Toward Reasonable Regulation of Debit Card Interchange Fees: The Case for Modifying the Federal Reserve Board's December 16, 2010 Proposals

By

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Abstract

This paper shows why the Federal Reserve Board's proposed alternatives for regulating interchange fees are not "reasonable" and therefore in direct violation of the statutory mandate that these rules be "reasonable" and "proportional" to the costs incurred by debit card issuers. The Board's December 16, 2010 proposal is not "reasonable" because it would lead to a series of "unreasonable" outcomes, which, in significant part, flow from the predictable responses issuers of debit cards would take in response to the proposal. Policy makers cannot reasonably assume that banks in competitive markets will sit idly by while being forced to reduce their current market-determined debit card interchange fees, which comprise much of their debit-card revenues and a material portion of bank profits, by anywhere from 73 to 84 percent. To the contrary, banks will attempt to make up as much of the lost revenue as they can by some combination of higher fees on checking accounts, fees or reductions of benefits for debit card use, or more refusals by issuers to permit consumers to conduct higher-cost types of transactions that impose greater fraud risk. We argue that the Board should find that, in the absence of empirical evidence evaluated using the analytical framework governing two-sided markets proving otherwise, market-set interchange fees are reasonable and proportional to cost. Any other decision would lead to the unreasonable outcomes.

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I. Introduction and Overview

Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Durbin Amendment") directs the Board of Governors of the Federal Reserve System ("Board") to issue rules regarding debit card interchange fees and other matters relating to debit card operations.[1] On December 16, 2010, the Board approved for public comment a set of rules proposed by the Board staff in response to this section of the Dodd-Frank Act.[2] We outline in this statement why the Board's proposed alternatives for regulating interchange fees are not "reasonable" and therefore in direct violation of the statutory mandate that these rules be "reasonable" and "proportional" to the costs incurred by debit card issuers. We endorse the alternative approach for implementing this Congressional directive outlined in the "Economic Principles Paper" submitted on this subject by David S. Evans, Robert E. Litan, and Richard Schmalensee.[3]

The Board's December 16, 2010 proposal is not "reasonable" because it would lead to a series of "unreasonable" outcomes, which, in significant part, flow from the predictable responses issuers of debit cards would take in response to the proposal. Policy makers cannot reasonably assume that banks in competitive markets will sit idly by while being forced to reduce their current market-determined debit card interchange fees, which comprise much of their debit-card revenues and a material portion of bank profits, by anywhere from 73 to 84 percent. To the contrary, banks will attempt to make up as much of the lost revenue as they can by some combination of higher fees on checking accounts, fees or reductions of benefits for debit card use, or more refusals by issuers to permit consumers to conduct higher-cost types of transactions that impose greater fraud risk. These easily anticipated responses, some of which are already under way or have been announced, make the proposal unreasonable for at least the following three reasons.

First, to the extent that banks respond by imposing fees on debit cards, many consumers are likely to turn to one or more alternatives, including credit cards, checks, and cash. These

[1] This section of Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") also becomes a new Section 920 of the Electronic Fund Transfer Act ("EFTA").

[2] "Debit Card Interchange Fees and Routing; Proposed Rule," The Federal Reserve System, *Federal Register*, 75:248, December 28, 2010. Available at: http://edocket.access.gpo.gov/2010/pdf/2010-32061.pdf ("The Proposed Rules").

[3] David S. Evans, Robert E. Litan, and Richard Schmalensee, "The Economic Principles for Establishing Reasonable Regulation of Debit-Card Interchange Fees that Improve Consumer Welfare," Submission to the Board of Governors of the Federal Reserve System, February 22, 2011 ("Economic Principles Paper"). We also draw in this statement elsewhere from another submission to the Board by the same authors, "Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Car Interchange Fee Regulations on Consumers and Small Businesses," Submission to the Board of Governors of the Federal Reserve System, February 22, 2011 ("Consumer Impact Study").

options could be more expensive for merchants, in direct conflict with one of the apparent objectives of Section 1075, which is to lower costs to merchants. In any event, the Board staff has provided insufficient analysis on this issue and thus the current record, at the very least, does not support the reasonableness of the proposal on this score.

Second, the banks' expected offsetting actions are very likely to impose significant costs on consumers if the proposal is implemented in its current form. Such an impact would be directly inconsistent with another major part of the Dodd-Frank Act, which creates a new agency within the Board to regulate consumer financial products, with the express objective of *helping* consumers, and indeed with the thrust of the entire Act itself, which is to protect users of financial products from various practices that led to the recent financial crisis. While the Board staff did address this issue in its analysis of its proposal, it admitted it did not know what the consumer impact would be, another indication that at the very least the record does not support the reasonableness of the proposal.[4] The Board staff also apparently did not consider the potential impact of the higher bank fees on small businesses as well.

The impact of any higher bank fees will be especially onerous for low income bank customers, who will thus have incentives to return to the ranks of the "unbanked", or if they are already in that category, not to enter into a banking relationship. Both outcomes are clearly inconsistent with another part of the Dodd-Frank Act that explicitly is designed to encourage movement of the unbanked to formal banking relationships.[5] This result would also contravene the intent of the FDIC's statutory reporting requirements on this issue.

Third, the Board's December 16, 2010 proposal is unreasonable because it runs the risk of conflicting with another important social objective, which the Board has long encouraged: moving retail payments away from paper (checks and currency) and toward electronic alternatives (debit and credit cards, Internet payments, and, most recently, mobile payments). Bank responses to the current debit card interchange fee proposal that discourage debit card use, which in recent years has done the most to move payments in the electronic direction, would have the opposite effect.

Fortunately, there is an alternative the Board can pursue that will avoid these unreasonable outcomes. As outlined in detail in a separate "Economic Principles Paper" authored by Evans, Litan and Schmalensee, the Board should find that, in the absence of empirical evidence evaluated using the analytical framework governing two-sided markets proving otherwise, market-set interchange fees are reasonable and proportional to cost. Any other decision would lead to the unreasonable outcomes documented in this statement.

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[4] See "Federal Reserve Board of Governors Holds an Open Meeting," CQ Financial Transcripts, December 16, 2010, at p. 11 of 28 ("Board December 16, 2010 Open Meeting").

[5] See Title XII – Improving Access to Mainstream Financial Institutions, from H.R.4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act. Available at http://www.opencongress.org/bill/111-h4173/text.

II. The Board Must Take Account of the Rational Responses of Banks to Any Rules It Will Set for Debit Card Interchange Fees

It is now well established under successive Executive Orders issued by all Presidents since the Ford Administration that Executive branch regulatory agencies must analyze the costs, benefits, and other impacts of their major proposed regulations before promulgating them, regardless of the degree to which the governing statutory language under which they are issued permits the final rules to reflect a balancing of these factors. Since the late 1970s, when the economic deregulation movement began (first with airlines, then with trucks and railroads, and continuing with telecommunications), few, if any, new regulations have entailed price controls, as the Board has interpreted the Durbin Amendment to require (notwithstanding the more permissive express language of the Section which refers only to fee "standards"). Instead, many if not most new federal regulations have taken the form of new standards, which means that agency analyses typically have focused on estimating both the compliance costs that would be imposed on regulated parties and social benefits those regulations could be expected to deliver. These analyses often do not take account of behavioral responses of the regulated parties, but instead implicitly assume either that the costs of the rules are passed on to consumers or absorbed in lower profits of the regulated parties, or some combination of the two.

We recognize, of course, that the Board is an independent agency, and as such is not bound by the Executive Orders requiring economic analyses of its rules. Nonetheless, earlier this month the Office of Management and Budget issued a guidance memorandum to all independent agencies requesting their compliance with the latest version of these orders, Executive Order 13563. Furthermore, the Board, being the preeminent "economic agency" of the Federal government, has conducted some economic analysis in this case, although as we elaborate below, we believe it is inadequate. Nonetheless, the Board staff has carried out the limited analysis that it presented to the full Board presumably because the statute under which it is acting, the Durbin Amendment, requires any interchange fee standards to be both "reasonable" and proportional to the cost of debit transactions.[6] This language implicitly, if not explicitly, entails a balancing of the costs and benefits of any final fee standards.

Even more to point, the Electronic Fund Transfer Act itself, which Section 1075 of the Dodd-Frank Act amends, specifically requires the Fed in promulgating any rule issued pursuant to EFTA (including the Durbin Amendment) to balance benefits and costs for a wide range of parties.[7] Nowhere in the Board's Proposed Rules is there any reference to the benefit-cost

[6] See Sec. 1075 Reasonable Fees and Rules for Payment Card Transactions, from H.R.4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act. Available at http://www.opencongress.org/bill/111-h4173/text.

[7] 15 U.S.C. § 1693b(a) (3). More specifically, Section 904 requires the Board to consider, among other things, the "costs and benefits to financial institutions, consumers, and other users of electronic fund transfers."

balancing requirements of EFTA, or an explicit determination that the proposal passes that test. For that reason alone, the proposal, if adopted, would not be in compliance with EFTA.

Furthermore, the balancing of benefits and costs cannot be performed where regulation takes the form of price controls without also considering how the parties subject to the controls – in this case, issuers of debit cards – are likely to respond to the controls. As the Board is aware, it is well understood in the economic literature that all price controls are intended to directly affect the behavior of regulated parties. Depending on the nature of the controls, the nature of the market (and products or services) subject to the controls, and the elasticity of demand and supply for the service, price controls can encourage efficiency or discourage innovation, limit the supply of the regulated product or service, or induce the regulated parties to take measures that offset as much of their ill impacts as market conditions will permit. Some combination of these reactions – which may differ across regulated parties where, as here, there are many of them – is especially likely where the controls will have a significant financial impact on the regulated parties and there are close substitutes for the products or services that are subject to the controls.

In fact, these conditions apply in this particular case. Both of the alternative fee limits proposed by the Board would significantly reduce the revenues that debit card issuing banks currently collect each year from interchange fees. In percentage terms, the proposed limits are also very substantial. Under the first proposed alternative, interchange fees would fall from their current average of 44 cents per transaction, to a cap of 12 cents or a safe harbor as low as 7 cents, representing a reduction of 73 to 84 percent.[8] Banks and credit unions would receive an estimated $33.4-$38.6 billion less revenue in the first two years after the imposition of these reductions absent any efforts to mitigate these losses.[9] By any standard, these are huge impacts, and any for-profit entity subject to them would do everything in its power to offset them, to the extent market competition permits.[10]

Both the Congress and the Board have recognized that banks subject to any interchange fee limits would take counter-measures because there are substitutes for debit cards including checks, cash, and credit cards. Thus, the Durbin Amendment itself *requires* the Board to consider the "functional similarity" between debit cards and checks, which clear at par. In the public hearing on the proposal, Governor Raskin noted that "to a great extent a debit card is just a plastic check."[11] This is a significant overstatement since debit cards are far more convenient

[8] The Proposed Rules, at p. 81726. Banks with assets under $10 billion are not subject to the proposed rules, but for reasons discussed below, it is likely that they, too, will be forced to suffer a significant loss in interchange revenue.

[9] Consumer Impact Study, at pp. 14-15. The study estimates the two-year revenue loss from the Board's proposal to range between $33.4 billion and $38.6 billion ($15.7 billion - $18.2 billion for the first 12 months after the proposed rules would go into effect and $17.7 billion - $20.4 billion for the second 12 months).

[10] In fact, as documented in the Consumer Impact Study, at pp. 42-45, a number of issuing banks are already on record indicating counter-measures they will take to make up for any mandated loss in interchange revenue.

[11] Board December 16, 2010 Open Meeting, at p. 21 of 28.

than checks for both consumers and merchants,[12] and offer significant features and functionality not provided by paper checks, such as guaranteed payment and fraud protection. Nonetheless, if confronted with higher fees and/or reduced rewards for using debit, at least some consumers who now regularly use these cards might go back to writing checks, which have their own significant processing fees and costs.

Most consumers who carry debit cards also carry credit cards.[13] Consumers who have both cards choose to use one or the other often by weighing the availability of reward or other card features for one or the other, or if available on both, then by deciding whether they want to subject themselves to the discipline of immediate point-of-sale deductions from their bank accounts, or preferring instead to take advantage of the float or credit features of credit cards. Debit card users have chosen to forego certain credit benefits in lieu of the budgeting controls provided by debit cards, but may now be required to move to a credit card because the cost of debit has increased, or issuers disallow certain higher-cost debit transactions, such as large ticket purchases or Internet transactions.

The colloquy between the Board and the staff at the public December 16, 2010 meeting makes clear that both recognize that banks in fact will take counter-measures in response to interchange fee standards. In response to Chairman Bernanke's opening question about the arguments for and against government intervention in interchange rates,[14] Dr. Robin Prager (Assistant Director of the Federal Reserve's Division of Research and Statistics) observed that "banks use the revenues from these interchange fees to offer more attractive deposit account terms to their customers, including, in some cases, rewards for making payments with debit cards."[15] By implication, any significantly binding limits on interchange fees, such as those in the Board's December 16, 2010 proposal, would thus have the reverse impact – that is, banks would cut back the "attractiveness" of their deposit account terms (raising fees, cutting the numbers of free checks or availability of free checking, and so on) and reducing some of the valuable features or reward programs for debit cards (or even conceivably implementing some kind of fees for debit use). Indeed, Dr. Mark Manuszak from the Federal Reserve's Division of Research and Statistics noted at the meeting that one of the first things debit issuers "may do [in response to the staff's proposal] is to reduce or eliminate debit card reward programs…"[16] Dr. Prager agreed with this projection.[17] In fact, some issuing banks already have either taken

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[12] Consumer Impact Study, at pp. 22-25.

[13] According to the 2007 Survey of Consumer Finances, over 70 percent of households with a credit card also had access to a debit card.

[14] We address below in more detail the claim that there is a "market failure" in the debit card interchange market that requires government intervention.

[15] Board December 16, 2010 Open Meeting, at p. 9 of 28.

[16] Ibid., at p. 11.

[17] Ibid. It is important to emphasize that none of these well anticipated counter-measures – higher fees or cutbacks in current benefits – constitutes "circumvention", as it is contemplated in Section 1075. That term is reserved for any other fees banks may levy on merchants to counteract limits on interchange fees, which the statute prohibits.

actions to offset the potential loss of their interchange revenue or have announced plans to do so, in anticipation of the Board's proposals being adopted.[18]

The incentives for consumers to use substitutes for debit cards is not likely to be offset to any significant degree by the fact that banks with under $10 billion in assets are exempted by the statute from any interchange fee standards. Even if one or both of the two major debit card networks adopt different interchange fee schedules for banks that are and are not subject to the standards, merchants won't have a financial incentive to accept cards from smaller banks that attempt to charge fees above the standard, or will aggressively steer consumers away from such cards. This is one of the reasons that smaller issuers appear to be just as concerned about the proposed fee caps as the larger issuers. Furthermore, the proposal's exclusivity and routing requirements apply to all debit card issuers regardless of size. The small issuers are not in a position to realize the same economies of scale in their debit operations as the larger banks.[19] For all these reasons, despite the exemption, it understandable why many smaller depository institutions are concerned that the Board's rules will end up hurting them, not leaving them untouched as the law theoretically attempts to do through the "exemption" from the mandatory fee standards.

To be sure, the Board staff does note that merchants would have incentives under the proposal to encourage consumers to make greater use of debit cards, both as a result of the lower acceptance costs and the additional ability the proposal gives merchants to steer customers toward the use of debit. Even so, because of the incentives the proposal would give issuers to steer customers *away from* debit, the Board staff concluded at the hearing that they didn't know what the net outcome would be in the marketplace.[20]

We believe the evidence supports a more definitive view – namely, that the current proposal actually *would* tilt payments away from debit and toward alternative means of completing transactions. This is because the proposed reductions in revenues earned by issuers from interchange – earned for an excellent market-based reason and not the result of a market failure, as we discuss below – are so substantial that debit issuers have strong incentives to accomplish this result. As we show next, it is not even clear that, when taking account of this fact, merchants as a group even will benefit from the proposal.

In any event, it is even clearer that consumers will be harmed because any increase in bank fees and reductions in card utility (e.g. declines of higher value transactions such as for furniture), or other valuable features such as debit rewards, will more than offset any lower prices they may receive from merchants, who are unlikely to pass on to the consumers anything close to the full savings of the limited reductions in merchant fees from acquiring banks they could realize under the proposal. The likely net result – a move away from debit – is

[18] Consumer Impact Study, at pp. 42-25.

[19] Ibid., at pp. 12-13 and pp. 67-68.

[20] Board December 16, 2010 Open Meeting, at p. 11.

inconsistent with long-running Federal Reserve policy and not in the social interest. Any one or more of these outcomes are not "reasonable" under the terms of the Durbin Amendment.

III. The Current Record Does Not Establish the Net Impact of the Board's December 16, 2010 Proposal on Merchants, Which Could Be Negative

Any final interchange standard cannot be "reasonable" in relation to cost if the Board cannot know with reasonable certainty, or even if it is likely, that the standard will not harm merchants, considered as a group, and taking all consequences of the proposal into account. This is because one of the stated purposes of the Durbin Amendment is to benefit merchants.[21] In this regard, it is a fallacy simply to look at the impact of the interchange fees alone on merchants. If the entirely reasonable and well-anticipated counter-measures that banks take in response to any fee limits impose *other costs* on merchants, then the *net effect* of the limits may not produce the outcome intended by the legislation.

The Board staff has not yet provided sufficient analysis to assess the net impact of its proposal on merchants, nor does the record establish that, on net, merchants would benefit from the Board's proposal. Even so, there are reasons to believe that the net impact could be negative, or at most small, for merchants as a group.

First, as documented in the "Consumer Impact Study", a significant portion of the proposed lower interchange fees for *merchant processors* is unlikely to be passed through to smaller merchants, but rather retained by the processors or their agents (because these merchants have "blended pricing" from acquiring institutions or their agents, and also have higher switching costs).[22] In fact, the vast majority of the reduction in interchange fees will flow to the largest merchants, making it even more difficult for smaller merchants to compete. Any calculation of the net impact of the proposal on merchants must therefore begin by taking this factor into account.

Second, as established in the foregoing section, taken as a whole the proposal is likely to generate a significant shift from debit card use to various forms of non-debit means of payment, which are more expensive and/or more inconvenient for merchants: cash (by increasing numbers of customers who, because of higher deposit account fees, are likely to join or re-join the ranks of the unbanked or who, because debit card use is made less attractive, will make larger or more frequent cash withdrawals from ATMs and pay with cash), checks (because of lower or eliminated debit card reward programs and any debit card fees, which could offset any negative effects on check use from higher deposit account or check fees), and

[21] *See* Floor Statement of Senator Durbin, S3588 (May 12, 2010) ("this amendment is on behalf of small businesses across the United States which have rallied behind this because of their concern about interchange fees on their cost of doing business.").

[22] Consumer Impact Study, at pp. 57-58.

credit cards (because of reductions to debit card benefits, higher debit fees, or issuer-declined debit transactions). *Each of these alternatives is likely to be more expensive or inconvenient, or both, for merchants than is the case under the current system of interchange fees.*

Cash: Cash is costly to handle and exposes consumers and merchants to security risks. From the government's perspective, cash is also expensive to produce and destroy and raises risks of money laundering and tax evasion.

Checks: Checks are not only costly to handle, but add delays at the point of sale that can be frustrating to both customers and merchants, especially during periods of heavy sales volumes. Checks also entail risks of collection for merchants, even though they impose charges on bounced checks (not all of these charges can be collected). Many merchants will not even accept checks.

Credit cards: Given the high degree of substitutability between credit card and debit cards (consumers can elect to pay off each credit card balance and not revolve, taking advantage of the float in between), any minor change in banks' reward or fee structures for debit card use in response to the proposed large reduction in interchange fees received by debit issuers could easily tip a substantial volume of current debit card use to credit cards. Any such shift could increase acceptance costs on net to merchants. As Dr. Prager noted at the Board meeting credit card interchange fees "are generally higher" than the analogous fees charged on debit card networks.[23]

Third, the higher bank fees that would follow the introduction of the Board's proposal, in its current form, would hit the millions of small merchants who use banking services. The Board took no account of this factor, which alone could easily more than outweigh any benefits many of these merchants might get from reduced interchange fees especially in the next year or so.[24]

IV. The Board's Proposal Is Likely To Harm Consumers, Especially Those with Low to Moderate Incomes

The objective of most regulation, including banking regulation, is to benefit consumers. This is clearly the case with the overall Dodd-Frank Act in particular, which has many provisions aimed at enhancing the safety and soundness of individual financial institutions, as well as the entire financial system, which are clearly in the interest of banking customers (in that capacity, and as taxpayers). More specifically, the Act lodges a new consumer financial products safety bureau within the Federal Reserve itself with the express mission of protecting consumers from harmful financial products and services. It would thus contravene a major

[23] Board December 16, 2010 Open Meeting, at p. 21 of 28.

[24] Consumer Impact Study, at pp. 64-66.

purpose of the Dodd-Frank Act for the Board to promulgate interchange fee standards for debit cards – a financial product and service heavily used by consumers – that harms consumers, or that the Board cannot reasonably conclude will improve consumer welfare (which, as noted, the Board staff acknowledged at the public hearing). Indeed, the proposed debit card interchange fee restrictions could push some consumers to use precisely those financial products that proponents of the new consumer financial products agency were concerned about – such as check-cashing services and payday lending.

Analysis of consumer impact appropriately begins where Chairman Bernanke started the public hearing, by asking the staff what the source of market failure was in the debit card industry. He was told that because of the unusual nature of the market, the issuers had incentives – funded by interchange fees – to expand use of the cards. This ostensibly was because consumers do not take into account merchant costs (of which the interchange fee is a part) when making their purchases.

But as explained in significantly more detail in the "Economic Principles Paper" this allegation of a market failure ignores the two-sided nature of the debit card – and other markets. In two-sided markets, as Dr. Prager and her colleagues have recognized, it is often the case that one side is charged more than marginal cost, and the other less.[25] Examples include over-the-air television (paid for by advertisers, not viewers), internet search (paid for by advertisers, not searchers), and shopping centers (paid for by the merchants, not by charging the customers for walking in). Debit cards are no different. It is entirely rational, and consistent with market health and not failure, for the issuers and the networks to encourage consumers to use the cards, and to provide competitive features and benefits for doing so, if that is what it takes to facilitate their use.

Moreover, from a broader social perspective, the expanded use of debit – which Governor Yellen implicitly applauded at the outset of the Board's hearing – is in the public interest. (Governor Yellen noted that nearly 38 billion debit card payments were made in the United States in 2009 and that they now account for 35 percent of non-cash payments transactions – all for a financial product that was barely provided or used 15 years ago and which many doubted would ever become as popular as it has become).[26] As discussed further below, the Federal Reserve and other policy makers have long been encouraging the use of debit as part of a large move of retail payments toward electronics and away from paper. The best economic evidence supports this policy objective. As suggested in the immediately preceding section, when all costs of transacting are taken into account – including not only the

[25] Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski (2009). "Interchange Fees and Payment Card Networks: Economic, Industry Development, and Policy Issues," Federal Reserve Finance and Economics Discussion Paper, 2009-23, at p. 3 ("The Fed Economists (2009)").

[26] Board December 16, 2010 Open Meeting, at p. 2 of 28.

costs of physically completing a purchase, but the value of time in doing so and the costs of security – debit cards represent one of the cheapest means of payment for merchants.[27]

Limiting the projected impact of the Board's proposal just to consumers, the Board staff admitted at the December hearing that it did not know its ultimate impact: higher bank fees and reductions of utility or features for debit use might more than offset any savings consumers might eventually realize from the proposed mandated lower interchange fees.[28] In fact, the best evidence we have seen is more definitive. The net long-term impact on consumers is very likely to be negative and almost certain to be negative for the first few years after the recommended regulation takes effect.

The logic and empirical analysis are laid out in the Consumer Impact Study. As noted earlier, given the magnitude of the proposed reduction in issuer revenue from interchange fees there is little doubt that the banks will seek to offset as much of this impact as they can with higher charges on deposit accounts and on debit cards themselves. And, as retail banking is generally highly competitive, economic theory says that much of this adverse impact will be passed on to banks' depository account customers. These higher costs will be felt by all of the banks' users in some manner, certainly by the vast proportion of the users of the banking system (banks with more than $10 billion in assets account for approximately two thirds of the deposits in the system, and as noted, smaller banks are not likely to benefit from the $10 billion statutory exemption).

Consumers who patronize merchants affected by the proposed drop in interchange fees, in contrast, almost certainly will not benefit to the same degree for reasons identified earlier as well. The merchant processors and independent sales organizations that service smaller merchants are unlikely to pass on all, or even most, of any mandated reductions in interchange to these firms. And the larger merchants who will receive more, or even all, of the reductions, face less competition in their markets and are unlikely to pass on the full amount of the benefits they receive from the interchange fee reduction (which is likely to represent less than .2 percent of their sales).[29] As shown in the Consumer Impact Study, merchants receiving the full interchange fee reduction would save only about 10 cents on the typical $59.89 transaction, or less than 2 cents on a $10 item. These savings are unlikely to be passed on to consumers, especially given the stickiness of prices in response to especially small changes in costs.[30] Further, as documented in Section II of this statement, these merchants would face offsetting higher costs as their consumers use other means of payment. It is clear from the colloquy at the

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[27] See Daniel D. Garcia-Swartz, Robert W. Hahn and Anne Layne-Farrar (2006). "The Move Toward a Cashless Society: Calculating the Costs and Benefits", *Review of Network Economics*, 5:2 (June).

[28] Board December 16, 2010 Open Meeting, at p. 11 of 28.

[29] Consumer Impact Study, at pp. 46-48 and pp. 54-56.

[30] Ibid., at pp. 48-51.

December 16, 2010 Board meeting that the staff had not yet taken adequate account of these factors.

Moreover, the consumer impact would be uneven, and generate another unreasonable outcome. Higher deposit account fees would have a disproportionate impact on low income users of bank services (who tend to be disproportionately from minority backgrounds), some of whom are likely to have recently patronized formal banking institutions. Higher account fees also would discourage currently unbanked individuals and households from patronizing banks.[31]

Both impacts run counter to national policy, clearly expressed both in the Dodd-Frank Act itself and elsewhere. In particular, the Act contains *an entire Title* (XII) devoted to "Improving Access to Mainstream Financial Institutions." Among other things, this part of the law gives authority to the Secretary of the Treasury to launch "a multiyear program of grants, cooperative agreements, financial agency agreements, and similar contracts or undertakings" in order to support the unbanked in establishing bank accounts, accessing small dollar loans and to participate in financial education. Likewise, the same title provides authority for the Community Development Financial Institutions Fund to provide financing and technical grants that support small dollar loans at these institutions. Some portion of these loans could support the currently unbanked.

Similarly, Section 7 of the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 requires the FDIC to conduct a bi-annual survey of depository institutions on their efforts to bring the unbanked into "the conventional banking system." The FDIC has even launched a website, www.economicinclusion.gov, which contains such information, as well as the deposit insurer's initiatives to promote this goal. There would be no point to these reporting requirements and to the FDIC's initiatives if it were not national policy to encourage the unbanked to bank at formal depository institutions.

Given these expressions of national policy, it would unreasonable on its face for the Fed to then promulgate another set of rules – standards governing interchange fees – that very likely would *increase* the ranks of the unbanked. This is especially likely in light of the finding in the latest FDIC National Survey of the Unbanked that about half of unbanked households previously had bank accounts, which suggests that many individuals and households are likely to be highly sensitive to the fees that banks charge them for banking services.[32] As the current interchange proposal gives strong incentives for banks to raise their deposit account fees, the likely outcome – an increase in the unbanked – is an unreasonable one.

[31] Ibid., at pp. 62-64.

[32] See home page of www.economicinclusion.gov.

V. The Board's Proposal Runs the Risk of Turning Back the Clock on Movement toward the Electronic Retail Payments

Even with its predominant duties of managing the nation's monetary policy and supervising many banks and the nation's largest financial organizations, the Board also has responsibilities more closely related to this particular matter in assuring innovation and efficiency in the nation's payments systems, of which debit transactions have been playing an increasingly important role. In particular, debit card use between 2000 and 2009 expanded at an annual rate 18%, eclipsing the rate of usage for credit cards.[33]

Many statements by different Federal Reserve officials through the years indicate the Fed's desire to move retail payments toward more efficient electronic means.[34] Indeed, the 2010 Federal Reserve Payments Study has not only reaffirmed the progress toward electronic payment and away from paper generally, but noted that its results "underscore this nation's effort to move toward a more efficient electronic clearing system for all payments."[35] In this regard, the study explicitly noted that despite a substantial increase in the number of electronic payments in 2009 "much opportunity lies ahead" for further increases in such transactions in light of the fact that over 27 billion checks were still written that year.[36]

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[33] "The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006 – 2009," The Federal Reserve System, December 2010.

[34] See, e.g. Governor Donald L. Kohn, "Investing in Payment Innovations: A Federal Reserve Perspective," At the 2006 Payments Conference, Federal Reserve Bank of Chicago, Chicago, Illinois, May 11, 2006, http://www.federalreserve.gov/newsevents/speech/kohn20060511a.htm ("As innovations occur in the payments system, market forces will determine which of these innovations [including debit cards] will ultimately best serve the needs of consumers and businesses. We, at the Federal Reserve, need to continue to address barriers to innovation to give the private sector scope to experiment with new payment services, while we continue to fulfill our responsibilities to foster a robust payments system that protects and benefits its participants."); Governor Randall S. Kroszener, "The Future of Payments: Challenges and Opportunities," At the 2007 Payments Conference Competitive Forces Shaping the Payments Environment: What's Next?, Federal Reserve Bank of Chicago, Chicago, Illinois May 10, 2007, www.federalreserve.gov/newsevents/speech/kroszner20070510a.htm ("In its role as a regulator, the Federal Reserve will need to be alert to the application of regulations in changing circumstances. As I have already noted, the Federal Reserve has, in recent years, modified its regulations to facilitate the greater use of electronics in the payments system and to address emerging risks."). ; "2006 Annual Report", Federal Reserve Bank of Atlanta, www.frbatlanta.org/pubs/annualreport/annual_report_2006_index.cfm; William Poole, "President's Message: Checks Lose Market Share to Electronic Payments – and the Economy Gains," Federal Reserve Bank of St. Louis, January 2002, www.stlouisfed.org/publications/re/articles/?id=451 ("Replacing checks with electronic payments is good for the economy; electronic payments are just plain more efficient."); Thomas Melzer, "President's Message: The Cashless Society and the Federal Reserve," Federal Reserve Bank of St. Louis, July 1995, www.stlouisfed.org/publications/re/;articles/?id=1825 ("In pushing for electronic over paper forms of payment, the Federal Reserve has advocated moving in this direction for years,.").

[35] "Federal Reserve Study Shows More Than Three-Quarters of Noncash Payments Are Now Electronic," *Federal Reserve Financial Services Policy Committee*, December 8, 2010, available at http://www.federalreserve.gov/newsevents/press/other/20101208a.htm.

[36] "Nearly 80 percent of noncash payments are now electronic," Federal Reserve Financial Services, January 2011, available at http://www.frbservices.org/fedfocus/archive_general/general_0111_01.html.

The Board's interchange fee standards proposal runs the risk of reversing, or at least slowing, the nation's progress toward electronic means of payment, debit in particular. By reducing issuers' revenues from debit card interchange by between 73 and 84 percent, the proposal strongly encourages banks to reduce or terminate popular products and programs associated with debit cards (such as online payments and easy access to banking information), and possibly to impose fees on debit card use (especially for higher price purchases, such as flat-panel televisions, which carry a greater risk of fraud for the issuers). To be sure, the proposal also provides these institutions incentives to raise other deposit account fees, which should discourage check use, too. But as we noted in the earlier section, reductions in checking could be concentrated among low to moderate customers leaving the banking system altogether. With debit rewards or other features of debit cards gone or reduced, fees on debit accounts or card usage increased, and more transactions declined, consumers are likely to turn to credit cards, checks or cash. The net result could be a reversal or at least a slowdown in the move toward electronics generally, and certainly debit in particular.

Given the Fed's strong and long commitment to electronic means of payment, one would have thought the this issue would have been addressed by the Board but it appears that it has not been. This is yet another example where the record lacks evidence to support a judgment of the reasonableness of the proposal.

VI. Given the Current State of the Record, and in the Absence of other Reliable Evidence, the Board Should Define the Fee Standards as Those Currently Set by the Market

In light of the lack of any compelling evidence in the record that the Board's proposal – as the Board staff acknowledges – will improve consumer (or even merchant) welfare, coupled with the likely impacts on the nation's payments system that are at odds with prior national policy and the public interest, the best course for the Board at this point is to impose no ceilings at all on current debit card interchange fees. Put differently, at least until it has done the research and analysis necessary to close the gaps in the record that we have identified, the Board should implement the mandate of Section 1075 to provide fee "standards" by defining those standards to be those determined by the market.

At the same time, the Board should commence an evidentiary and analytical exercise different from the cost surveys it has just completed to see if the evidence supports a different result, consistent with the norms in the extensive literature on this market, and two-sided markets in general. The "Economic Principles" paper outlines how the Board can and should go about this task.

In carrying out this analysis, the Board should be mindful, as also suggested in that paper of first doing no harm, while proceeding with caution, as several of its staff economists counseled even before this proceeding began.[37]

Whatever it does, the Board should withdraw its current proposal on the grounds that the outcomes it would likely lead to would not be "reasonable" within the terms of Section 1075 of the Act.

[37] The Fed Economists (2009), at p. 43.