Sarah Bloom Raskin: Interchange fees

Testimony by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, US House of Representatives, Washington DC, 17 February 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

1 See http://www.federalreserve.gov/newsevents/press/other/20101208a.htm.

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.

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 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

---

[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.

[3] The meeting summaries and written submissions are posted on the Board's public website at http://www.federalreserve.gov/newsevents/reform_interchange.htm.

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 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 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

---

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.

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 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.

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.

---

[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).

[9] EFTA § 920(a)(6), 12 USC § 1693o-2(a)(6).

[10] EFTA § 920(a)(7), 12 USC § 1693o-2(a)(7).

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.

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

[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.

[12] EFTA § 920(a)(5), 12 USC § 1693o-2(a)(5).

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. 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.