Consumer Federation of America

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Comments of Travis B. Plunkett,

Legislative Director

To

The Federal Reserve Board of Governors

On

12 CFR Part 235

Docket No. R–1404

Debit Card Interchange Fees and Routing;

Proposed Rule

February 22, 2011

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Debit Card Interchange Fees and Routing; Proposed Rule (Docket No. R–1404)

The Consumer Federation of America[1] (CFA) appreciates the opportunity to provide our comments and recommendations on the Federal Reserve System's proposed rule under the Electronic Fund Transfer Act (15 U.S.C. 1693 et seq.) regarding debit card interchange fees, debit card payment network exclusivity requirements and the routing of debit transactions (12 CFR Part 235). These rules are required by Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L.111-203, 124 Stat. 1376 (2010)). This statute also limits the ability of payment networks to restrict merchants from offering discounts or in-kind incentives to consumers for paying by cash, checks, debit cards or credit cards, and from setting minimum payment requirements for credit cards.

Although CFA did not take a position on Section 1075 of the Dodd-Frank Act during Congressional debate on it,[2] its implementation could have a very significant impact on consumers who use debit cards or participate in the banking system, as well as the many who do not. Our comments are focused on ensuring that both groups of consumers are treated fairly under the rule.

CFA strongly endorses the intent of the statute and proposed rule: to restructure an uncompetitive and opaque payment card market that has significant harmful effects on consumers by using both competitive forces and pricing standards to bring interchange charges into line with the incremental costs to provide debit cards. In developing these pricing standards, we urge the Federal Reserve to ensure that financial institutions are reimbursed for legitimate, incremental costs associated with the provision of debit cards. If such compensation does not occur, these institutions could increase debit card and other related banking charges on their least desirable and most financially vulnerable consumers: low- to moderate-income (LMI) accountholders. We also urge the Federal Reserve to pay close attention to how this rule would affect the financial viability of small depository institutions, especially credit unions, which often provide safe, lower-cost financial products to millions of Americans.

Harmful Effects on Consumers of the Current Interchange System

There is considerable evidence that the payment card market is not functioning competitively or fairly, and that these distortions are harming consumers, especially LMI consumers. We are particularly concerned about the effects on consumers of poor competition among payment networks, hidden interchange pricing and cross subsidies that are paid by LMI consumers.

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[1] The Consumer Federation of America is an association of nearly 300 nonprofit organizations that was established in 1968 to advance the consumer interest through research, advocacy, and education.
[2] CFA has previously supported proposals to prohibit payment card networks from limiting discounts that merchants can offer based on payment method.

Two-sided markets, like the one that exists for payment cards, often unjustifiably drive up prices for consumers or lead to a reduction in the value of goods or services. The providers of goods or services compete not to offer lower prices to consumers or end users, but to offer high compensation to sellers to entice them to distribute these goods or services. In the case of the payment card marketplace, this "reverse competition" appears to cause the two largest payment card networks to pay rich interchange fees to issuing financial institutions that are far beyond the cost of providing debit cards so that these institutions will offer VISA and MasterCard cards. This market dynamic means that the networks can raise prices without suffering competitive effects and that merchants and consumers must pay these increases even if the actual costs for providing debit card services are dropping.[3]

Payment networks dictate interchange charges and set network rules. If merchants want the benefits of accepting payment cards, which include greater sales than for other payment methods, they must comply with rules and practices that have frequently been deemed to be anti-competitive. For example, the Department of Justice last year sued several payment networks (and reached a settlement with MasterCard and VISA) about unilateral network rules that prevent merchants from offering consumer discounts based on the method of payment or type of card being used, "ultimately resulting in consumers paying more for their purchases."[4]

Concerns with the structure of the payment card market and anti-competitive network practices are compounded by the concentration of this market. VISA and MasterCard controlled 71 percent of the payment card market in 2008,[5] which gave them significant power to dictate terms that affect virtually all merchants and consumers who accept or use payment cards.

Consumers do not "see" the cost of interchange fees, because they are paid by acquiring banks operating on behalf of merchants to issuing financial institutions, but they have no choice but to pay interchange costs indirectly through the cost of banking and debit card services and/ or the cost of goods and services. It is simply unjust to require Americans, mostly LMI, who do not participate in or benefit from the debit payment or banking system to pay for excessive debit interchange fees, when these fees are passed through – in part or in whole – to the costs of goods and services. Even if price competition means that retailers pass through only some interchange costs, the financial burden borne by consumers is quite significant when fees total in the billions per year.

Non-transparent pricing often leads to market distortions, such as unjustifiably high pricing and questionable cross subsidies from one group of market participants to another. Indeed, aggregate interchange fees for debit and credit cards have increased sharply from $20 billion in 2002 to approximately $35 to $45 billion in 2007, according to the Federal Reserve.[6] One development that appears to have occurred at least in part because of hidden pricing and lack of competition is the huge growth of "signature" debit cards compared to "PIN" cards.

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[3] "Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges", United States Government Accountability Office (GAO), November 2009, pg. 20, 21.
[4] "Justice Department Sues American Express, MasterCard and VISA to Eliminate Rules Restricting Price Competition; Reaches Settlement with VISA and MasterCard", United States Department of Justice, October 4, 2010, http://www.justice.gov/atr/public/press_releases/2010/262867.htm.
[5] Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges", Untied States Government Accountability Office (GAO), November 2009, pg. 19.
[6] Id, pg. 14.

Signature debit cards are more expensive and more prone to fraud and security breaches than PIN cards, but they have become dominant in the market. Issuing banks receive significantly more interchange compensation for signature cards, and thus have a strong incentive to promote the use of signature over PIN card processing.

<u>Implementing the Statute to Protect Consumers</u>

Effective implementation of the statute could help eliminate many of these negative effects involving debit cards, especially the pass-through to the cost of goods and services for non-card using consumers, and subsidies of reward cards. In Australia, where regulators mandated a series of credit and debit interchange reductions beginning in 2002, the Reserve Bank of Australia determined that most of the cost savings associated with credit card rate reductions were being passed through to consumers in the form of lower prices for goods and services, concluding that, "Despite the difficulties of measurement, the Board's judgment remains that the bulk of these savings have been, or will eventually be, passed through into savings to consumers. This judgment is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge." [7] Economic theory also indicates that the cost savings that are passed through to consumers are not likely to be uniform. Retailers with market power may simply use debit interchange savings to increase their profit margins. However, cost savings are likely to be passed through in areas or industries in which price completion is significant and margins are low, such as supermarkets in many parts of the country.

As the Federal Reserve develops the "reasonable and proportional" fee standards that are required under the statute, we strongly recommend that the standards ensure that financial institutions are reimbursed for legitimate, incremental costs associated with the provision of debit cards. Requiring that payment networks charge interchange fees at very low "par" rates that do not reflect some incremental costs (as banks are required to do under federal law with checks) would certainly increase economic efficiency. However, the debit card infrastructure is currently paid for by debit interchange rates. Mandating par rates – or rates as close to par as the statute would allow – might lead financial institutions to significantly increase costs imposed directly on consumers for debit card or other banking services. We are particularly concerned about the effects on LMI accountholders of such increases, especially if the increases lead some accountholders to leave their bank or credit union entirely.

We have been provided information by a member of CFA – Navy Federal Credit Union– that indicates that the 7 to 12 cents per transaction reimbursement contemplated by the proposed rule would not allow them to cover some actual, incremental costs for providing debit cards. In addition, the proposal does not yet contemplate reimbursement for fraud prevention costs, as the Federal Reserve is asking for comment on two possible approaches.

We recommend that the Federal Reserve consider broadening its pricing standard to include compensation for additional, legitimate incremental expenses. Such expenses could include, for example, network processing fees for each transaction processed, charge-backs

[7] The Reserve Bank concluded that estimated that one-year cost savings passed through to consumers as a result of credit card interchange rate reductions to 50 cents per transaction was around $1.1 billion (Australian.) "Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review", Payments System Board, Reserve Bank of Australia, pg. 23.

involving billing errors, and fraud losses over which the Federal Reserve determines issuers have no ability to prevent. These types of costs are associated with the authorization, clearance and settlement of particular transactions, as required by the statute. A separate adjustment for effective fraud prevention measures, as allowed in the law, is also justifiable.

We also recommend that, in choosing how to implement this rule, the Federal Reserve pay close attention to the effects of particular options on smaller depository institutions, especially credit unions. Institutions with less than $10 billion in assets are not required to meet the interchange fee standards required in the statute. As a result, VISA has indicated that it will bifurcate interchange rates. If smaller institutions receive higher interchange rates, it could help them cover the higher incremental costs they normally pay because they lack economies of scale. However, Federal Reserve Chairman Bernanke has stated that market competition might nonetheless cause these institutions to receive lower interchange income. We urge the Federal Reserve to closely monitor how the debit interchange market for small institutions develops and how the financial viability of these institutions is affected. Credit unions especially often provide a safe, lower-cost alternative for many Americans.

We strongly recommend that the Federal Reserve launch a broad, balanced study of the effects of the rule upon implementation. This study should evaluate a number of factors, including its impact on the following:

- Whether, and to what extent, retailers pass through interchange savings to the cost of goods and services paid by all consumers;
- The cost of debit card and all related banking services, especially for LMI consumers;
- The structure, market concentration and practices of payment card networks, and
- The financial viability of smaller financial institutions, especially credit unions.

Finally, we would note that the exemption from interchange cost standards for prepaid cards that do not have overdraft fees or a fee for the first in-network ATM fee could encourage the provision of transaction accounts for LMI consumers. However, for prepaid cards to be a safe alternative to regular bank accounts, consumer protections and recourse rules must be adopted either by Congress or the Consumer Financial Protection Bureau. To protect funds on the cards, the overdraft exception should be expanded to prohibit any form of credit that triggers automatic repayment from funds deposited to the card. Additionally, consumers who use prepaid cards must have pass-through FDIC insurance coverage and protections under Regulation E of the Electronic Fund Transfer Act to set liability limits for unauthorized transactions, to provide recourse for billing errors and unauthorized charges, to get provisional re-credit of disputed funds pending investigation, and to require access to statements, fee disclosures and transaction information.

Thank you.