and loss statement; rather, it shows up in avoided costs and incremental benefits, such as reduced labor costs, reduced losses on bad checks and increased sales. In contrast, debit fees are directly measured and presented on each profit and loss statement.[33] As a result, merchants are likely to misperceive the debit value proposition once debit acceptance becomes part of the status-quo for the merchant and its competitors, recognizing its costs more clearly than its benefits.

Debit's continued adoption by a wider array of merchants demonstrates its benefits. Evidence summarized by Dr. Anne Layne-Farrar shows how debit's acceptance by quick-service restaurant ("QSR") chains grew from 2000 to 2005, as operators recognized the benefits of debit over cash for the typical small transactions that QSRs process, and restaurants found that the

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[33] Senator Durbin explained, as noted earlier, that he introduced his amendment after the CEO of Walgreens, a constituent, told him "that when they look at the expenses of this national chain of drugstores, the No. 1 expense is compensation of employees, personnel costs; No. 2, mortgage and rent payments; No. 3, health insurance; No. 4, interchange fees. It turns out the fees Walgreens pays to credit card companies is the fourth largest item of cost for their business." The problem with the perspective of the Walgreen's CEO is that he focused only on his bank-fee expense from accepting debit and credit cards, and not the benefits. *See,* Transcript to Senator Richard Durbin's "Interchange Amendment – Senate Floor Statements," May 5, 2010, p. 9.

average transaction size with debit was greater than with cash.[34] The benefits from accepting debit became clear to QSRs, and they voluntarily joined debit networks as a convenience to customers, a way of lowering their costs of processing transactions and in order to get customers to purchase more than they might if they were constrained by the amount of cash in their pockets.[35]

Merchant discount fees are an explicit cost of doing business, and thus an easy focus for merchant complaint. But the benefits provided by debit are like other benefits that merchants obtain by improving their service relative to their competitors. A merchant can reduce the number of sales clerks to reduce its labor costs, crowd merchandise into smaller floor space to lower its rent, lower the lighting and heat and reduce the amount of air-conditioning to lower its utility bills, reduce or eliminate advertising of the services it offers and make other adjustments in its operations to lower its costs. Still, the merchant chooses not to do so because such actions would make it less attractive relative to its competitors. Thus, many cost-saving measures are unprofitable when the merchant weighs the benefits against the cost in terms of lost customers and/or lost customer purchases. The same is true for debit.

At the same time, the merchant would welcome regulation that forced its competitors to take the same actions – reducing the number of sales clerks, crowding merchandise into less floor space or limiting their advertising – because then it would not be disadvantaged relative to the competition. For example, a law prohibiting advertising would benefit merchants; to a large extent, each merchant's advertising simply attracts customers that the merchant otherwise would lose when its competitors advertise.[36] But a prohibition on advertising, even if it were in the interest of competitors, would not be in the interest of consumers. Consumers are harmed by restrictions that prevent merchants from competing to please shoppers, even if such restrictions lower merchants' costs.[37]

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[34] Layne-Farrar Report.
[35] Layne-Farrar Report.
[36] *See e.g.,* Benham, Lee, "The Effect of Advertising on the Price of Eyeglasses," *Journal of Law and Economics,* Vol. 15, No. 2 (October 1972), pp. 337-752.
[37] For example, by proclaiming a national emergency in 1979 and regulating the temperature in non-residential buildings, President Carter eliminated the competitive disadvantage that would have been suffered by any firms that

In the same way, merchants would like government to regulate debit interchange rates, and thereby enable each merchant to obtain all the benefits from accepting debit without directly paying for them. The Amendment and the FRB's proposed debit interchange rules provide merchants with the advantage they seek, but the consequences would be harm to competition and to consumers.

E. Merchants' Reaction to OpenTable Fees Demonstrates the Same Merchant Bias to Avoid Paying for the Value they Receive

OpenTable – a relatively new internet provider of "real-time online restaurant reservations for diners and reservation and guest management solutions for restaurants" – is experiencing the same "lifecycle" reaction that debit cards face.[38] OpenTable, an intermediary that delivers customers to merchants, is an internet site that allows users to search for and make reservations at restaurants in cities throughout the world (and it offers a Dining Reward Program and an Affiliate Revenue Sharing Program for restaurants that link their own website to OpenTable's website).[39] Established in 1998, OpenTable currently has more than twenty thousand restaurant customers and has seated more than 200 million diners around the world.[40] The company had its initial public offering in May 2009, and now operates throughout the United States, Canada, Germany, Japan, Mexico and the United Kingdom.[41]

OpenTable acknowledges that, like debit cards and other intermediaries, it is a two-sided platform, with the ability to attract merchants dependent on the ability to attract diners.[42] To consumers, OpenTable "provides a fast, efficient way to find available tables that meet desired criteria for cuisine, price and location at a specified time." For "reservation-taking restaurants, OpenTable helps fill seats through the company's online booking service" and can help reduce

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unilaterally elected to lower their energy costs by making customers uncomfortable. *See,* "Energy Timeline from 1971 to 1980," U.S. Department of Energy. Available at www.energy.gov/about/timeline 1971-1980.htm.

[38] "About OpenTable." Available at www.opentable.com/info/aboutus.aspx.

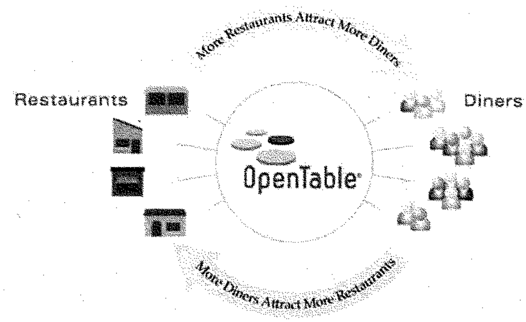
[39] *See,* "Frequent Dining Has Its Rewards," OpenTable. Available at www.opentable.com/popups/rewardsbrief.aspx?ltms=1260485927018&ltzo=360 (accessed December 12, 2009). *See also,* www.opentable.com/info/affiliates.aspx.

[40] "About OpenTable." Available at www.opentable.com/info/aboutus.aspx.

[41] "Investor Relations" and "Investor FAQs." Available at investors.opentable.com/index.cfm.

[42] "Our strategy is simple: We grow the OpenTable network by adding restaurants and attracting more diners. The more restaurant selection we offer to diners, the more diners use the system. The more diners use the system, the more value we offer to restaurants." *See,* "OpenTable Corporate Presentation." Available at files.shareholder.com/downloads/ABEA-2TKK09/1013420981x0x393323/874d4f1c-9789-470e-8291-ddd314f29ecb/OpenTable%20Corporate%20Presentation%20August%202010%20FINAL.pdf.

costs by "replac[ing] pen- and-paper at the host stand" and "streamlin[ing] the reservation- and table-management process…"[43]



Source: OpenTable Corporate Presentation, p. 6.[44]

Diners pay nothing to use OpenTable. In exchange for a per-diner fee, restaurants that belong to OpenTable outsource part of their reservation handling and potentially obtain additional diners. Participating restaurants pay a fee for every diner who reserves through OpenTable, and not just for customers delivered by OpenTable who would not otherwise have dined at the restaurant. In 2009, OpenTable charged merchant fees of about $1.60 per seated diner, or 3.2 percent of the price of a $50 meal.[45]

By using OpenTable, consumers benefit from reduced costs of search and ease of making a reservation, while restaurants pay an intermediary to recruit and deliver diners in an effort to gain incremental business and to lower their costs to process reservations. Diners do not pay fees for a reservation, although clearly they benefit from OpenTable's convenience, including its ability to identify restaurants available at a particular time and to quickly book a table ("[t]he

[43] "Investor Relations." Available at investors.opentable.com/index.cfm.
[44] "OpenTable Corporate Presentation." Available at files.shareholder.com/downloads/ABEA-2TKK09/1013420981x0x393323/874d4f1c-9789-470e-8291-ddd314f29ecb/OpenTable%20Corporate%20Presentation%20August%202010%20FINAL.pdf.
[45] The average of $1.60 per diner is calculated by dividing OpenTable's 2009 Revenues ($68.6 million) by the number of seated diners (42.7 million). *See*, OpenTable 2009 Annual Report at p. 31. OpenTable reported a $50 average ticket size in an article in May 2010. *See also*, Schonfeld, Erick, "OpenTable's $150 Million Mobile App (And Q1 Earnings)," TechCrunch, May 4, 2010. Available at techcrunch.com/2010/05/04/opentables-150-million-mobile/.

convenience of seeing great restaurant choices in one place, with table availability organized by time, is palpable").[46] Diners sometimes receive rewards for using OpenTable financed from the fees that restaurants pay, including earning points "redeemable for OpenTable Dining Cheques which can be used at any OpenTable restaurant."[47]

When OpenTable was introduced, its adoption clearly was voluntary – a restaurant would choose to join the program if it viewed the reduction in the cost of taking reservations and the additional customers delivered as worth the expense (including the initial enrollment fee and the ongoing monthly cost, as well as the per-diner fee). OpenTable has been tremendously successful, and many restaurants (estimated at one third of U.S. restaurants that accept reservations[48]) found the fee worth paying.

However, the same phenomenon that occurred as debit's adoption became ubiquitous now is occurring with OpenTable – restaurants feel that they are forced to continue to purchase the service because they will suffer if they do not, given that their competitors offer the convenience to their customers. According to a headline in the New York Times, OpenTable provides the "Online Reservations that Restaurants Love to Hate," and the article notes that "[w]hat perhaps most rankles restaurateurs is the reservation fee: $1 per patron," a fee unchanged since restaurants voluntarily elected to sign up for the program.[49]

In the language of debit's critics, the OpenTable system is "broken"[50] – merchants are forced to pay an average of $1.60 for each diner that books through OpenTable,[51] and they prefer to pay less and have the diner book directly. However, the absurdity of expecting Congress to intervene is obvious. Although the ubiquity and popularity of OpenTable may mean that restaurants as a whole now would be better off if regulatory intervention prevented them from "competing" by signing up for the service, competition and consumers would be harmed. The reason why individual restaurants continue to pay $1.60 for OpenTable customers is the essence

[46] Stross, Randall, "The Online Reservations that Restaurants Love to Hate," New York Times, December 12, 2010.
[47] "Frequent Dining Has Its Rewards!" Available at www.Opentable.com/info/diningrewards.aspx.
[48] Stross, Randall, "The Online Reservations that Restaurants Love to Hate," New York Times, December 12, 2010.
[49] Stross, Randall, "The Online Reservations that Restaurants Love to Hate," New York Times, December 12, 2010.
[50] MPC Letter to Senator Crapo.
[51] As described above, this calculation is based on OpenTable's total revenues and therefore includes the setup, monthly and per-diner fees outlined elsewhere.

of competition, even though OpenTable's "authorization, clearance and settlement" ("ACS") costs (the costs that the FRB concluded determine the proposed regulated interchange rate) likely are substantially lower and OpenTable does not have market power in any meaningful sense.

The history of OpenTable illustrates the economic flaws in the logic of the Durbin Amendment and the danger of the FRB's proposal for dramatically reducing debit interchange rates and shifting the banks' costs of operating the debit programs to cardholders and other bank customers. First, there is no evidence that the competitive outcome in a debit network is to impose fees on consumers rather than merchants. OpenTable decided to impose the cost of operating the platform on merchants rather than consumers, just as debit networks did. Given that this model – where the merchants that benefit from the payment and/or transactions method incur the costs to finance the program – is selected in a competitive marketplace, there is no logic to merchants' claims that the debit system is "broken" because the debit network imposes a fee on the merchants that benefit. That is how these networks work.

Second, there is no relationship in a competitive two-sided market between the fee charged to a merchant and the marginal per-transaction cost of processing a transaction. From its inception, OpenTable's pricing involved a one-time $600-700 setup fee, a monthly fee of $199 plus add-ons (currently averaging $270 per month), and a per-diner fee of $1.[52] Thus, the FRB's proposal to force down the debit interchange fee to a level that covers only a small fraction of issuers' true incremental cost is inconsistent with how competitive markets operate. It creates, rather than repairs, a market distortion and failure.

Third, merchants are not adept at recognizing the value they receive from a service once they are accustomed to the benefits. Restaurants were quick to sign up for OpenTable, which after only 12 years now services about one third of U.S. restaurants that take reservations.[53] Each restaurant recognized the benefit of joining the program – the convenience and incremental

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[52] Although OpenTable's original fees were slightly different, its fee structure has remained largely the same (an article from 1999 lists charges of between $500 and $1000 for setup plus a $100 to $200 per month fee as well as the $1 per reservation fee). *See,* "OpenTable Corporate Presentation," p. 12. Available at files.shareholder.com/downloads/ABEA-2TKK09/1013420981x0x393323/874d4f1c-9789-470e-8291-ddd314f29ecb/OpenTable%20Corporate%20Presentation%20August%202010%20FINAL.pdf and Copage, Eric V., "Tables Are Waiting On the Internet" *The New York Times*, November 24, 1999.
[53] Stross, Randall, "The Online Reservations that Restaurants Love to Hate," New York Times, December 12, 2010.

sales, and the improvement in its competitive position. Once accustomed to those benefits, some restaurants began to question whether they receive sufficient value, and wished that they were not "forced" to continue to participate. However, it was not OpenTable that "forced" them to participate; it was competition – the same motivation that "forces" restaurants to charge lower prices than they otherwise would want and to provide other costly services to their customers.

A recent article quoted the view that restaurants "retained [OpenTable] because they feared that customers would revolt and stop coming to their establishments" if they dropped it,[54] presumably the same reason that those restaurants offer clean table cloths, well-trained servers, high quality food, etc. This illustrates the pressure that competition places on merchants – forcing them to incur marketing and other costs to remain competitive. It is misguided to interpret these kinds of complaints (such as the representation by Senator Durbin that it is in the interest of economic efficiency to use regulation to lower the interchange fees that Walgreens' pays) as evidence that there is a need for intervention in the operation of a tremendously successful service.

F. Merchants Voluntarily Pay to Participate in Customer Acquisition Networks Because They Receive Value in Return, Just as They do from Accepting Debit

"Group buying" programs – such as Groupon, LivingSocial, Dealster, and YouSwoop – are examples of competitive two-sided markets where merchants pay fees to participate in a network that delivers customers (who pay no explicit fee).[55] These sites typically charge merchants a per-transaction fee calculated as a portion (10-50 percent) of the coupon value. The sites generally operate by working with the merchant to develop a significantly discounted offering (say, $20 worth of goods for $10), which the site offers to its network of customers.

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[54] "Is OpenTable Bad for Restaurants," *Inc.* November 18, 2010.

[55] The competitive nature of the daily deal services is readily apparent. The technology is simple and the startup costs are low. In March 2010, Groupon's CEO estimated that there are between 100 and 150 "Groupon clones" around the world. (*See,* Coburn, Lawrence, "Groupon CEO Andrew Mason Talks Growth, Clones, and why Groupon isn't a Coupon Site," The Next Web, March 24, 2010. Available at thenextweb.com/location/2010/03/24/groupon-ceo-andrew-mason-talks-growth-clones-groupon-coupon-site/). If competition favored a different way of financing such services, such as by imposing fees on consumers and none on merchants, then another business model would have succeeded. The efficiency of the pricing model adopted by Groupon (charging fees to merchants and none to consumers) is confirmed both by Groupon's own success as well as by the fact that the same fee structure has been adopted by the large number of firms that have challenged Groupon. *See e.g.,* Overly, Steven, "LivingSocial deals draw mixed merchant reactions," The Washington Post, December 6, 2010.

When a customer purchases the offer or "coupon," the site retains a portion of the price paid by the customer (say, 50 percent), and delivers the remainder (say, 50 percent) to the merchant.

One of the best-known and most successful group-buying sites is Groupon, which initially was established in Chicago and Boston in 2008 and by March 2010 had expanded to 50 cities and three million subscribers. Today, Groupon covers more than 300 markets in 35 countries, and has over 27 million subscribers.[56] Groupon's highly successful business model – adopted when it was established and still used today – is to impose all fees on merchants, and none on consumers. In this way, Groupon balances demand from the two sides of the platform in a way that expands the size and value of the network.

Groupon retains approximately 30-50 percent of the revenue from the "Groupons" it sells, remitting the rest to merchant partners.[57] Combined with the fact that Groupons typically sell at a discount from the retail price, this means that the net amount earned by the merchant can be substantially less than the full retail price.

Many merchants have chosen to join Groupon and other "group-buying" programs, despite what might seem to be a substantial cost for the service.[58] Groupon not only imposes no fees on consumers, but it even provides "referral rewards" if a customer refers someone to Groupon who makes a purchase within 72 hours of when he or she clicks on the referral link (a type of incentive to expand the consumer side of the platform similar to payment card rewards).[59]

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[56] www.groupon.com/about; Coburn, Lawrence, "Groupon CEO Andrew Mason Talks Growth, Clones, and why Groupon isn't a Coupon Site," The Next Web, March 24, 2010. Available at thenextweb.com/location/2010/03/24/groupon-ceo-andrew-mason-talks-growth-clones-groupon-coupon-site/; www.grouponworks.com/.

[57] *See,* "Game on with Groupon" December 3, 2009, available: smokejumperstrategy.com/archive/game-on-with-groupon/; Coburn, Lawrence, "Groupon CEO Andrew Mason Talks Growth, Clones, and why Groupon isn't a Coupon Site," The Next Web, March 24, 2010. Available at thenextweb.com/location/2010/03/24/groupon-ceo-andrew-mason-talks-growth-clones-groupon-coupon-site/.

[58] Merchants receive many benefits from participating in Groupon, including targeted email advertising sent to the Groupon subscriber base that provides valuable exposure to the local customer base even if no customers purchase the deal. Once consumers purchase the deal, merchants also gain from any incremental spend over the face value of the Groupon and from repeat business generated by the new customers. Groupon also claims that it provides a type of city guide to the consumers. *See,* Coburn, Lawrence, "Groupon CEO Andrew Mason Talks Growth, Clones, and why Groupon isn't a Coupon Site," The Next Web, March 24, 2010. Available at thenextweb.com/location/2010/03/24/groupon-ceo-andrew-mason-talks-growth-clones-groupon-coupon-site/.

[59] Other sites, such as LivingSocial.com provide similar consumer side expansion incentives. A consumer who refers three purchasers of the deal receives his deal for free. *See,* livingsocial.com/deals/how_it_works; and www.groupon.com/faq.

Groupon's fee structure (charging merchants but not consumers), which is the same as observed for debit networks, reflects the value that merchants obtain from freely joining the system (Groupon claims to have over 100 merchants in a queue waiting to become the daily deal[60]). Thus, the competitive industry of group buying programs has adopted the same pricing model as we observe for debit card networks. The incentive to support the network through fees on merchants, not consumers, is not evidence of market failure or absence of competition, but rather the competitive outcome in many two-sided markets.

III. PRICE CONTROLS, LIKE THOSE PROPOSED BY THE FRB, ARE AN INEFFICIENT AND HARMFUL WAY TO CONTROL DEBIT INTERCHANGE RATES, EVEN IF (CONTRARY TO THE EVIDENCE) THE DEBIT INTERCHANGE SYSTEM WAS FLAWED

A. The Economic Framework

Contrary to critics' claims that debit cards are just electronic checks,[61] debit cards represent a payment method innovation with substantial advantages to merchants and consumers over alternatives such as checks and cash. The rapid worldwide growth in debit demonstrates debit's advantages relative to paper-based payment methods. According to one study, "[t]he increase in debit card transactions [in 13 countries studied] suggests that the net benefits of using debit cards have increased vis-à-vis other payment instruments for consumers and merchants..."[62]

In an unregulated market, when a new product presents advantages over the current method, those advantages ensure growth and the displacement of less efficient alternatives. This occurs when firms have incentives to supply those efficient products to the market and consumers face incentives to shift their purchases to those new products. The efficiency gain from a new product provides the incentive to do so; to the extent that the new product costs less

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[60] Coburn, Lawrence, "Groupon CEO Andrew Mason Talks Growth, Clones, and why Groupon isn't a Coupon Site," The Next Web, March 24, 2010. Available at thenextweb.com/location/2010/03/24/groupon-ceo-andrew-mason-talks-growth-clones-groupon-coupon-site/.

[61] For example, the Merchants Payments Coalition ("MPC") claims that "[d]ebit cards are simply electronic versions of checks and were introduced to save the banks money on processing paper check transactions." *See,* MPC Letter to Senator Crapo.

[62] The authors found that, between 1988 and 2003, "debit card usage grew rapidly" and "check usage continues to decrease in most countries and has disappeared in many countries" studied. *See,* Amromin and Chakravorti, pp. 4-5.

to produce than the old one, suppliers have an incentive to shift to producing the new product; to the extent that the new product is more valuable to customers, customers have an incentive to buy it instead of the older products. Prices provide the mechanism by which both sides are induced to switch to the superior technology. By equating market supply and demand, competitive pricing tends to maximize market output and efficiency by splitting the gains between the parties efficiently.[63]

This mechanism is impaired when prices are controlled by regulators, rather than the market. The FRB views its mandate under the Durbin Amendment to be to impose price controls on debit interchange fees, and it has set for public comment rate levels that would reduce interchange revenues for issuers by about 80 percent.[64] Economic analysis of price controls has been done mostly in the context of "one-sided" markets, but the same basic principles extend to understanding the impact of price controls in two-sided markets such as debit systems. The economic evidence is clear – *price controls create inefficiencies that harm consumers.*

When prices are controlled, the price signals needed to achieve efficiency are absent. If the benefits on the consumer side are reduced, consumers have less incentive to switch to new and better products, which limits growth of the more efficient alternative. Similarly, if surplus on the producer side is reduced, suppliers have less incentive to switch, which also limits growth of the more efficient alternative. Output is limited by the minimum of supply and demand (*i.e.*, consumers cannot purchase more than suppliers supply and suppliers cannot sell more than consumers demand). This same logic extends to two-sided markets, where the roles of suppliers and demanders are played by the two sides of the market (in this case merchants on one side and issuers/cardholders on the other).

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[63] Prices above the competitive level would give consumers enhanced incentives to switch, but would reduce the amount suppliers would be willing to supply and thus would reduce overall output. Similarly, prices below the competitive level would enhance the incentives of suppliers to switch, but would limit output by reducing the incentives of buyers to do so.

[64] The FRB Proposal states that rates shall be no more than seven cents per transaction or a cost-based rate up to twelve cents. TCF's average debit interchange rate was 47 cents per transaction; therefore, the midpoint of the seven and twelve cent caps (9.5 cents) would imply an 80 percent reduction in TCF's interchange rate (= (47-9.5)/47). *See,* FRB Proposal, p. 81755 and Exhibit A to the Declaration of Anne Layne-Farrar in the matter of TCF National Bank v. Bernake et. al., ¶4.

The United States has considerable experience with the harmful effects of price controls that limit price below the level that covers the relevant measure of economic cost. Examples include retail and wholesale price controls on gasoline,[65] rent controls[66] and limits on payments to providers under Medicaid.[67] Economic literature shows that the adverse impact of below-cost price caps manifests in two ways: lower output and reduced quality of products and services.

The demand for price controls typically originates with buyers, who focus on how they will benefit from forced reductions in "price," as if this can be accomplished without affecting supply. Not surprisingly, buyers prefer to pay less for a given volume and quality of purchases. However, in both perfectly competitive and imperfectly competitive markets, price and supply cannot be separated in this way. A forced reduction in price increases demand, while it lowers incentives for suppliers to satisfy demand.

For this reason, price controls can harm even the parties they were intended to help. The impact on buyers may be uneven, as they historically are with rent controls. Those lucky enough to have a rent-controlled apartment may benefit in the short term, while those who are trying to rent an apartment and are willing to pay the "market" price find no supply available. The market may "clear" at the controlled price, but a lower quality product or service generally develops, so that suppliers can satisfy demand for the lower-cost, lower-quality product that they can supply profitably at that price.

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[65] *See e.g.*, Hans H. Helbling and James E. Turley, "Oil Price Controls: A Counterproductive Effort," Federal Reserve Bank of St. Louis (1975), p. 3 ("domestic producers are discouraged from producing [] oil, insofar as the implicit rate of return of keeping oil in the ground exceeds that of investing the proceeds from the current sale of oil at $5.25 per barrel [the maximum price]").

[66] *See e.g.*, Edward L. Glaeser and Erzo F. P. Luttmer, "The Misallocation of Housing under Rent Control," 93 *The American Economic Review* (2003), pp. 1027-1046 ("in many cases products under price controls will be allocated somewhat (or completely) randomly to everyone who wants them. Furthermore, binding price controls attract new renters who would not be interested in renting at market prices. As such, rent control means that some renters, who would greatly value an apartment, are shut out while others, who never would have rented an apartment under free-market rates, obtain rental apartments").

[67] *See e.g.*, David C. Grabowski, "A Longitudinal Study of Medicaid Payment, Private-Pay Price and Nursing Home Quality," 4 *International Journal of Health Care Finance and Economics* (2004), pp. 5-26, p. 23 ("the estimated Medicaid payment-quality elasticities were fairly sizeable for the health care sector and indicate that the Medicaid rate may indeed be an important policy instrument towards addressing the quality of nursing home care"); Mark Duggan and Fiona M. Scott Morton, "The Distortionary Effects of Government Procurement: Evidence from Medicaid Prescription Drug Purchasing," 121 *The Quarterly Journal of Economics* (2006), pp. 1-30, p. 4 ("our results strongly suggest that Medicaid coverage of prescription drugs has increased the price paid by other health care consumers for these same treatments").

The same economic principles apply, but with additional complexity, in the case of two-sided markets such as debit. In two-sided markets, producers set two "prices," one for each side of the market, although the relevant price when analyzing competitive effects is the combined or "total price" of a transaction. In such markets, a regulated "price" to one side of the market (here, the interchange fee charged to acquirers, which thereby affects the merchant discount fee charged by acquirers to merchants) has an impact on pricing to the other side of the market (the cost to cardholders to obtain and use a debit card). If lowering the "price" to acquirers results in higher prices to cardholders for using debit, then debit becomes less attractive and will be used less by consumers.[68]

Consumers of course are harmed directly by the higher "prices" they face, but merchants and overall efficiency can be harmed as well if consumers shift to other payment mechanisms that are less efficient from the point of view of the merchant or less efficient generally. Because debit provides benefits to merchants compared with alternative payment methods, reduced usage of debit will harm merchants and overall economic efficiency.

The growing provision of rewards, which have been common for credit cards for many years, to debit cardholders suggests how interchange rate regulation that limits interchange to a level that compensates issuers for only a portion of the cost of processing an additional transaction would result in less attractive debit products offered to cardholders. The revenue earned through interchange provides issuers with the incentive to induce consumers to use debit rather than alternative payment mechanisms such as checks. Debit rewards provide a mechanism for issuers to do so in addition to the incentives provided by reduced cardholder fees. Limiting the interchange fee will mean that issuers' costs to provide benefits to cardholders and merchants will be financed in other ways, in particular, through increased prices charged to cardholders for use of debit cards (by imposing explicit fees and/or reducing rewards and other benefits and by reducing service quality).[69] Although increasing the direct costs to cardholders for using debit

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[68] When I discuss the potential for regulation to reduce debit use if the Board fails to consider how interchange rates motivate cardholder adoption and use of debit, I am not claiming that debit use will necessarily decline absolutely, but rather that growth in debit use will slow relative to growth if interchange rates were unregulated or a higher proportionality factor were selected.

[69] Some issuers will be more successful than others in raising other fees to compensate for lost revenue. In particular, banks that complete largely with small local banks that qualify for the $10 billion exemption may be

might not seem to be harmful from the perspective of an individual merchant, slowing or reversing the movement by consumers toward use of debit could harm merchants by causing consumers to shift to payment methods that are more costly for merchants.

B. Cardholders Respond to Debit Fees and Rewards

The quantitative impact of price controls depends on the elasticity of response on the constrained side of the market (the elasticity of supply in the case of a price ceiling). In order to understand the likely impact of the FRB's Proposal, it is necessary to evaluate the response of issuers and cardholders to the lower revenues received (issuers) and higher fees paid (cardholders).

Given the benefits of debit compared with checks, it is helpful to understand how debit has been "priced" to consumers. Debit cards are linked to a cardholder's Demand Deposit Account ("DDA"). In general, debit cards are provided to cardholders without an incremental annual fee or any explicit cost of use, even though issuers incur costs to attract and service users of debit cards. Under the FRB's Proposal, interchange rates would be limited to a level that does not compensate issuers for any of their activities to recruit cardholders and encourage debit use (the level of fees does not even cover the narrow costs associated with an individual transaction).[70]

Consequently, issuers either will reduce those efforts, and thereby cause a reduction in debit use, or increase fees to consumers, to the extent possible, in order to finance those efforts, and thereby also reduce the usage of debit by reducing its attractiveness to consumers. As a matter of economic theory, this impact will be larger (a) the greater the elasticity of cardholder

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constrained from raising other fees to consumers. This constraint does not change the fact that the Amendment and reduction in debit interchange will generate substantial harm and reduce the use of debit to the detriment of consumers and overall efficiency.

[70] The FRB staff noted, "We also looked at whether we should have a more expansive definition of allowable costs that would go beyond authorization, clearing and settlement, and look at other costs that are specific to a transaction. Those are costs that the act is silent on on (sic) whether we can take into consideration or not. So things like the costs associated with rewards programs or if issuing banks – you know, the costs that they incur to handle card holder inquiries about particular transactions. But again, those are costs that if they were to have been incurred in the check context, the bank would not be able to get reimbursement of those costs from the payee's bank, so because of that we did not put them into the bucket of costs that would be considered in determining what the maximum interchange fee initially would be allowed to have. So that's really how we took that comparison with check into consideration." *See,* Transcript of Fed Governors-Staff Colloquy, p. 12.

demand for debit and (b) the greater the pass-through of interchange to cardholders through rewards and other benefits.

Empirical literature on the responsiveness of consumers' use of debit to the cost of use of such cards is limited, but one study found:

> ...a substantial price response for debit card use. Consumers respond strongly to fees charged for so-called PIN (personal identification number) debit transactions by using a signature rather than a PIN to secure transactions; however, the fee also reduces the likelihood that the consumer uses a debit card at all. On average, a 1.8% fee on a debit card transaction (nearly all of which are charged only on PIN transactions) is associated with a 12% decline in the likelihood of use. We believe this to be a conservative estimate of the response to payment price at the point of sale.[71]

Another study, using the same dataset, found that, in a hypothetical situation where a merchant decides not to accept debit, consumers select paper-based payment methods instead. The authors conclude that:

> ...dropping debit or checks shows little gain or a slight loss. These merchant incentives do not appear socially optimal, since dropping credit or debit card payments causes market share to shift away from electronic payments and toward paper-based payments, which may be more costly to society.[72]

Analysis has found that consumer choice between debit and alternative payment mechanisms of checks and credit cards is affected by the "price" (benefits) to consumers of the alternatives. A recent study found that the probability of using debit likely would decline if debit rewards were eliminated. The study evaluated the impact for two different sets of such consumers: "consumers who receive rewards on debit cards only [and] consumers who receive rewards on both credit and debit cards."[73] It found that "[a]t all types of stores except fast food, both groups of consumers would reduce their probability of choosing debit cards if rewards on debit cards were removed... [with reductions ranging from] 2.1 to 6 percentage points for consumers with DC [debit card] rewards only, and from 3.4 to 7.5 percentage points for

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[71] Borzekowski et al., p. 151.
[72] Ron Borzekowski and Elizabeth K. Kiser, "The choice at the checkout: Quantifying demand across payment instruments," *International Journal of Industrial Organization* 26 (2008) 889-902, p. 891.
[73] Andrew T. Ching and Fumiko Hayashi, "Payment card rewards programs and consumer payment choice," 34 *Journal of Banking & Finance* 34 (2010), 1773-1787 ("Ching and Hayashi"), p. 1783.

consumers with CC&DC [credit card and debit card] rewards" (or by about 10 percent on average, given the initial probability of using debit).[74]

C. The Level of Interchange Provides Incentives for Consumers and Merchants to Use Debit

The value of the payment guarantee from banks to merchants when debit cards are used provides a good example of the general importance of the functional differences between payment by debit and check. Assume (counterfactually) that this payment guarantee is the only difference between debit and checks. For most transactions, the payment guarantee is included as part of the debit transaction, while merchants must pay separately for that service for checks. If it costs issuers less to provide a payment guarantee as part of the debit transaction than it costs merchants to purchase a payment guarantee themselves, then all else equal (as I have assumed here) there will be an efficiency gain from shifting from checks to debit.

However, the transaction will shift to debit only if the issuer and cardholder jointly find it cheaper for themselves, ignoring the benefits to the merchant. If the merchant expects to save 50 basis points ("bps") on the transaction from the shift to debit (due to the provision of payment guarantee) but the net cost to the issuer (who absorbs some of the cost of the payment guarantee) and cardholder is 30 bps, then the transaction will be done by check even though there is a net 20 bps gain from shifting to debit. If the interchange fee is set so that the price of debit reflects the 50 bps value to the merchant, then the transaction will shift to debit if the costs to the issuer and consumer are less than 50 bps or, equivalently, when overall costs are reduced by shifting the transaction to debit.

This example illustrates why forcing debit users to pay for the benefits debit provides to merchants (as the FRB's proposed rules would do) would reduce efficiency and harm consumers and could harm merchants in the end. When consumers bear the cost but merchants receive the benefits, consumers will shift their payment choices to alternative payment methods such as cash, checks and credit. This hurts consumers directly, because they must pay more to use debit or switch to less desirable alternatives. Merchants will be harmed as well to the extent that

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[74] Ching and Hayashi, p. 1784.

consumers switch to payment methods that are more costly for merchants, such as checks or credit cards.

In contrast, when the fees charged to merchants more correctly reflect the value that they receive, the value to the merchant is reflected (through interchange) in the price paid by consumers and consumer payment choice will correctly reflect that value.

IV. EVEN IF DEBIT INTERCHANGE RATES HAD BEEN INCREASING, THERE IS NO NEED FOR THE "KIND OF REGULATORY INTERVENTION IN WHICH A REGULATOR HAS TO INTERVENE IN A MARKET [TO] BETTER ALIGN PRICING WITH COSTS."[75]

In the discussion leading up to its unanimous vote to issue the Proposal for public comment, one of the FRB's Governors commented that "I think what we've heard in other comments around the table is this kind of regulatory intervention in which a regulator has to intervene in a market with [sic] better align pricing with costs, is unusual. In my mind the directive for this kind of intervention results from a market that is working less than competitively."[76] However, there is no evidence that the "market" for debit cards is not competitive.

A proper understanding of the economics of interchange fee determination in a competitive market shows that we observe exactly what is expected from competition – that the network sets interchange rates to balance the two sides of the platform. Competition also implies that reductions in network costs will lower the overall price of debit (to cardholders and merchants combined) but can lead to higher, rather than lower, interchange rates. However, even when interchange rates increase, the corresponding reduction in the costs to cardholders expands the use of debit by more than if interchange rates were forced down or prevented from rising. The increase in the interchange rate is the mechanism by which a competitive market induces consumers and merchants to expand the use of debit, enabling the market to take maximum advantage of the reduction in cost.

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[75] Transcript of Fed Governors-Staff Colloquy, p. 14.
[76] *See,* Governor Raskin's comments (Transcript of Fed Governors-Staff Colloquy, p. 14).

A. Balancing in a Two-Sided Market

In a two-sided market, such as debit cards, competition determines the full price of providing network services – the total price charged to participants on both sides of the platform (merchants and cardholders). Competition between payment card networks, and between payment cards and other payment methods, encourages efficiency, which can drive down the *total* costs to operate the network. But the network's choice whether to charge those costs to merchants or cardholders depends on how alternative ways of dividing the cost of financing the system between the two sides of the market affect total demand for the network. As the U.S. Government Accountability Office ("GAO") noted in its recent report on credit cards:

> ...card networks use interchange fees as a way to balance demand from both consumers (who want to use cards to pay for goods) and merchants (who accept cards as payment for goods). As with newspapers, the costs to both sides of the card market are not borne equally. To attract a sufficient number of consumers to use their cards, card networks compete to attract financial institutions to issue them, and institutions in turn compete to find additional cardholders. Just as readers have a variety of sources from which they can receive their news, consumers also have a number of different methods (such as cash, check, or credit card) by which they can pay for a good or service. Because of the choices consumers have available, card networks and issuers want to minimize the costs for consumers to carry their cards to encourage greater acceptance and use. In contrast, merchants have less choice about card costs, particularly once a large number of consumers are using a particular network's cards. Whereas a consumer may not pay any fee or charge for using a card, card networks charge merchants for accepting cards through interchange and other network fees. Consumers' payment choices, such as using rewards cards with higher interchange fees, also affect merchants' costs for card acceptance. As a result, some academic researchers have argued that card networks can keep attracting cardholders by offering them increasingly attractive terms while increasing costs to merchants, whose ability to refuse to accept cards is more limited.[77]

The network's ability to expand use of a payment system by charging more to the side of the platform that has the least elastic demand (*i.e.*, the side that can pay for financing the service with the least impact on network output) is a sign of efficiency, and does not reflect lack of competition.

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[77] "Credit Cards – Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges," United States Government Accountability Office Report to Congressional Addressees, November 2009, p. 19.

The balancing by payment card networks in setting interchange fees was explained recently in a submission by a delegation of the United States to the OECD Competition Committee (found on the Federal Trade Commission website). The report noted that:

> A feature of many two-sided markets is a highly skewed pricing structure. That is, one group of customers pays a high price to use the platform, while the other group pays a very low or even negative price...In credit card systems, the transactional services (those services associated with the physical process of making a payment, as distinct from the supply of credit) are sometimes provided to cardholders for free. For credit cards that carry reward programs, the cost of the transactional services is subsidized by the rewards so that the effective price to a cardholder for using the card is negative. Merchants, on the other side of the market, however, often pay substantial fees for credit card transactions.[78]

The Submission explained that, "[i]n a two-sided market...a highly skewed pricing structure may be efficient...A basic feature of payment networks is that it may be efficient for price to be below marginal cost on one side of the market...and above marginal cost on the other side of the market."[79]

The services provided by payment cards to merchants and cardholders have the key characteristic of joint products – one cannot be provided without the other. The cardholder and merchant services provided by payment cards are created and consumed in strict proportion, because there is a single transaction with two participants – a cardholder that uses the network to remit payment and a merchant that uses it to receive payment.[80] The price of the product, in this case a transaction, is the total amount paid by both the merchant and cardholder for a transaction to take place.[81]

The competitive process does not require that fees collected from *one* side of the platform must equal or exceed the costs "incurred" on that side, but only that the *sum* of the fees collected

[78] Delegation of the United States to the Competition Committee, "Roundtable on Two-Sided Markets," Organisation for Economic Co-Operation and Development, DAF/COMP/WD (2009)68, June 4, 2009 ("Roundtable on Two-Sided Markets"), ¶ 5.
[79] Roundtable on Two-Sided Markets, ¶¶ 6, 8.
[80] The classic example of a two-sided market characterized by fixed proportions is a dating service. Each match involves a pair consisting of one man and one woman, even though there may be different numbers of women and men participating in the services (just as there may be different numbers of cardholders and merchants in a payment system).
[81] Roundtable on Two-Sided Markets, ¶¶ 5-8.

from customers on both sides of the platform is greater than or equal to the sum of costs incurred.[82] A profit-maximizing network sets a combination of merchant and cardholder fees that maximizes network profits, taking into account the effect of fees on each side's willingness to participate in and utilize the platform as well as the effect of each side's participation and use on the willingness of the other side to participate and use the platform.

The pricing incentives facing payment card systems are not unique, but apply to any two-sided platform.[83] Adobe, a seller of proprietary software that both writes (Adobe Acrobat) and reads (Adobe Reader) documents that can be displayed on a computer screen, is one well-known example. The Adobe platform is two-sided – the number of users who wish to write documents with Adobe Acrobat depends on the number of users who can read documents with Adobe Reader, and the demand for Adobe Reader depends on how many documents are written with Adobe Acrobat. Fees collected from users on both "sides" of the Adobe platform must cover the cost of producing and distributing the two software components, but the fee charged to users of Adobe Reader need bear no relation to the costs of producing and distributing that component.

In fact, Adobe's successful pricing strategy is to distribute Reader free, while charging a fee for Acrobat. If users of Reader are more price sensitive than users of Acrobat, then balancing fees away from Reader and toward Acrobat raises the value of the platform by increasing the distribution and use of the Adobe technology. Adobe chooses not to obtain revenue from sales of Reader, so it must have concluded that a positive fee for Reader would lower Acrobat sales. In the case of Adobe, the total cost of producing and maintaining both products (Adobe Acrobat and Adobe Reader) is paid for by the buyers of Acrobat who benefit from the ability to distribute content to users of Acrobat Reader.

Newspapers are another two-sided platform, generating revenues from two sets of customers – advertisers and readers. Newspapers produce content and print advertising that is

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[82] To the extent that transactions are also joint products (*i.e.*, that cardholders choose cards expecting to make multiple transactions), the fees collected do not need to balance costs on a transaction level either.
[83] For a network with fixed proportions, per-unit fees on both sides of the market, and costs and revenues that are related only to network volume and the sum of the fees, the network will seek the combination of fees that maximizes network volume and thus generates the greatest profit given any total level of fees. When fees charged and costs incurred are not simply proportional to output, a network will not necessarily maximize volume since fees collected and costs might vary with other variables, such as the number of merchants or the number of cardholders.

attractive to readers, while advertisers value the platform based on the number of readers. Even though newspapers are highly competitive, advertising fees are not set simply to cover the incremental cost of printing ads, and readers typically do not pay the full incremental cost of creating and distributing the newspaper.[84] Instead, advertising fees cover much of the cost of *both* content and distribution, while readers get the newspaper at little or no cost. If readers are sensitive to the price they pay for the newspaper, while advertisers are less sensitive to the price they pay for newspaper advertising, it is efficient to "balance" pricing by making advertisers pay for both the cost of printing their ads as well as for the service the newspaper provides in recruiting and delivering readers who will see the ads and buy their products and services. If, instead, advertiser fees covered only the cost of printing advertisements, and the price of newspapers was increased to cover the full incremental cost of distribution, there would be fewer readers, and advertisers and readers collectively would be worse off.

More recent examples of two-sided platforms are OpenTable and Groupon. As described above, OpenTable, an online restaurant reservation system, attracts restaurants based on its ability to attract diners. Restaurants that join OpenTable pay a setup and monthly fee, as well as a per-diner fee averaging about $1.60 per seated diner in 2009, or 3.2 percent of the price of a $50 meal.[85] Diners are not charged. OpenTable balances the need to attract both merchants and diners by imposing the cost of operating the platform on merchants, whose demand is relatively inelastic, rather than consumers. "Group buying" programs like Groupon are another example of competitive two-sided markets where merchants pay fees to participate in a network that delivers customers (who pay no explicit fee).

I previously explained the economics of pricing in two-sided markets in a co-authored paper:

> In general, firms selling goods or services in two-sided markets to two different groups of consumers will tend to charge a lower price relative to marginal cost to the group that is more price sensitive (i.e., has a higher elasticity of demand) and generates greater marginal network effects (i.e., where increased quantity has a larger effect on the value of goods or services supplied on the other side of the market). If a supplier wishes to

[84] The same is true of over-the-air broadcast television, where consumers pay nothing and the cost of running the network and acquiring or purchasing content is covered by advertising fees.
[85] *See,* footnote 44, above.

increase price, it will be more profitable to do so on the side of the market where the demand response and network effects are likely to be lower.[86]

B. It is Not "Perverse" for Interchange Rates to Increase when the Cost of Operating the Network Declines

An increase in debit interchange rates over time is not a "perverse" effect of competition to attract issuers and cardholders. It is neither unusual nor "perverse" for the "price" charged to one side of the platform (*e.g.*, merchants) to increase, even though the full price of operating the network declines. This can occur particularly when creating value on one side of the market (*e.g.*, cardholders) generates value for the other side (*e.g.*, merchants).

If the cost of providing debit declines and the full reduction in cost is transferred to cardholders through lower fees and/or greater incentives to use debit (such as by offering rewards), debit becomes a more attractive method of payment for consumers. This in turn increases merchants' incentive to accept debit and results in greater benefits to merchants as customers substitute debit for more costly payment methods such as checks. Cardholders receive the full amount of the reduction in the cost of operating the debit network through increased incentives for them to use debit. However, merchants also receive additional value, since consumers' increased desire to use debit makes the sales gain from debit acceptance greater than it was previously.

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[86] Benjamin Klein, Andres V. Lerner, Kevin M. Murphy and Lacey L. Plache, "Competition in Two-Sided Markets: The Antitrust Economics of Payment Card Interchange Fees," *Antitrust Law Journal*, Vol. 73 (2006), p. 571-626 at 579. Many economists have recognized the role of demand elasticity and network effects in addition to marginal costs on the two sides of the market in the determination of merchant and cardholder prices for payment card services. *See e.g.*, Howard H. Chang and David S. Evans, "The Competitive Effects of the Collective Setting of Interchange Fees by Payment Card Systems," *The Antitrust Bulletin*, Vol. 45, Iss. 3 (Fall 2000), p. 641; Jean-Charles Rochet and Jean Tirole, "Cooperation Among Competitors: Some Economics of Payment Card Associations," *RAND Journal of Economics*, Vol. 33, No. 4 (Winter 2002), p. 549; Richard Schmalensee, "Payment Systems and Interchange Fees," *The Journal of Industrial Economics*, Vol. 50, No. 2 (June 2002), p. 103; Sujit Chakravorti, "Theory of Credit Card Networks: A Survey of the Literature," *Review of Network Economics*, Vol. 2, Iss. 2 (June 2003), p. 50; Jean-Charles Rochet & Jean Tirole, "An Economic Analysis of the Determination of Interchange Fees in Payment Card Systems," *Review of Network Economics*, Vol. 2, Iss. 2 (June 2003), p. 69; Jean-Charles Rochet, "The Theory of Interchange Fees: A Synthesis of Recent Contributions," *Review of Network Economics*, Vol. 2, Iss. 2 (June 2003), p. 97; Julian Wright, "The Determinants of Optimal Interchange Fees in Payment Systems," *The Journal of Industrial Economics*, Vol. 52, No. 1 (March 2004), p. 1; David S. Evans and Richard Schmalensee, "The Economics of Interchange Fees and Their Regulation: An Overview," prepared for Federal Reserve Bank of Kansas City Interchange Fees in Credit and Debit Card Industries Conference, April 6, 2005, p. 73, available at http://www.kansascityfed.org/econres/PSR/psrconferences/2005/Evans-Schmalensee.pdf.

The fee to merchants can rise in equilibrium when the cost of the debit network declines, because merchants are getting more value from accepting debit when consumers have a stronger preference for debit use. The value created by reduced fees or increased rewards to consumers indirectly creates increased value for merchants. This is one reason more merchants have joined the debit systems, even as merchant discount rates have increased – the value merchants receive has increased faster than the cost of accepting debit.

V. THERE IS NO EVIDENCE THAT CUSTOMERS THAT PAY WITH CASH AND CHECKS ARE SUBSIDIZING DEBIT-CARD CUSTOMERS

Supporters of regulation to set debit interchange rates claim that consumers who pay with cash and checks subsidize those paying with debit (and credit) cards. The FRB Staff claims that "[c]onsumers that use cash or checks may pay more than if the cost of card acceptance were not reflected in the price of goods or services. So given reductions in interchange fees and in overall debit card acceptance cost, merchants could choose to pass the savings through which could benefit both the consumers that primarily pay with cash or checks, as well as debit card users. We expect this would be most likely to happen…in those markets with lower margins and intense price competition."[87]

The simple argument made by these critics that each debit transaction has an associated merchant fee (the MDR), while there is no fee associated with cash or checks (these payment methods are "free"), is wrong. Critics argue that, if debit accounts for 50 percent of a merchant's sales (and the per-transaction MDR is, say, 0.4 percent of the transaction amount) and cash and checks account for the remainder, then all the merchant's prices will increase by 0.2 percent, including prices paid by cash and check customers. Critics claim that, in this way, non-debit users subsidize the benefits (including rewards and convenience) that accrue only to debit users.

This argument has several important logical fallacies (as well as no empirical support). First, the argument made by cross-subsidization proponents is completely one sided – it masquerades as a cost-benefit analysis, but it addresses only the explicit costs (that can be found on a profit and loss statement ("P&L")) and only the costs of one of the relevant payment

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[87] Transcript of Fed Governors-Staff Colloquy, p. 5.

methods. As I explained above (and as quantified by Dr. Layne-Farrar for the QSR industry[88]), the costs associated with accepting cash and checks are substantial (although not as easily quantified and generally not segregated on a P&L), and may even exceed costs associated with debit. Indeed, the fact that airplanes no longer accept cash for in-flight sales of food, beverages and other items is further evidence of the substantial handling costs of cash. Although checks "clear at par," frequently posted signs and policies of retailers that discourage or prohibit checks, along with the explicit costs incurred by the merchant for check authorization, guarantee, etc., demonstrate that "par" is not relevant for understanding retailers' real economic costs for accepting checks. At a minimum, any discussion of cross subsidization must consider the full range of costs and benefits of debit and other payment mechanisms. As I point explain below, such an analysis indicates that debit is a low-cost rather than high-cost payment mechanism, which reverses the direction of any cross-subsidization.

Second, by focusing only on the easily quantifiable bank fees paid by the merchant for a debit transaction, this argument ignores all operational and competitive benefits that the merchant receives in exchange. As described by Dr. Layne-Farrar, evidence from debit's adoption by QSRs shows that chains like Sonic introduced debit to gain a competitive advantage. This is inconsistent with claims that, by doing so, they had to increase their prices to all their customers.[89] In particular, given the FRB Staff's position that lower debit interchange rates are most likely to be passed through to consumers in "those markets with intense price competition," the hyper-competitive fast-food industry would have introduced debit only if the benefits exceeded the costs.[90]

Third, critics focus on assumed cross-subsidization of debit, but they ignore the ubiquity of "cross-subsidization" in the economy and in retailing operations in particular, and thus the clear evidence that any distortion from cost averaging generally is economically meaningless. I discuss further below (when I address the fallacy in arguments about "transparency") that merchants incur many costs that benefit only a fraction of their customers, and thus result in

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[88] Layne-Farrar Report.
[89] Layne-Farrar Report.
[90] *See e.g.*, Spain, William, "Fast-food outlook: Intense competition, margin pressures," Market Watch, January 14, 2010. Available at www.marketwatch.com/story/story/print?guid=1CDC72ED-8DA6-487A-97BF-B280883D8DFC.

"cross-subsidy" of higher-cost customers by those imposing lower costs. For example, many department-store shoppers choose their own merchandise, while others rely heavily on time and advice from sales people. Yet, merchandise prices do not vary according to whether or not sales assistance was provided (even though some retailers pay sales people explicit commissions for assisting customers). Many other merchant amenities have the same feature. But no one claims that averaging these costs across customers creates competitive harm, or amounts to a cross subsidy, and indeed such an argument would be absurd.

Finally, critics ignore the impact on merchants' sales from offering debit. If customers purchase more than they otherwise would have purchased because a merchant accepts debit, then the margin on these incremental sales is a benefit of accepting debit that will factor into the merchant's pricing decisions. The result could be lower prices across the board, including prices charged to cash and check customers.

Even if arguments regarding the importance or implications of alleged cross-subsidization were relevant, any cross-subsidization likely goes in the opposite direction from that claimed by critics – the transaction costs savings and other merchant benefits when consumers use debit are more likely to "cross-subsidize" cash and check users. This means that a reduction in debit use because of regulatory interference that lowers interchange rates and results in less incentive for consumers to use debit could cause merchants to raise prices. Certainly, the market evidence that merchants, even in highly competitive segments like QSR, freely adopt debit refutes concern about market distortion from interchange fees.

VI. THE "TRANSPARENCY" OF THE INTERCHANGE FEE TO CONSUMERS IS NOT RELEVANT TO UNDERSTANDING WHETHER DEBIT INTERCHANGE FEES ARE "TOO HIGH" AND WHETHER COMPETITION IS ENHANCED BY LOWERING DEBIT INTERCHANGE FEES THROUGH REGULATION

Critics of debit interchange rates claim that they compromise competition because they are "too high" and they are not transparent to debit cardholders.[91] Yet critics provide no valid

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[91] For example, Professor Steven Salop, who submitted comments on behalf of the MPC, claims that "market efficiency will be enhanced, because the price of debit card usage will become more transparent as the consumers using the product will pay for it as opposed to the current system that externalizes those costs to all consumers."

economic explanation for why lack of transparency either demonstrates or contributes to an absence of competition. FRB Governor Raskin claimed that:

> First of all, the interchange fee system is one that is pretty much hidden from consumers and the public, and most people have no idea that interchange fees exist and that they're paying for services that they may not even use...In addition to potentially higher prices, the nontransparent nature of the interchange fee suggests that these interchange fees may or may not be in line with the cost to banks that are offering these debit cards, and I think what this rule making is doing with, what this process is doing, is it's an attempt to ascertain these costs and determine whether, in fact, they're reasonable.[92]

Yet, Governor Raskin does not explain how greater transparency would change outcomes or benefit merchants or consumers.

Indeed, claims by merchants, evidently accepted by Governor Raskin and perhaps other Governors, that the interchange fee system is "hidden" and that "the public's" lack of understanding about how interchange works affects competition and harms consumers is inconsistent with economics and is without any support.[93]

Most merchant costs are not explicitly itemized for consumers. Importantly, customers are not informed about the costs incurred by merchants to accept checks, including bad-check losses, cost to purchase payment guarantees from a third party, the cost of additional time required by cashiers to handle check payments (including request identification, asking the customer to write his or her telephone number on the check, etc.). Neither are they informed about the pilferage costs associated with use of cash. Yet, neither merchants nor the government argues that customers must be provided with and consider these costs as they make their purchases, or else they cannot make appropriate decisions.

Proponents of transparency, including merchants, the FRB, Congress and other analysts, do not explain how competition will be enhanced if the interchange fee system that debit networks use to balance demand on the two sides of the debit platform is made more transparent,

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See, Salop, Steven C. et. al. "Economic Analysis of Debit Card Regulation Under Section 920," Charles River Associates, On Behalf of the Merchants Payments Coalition, ¶80.
[92] Transcript of Fed Governors-Staff Colloquy, p. 14.
[93] The MPC alleges, "Consumers pay swipe fees right now in the form of higher prices even though the fees are hidden from them." *See,* MPC Letter to Senator Crapo.

while the costs associated with other payment methods remain "hidden." Economic theory shows that the "transparency" that merchants and the FRB seek is more likely to distort than to improve the efficiency of consumers' choices. A consumer simply informed about the debit MDR incurred by a merchant likely will ignore this information. Moreover, to the extent the consumer is forced to pay higher bank fees for the use of debit as a result of the lower interchange rates, the consumer might select another payment method. Given the disadvantages of payment methods such as checks, and the even higher interchange fees associated with credit cards, transparent debit interchange fee but no additional transparency in costs of other payment methods likely would lead to less efficient choices among payment methods (*e.g.*, more use of checks) and potentially result in higher bank fees for the merchant (*e.g.*, credit card fees). This is an implication of economic theory – what appears to be a "second best," but not perfect, option (providing information about the interchange fees associated with debit, but providing no information about costs to the merchant of other payment methods) can reduce, rather than improve, consumers' choices relative to the status quo.

The claim that there is something nefarious because consumers are not provided explicit information about merchant discount fees makes no economic sense, based on even a rudimentary understanding of retailing. Merchants face a variety of different costs. Retailers' greatest expense likely is for acquiring merchandise, yet with very limited exceptions retailers need not and do not disclose their wholesale costs. Consumers likely would be very surprised, and might even adjust their purchases,[94] if they understood that retailers earn higher margins on many private-label products (*e.g.*, private-label over-the-counter pain relievers) at stores like Walgreens than they do on brand names like Tylenol, Advil, etc.[95] Yet merchants do not claim that retailing would be more competitive, and that consumers would be better off, if Walgreens posted both the retail and wholesale price of each product (including any rebates to which it

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[94] Retail price is a signal for quality – more expensive products are considered to be higher quality. A consumer who understood that the retailer's margin on private label products was higher than on brand-name products could decide that product quality differences were greater than the consumer previously believed, and change its purchasing decisions accordingly.

[95] Studies have found that retailers' gross margins on private label products often exceed their gross margins on comparable branded products. *See e.g.*, Mills, David E. "Why Retailers Sell Private Labels" *Journal of Economics & Management Strategy*, Vol. 4, No. 3 Fall 1995, 509-528, at 511 and 522. A White Paper by Weatherchem reports that "[t]he profitability of private label is substantial, with margins that are generally 6% to 10% higher than national brands." *See*, "Branding and Packaging of Private Label" Weatherchem White Paper.

might be entitled if it met certain volume targets) so that consumers could make choices based on a full understanding of cost.

The fact that merchants spread costs incurred to serve some but not all customers across all their customers reinforces the economic logic that cost transparency is not expected in competition and that greater transparency need not benefit consumers. Many amenities offered by a merchant benefit some, but not all, of its customers. A merchant provides free parking, even though some customers walk or take public transportation to the store. A retailer provides shopping carts even though some customers purchase only one or two items. Merchants may advertise, even though advertising attracts only some, but not all, customers. A retailer may train its sales staff, and may hire only experienced personnel that command a higher market wage than average, even though some customers do not use the sales staff's services.

None of these costs are itemized to customers, and customers are not offered a discount if they do not use the parking lot, a shopping cart, or the time of the sales staff. While all these costs may influence the merchant's pricing, it violates common sense to accuse a retailer of "cross-subsidizing" certain customers by not itemizing each cost and then letting the customer decide, for example, whether or not the assistance provided by a sales person is worth the cost.[96]

Similarly, merchants do not add a surcharge to purchases made with a check to compensate for the extra time spent by the cashier to process a check transaction or itemize the cost of the armored truck or employee time to transport cash to the bank. Competition is not limited and consumers are not harmed because merchants do not itemize each cost incurred to serve each individual customer. Indeed, since the FRB regards many retail markets as highly competitive, evidence that retailers themselves engage in widespread "cross-subsidization" in those markets refutes the FRB's claim that cross subsidization reflects a lack of competition and/or the exercise of market power.

Finally, it is ironic that merchants' concerns about transparency relate only to the cost of interchange fees, and not to transparency regarding the benefits they obtain from accepting debit.

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[96] Data from the Bureau of Labor Statistics indicate that the median wage for a retail salesperson was $9.74 in May 2009. If a salesperson assists a customer for 15 minutes, this is equivalent to $2.44 per customer. *See,* "Occupational Employment and Wages, May 2009 41-2031 Retail Salespersons," Bureau of Labor Statistics. Available at www.bls.gov/oes/2009/may/0es412031.htm.

These cost savings (reduced transaction time, virtually immediate transfer of funds) also are "hidden," and are not easily identified on merchants' profit and loss statements, and merchants may take them for granted. To the extent that merchants claim that consumers' choices are distorted by lack of transparency, they also should recognize that their own preference among payment methods is distorted by their failure to take account of the "hidden" benefits debit provides.

VII. THE SMALL NUMBER AND LARGE SIZE OF DEBIT NETWORKS DOES NOT MEAN THAT RESULTING MERCHANT DISCOUNT RATES ARE HIGHER THAN IF THERE WERE MORE OR SMALLER NETWORKS

Critics often claim that the level of debit fees reflects the exercise of market power and a lack of competition in the debit marketplace. They point to the scale of Visa and MasterCard as evidence that these networks must charge supracompetitive rates. However, this is wrong as a matter of economics and it is contradicted by empirical evidence. Proper economic analysis shows that there is no reason why the level of interchange fees would be lower if there were more networks, and empirical evidence indicates that there is no such relationship between network size and the magnitude of bank fees.

Based on at least three benchmarks, debit fees are not unreasonably high. First, as I stressed above, they are low relative to the value of the services provided. Second, they are low relative to what merchants pay for other services that expand sales and provide value to consumers (such as OpenTable and Groupon). Services such as OpenTable and Groupon charged substantial fees (much higher than those charged by the major debit networks) from their inception, even though those services could not have had market power. Third, the FRB has provided no evidence that debit fees are high relative to the full economic cost of servicing debit transactions. In particular, the provision of debit requires many costs not covered by the FRB proposed fee structure.

A. The Merchant Acceptance Decision is Independent of Network Size

Merchants accept debit cards if the benefits of acceptance outweigh the actual (or potential) loss from not accepting a card. The question of whether a merchants gains from card acceptance is independent of the size of the network. The merchant will accept a card when the

gain from added sales (*dS*) times the margin (*M*) on those sales exceeds the incremental fees paid ($f*S$), where f is the net fee paid on a given network's transactions and S is the merchant's sales on the given card network in question:

$$(1)\ ds * M > f * S,$$

which can be rewritten as:

$$(2)\ \frac{ds}{S} > \frac{f}{M}$$

Equation (2) compares the ratio of the change in sales over total sales to the ratio of the card fee divided by the merchant's margin, and shows that a small network that generates an additional \$100 in sales (dS = \$100) for a merchant with \$10,000 in total sales on the card network (S = \$10,000) would have the same attractiveness as a much larger network generating an additional \$10,000 in sales (dS = \$10,000) on a network with \$1,000,000 in total sales (S=\$1,000,000). In both cases, the merchant loses one percent of customers presenting the card if it does not accept the card in question, so it is better off accepting the card if the ratio of lost sales to total sales on the network is greater than the ratio of the network fee to the merchant's margin. The total size of the network, and whether there are more or fewer networks, does not affect this decision.

This illustrates the critical point that *it is the strength of the cardholder's loyalty to its network that determines whether a network can charge higher fees*, not the size of the network. Fleet cards (used by long haul truckers) generally carry a higher merchant fee than typical debit cards,[97] likely because fleet-card users typically are willing to drive to a different supplier where they know their card is accepted (and therefore the ratio dS/S is quite large). The same considerations also likely explain why merchants accept cards from very small networks (such as university identification cards), even though those cards may have relatively high merchant discount rates. The Indiana University Southeast "UCARD" debit card is one example. The UCARD program charges participating merchants a fee equal to five percent of the retail

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[97] For example, some fleet cards offer transaction fees on a sliding scale from \$0.20 to \$0.48 plus 1.25 percent of the transaction total, depending on the level of service. *See e.g.,* Keller, Maura, "Fueling Commercial Transactions," NPN, National Petroleum News, June 2007, Vol. 99, Iss. 6, pp. 34-38.

transaction, which far exceeds the MDR typically charged retailers for participation in the major debit networks, even though UCARD represents a far smaller network. The key economic principle this illustrates is that it is attractive for local area merchants to accept UCARD, despite the relatively high merchant fee, because many students have a strong desire to use their university card for purchases at local merchants and thus merchants that do not accept the card would be at a competitive disadvantage relative to merchants that accept UCARD.[98]

B. Available International Evidence Indicates that Merchant Fees are Independent of Network Size

Experience in foreign countries provides no evidence that debit fees would be lower if there were more card networks in the United States. Japan, for example, historically had fragmented card issuance, with merchants able to join 12 or more networks. Yet, research shows that Japanese merchant discounts typically ranged from 3-3.5 percent, and occasionally exceeded five percent, compared to fees of less than two percent in the United States.[99] Even though Japan has many competing card networks, fees there have not been lower than the rates that prevail in the United States.

C. Network Growth is not Associated with Increases in Merchant Fees

As discussed above, OpenTable has maintained the same fee structure as the number of participating merchants and cardholders has grown dramatically. Table 1 shows the substantial growth in OpenTable's diners and restaurants from 2005 through 2009. While OpenTable's per diner fee remained constant at $1.00 over the period, average fees per diner actually decline somewhat.

The example of OpenTable illustrates the key point outlined above. Even though the size of the OpenTable network increased roughly five fold from 2005 to 2009, the per-diner fees charged to merchants remained the same and average fees declined. OpenTable's pricing strategy is inconsistent with the theory that fees are higher than the competitive level because networks are large and therefore are "must have" for merchants. Indeed, the FRB has not

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[98] *See,* "IU Southeast UCARD – Frequently Asked Questions." Available at www.ius.edu/ucard/pdf/MerchantFAQs.pdf.

[99] Ronald J. Mann, "Credit Cards and Debit Cards in the United States and Japan," *Monetary and Economic Studies,* January 2002, pp. 149-151.

presented any evidence linking network size or the number of networks to the level of merchant fees. The underlying economic theory does not predict such a relationship, and the FRB provides no evidence that such a relationship exists.

Table 1
OpenTable – Diners, Restaurants, and Revenues
(2005 – 2009)

	2005	2006	2007	2008	2009	CAGR (2005-2009)
Seated Diners *(thousands)*	8,332	15,255	24,858	34,178	42,866	**51%**
Restaurants *(thousands)*	3.944	5.787	7.861	10.335	12.351	**33%**
Revenues *(thousands)*	$16,715	$27,168	$41,148	$55,844	$68,596	**42%**
Revenue per Diner	$2.01	$1.78	$1.66	$1.63	$1.60	**-5%**

Source: OpenTable 2009 Annual Report, p. 31.

VIII. EVEN IF THE U.S. DEBIT SYSTEM SURVIVES THE PROPOSED RATES AND REGULATORY STRUCTURE, THE DEBIT NETWORKS, CONSUMERS AND ECONOMIC EFFICIENCY WILL SUFFER

Proponents of the Durbin Amendment and the FRB's Proposal claim that debit systems in other countries have survived regulation that forced down interchange rates. Even if this is true, economics does not support regulatory interference just because the negative impact is sufficiently modest to avoid destroying a payment system. For example, government could make it illegal for theater owners to charge for admission to movies. Theatrical movie exhibition would continue, because theater operators would find alternative ways to support their businesses – inserting commercials into movies, for example, or requiring each moviegoer to purchase a large popcorn and large drink or a meal. But the fact that the industry would survive does not make this a benign restriction. Since the movie itself has value, it should be exhibited for any patron willing to pay to see it, and requiring that this value is collected in other ways will distort provision of both movies and the other goods and services "taxed" to finance movie exhibition. The result will be less movie viewing and less efficient outcomes.

Debit provides value to merchants, and the efficient way to collect for that value is to do so directly from the merchants that benefit. Using regulation to force banks to collect the value

provided to merchants from demand-deposit holders generally, or even from other bank customers or through a "tax" on other bank services, is inefficient.

The regulation contemplated by the Durbin Amendment and proposed by the FRB will cause great economic harm without any substantial offsetting benefit. These interventions do not satisfy any of the criteria economics identifies as warranting market intervention. In particular, any such interference with market pricing should be supported by (a) a clear identification of a market failure that the regulation is intended to address, (b) a thorough analysis of the regulation's benefits and costs, and (c) a thorough analysis to ascertain whether similar regulatory intervention elsewhere had unintended consequences and the likelihood that the impact of the proposed regulation is accurately predicted. The Durbin Amendment and the FRB's Proposal meet none of these criteria.

A. No Identified Market Failure

Debit's critics have provided no evidence of a "market failure" that requires regulatory intervention. I explained above that the fact that fees to operate the system and balance demand on the two sides of the platform are imposed on merchants, rather than consumers, does not reflect a lack of competition. This way of pricing is common in two-sided markets, and it does not originate when a network becomes "ubiquitous" and well established. The economics that explains pricing of debit is common across competitive markets, and the hallmark of a competitive outcome is evident here – the tremendous success of debit and resulting displacement of less attractive (and less competitive) alternatives.

B. Costs of Regulation Vastly Exceed the Claimed Benefits

The Durbin Amendment exempts banks with less than $10 billion in assets from the proposed restrictions on the interchange rate. I understand that this was not supported by any economic analysis, but rather by political considerations. One way of interpreting this exemption is that it acknowledges that inefficient smaller institutions could not adapt to additional inefficiency from the regulation of interchange rates. Otherwise, it is unclear why the supposed market failure that motivated the Amendment can be addressed while exempting the overwhelming majority of financial institutions.

A two-tiered interchange system, which Visa announced it will implement (at least initially[100]), will create distortions and promote inefficient bank operations. Large efficient banks will be forced by competitive pressures to try to increase other fees in order to recover lost interchange revenue. Imposing costs of operating their debit operations – including the incremental costs "with respect to the transaction" that the FRB wrongly ignored in preparing its Proposal, fixed costs of providing debit,[101] fraud prevention costs, etc. – on demand-deposit customers generally and even on other bank customers will distort choices. The FRB Staff acknowledges that costs will be shifted and that "it's hard to anticipate what the overall effect on consumers will be,"[102] and yet it ignored these effects in recommending an extreme form of regulation that must shrink the debit system because the price cuts are clearly below cost and the proposed rates do not reflect the benefits provided to merchants.

Smaller banks will remain free to support their debit programs with interchange fees that exceed the cap proposed by the FRB (as long as Visa and MasterCard maintain a two-tiered interchange schedule). However, these institutions likely are small because they are relatively inefficient and have higher costs. If customers switch from large banks to smaller, less efficient ones, there will be harm to competition and consumers. The shift will not be motivated by appropriate price signals, but rather by the fact that large institutions lost their freedom to price efficiently. The result will be a less efficient banking industry – expanding the output of less efficient suppliers and reducing output of the most efficient ones. The end result will be that debit services generally will be supplied at a higher cost, there will be less usage of debit than would exist under the current system, and likely less use of other bank services that now will be implicitly taxed (such as demand deposit accounts, which now may not be "free") as well.

From an economic perspective, a subsidy that allows one group to survive and expand in ways that would not be efficient absent the subsidy is worse than simply transferring money to the inefficient group. If the exemption for small institutions was motivated by concern that they might not be viable (as debit issuers at least) if their interchange revenue were reduced to the

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[100] Visa has announced that it will implement a two-tier system, while MasterCard has yet to make an announcement. *See*, "Visa Commits to a Two-Tier Debit Card Interchange Structure," Digital Transactions, January 7, 2011. Available at www.digitaltransactions.net/news/story/2861.

[101] There may be no fixed costs under an appropriate economic definition of incremental costs.

[102] Transcript of Fed Governors-Staff Colloquy, p. 5.

level proposed for larger banks, then regulation will create more harm than if lump-sum transfers were made to small institutions (thereby avoiding the distortion).

Finally, an important impact of the proposed debit interchange regulations likely will be to make certain business models uneconomic and potentially cause harm to certain demographic groups. In particular, the free-checking model that TCF has followed successfully to become the twelfth largest issuer of Visa debit cards (although it is only the 47th largest commercial bank) likely will not be viable.[103] As explained by Dr. Layne Farrar, TCF has been able to serve low- and middle-income customers who otherwise might not have checking accounts,[104] and thus might rely instead on currency exchanges, less convenient cash transactions, etc. The loss of business models, such as TCF's, may reduce consumer welfare.

C. Unintended Consequences are Likely Given the Magnitude of the Changes Required

By their very nature, predicting "unintended consequences" is difficult, decidedly so when regulators substitute their judgment for market prices. However, the likelihood that regulators will create unintended (and harmful) consequences increases with the magnitude of the changes imposed by regulation. Here, two features of the FRB Proposal are dramatic when compared with changes in debit and credit regulation in other countries. First, the Proposal would reduce debit interchange rates by about 80 percent, which the FRB acknowledges results in fees that do not compensate even for the most limited per-transaction cost.[105] The reduction exceeds that imposed in Australia and other countries that regulated debit rates. The larger the reduction in the controlled price, and thus the greater the shift to recovering costs from a bank's other operations, the greater the resulting distortion and inefficiency.[106]

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[103] TCF National Bank v. Bernake et. al. Complaint, ¶27.
[104] Exhibit A to the Declaration of Anne Layne-Farrar in the matter of TCF National Bank v. Bernake et. al., November 3, 2010, ¶¶ 8, 18, 66.
[105] As the FRB Staff noted, "And so taking those both – those considerations both into account, that's how we determined that we should probably limit the allowable costs just to those functions that were specifically mentioned in the statute: Authorization, clearing and settlement." *See,* Transcript of Fed Governors-Staff Colloquy, p. 12.
[106] Indeed, a well know result in economics is that the resulting distortion increases with the square of the price change, which would imply that an 80 percent reduction in debit fees would generate roughly 16 times the distortion of a 20 percent reduction.

Second, based on my review of regulatory intervention in credit and debit networks in other countries, regulators have never exempted a group of small banks from regulation of interchange rates and thereby created a two-tier system that distorts usage within the banking industry. Given the substantial and unprecedented proposed regulations, considerably greater analysis and evaluation should be performed and made available for review by interested parties in order to avoid potentially great harm to efficiency and consumers.

IX. CONCLUSION

A sound economic approach to formulating regulation to remedy a claimed market failure should be implemented as follows. First, it is essential to clearly identify the nature and scope of the alleged market failure that the regulation's supporters claim exists. Market participants have incentives to attempt to reduce competition through regulation, so a critical first step is to perform a thorough economic evaluation to understand whether the alleged "market failure" instead results from vigorous competition. Here, as I explain, the outcome that we see for debit networks as well as many other two-sided platforms reflects precisely the outcome that economics predicts results from vigorous competition. There is no evidence of market failure, and thus no need for regulation such as required by the Durbin Amendment and implemented provisionally by the FRB.

Second, if a sound economic analysis identifies a market failure, and not just a competitive outcome that certain market participants dislike, then any regulation should target the specific market failure, and not be more general than necessary, while considering both the costs and benefits of such a remedy. Even if there were a "market failure" in the debit system, it is possible that any proposed remedy would create greater costs than benefits. If a cost-benefit analysis shows that there is no way to "remedy" a market failure without creating greater harm to efficiency and consumers, then regulation should be avoided.

Third, even if a remedy can be devised that static analysis suggests creates more benefits than harm, it is important to consider the likelihood of unintended consequences, including the possibility of unforeseen consequences (which almost inevitably occur). It also is important to consider that unintended and unforeseen consequences become more likely the greater the magnitude of regulatory interference. Here, experience with intervention in foreign countries

should be considered thoroughly, both to confirm that the expected and claimed benefits were achieved, but more importantly to understand whether the FRB's proposal is sufficiently similar to regulation in those countries that it is reasonable to predict the consequences if the FRB Proposal is adopted.

Thus, the key economic principles to guide future consideration of the wisdom of the Durbin Amendment and the FRB's proposed implementation is whether there is a market failure to solve (and there is not), whether the proposed rule does more good than harm (it does not), and whether there is a likelihood of harmful unintended consequences (there is). Thus, the consequence of the current proposal likely will be substantial loss of efficiency and harm to consumers.

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CREDIT CARD FAIR FEE ACT OF 2008

HEARING

BEFORE THE

TASK FORCE ON COMPETITION POLICY AND ANTITRUST LAWS

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

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side, we have always allowed and continue to allow the discount for cash. But when it comes to between different electronic forms, we do not allow that.

Mr. KELLER. Would he be allowed to put a sign there in front of his cash register that said, "Please use your debit card instead of your credit card"?

Mr. PEIREZ. Yes.

Mr. KELLER. He would.

Mr. Floum, do you concur in that? Would he be able to first have a sign that says he can offer a cash discount?

Mr. FLOUM. Absolutely, Congressman.

Mr. KELLER. Would he be able to have a sign that says he can offer a discount over the credit cards if you use your debit card?

Mr. FLOUM. Yes. Under our rules for pin debit, he could also offer a discounted price.

Mr. KELLER. Okay.

You have said that you don't think that the retailers would pass along their savings if they did get a lower interchange fee. Is that correct?

Mr. FLOUM. That is what the evidence would suggest, yes, sir.

Mr. KELLER. The evidence in Australia, correct?

Mr. FLOUM. Yes, and also in a litigation settlement, interchange rates were lowered, the Wal-Mart settlement, and there was no passing along of those increased retailer profits to consumers.

Mr. KELLER. All right. I would think Wal-Mart would think they offer a pretty good deal. I mean, they are doing pretty well. But we will let them speak for themselves; they are big boys.

Mr. Robinson, you heard that you are not going to pass along any of the savings to your consumers. Let me just ask you point-blank, if you have a favorable result, either through legislation or litigation, where you pay lower interchange fees, are you going to pass along the savings to consumers, or are you going to take all the money and put it in your pocket as additional profits?

Mr. ROBINSON. Petroleum retailing is a fiercely competitive business. Generally when costs go up, generally when costs go up, we increase our prices. And generally when costs go down or benefits increase, we pass those along to the consumer also.

Mr. KELLER. Let me just be crystal-clear. Let's say you are paying 2-percent interchange fees now, and the Conyers bill passes, and you go to the arbitrator, and the arbitrator says, "I agree with 100 percent with Rotten Robbie, and it is going to be 1 percent," will Rotten Robbie customers get a discount when they go to buy donuts or gasoline or Coca-Cola as a result of that taking interchange fees from 2 percent to 1 percent?

Mr. ROBINSON. Well, I don't think the marketplace works exactly like that.

Mr. KELLER. But your whole argument——

Mr. ROBINSON. But, ultimately, ultimately, the answer to your question, the consumer will benefit.

Mr. KELLER. Okay. That is the $64,000 question, because your whole argument is you want lower interchange fees because it is better for consumers. And so that is why I want to give you the chance. He is saying it is not going to benefit consumers. Is it going to benefit consumers or not?

Mr. ROBINSON. There is not a businessman that doesn't attempt to keep the margin. But the competition always drives it back out. And when you have a competitive market—and we definitely have a competitive market, unlike some others—those benefits will go back to the consumer.

Mr. KELLER. All right. My time has expired. Let me just give you one last question. You said over and over you are a businessman and not a lawyer, and I really respect that. But I am going to ask you sort of a legal question here anyway.

And that is, when you look at this lawsuit, one of the big things in bold that you see is "jury trial demanded." And there is a reason for that, as someone who spent many years as a litigator, often on the side of the big companies, in the interest of full disclosure. But the little guy wants to have a jury. Often, the big guys would rather not have a jury; they would rather have a judge or an arbitrator and other folks, so you don't have the possibility of massive, inflated verdicts from emotion and that sort of thing. And there are always exceptions, but that is the general rule.

You are seeking legislation that is going to put you in front an arbitrator that is binding, not a jury. And, in fact, if you say you want a 1-percent fee and Mr. Floum's Visa client says, no, we want 5 percent, you are taking a real risk that this binding arbitrator may go with his side.

Are you comfortable taking that gamble and putting yourself in that forum, as opposed to the jury trial situation?

Mr. ROBINSON. The short answer is yes.

As we looked at the problem in trying to do something about the anti-competitive behavior of Visa and MasterCard, we looked at the various options. We looked at the option of breaking it up like AT&T. We looked at it dealing with it like a utility. And we felt that this was a competitive marketplace solution that, quite frankly, we might not do better with.

I have a hard time believing that we will not.

Mr. KELLER. But the gist of it is you are willing to take that gamble?

Mr. ROBINSON. Yes.

Mr. KELLER. Okay.

Issues have been raised about whether or not you have bargaining power. Have you ever worked with a merchant bank that was willing to negotiate a lower interchange fee rate?

Mr. ROBINSON. No.

Mr. KELLER. Have you ever attempted to negotiate a lower interchange fee rate with a merchant bank?

Mr. ROBINSON. We don't even know who to talk to. So, no, to answer your question, no.

Mr. KELLER. Well, your own bank you can talk to, right? I mean, the acquiring bank you can talk to?

Mr. ROBINSON. Yes. And we negotiate—the acquiring bank, we negotiate processing. And it is interesting, on the processing side, that is fiercely competitive. I mean, it is amazing how aggressive the processing banks. So you have a processing rate—and they have negotiated a processing fee, and that has come down because of competition.

○

American Bankers Association
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March 9, 2011

Honorable Shelley Moore Capito
Chairman
Subcommittee on Financial Institutions and Consumer Credit
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Capito,

I am responding on behalf of David Kemper, Chairman and CEO of Commerce Bancshares, who testified at your February 17, 2011 hearing on the Federal Reserve's proposed Interchange Rule. At that hearing, questions arose about quantifying the costs and benefits of debit cards, the societal costs of different payment methods, the cost of check guarantee, and the implication to the unbanked.

Quantifiable Benefits of Debit Cards to Merchants
In February, a new study was released by consulting firm, LECG[i] which quantified key benefits to merchants from accepting debit cards. The study found that:

- Merchants save up to 35 cents per transaction accepting debit compared to the same purchases made by check.
- Debit cards increase per transaction sales volumes by 20-30 percent at fast food restaurants and 10 percent at big box discount stores.
- Sales transaction speeds at fast food restaurants are reduced by half using debit compared to cash, which increases the number of customers serviced, resulting in greater sales and profits for merchants.

The growing preference for debit cards by consumers and the rising volume of payment card transactions show that both consumers and merchants recognize the benefits of debit over other forms of payment.

Societal Benefits of Debit Cards
Any method to pay for goods and services involve costs. To understand if society is better off from a switch to debit from cash or check, the costs and benefits to all parties involved in the transaction must be considered. A study by the AEI-Brookings Joint Center for Regulatory Study[ii] does this by considering each party to a transaction:

- **Merchant:** interchange fees, the cost of point-of-sale time, back office costs, float costs, the cost of theft/robbery/fraud and counterfeit prevention
- **Consumer:** the cost of waiting for a transaction to process and waiting in the queue, the cost and time to withdraw cash, and the cost of a paper check
- **Bank:** the cost of maintaining an automatic teller machine (ATM), the cost of replacing cards, processing checks, and the cost of handling and moving paper currency and checks
- **Central Bank:** the cost of handling and removing unfit bills, the cost of clearing checks

When considering all of the costs and benefits, the study shows that a $54 debit card transaction costs the least to society, reducing costs by as much as 39 cents per transaction, under the current rules and including interchange fees. Therefore, the transition to debit cards has fundamentally benefited society.

Payment Type	*Social Marginal Cost*
Cash	*$2.66*
Non-verifiable Check	***$1.40***
Verifiable Check	*$1.08*
Credit	*$1.22*
Signature Debit	***$1.01***
Pin Debit	*$1.08*

Check Guarantee Costs are Significantly Higher than Retailers Suggest
The witness from 7-Eleven, David Seltzer, commented that paying for a check guarantee costs his institution about 14.5 cents. This figure that he referenced appears to be only the transaction fee and fails to recognize the other costs that should be accounted for, such as the 1-1.5 percent discount rate for each transaction and the monthly service fee of $5-15. Moreover, even the transaction cost cited is at the low end of the range and actually can be as high as 25 cents per transaction (see table[iii]). When the full cost of guaranteeing a check is considered these costs are significantly more expensive than accepting a debit card – which Seltzer testified as being on average 29 cents per transaction for his store.

	Check Guarantee Cost
Discount Rate	1-1.5% of check amount
Transaction Fee	14-25 Cents per transaction
Monthly Fees	$5-15 per month

Interchange Rule has Implications for Low-Income Households
The Federal Reserve's proposal makes debit cards completely unprofitable. In fact, the proposed rule dictates that banks must lose money on every debit card transaction a bank processes unless it charges consumers more. As the cost of using a debit card shifts from the merchants to customers, some individuals will not be able or willing to pay the higher cost even though they value the use, safety and convenience of using their debit card to buy goods and services. One analyst estimates that as much as 15-20 percent[iv] of customers may leave the banking system because of new checking fees. Another large bank predicted that 5 percent[v] of customers will become unbanked.

What these customers may not realize is that the cost of non-banking services over time can end up being much more costly. It could cost as much as $93 per month[vi], based on a story by an Associated Press journalist.

We hope that the information will be helpful and we would be happy to discuss the issue further.

Sincerely,

Floyd E. Stoner

cc: Honorable Carolyn Maloney, Ranking Member
David W. Kemper, Commerce Bancshares, Inc.

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[i] Assessing Retailers' Costs and Benefits from Accepting Debit Cards. Anne Layne-Farrar, LECG. February 2011.
[ii] The Economics of a Cashless Society: An Analysis of the Costs and Benefits of Payment Instruments. Daniel D. Garcia Swartz, Robert W. Hahn, and Anne Layne-Farrar, AEI-Brookings Joint Center for Regulatory Studies, September 2004.
[iii] Data gathered through looking at four check guarantee providers: InstaMerchant, Cross-Check, 1[st] National Processing and Merchant Seek.
[iv] New fees could drive millions to join the 'unbanked'. Chris Serres, Star Tribune. February 13, 2011.
[v] Retail Financial Services. JPMorgan Chase 2011 Investor Day. February 15, 2011.
[vi] Living without a bank: Fees and Confusion Galore. Candice Choi. Associated Press. October 4, 2010.

Questions for the Financial Institutions Subcommittee Hearing:
"Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment"

Rep. Carolyn McCarthy (NY-4)
February 17, 2011

Panel 2: Mr. Michael and Mr. Kemper
Many consumers use debit cards as a means to be fiscally responsible, and not depend on credit. For low income consumers, a debit card is a means to enter into the "banked" world.

- What impact could this rule have on debit cards in general and more importantly on low-income consumers?

Mr. Kemper's Answer:

Your question, Representative McCarthy, hits on one of the major unintended consequences of the Durbin Amendment interchange fee restrictions. It would have a very negative impact on some low-income consumers.

You are absolutely correct that debit cards are often used instead of relying on credit. They offer the kind of accessibility that is necessary in today's economy for those people who cannot or won't access credit. They are also much safer than carrying cash. Debit cards have encouraged low-income consumers to enter the "banked" world as you noted. This is now at risk if the Federal Reserve's proposed rule becomes final.

The reduction in interchange revenue expected under the Federal Reserve's proposed rule – up to an 85 percent reduction – means that revenue does not begin to cover the cost of providing debit cards. In fact, the yearly cost of providing a checking account averages between $250 and $300. The return on that investment averages around 13 percent, so an 85 percent reduction in debit card revenues means that banks will lose money, on average for each account.

Thus, banks will have no choice but to recover some of the lost income through checking account-related fees, such as monthly maintenance fees, debit card and debit card transaction fees, or other fees.

Some individuals will not be able or willing to pay the higher cost even though they value the safety and convenience of using their debit card to buy things. Some accountholders may find themselves ineligible for a debit card. Many banks may find it uneconomical to provide these accounts at all. ***Thus, the debit interchange rule will drive some low-income consumers out of the banking system to check-cashers and similar unregulated entities.*** This is a terrible policy outcome from the proposed rule for millions of Americans living from paycheck to paycheck.

This is just one of many important reasons why Congress should act immediately to stop the Federal Reserve's rule.

Panel 2: Mr. Michael and Mr. Kemper
Many consumers use debit cards as a means to be fiscally responsible, and not depend on credit. For low income consumers, a debit card is a means to enter into the "banked" world.

* What impact could this rule have on debit cards in general and more importantly on low-income consumers?

Mr. Michael: The proposed rule will make it more expensive to consumers to use a debit card. Instead of the current system, in which merchants pay their fair share of the costs providing debit services, some of those costs will be transferred to consumers in the form of higher fees. To the extent a debit card is the entry point to the financial institutions world for many low-income consumers, making that gateway more expensive will only discourage such consumers from taking advantage of the safety, cost and convenience advantages of using a financial institution.

Frank Michael
Allied Credit Union

Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative Capito:

1. Do MasterCard and Visa impose network rules on the ATM industry that are similar to the rules that raised concerns in the point-of-sale context?

ATM networks differ in material respects from point-of-sale (POS) networks. In an ATM transaction, the issuer pays, rather than receives, the interchange fee. We understand that one or both of the major card networks may impose rules on ATM operators that restrict the ATM operators' routing choice and limit their ability to impose differential surcharges based on the network over which the transaction is routed. Such ATM rules, however, may not raise the same concerns that existed for similar POS network rules, which imposes restrictions on the party that pays the interchange fee.

2. Do MasterCard and Visa impose rules on ATM operators that would require them to route ATM transactions over their ATM networks?

We understand that at least one of the major card networks imposes routing restrictions that may require ATM operators to route transactions over that network in certain circumstances.

3. Do you think the Department of Justice should investigate whether the dominant payment card networks are imposing anticompetitive network rules on the ATM industry?

The Board does not have a view on whether the Department of Justice should investigate network rules in the ATM industry.

Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative Maloney:

1. Representative Maloney requested that the Board comment in writing on the review process that was conducted in advance of drafting the proposed rule.

The Board's staff developed surveys of issuers that would be subject to the interchange fee standards and payment card networks to obtain information regarding issuer costs, interchange fees, network fees, network exclusivity, and routing restrictions. The surveys also asked for information regarding fraud-prevention activities, fraud-prevention costs, and fraud losses. The Board's staff also arranged multiple public drop-in calls for industry participants to comment on the draft surveys (some calls had well over 100 participants) and accepted many written comments on the drafts; this input helped the Board's staff refine the survey instruments. Based on the industry input, the Board's staff also developed a survey of large merchant acquirers. The Board's staff distributed that survey on September 13, 2010, with responses due October 12. The Board's staff sent the issuer survey to 131 financial organizations with over $10 billion in assets: 89 responded with data; 13 indicated they did not have debit card programs; 3 declined to participate; and the Board's staff did not receive any communication from 26. The Board's staff distributed the network survey to all 14 networks that the Board's staff believes process debit card transactions and received responses with data from all 14. All 9 of the merchant acquirers that received the survey responded with data.

As input to the development of the proposed rule, the Board's staff also held 27 meetings with industry participants, including issuers, networks, merchant acquirers, merchants, and consumer representatives, and reviewed 47 written submissions by industry participants to deepen its understanding of the debit card industry and issues related to the rulemaking.

Regarding your request that I provide a list of studies related to interchange fees, please see the attached bibliography, which provides an overview of some of the many theoretical and empirical papers that were referred to regarding interchange fees and payment cards.

Bibliography Of Papers On Interchange Fees And Payment Cards

I. Economics of Payment Cards

A. Surveys

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Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative McCarthy:

1. We have heard from parties who favor the proposed rule, that there will be significant savings to the consumers once the proposed rule goes into effect. While not included in the Durbin provision, does the Board believe that there should be a periodic review to show consumer savings and value?

The magnitude and direction of the ultimate effect on consumers is not clear and will depend on the behavior of various participants in the debit card networks. For example, card issuers may choose to make up their lost interchange fee revenue by imposing higher fees, or reducing rewards programs, for debit card use or for deposit accounts in general. On the other hand, consumers will benefit to the extent merchants pass on their interchange fee savings in the form of lower prices.

It is reasonable to assume that, in a competitive market, changes in merchants' costs are generally reflected in the prices that they charge. However, it is not practical to measure, or to be confident about, the extent to which lower interchange fees translate into lower merchant prices, because of the many other factors that also influence merchant prices. Australia has the longest experience with government limits on interchange fees. The Reserve Bank of Australia has indicated that it is confident that savings are passed through to consumers, but acknowledges the difficulties involved in measuring the effect of the interchange fee reductions on merchant prices and has not been able to quantify the savings to consumers.

Because the effect on consumers will depend on the behavior of many parties outside the jurisdiction of the Federal Reserve, if Congress believes that information relating to possible consumer savings and value would be useful, broad new data collection authority covering merchants and issuing insured depository institutions would be needed to allow the Federal Reserve (or another agency) to collect that data.

2. Many argue that the Durbin provision and subsequently the proposed rule will encourage and foster consumer choice and savings. How do you envision consumer choice working if merchants are able to set minimum and maximum amounts for debit transactions, and choose the network the transaction will be routed?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) prohibits payment card networks from inhibiting the ability of merchants to set minimum amounts for credit card transactions provided that amount does not exceed $10 and does not differentiate between issuers or payment card networks. This would allow merchants to limit the form of payment accepted for small purchases by prohibiting the use of credit cards for purchases under $10. Dodd-Frank also prohibits payment card networks from inhibiting the ability of Federal agencies or institutions of higher learning from establishing maximum amounts for credit card transactions. Dodd-Frank does not contain similar provisions related to debit card transactions. As a result, payment card networks may prohibit merchants from setting minimum or maximum amounts for debit card transactions. If the payment card networks choose to establish such a

prohibition, one would expect consumers to continue to have the choice to use debit cards for small transactions.

Permitting the merchant to make routing choices should not limit the payment choice for the consumer. Once a consumer chooses to pay for a transaction with a debit card, the proposed rule would enable merchants to influence the routing of that transaction in order to better control their costs. As they do today, some merchants may attempt to influence customer choice by prompting cardholders to enter a PIN if their card is enabled on a PIN debit network. Note that the routing of PIN debit transactions to specific networks is not known by the consumer today; such transactions may already be routed over one of multiple PIN networks, if multiple networks are enabled on the card. However, this routing decision should not affect the ability of the consumer to use the debit card as a form of payment.

Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative Pearce:

1. During the February 17, 2011 hearing, Representative Pearce asked whether overdraft costs are "allowable" costs under the proposed rule, and I responded that I would provide an answer at a later time.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) directs the Board to consider the incremental costs incurred by an issuer to authorize, clear, and settle a particular electronic debit transaction, and to not consider other costs incurred by an issuer that are not specific to a particular electronic debit transaction. Dodd-Frank is silent regarding the treatment of issuer costs that are specific to a particular electronic debit transaction, but do not relate to authorizing, clearing, or settling a transaction, such as overdraft costs. The proposed rule did not include overdraft costs as allowable costs. However, the Board requested comment on whether to include further additional costs or to construe costs more narrowly. The Board received many comments regarding the costs the Board should consider as "allowable costs" in the final rule and we are currently evaluating those comments.

Questions for The Honorable Sarah Bloom Raskin, Governor, Board of Governors of the Federal Reserve System, from Representative Westmoreland:

1. Did the Federal Reserve conduct any sort of dynamic analysis on the cost that implementing its proposed rule would have on consumers?

The Federal Reserve did not conduct a dynamic analysis on the cost to consumers of implementing the proposed rule. The magnitude and direction of the ultimate effect is not clear and will depend on the behavior of various participants in the debit card networks. For example, card issuers may choose to make up their lost interchange fee revenue by imposing higher fees, or reducing rewards programs, for debit card use or for deposit accounts in general. On the other hand, consumers will benefit to the extent merchants pass on their interchange fee savings in the form of lower prices.

2. As technology has become better and faster, has there been any corresponding decrease in the interchange fee being charged to merchants? Likewise, as technology improves and a merchant needs to install newer technology, is there any corresponding decrease in charges to the merchant to offset requirements for new technology?

Based on information payment card networks reported to us in our interchange survey last fall, interchange fee rates for signature debit transactions are about the same, on a transaction-weighted average level, as they were in 2000. In contrast, interchange fee rates for PIN debit transactions over the major PIN networks have roughly doubled during this time period. On the whole, changes in interchange fees over time do not appear to reflect changes in costs due to technological improvements.

3. Due to the high risk of internet payment transactions, some banks and payment networks may decide not to clear online payments made by debit cards. Were online transactions considered by the Federal Reserve when issuing their formula debit interchanges fees? Are there provisions in the Federal Reserve rule to allow higher debit interchange fees for these types of higher risk transactions? Does the Federal Reserve anticipate changing the proposed rule to include higher fees for higher risk transactions?

The allowable costs in the Board's proposed rule relate to the cost of the authorization, clearing, and settlement of a particular debit card transaction. Issuers typically do not capture their operating costs separately for card-present and card-not-present transactions; therefore, our survey did not ask for this cost information at this level of granularity. However, many issuers do capture their fraud losses separately for card-present and card-not-present transactions.

Virtually all Internet debit card transactions are routed over signature debit networks. Card issuers responding to the Board's interchange survey in fall 2010 reported that, in signature debit systems, fraud losses for card-not present transactions were higher than fraud losses for card-present transactions. On a transactions-weighted average, card-not-present fraud losses represented 14 basis points of the value of card-not-present signature debit transactions; card-present fraud losses represented 11 basis points of the value of card-present signature debit transactions. The higher risk of these transactions is generally borne by the online retailer, not

the card issuing bank. Survey respondents reported that 76 percent of card-not-present fraud losses on signature debit systems are charged back to the merchant, compared to 29 percent of card-present fraud losses.

As is the case with all aspects of the proposed rule, the Board will consider carefully the comments it has received as it refines the rule for adoption in final form.

4. Does the Federal Reserve believe the policy of the federal government and Congress should be to cap what business can charge for their products, be it debit card fees for banks and credit unions or the sale of a hamburger at McDonald's?

As a general matter, the Federal Reserve believes that price caps are not necessary in an effectively functioning competitive market.

5. In Georgia, many community banks are struggling to raise capital and shore up losses on their current book of business. While the proposed rule would not apply to banks and credit unions with under $10 billion in assets, many community banks are concerned merchants will not accept cards from smaller banks and credit unions because of the higher cost. Has the Federal Reserve analyzed the potential anti-competitive environment that may arise from this proposed rule on smaller banks and credit unions? Will the Federal Reserve include a provision in the proposed rule to prohibit this potential anti-competitive consequence?

We recognize that some small issuers are concerned that merchants will try to steer their debit-card customers to other forms of payment or not accept their debit cards at all. We believe that there are strong incentives for merchants that would make this behavior uncommon. Although some merchants have been known to steer customers who present a high-cost credit card to a lower-cost credit card, they have been able to do so because consumers often carry multiple credit cards. That is not the case with debit cards; consumers typically have only one checking account. Small-issuer debit-cardholders may have limited or no alternative payment options, and merchants risk losing the sale entirely if they attempt to steer these customers away from using their debit cards. Payment by credit card would generally result in a higher price to the merchant; therefore, they would have no incentive to steer the customer to that payment alternative. Moreover, steering consumers to pay by check or cash would be unlikely to occur because fewer and fewer consumers carry checks, and consumers often don't carry sufficient cash to pay for the transaction.

In addition, the Board believes that the rules of the payment card networks prohibit merchants from discriminating against cards of different issuers. For example, the honor-all-cards rules of the networks require a merchant that accepts a network's debit cards to accept all of that network's debit cards, regardless of the issuer. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) does not prohibit card networks from having such rules. Moreover, although Dodd-Frank provides that a payment card network cannot restrict merchant

differential pricing across methods of payment, it would continue to allow a network to prohibit differential pricing on the basis of the issuer.

6. There have been numerous bank failures in Georgia, while the proposed debit interchange rule does not apply to community banks and credit unions with under $10 billion in assets, many are concerned the rule will further erode their capital base and could potentially cause more banks to fail. Has the Federal Reserve studied the potential losses community banks and credit unions might suffer? Could this proposed rule increase the number of bank failure[s] in Georgia and the U.S.?

Congress exempted small issuers (under $10 billion) from the interchange fee standards and the Board's proposed rule reflects this exemption. Some small issuers are concerned that the interchange revenue they currently receive will decline sharply if networks do not implement a two-tier interchange fee system that retains the current interchange fee levels for exempt issuers. In fact, nothing in the statute requires networks to implement different interchange fee schedules for exempt and covered issuers. We understand that several large debit card networks, however, including Visa, STAR, PULSE, and SHAZAM, have indicated that they will implement a two-tier interchange system. This two-tier interchange system would thus provide small issuers the ability to contract with multiple networks that would provide higher interchange fees to small issuers.

Small issuers have also expressed the concern that even with a two-tier interchange fee system, their interchange fee revenues may decline. Congress did not exempt small issuers from the statute's network exclusivity/routing provisions. These provisions, which are designed to give merchants greater choice in how to route debit card transactions, may place downward pressure on interchange fees received by all issuers, including small issuers, because merchants may choose to route transactions to the least cost network. Because interchange fees represent only one source of revenue for covering the costs of debit interchange programs, at this time, we cannot predict whether issuers might experience losses as a result of the Dodd-Frank interchange provision. However, the Federal Reserve will monitor this matter closely and report to Congress any consequences of the provision on the safe and sound operation of small issuers.

7. Many of my small business owners truly have to accept debit and credit cards out of necessity. In the research the Fed did prior to issuing the rule, what negotiating power do independent, Mom and Pop shops have with respect to debit interchange fees?

Commenters have similarly informed us that small retailers have little or no negotiating power to influence the level of interchange fees they are assessed.

8. What percentage of business accepts debit and credit cards? What percentage does not? What is demographic of the businesses that do not accept debit or credit payments?

The major payment card networks have indicated that roughly 8 million merchant locations in the United States accept debit cards. (We believe that the number of merchant locations that accept credit cards is about the same.) We do not have information on the total number of merchant locations in the United States, and therefore cannot say what percentage of the total this represents or the demographics of the businesses that do not accept card payments.

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Responses from David Seltzer to Representative McCarthy

Panel 2: Mr. Seltzer

It is my understanding that 7-11 stores offer a prepaid debit card, which is exempt from the Durbin provision.

- Could you explain your debit card program, as well as profits to your store from the fees associated with the card?
- Do you anticipate any losses to your store from the interchange rule?

Many retailers, including 7-Eleven, sell prepaid debit cards. Like the debit card market as a whole, prepaid debit is dominated by the VISA and MasterCard brands. We sell prepaid cards at prices determined in the marketplace, as these cards are available for sale through a variety of merchants and the price being charged for a given card is visible to the consumer. Unfortunately, when prepaid debit cards are used to purchase goods and services, VISA and MasterCard charge hidden interchange rates that are set without merchant input. It is worth noting that prepaid debit interchange cards were exempted from the Durbin amendment in an attempt to protect under banked segment of our society.

We do not anticipate losses arising from the Durbin amendment.