

April 14, 2017

The Honorable Mike Crapo
Chairman
Senate Committee on Banking,
Housing and Urban Affairs
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking,
Housing and Urban Affairs
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

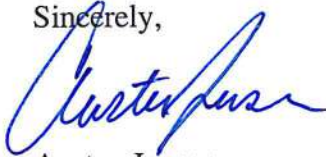
The Retail Industry Leaders Association (RILA) welcomes the opportunity to provide recommendations to the Chairman and Ranking Member on policy proposals that will empower consumers, market participants and financial companies to more effectively and efficiently participate in the economy. This is an important opportunity to have industry stakeholders engage with the committee in a bipartisan and proactive manner.

By way of background, 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.

The following proposals focus on protecting important reforms in the payment ecosystem as well as expanding certain policies to bring more transparency, innovation, and competition to the market. These recommendations do not reflect the full scope of RILA's priorities before the committee, but it is important to understand where Congress can make the most impact in the payments arena.

Thank you again for the opportunity to provide policy proposals to the committee. If there are questions or requests for further information about this submission, please feel free to contact me at austen.jensen@rila.org or 703-600-2033.

Sincerely,



Austen Jensen
Vice President
Government Affairs

Overview of Proposals

1. Protecting Debit Swipe Fee Reform

- a. Issue Background
- b. Federal Reserve Bank of Philadelphia, *How Dodd-Frank Affects Small Bank Costs*, First Quarter 2016
- c. Dr. Robert Shapiro, *The Economic Effects of Recent Regulations of Debit Card Interchange Fees*, October 2013
- d. RILA Letter to House Financial Services Committee on the Financial CHOICE Act and Repeal Effort, July 2016

2. Establishing Free Market Policies for Card Network Rules

- a. Issue Background
- b. Legislative Language on Open Standards
- c. Retail Coalition Letter to Visa CEOs Charles Scharf & Al Kelly on violation of Regulation II, November 2016
- d. Federal Trade Commission, Bureau of Competition Letter to Visa on EMV Transition, November 2016

3. Mobile and the Evolution of Payments

- a. Issue Background
- b. RILA & Merchant Advisory Group letter to the Office of the Comptroller of the Currency on Innovation, May 2016

4. Expanding Reforms to the Credit Card Market

- a. Issue Background

5. RILA Membership

Issue Background: Protecting Debit Swipe Fee Reform

Description:

RILA strongly encourages the Senate Banking Committee to maintain and protect Section 1075, of the Dodd–Frank Wall Street Reform and Consumer Protection Act (DFA).

Impact on Economic Growth:

Dr. Robert Shapiro’s analysis is the only comprehensive study to date on the DFA’s debit fee reforms. It shows that the reforms saved consumers six billion dollars and created 37,000 jobs in the first year alone.

Impact on Consumers & Market Participants:

One of the primary pillars of the DFA reforms was to finally bring a measure of competition to the debit market. The specific policies of a debit fee threshold and dual network routing have been paramount for retailers—especially small businesses who now have the ability to bring in other routing options outside of the dominant card networks and avoid their draconian fee structure. The ripple effect from this free market policy has allowed businesses of all sizes to control costs and be more competitive, which has in turn benefited the American consumer.

Other Background Materials:

-Federal Reserve Bank of Philadelphia, *How Dodd-Frank Affects Small Bank Costs*, First Quarter 2016

- Dr. Robert Shapiro, *The Economic Effects of Recent Regulations of Debit Card Interchange Fees*, October 2013

- RILA Letter to House Financial Services Committee on the Financial CHOICE Act and Repeal Effort, July 2016



BANKING TRENDS

How Dodd–Frank Affects Small Bank Costs

Do stricter regulations enacted since the financial crisis pose a significant burden?

BY JAMES DISALVO AND RYAN JOHNSTON

“With respect to supervisory regulations and policies, we recognize that the cost of compliance can have a disproportionate impact on smaller banks, as they have fewer staff members available to help comply with additional regulations.”

— Federal Reserve Chair Janet Yellen

New regulations imposed on banks since the financial crisis and Great Recession are primarily directed toward large banks, especially banks that regulators deem systemically important. However, small banks have argued that the stricter regulations are excessively costly for them. Often they have identified the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 as the main culprit, and this charge has been taken up by politicians who have cited the higher regulatory burden on small banks as a reason that various parts of Dodd–Frank ought to be repealed. Small banks have also complained that new capital requirements under the international Basel III accord have been unduly burdensome. Recently, some regulators have made proposals to lower regulatory costs for small banks.¹

We examine the effects of regulatory changes since the Great Recession on banks with assets below \$10 billion, which we refer to as small banks.² We show that new home mortgage lending rules imposed by the Consumer Financial Protection Bureau likely significantly affected small banks, despite a wide range of exemptions that limit the effects of new regulations. Another important line of business for small banks, commercial real estate lending, may also be significantly affected by new risk-based capital requirements. However, regulations on debit card transaction fees do not appear to have hurt small banks, despite complaints from bankers.

Because direct measures of regulatory costs are not

available, we mainly use a rough indicator of regulatory burden: the share of bank portfolios potentially affected by new regulations. Apart from these measures of bank activity that might be affected, regulatory compliance costs — in particular, the standardized reports required to qualify for the exemptions — may hit small banks disproportionately hard, as Chair Yellen has argued. These costs are largely anecdotal and hard to measure, but we report some estimates from economists at the Minneapolis Fed.³

In this article, we examine only the costs imposed on small banks without factoring in some new regulations that reduce their costs such as lower FDIC assessments.⁴ Nor do we discuss the intended benefits of the new regulations. We focus on the three regulatory changes that have elicited the most complaints from small bankers and their representatives: the qualified mortgage rule, Basel III capital standards, and the Durbin Amendment.

QUALIFIED MORTGAGE RULE

This rule mandated by Dodd–Frank is designed to force banks to maintain higher lending standards for home mortgages. It imposes rigorous standards of proof that a loan is not high risk. Notably, banks must document that a borrower has the ability to repay the loan and that the mortgage has no nonstandard contract structures, such as balloon payments. A mortgage that meets these conditions is called a *qualified mortgage*.⁵ Mortgages are presumed to be qualified mortgages if they are guaranteed by a

James DiSalvo is a banking structure specialist and **Ryan Johnston** is a banking structure associate in the Research Department of the Federal Reserve Bank of Philadelphia. The views expressed in this article are not necessarily those of the Federal Reserve.

government entity such as the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA) or meet the standards of a government-sponsored enterprise (GSE) such as Fannie Mae.

For the small bank, the key benefit of making qualified mortgages is that it then has protection against lawsuits by borrowers and against attempts by borrowers to avoid foreclosure.⁶ The legal protections are even stronger for qualified mortgages that are not *high priced*. A high-priced loan is one with an interest rate that exceeds the average prime rate by more than 1.5 percentage points for a loan secured by a first lien or by 3.5 percentage points for a junior lien. In recent surveys conducted by Fannie Mae and the Fed, small bankers report higher lending costs and lower approval rates because of the new qualified mortgage requirement.⁷

We can estimate the fraction of small bank portfolios affected by the qualified mortgage rule by examining the share of mortgages that would not have qualified for legal protections in the year before the new requirements were imposed. We use 2013 numbers because the economy had substantially recovered from the Great Recession by 2013 and because the rule was imposed in 2014.⁸ Unfortunately, Home Mortgage Disclosure Act (HMDA) data do not include enough information about each loan to know for certain whether a loan is a qualified mortgage or whether it is high priced, but we construct a rough approximation. First, the data do indicate whether a loan is FHA or VA insured, so those loans are automatically qualified mortgages. Our proxy for whether a loan conforms to GSE standards is that the face value of the loan is lower than the conforming loan limit for the geographic area of the property for which the loan was made.⁹ We also construct a proxy for high-priced loans.¹⁰ Our conservative measure of loans affected by the qualified mortgage rule adds nonconforming loans and conforming loans that are high priced. We call these loans *affected loans*.

Figure 1a illustrates that the median share — think of it as the measure for the “typical” bank — of affected loans by *number* of loans was approximately 10 percent for banks with less than \$100 million in assets, dropping to under 5 percent for banks with assets of \$2 billion to \$10 billion. The average number of affected loans was about 22 percent for the smallest banks, dropping to 9 percent for the largest category (Figure 1b). (The median share of affected loans by *dollar value* is somewhat higher than the share by number, ranging from 9 percent to 13 percent for different size banks, while the averages ranged from about 26 percent for the smallest banks to 17 percent for the largest.) The difference

FIGURE 1a

Qualifying Mortgage Rule Affects Small Bank Mortgage Lending

Median share of affected and unaffected mortgages by number of loans, 2013.

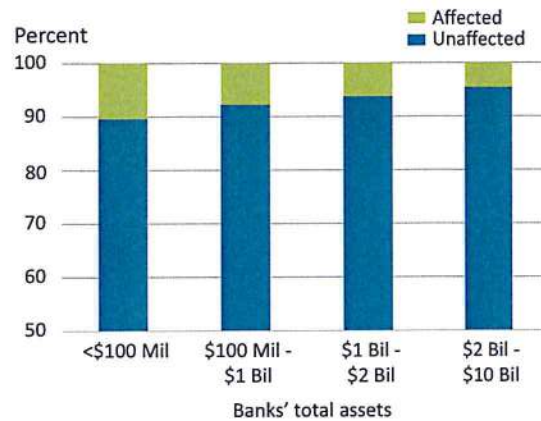
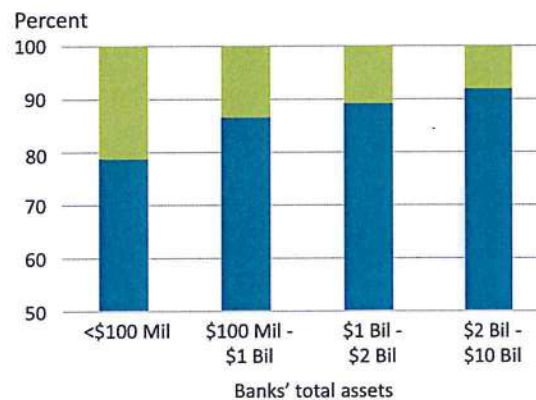


FIGURE 1b

Average share of affected and unaffected mortgages by number of loans, 2013.



Source: Home Mortgage Disclosure Act data.

Note: Affected mortgages include nonconforming loans and conforming loans that are high priced. Unaffected mortgages include FHA insured loans, VA insured loans, and conforming loans that are not high priced.

between the median and average values indicates that some banks in each size class specialized in lending mortgages that are affected by the qualified mortgage rule, but a closer examination of individual banks shows that the higher average values were not driven by a small number of banks with high concentrations of nonexempt mortgage lending. No less than 20 percent of the banks in each size class dedicated at least 10 percent of their portfolios to affected loans.

The number of loans is probably most relevant for thinking about compliance costs, which must be borne regardless of loan size. The dollar value is more relevant for

thinking about lost profits should small banks make fewer affected loans.

To sum up, the qualified mortgage rule affects a significant share of mortgage lending by small banks, and by some measures, the effect appears to be greatest for the smallest banks.¹¹

BASEL CAPITAL STANDARDS

While not directly the result of Dodd–Frank, capital requirements for banks have been raised and the risk weights on some classes of assets have risen significantly since the Great Recession.¹² The rise in total capital requirements primarily affects large banks, especially systemically risky banks.¹³ But the rise in the risk weights on certain types of commercial real estate (CRE) may have disproportionately affected small banks because they invest relatively heavily in commercial real estate. Indeed, CRE represents approximately 50 percent of small bank loan portfolios, compared with just over 25 percent of large bank portfolios. Raising the cost of making CRE loans could reduce small banks' competitiveness because detailed knowledge of local real estate markets is probably a significant source of comparative advantage for small banks.

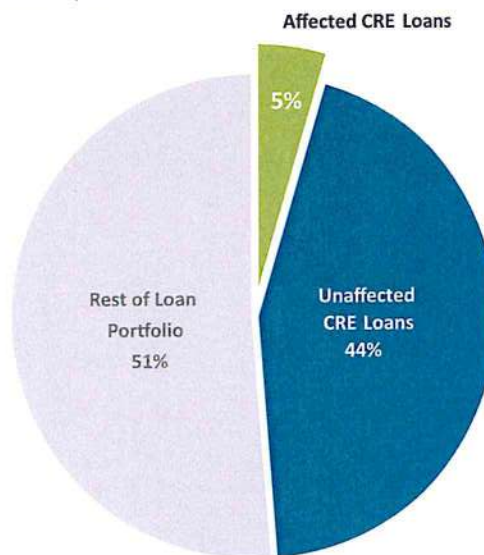
Specifically, the new capital requirements impose a 150 percent risk weight on particularly risky CRE loans known as high-volatility commercial real estate.¹⁴ For the purpose of determining a bank's capital requirements, this means that each dollar lent through such loans raises the value of bank assets by \$1.50.¹⁵ Previously, the risk weights on CRE had not exceeded 100 percent. Apart from concerns about the higher risk weight, bankers have also argued that the rules for determining whether a particular deal is a high-volatility loan are flawed.

While we can't directly determine the share of high-volatility CRE in small bank loan portfolios, we can get an upper-bound estimate of the share that could be classified as high-volatility CRE.¹⁶ First, the 89 percent of commercial banks with assets of less than \$1 billion are exempt from the higher capital requirement. For the remaining small banks, while CRE is a large component of small bank lending, neither mortgages for multifamily housing nor construction loans for one- to four-family housing — detached single-family homes plus attached homes of two to four units — can be classified as high-volatility CRE under the new capital standards. Figure 2 shows that the construction loans that might be so classified represent approximately 5 percent of total loans (2 percent of total assets) for the median commercial

FIGURE 2

New Requirements Affect Modest Portion of Small Bank Portfolios

Affected and unaffected commercial real estate loans as share of total loans, 2013.



Source: Federal Financial Institutions Examination Council Call Reports.

Notes: Affected CRE loans are defined as all construction loans for purposes other than constructing one- to four-family residential properties, all land development loans, and all other land loans. Total CRE loans include construction and land development loans, real estate loans secured by farmland, real estate loans secured by multifamily (five or more) residential properties, and real estate loans secured by nonfarm nonresidential properties.

bank with total assets below \$10 billion, while the average values are slightly larger.¹⁷ While this is an upper bound on the share of CRE loans actually subject to the higher capital requirements, it may be the appropriate measure for judging higher compliance costs. Even if a loan doesn't qualify as high-volatility CRE, the bank must provide adequate documentation to demonstrate that to examiners.¹⁸

In summary, the new capital requirements potentially affect a modest, but certainly not insignificant, portion of small banks' CRE portfolios.

THE DURBIN AMENDMENT

The Durbin Amendment of Dodd–Frank, which the Federal Reserve implemented as Regulation II in 2011 and amended in 2012,¹⁹ requires regulators to impose a ceiling on the *interchange fees* that covered banks charge for debit card transactions.²⁰ Each time a customer buys something with a debit card, the bank that issued the card charges the merchant's bank an interchange fee. All banks with assets below \$10 billion are exempt from the regulation. But

according to the American Bankers Association, “Interchange is one of the most important sources of non-interest income for community banks, and the severe reductions in debit-card interchange income that would result from the implementation of Durbin would be a major hit to the overall earnings of community banks.”²¹

Since the regulation imposes a ceiling on interchange fees only on banks with assets of more than \$10 billion, how would that affect small banks? Small bankers have argued that competition between large card issuers and small issuers would effectively impose the ceiling on small banks. What does the evidence say?

There is substantial evidence that the ceiling did lower interchange fees collected by banks with assets above \$10 billion, from around 44 cents to about 22 cents per transaction.²² But there was no such decline for small banks. Furthermore, after the ceiling was imposed, the volume of transactions conducted with cards issued by exempt banks grew faster than it did for large banks.²³ Finally, Zhu Wang shows that interchange revenue fell substantially at large banks after the fee ceiling was imposed but continued rising for small banks.²⁴

In sum, the evidence does not support the claim that competitive forces have effectively imposed the interchange fee ceiling on small banks, although it is possible that longer-term competitive effects might yet put small banks at a disadvantage.

COMPLIANCE COSTS

Regulations can impose significant costs if they increase regulatory reporting and compliance requirements. For example, the information required to document for regulators that a particular commercial real estate loan is not a high-volatility loan might be more costly to acquire than the information that the bank would routinely collect as part of its own due diligence and monitoring efforts. And to the extent that these costs are not divisible — for example, if the bank must hire a lawyer to ensure its regulatory compliance — then the small bank may be at a competitive disadvantage compared with a large bank that already has a legal department.

To date, reports of the costs of regulatory compliance have been largely anecdotal. But economists at the Minne-

apolis Fed have developed a simple methodology for estimating compliance costs for very small banks, measured by the cost of adding an employee dedicated solely to managing regulatory compliance. They estimate that 40 basis points is the minimum return on assets that investors require of a small bank.²⁵ They find that nearly 18 percent of banks with less than \$50 million in assets would fall below this minimum return if they had to hire an additional full-time employee, while 2.5 percent of banks with assets of \$500 million to \$1 billion would fall below the minimum.

While it is plausible that the fixed costs of hiring another employee impose a larger burden on small banks, it should be kept in mind that many small banks use consultants and vendors to handle regulatory compliance. These outside contractors spread their own fixed employment costs across their many small bank clients. Ultimately, the magnitude of the rise in regulatory costs due to Dodd–Frank and the accompanying regulatory changes since the Great Recession is an empirical question that will require more time and analysis to determine. However, even with years of data in hand, it will remain difficult to disentangle regulatory costs from other factors that affect small banks’ cost structures.

CONCLUSION

The inconclusive nature of the evidence notwithstanding, we note one interesting proposal from Federal Reserve Governor Daniel Tarullo, echoing a more detailed proposal by FDIC Vice Chairman Thomas Hoenig, designed to reduce regulatory costs for small banks. It offers small banks a trade. In exchange for maintaining a somewhat higher capital level than the minimum, small banks that do not engage in nontraditional activities would be permitted to use much simpler risk-based capital requirements similar to those of Basel I, which required only elementary distinctions between assets according to risk. For example, in exchange for holding a higher capital level, small banks would not be subject to the Basel III requirements for CRE.²⁶ This proposal might significantly reduce record keeping and compliance costs without posing a significantly higher risk to safety and soundness. ■

NOTES

¹ Concern about the impact of regulatory costs on small banks has two main rationales. First, as shown in our third quarter 2015 issue of *Banking Trends*, small banks play an outsize role in small business lending in the U.S. Second, small bank failures do not pose the same risks to financial stability as do large bank failures.

² In this article, we do not address the effects of the new regulations on large banks.

³ Bankers have also complained about overzealous and inconsistent examiners, but these costs have little to do with Dodd–Frank and are difficult to verify or quantify.

⁴ See Jim Fuchs and Andrew Meyer’s estimates.

⁵ A bank can make a qualified mortgage by documenting certain facts about the borrower: income or assets, employment, credit history, monthly mortgage payment, other monthly payments associated with the property, other monthly obligations associated with the mortgage, and other debt. Also, a borrower’s debt-to-income ratio must be 43 percent or less; the bank cannot charge more than 3 percent in points and fees; and the loan cannot have a special structure such as balloon payments, negative amortization, interest-only payments, or terms beyond 30 years. For more information on the qualified mortgage rule for small banks, see the Consumer Financial Protection Board’s *Ability-to-Repay and Qualified Mortgage Rule Small Entity Compliance Guide*.

⁶ Nonqualified loans are also significantly more costly to securitize — that is, to package along with other mortgages into a security that can be sold to investors. This cost is very important for large banks, less so for small banks, which generally retain more of their mortgage loans in their own portfolios.

⁷ While 67 percent of respondents to the Fed’s July 14, 2014, Senior Loan Officer Opinion Survey reported that the qualified mortgage requirements had no effect on their lending standards, those respondents reporting a decline in making nonqualified mortgages were more likely to be from smaller banks. Fannie Mae reported similar results, finding that most lenders had experienced or expected a rise in compliance costs.

⁸ In fact, the numbers are similar for 2013 and 2014. It is possible that banks were adapting to the impending regulation ahead of its enactment. Furthermore, most observers agree that bank credit standards for mortgage loans have been quite tight even as the economy recovered, so we might expect the new regulations to bind more tightly in future years.

⁹ We exclude home improvement loans because they would typically be below the conforming loan limit.

¹⁰ We define a high-priced loan as one in which the annual percentage rate is more than 1.5 percent higher than the average prime offer rate for loans secured by first liens and 3.5 percent higher for loans secured by junior liens. Still, some high-priced loans by our measure may meet GSE standards.

¹¹ Consumer Financial Protection Bureau regulations reduce the reporting burden for banks with less than \$2 billion in assets that made fewer than 2,000 mortgage loans in the previous year. This is a potentially large source of regulatory relief. We do not adjust our numbers to take this potential into

account because the extent to which a bank actually has a legal safe harbor if it takes advantage of the less stringent requirements is not yet clear. Nonetheless, we think of our portfolio measure as an upper bound.

¹² The Bank for International Settlements concisely describes the Basel agenda, www.bis.org/bcbs/basel3.htm.

¹³ See Ronel Elul’s article for a description and discussion of capital regulation from pre-Basel to Basel III.

¹⁴ High-volatility commercial real estate includes all acquisition, development, and construction (ADC) commercial real estate loans except one- to four-family residential ADC loans and commercial real estate ADC loans that meet regulatory requirements imposing a maximum loan-to-value ratio both at the outset and throughout the life of the loan.

¹⁵ Joseph Rubin, Stephan Giczewski, and Matt Olson discuss the possible effects of the new CRE capital standards.

¹⁶ Banks began reporting high-volatility CRE only in 2015.

¹⁷ Unlike for the HMDA data, the Call Reports provide no information about the number of CRE loans, only their total outstanding dollar value.

¹⁸ Bankers have also complained about the added complexity of the Basel III risk-weighted capital rules. This is difficult to quantify. Below, we briefly discuss a proposal to lessen this burden.

¹⁹ For more on Regulation II, see www.federalreserve.gov/paymentsystems/regii-faqs.htm.

²⁰ We will focus on the ceiling on interchange fees because this has been the primary source of complaints from bankers. Durbin also mandates that merchants be permitted to route debit card transactions through whichever networks are least costly for them.

²¹ Letter from Stephen Wilson to Sheila Bair.

²² See the report from the Board of Governors and the paper by Benjamin Kay, Mark Manuszak, and Cindy Vojtech.

²³ See the report on interchange fees by the Board of Governors.

²⁴ The Call Report lumps together interchange fees from debit cards and credit cards, so the different responses for large and small banks might, in principle, be due to a change in credit card fees rather than the result of the imposition of ceilings for debit cards. Wang addresses this issue by dropping all monoline credit card banks and finds identical results.

²⁵ This is the historical return on assets for a de novo bank after five years.

²⁶ Note that this would not address the qualified mortgage rule. The American Bankers Association has proposed that loans kept on balance sheets be exempt from the rule. To evaluate this proposal, we would need to address concerns about consumer protection and financial stability that underlie the rule.

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**The Costs and Benefits of Half a Loaf:
The Economic Effects of Recent Regulation of
Debit Card Interchange Fees**

Robert J. Shapiro

October 1, 2013

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**The Costs and Benefits of Half a Loaf:
The Economic Effects of Recent Regulation of Debit Card Interchange Fees¹**

Robert J. Shapiro

I. Introduction

The ultimate benefits and costs associated with the Dodd-Frank “Wall Street Reform and Consumer Act” enacted in July 2010 are matters of heated debate among public officials, financial-sector experts, and economists. This study examines one section of that Act, sponsored by Senator Richard Durbin, which directed the Federal Reserve Board to develop new regulations for the “interchange fees” charged for debit card transactions. These are fees charged by the banks that issue debit cards and paid by merchants every time a customer uses a debit card. The Durbin amendment, intended to “help small businesses, merchants, and consumers by providing relief from high interchange fees,”² instructed the Federal Reserve Board to develop binding standards for debit interchange fees that would be “reasonable and proportional” to the costs of processing these transactions.³ In December 2010, the Board issued its proposed rule; and six months later, on June 29, 2011, the Board issued its final rule, “Regulation II: Debit Card Interchange Fees and Routing,” which became effective on October 1, 2011.⁴ As we will see, new data show that under most conditions, this final rule has achieved significant savings for consumers and merchants. However, the evidence also shows that the new regulation has had certain perverse results harmful to the same consumers and merchants. The standards set out in the final rule also depart sharply from those provided under the Board’s original proposal, and in ways which impose much greater costs on consumers and merchants.

With more than two-thirds of U.S. households now using debit cards, Regulation II affects most Americans. In the first three quarters of 2011, before the Durbin Amendment took effect, Americans used their debit cards more than 3.8 billion times per month for purchases totaling some \$150 billion each month. Debit card issuers collected interchange fees averaging \$0.48 on each of those transactions, for a total of \$16.7 billion over the nine-month period; and most of these charges were passed along to consumers through higher prices. Yet, the Federal Reserve Board found that the actual costs of processing these transactions averaged just \$0.05 per transaction. The large gap between these costs and the interchange fees charged to cover them drove the new public demands to regulate these fees.

The standards for debit interchange fees set out in Regulation II have two major components. First, they cap debit card interchange fees at \$0.21 per transaction, plus 5 basis points (0.05 percent) of the transaction’s value, plus a \$0.01 charge per transaction for debit card issuers that meet certain fraud prevention standards. Second, these standards apply only to

¹ The author gratefully acknowledges the research provided by Dr. Nam Pham and Doug Dowson, and the support provided by the Merchants Payments Coalition. The views and analysis are solely those of the author.

² Congressional Record (May 13, 2010).

³ Sec. 1075, Wall Street Reform and Consumer Protection Act: Reasonable Fees and Rules for Payment Card Transactions.

⁴ Federal Reserve Board (June 29, 2011).

transactions with debit cards issued by financial institutions with assets of \$10 billion or more, covering about two-thirds of all debit transactions.⁵

Our analysis shows that these standards have had significant effects. We find, first, that the new cap on debit interchange fees reduced the fee on the debit transactions covered by the regulation from an average of \$0.51 per transaction (with large variations) to \$0.24 (with less variation).⁶ This overall reduction saved consumers and merchants an estimated \$8.5 billion in 2012, although some sectors such as supermarkets benefited little or, in some cases, are paying more. We also estimate that \$5.87 billion of the \$8.5 billion in 2012 savings was passed along to consumers in lower prices, and merchants retained \$2.64 billion. Economic theory and evidence suggest that these savings supported job gains in certain sectors. Lower prices for consumers lead to more consumption of goods and services, which drives the employment to produce them. Merchants' higher retained earnings also support more consumption by them as well, with the same employment effects. Merchants also use some of those higher earnings for additional investment that supports more jobs, as well as for direct hiring. All told, we estimate that the \$8.5 billion in 2012 cost savings was sufficient to support 37,501 new jobs.

These savings and job gains could and should have been substantially larger. While the bulk of most interchange fees before Regulation II depended on the transaction's size, the terms of Regulation II include a \$0.21 fixed fee per transaction, which disproportionately burdens small transactions and merchants that rely on them. We found that Regulation II actually raised interchange fees on transactions of \$15 or less. In fact, under Regulation II, the fee on the average small transaction of \$7.50, as a share of the transaction, exceeds the profit margins on such transactions for six industries that depend on small purchases, including supermarkets, groceries, convenience stores, gas stations and pharmacies. We found that if Regulation II had not raised interchange fees on small debit transactions, consumers and merchants would have saved an additional \$690 million in 2012, which could have supported 3,044 more jobs.⁷

The standards for debit interchange fees contained in Regulation II also are much less strict than those first proposed by the Federal Reserve Board. The Board's original proposal to cap debit interchange fees at \$0.12 per transaction attracted major lobbying efforts by financial institutions. As directed by the Durbin amendment, that \$0.12 cap reflected the costs for the median debit card issuer to authorize, clear and settle a debit transaction. Our analysis found that the Board's original proposal would have increased the benefits for consumers and merchants from \$8.5 billion to \$12.54 billion in 2012, an increase of \$4.04 billion or 52 percent. Moreover, these additional benefits could have supported substantial employment, which we estimate at an additional 17,815 jobs in 2012. All told, therefore, the Federal Reserve's original proposal would have generated benefits sufficient to support 55,316 new jobs in 2012 alone.

⁵ To encourage competition, Regulation II also stipulates that debit card issuers allow their cards to be used on at least two unaffiliated networks (for example, Visa and Discover).

⁶ Before Regulation II, the average fee for a signature debit transaction was \$0.57, versus \$0.33 for a PIN debit transaction. Moreover, since most of the fee before Regulation II depended on a transaction's size, the regulation did not cut interchange fees on most smaller transactions – and raised them on many small purchases.

⁷ The Durbin Amendment applies to interchange fees collected only on cards issued by financial institutions with assets of \$10 billion or more. The 7,494 banks and credit unions with assets of less than \$10 billion issued debit cards which accounted for 34 percent of 2012 debit transactions, totaling some \$664 billion. The interchange fees charged on these exempt transactions have not declined and averaged \$0.43 per transaction in 2012.

Finally, the new standards do not affect credit card transactions. Americans made an estimated 25.4 billion credit card purchases in 2012 with a total value of \$2.4 trillion. These transactions carried interchange fees which in 2012 totaled an estimated \$41.2 billion and averaged \$1.62 per transaction. Our analysis found that if credit card interchange fees on the two dominant, four-party payment networks, Visa and MasterCard, were capped at the maximum \$0.24 per-transaction rate set by Regulation II for covered debit transactions, consumers and merchants would have saved an additional \$ 22.4 billion in 2012. Consumers would capture \$15.4 billion of those benefits, and their additional spending could support 56,733 jobs. Merchants would likely retain roughly \$6.9 billion of the cost savings, and their additional spending and investments could support another 41,918 jobs. Extending Regulation II in its current form to Visa and MasterCard credit card transactions in 2012, therefore, would have produced savings sufficient to support an additional 98,651 jobs.

Congress and the Federal Reserve have reduced excessive interchange fees on many debit transactions. However, they could substantially improve on that work. First, the standards for interchange fees should reflect the real costs of processing debit transactions, as reflected in the Federal Reserve’s first proposal and as directed by the Durbin Amendment. Second, these standards should ensure that the fees for small transactions do not impose a disproportionate burden. Finally, Congress should extend these standards to credit card transactions.

II. The Economics of Interchange Fees

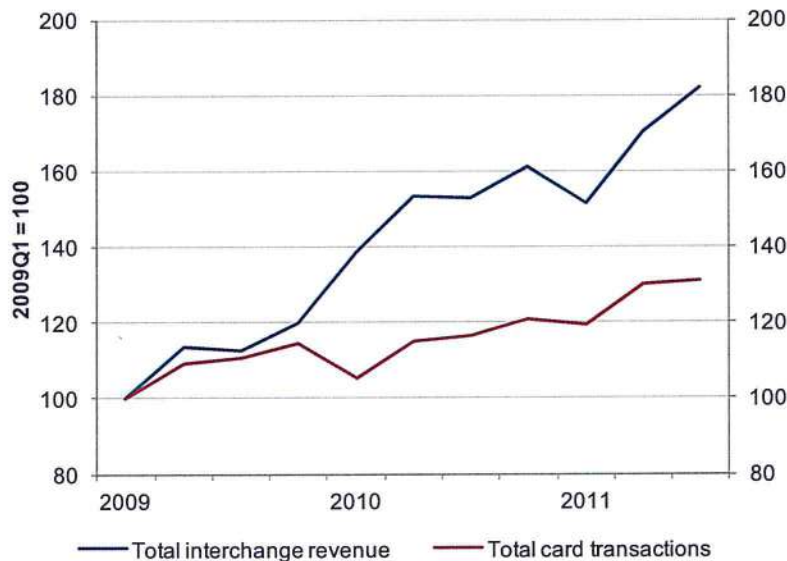
The economics of interchange fees, like the economics of many things, are more complicated than they initially may seem to be. First, the basic process: When a merchant processes a sale paid for with a debit or credit card, his bank charges him a fee to cover its own costs as well as fees it has to pay to the bank that issued the card and the payment card network. These fees are set by the payment card networks, such as Visa and MasterCard, and collected by card issuers such as Bank of America, Wells Fargo, and JP Morgan Chase. The largest of these fees is the interchange charge that goes to the card-issuing bank, applied to more than 200 million debit and credit card transactions every day across the United States.⁸

In a typical transaction, a cardholder swipes a debit card at a point of sale. Immediately, the merchant’s bank receives an electronic authorization request with the debit card holder’s account information and transaction amount. In less than a second, the merchant’s bank transmits these data to the bank that issued the card, which transmits its approval or rejection of the transaction to the debit card network, the merchant’s bank, and the merchant. In approved transactions, the card-issuing bank posts the debit to the cardholder’s account, the card network processes the transaction on behalf of the cardholder’s and merchant’s banks, and the merchant’s bank credits his account for the transaction, minus a “merchant discount” fee. The interchange fee accounts for about 80 percent of the merchant discount.

⁸ The cash flow runs in the opposite direction, from the cardholder to the card-issuing bank, to the card network, to the merchant’s bank, and finally to the merchant. After the transaction is authorized, the issuing bank posts the charge on the cardholder’s account and sends the charge less the interchange fee to the merchant’s bank. Both the network and the merchant’s bank deduct their own fees, and then send the charge less the fees to the merchant.

The merchants who pay interchange fees and many of their customers receive certain services. Some customers will purchase more using debit cards than with cash, and merchants receive payment more quickly than when they accept personal checks. The proper level of these fees, however, remains controversial – and consequential, since debit cards are the most popular form of noncash payment.⁹ Part of the controversy reflects evidence that interchange charges have risen much faster than the number or value of debit and credit card transactions. From the first quarter of 2009 to the fourth quarter of 2011, when Regulation II took effect, interchange fee revenues grew at a 27 percent annual rate while the volume of credit and debit card payments grew at an 11 percent rate. Therefore, 62 percent of recent increases in interchange revenues reflect higher interchange rates while the increases in transactions explain only 38 percent of rising interchange revenues. (Figure 1, below) The source of higher interchange charges matters, since most of the fees are passed along to consumers in higher prices, including higher prices for millions of low and moderate-income people who do not use payment cards.

Figure 1. Growth in Debit and Credit Card Interchange Revenues and Transactions, 2009-2011 (Index: 2009 = 100)



The Academic Consensus on Interchange Fees

The economic literature on interchange fees affirms the role the fees play in supporting a set of arrangements which encourage consumers to adopt the cards and merchants to accept them. A growing body of research also has found that the levels set for interchange fees exceed the “socially-optimal” levels justified by the system’s actual value and costs. From an economic vantage, therefore, lower interchange fees should improve market efficiency and social welfare. A distinguishing feature of these payment card systems is that they operate in “two-sided” markets that provide services to two independent groups – here, cardholders and merchants. The newspaper industry is sometimes cited as a typical two-sided market, providing services to both subscribers and advertisers. Rather than set prices independently for each group, newspapers set their subscription prices below their production costs and then compensate for it with higher

⁹ Board of Governors of the Federal Reserve System (2013A).

prices for advertising. By using advertising revenues to subsidize subscribers, newspapers can increase their circulation, for the benefit of both subscribers and advertisers.

In an early (1983) study, the lawyer-economist and U.S. Assistant Attorney General William Baxter demonstrated that, in principal, payment card networks set their fees in much the same way as newspapers.¹⁰ At the optimal level of interchange fees, the costs of the payment network should be distributed in ways which attract the highest numbers of cardholders and merchants. The interchange fee helps balance the two sides of the payment card market and, in theory, ensure that cards are adopted and accepted at levels which maximize social welfare.

Many empirical studies, however, have found that interchange fees are generally set at relatively high levels that are not economically and socially optimal. To begin, Baxter's classical interchange model depends on the unrealistic assumptions that merchants, customers and payment card issuers all operate in perfectly competitive markets that lead to efficient interchange fees.¹¹ In fact, merchants have little choice but to accept most major payment cards even when their interchange fee rises; and a 2002 study found that when merchants' demand for network card services is "price inelastic" in this way, the fee will exceed the socially-optimal level.¹² In a similar vein, a 2004 study found that when the card-issuing side of the market is less competitive than the card-accepting side, interchange fees also will be set too high.¹³ In other words, both studies showed how merchants will accept cards even when the fee exceeds the benefits, which in turn allows card networks to set those fees at inefficiently high levels.

Other economic analyses have explored why consumers adopt and use cards in ways that lead to excessively high interchange fees. A 2009 study noted that consumers generally pay the same retail price regardless of how they pay, giving them an incentive to sign up and use cards with generous rewards and higher interchange fees to finance them.¹⁴ Building on this and other research, another recent analysis showed that when consumers' decisions about whether to use cards are sensitive to the membership or late fees they pay to card companies, the interchange fees paid by merchants again tend to exceed optimal levels.¹⁵ That researcher, as well as another study, also found that when card holders' costs fall – for example, by paying their bills on time – card issuers raise interchange fees to maintain their profits from the system. They concluded, "...market-determined merchant fees tend to be too high from a consumer welfare point of view ... imposing a cap on merchant (interchange) fees may improve consumer welfare."¹⁶

III. Evidence that Interchange Fees Are Set Too High

Real world experience with debit and credit card markets confirms most economists' view that interchange fees are likely to exceed socially optimal levels, and that therefore

¹⁰ Baxter (1983).

¹¹ Under this assumption, interchange fees serve simply as transfer payments between merchants and cardholders. Any increase in interchange fees is simply competed away by issuers in the form of lower fees or higher benefits for cardholders, and any decrease in interchange fees is competed away by acquirers in the form of reduced merchant discounts.

¹² Rochet and Tirole (2002); Wang (2010).

¹³ Wright (2004).

¹⁴ Bedre-Defolie et al. (2009).

¹⁵ Wang (2010); McAndrews and Wang (2012).

¹⁶ McAndrews and Wang (2012).

regulation to limit them could be economically warranted and desirable. One example is evident in the PIN and signature debit card systems. Signature debit cards have relatively high interchange fees, and yet are more popular than PIN debit cards with lower fees. With PIN debit, users input their personal identification numbers (PIN) and their transactions are routed through electronic-funds-transfer (EFT) networks, the same networks that process ATM transactions. By contrast, signature debit card transactions require the cardholder’s signature and are then routed through the Visa and MasterCard’s credit card networks. So, while PIN debit transactions are processed in a single step, signature debit transactions require two steps (authorization, followed by settlement). PIN debit cards also have a lower risk of fraud, because a PIN code is easier to verify than a signature.

In fact, when PIN debit cards were first introduced, they did not carry any interchange fee at all, since the funds to cover the charge were immediately debited from the customer’s bank account. By contrast, signature debit cards were introduced in the late-1970s by VISA and Mastercard, which used their existing credit card networks and applied a 1.3 percent interchange fee to signature debit transactions. VISA and Mastercard then introduced their own PIN debit cards and applied interchange fees to those transactions as well.

In 2011, according to the Federal Reserve, the processing costs were 1.8 times higher for signature debit transactions than for PIN debit transactions. In addition, fraud was seven times more likely with signature cards than PIN card, and total fraud costs were 3.2 times higher with signature cards.¹⁷ (Table 1, below) Yet, signature debit card transactions, which provide no additional service, account for 63 percent of all debit card transactions while PIN debit transactions comprise the remaining 37 percent.

Other data on signature and PIN debit cards illustrate the absence of a reliable relationship between processing costs and interchange fees. Processing a signature card transaction in 2011 cost \$0.055. Yet, before Regulation II took effect, the interchange fees for signature debit transactions averaged \$0.57 or 10.4 times the processing costs.¹⁸ (Table 1) Processing a PIN debit transaction is less costly: \$0.031 for authorization, clearance and settlement. The interchange fees for these PIN debit transactions averaged \$0.33 in 2011 before Regulation II took effect – about 10.6 times the processing costs but still \$0.24 less than the average cost for signature debit transactions.

Table 1. Costs of Debit Card Use, Per-Transaction, and Related Interchange Fees, January – September 2011¹⁹

	Authorization, Clearing, and Settlement Costs, Per Transaction	Interchange Fee Per Transaction
Signature	\$0.055	\$0.57
PIN	\$0.031	\$0.33
Prepaid	\$0.122	\$0.44
All Types	\$0.050	\$0.48

¹⁷ Board of Governors of the Federal Reserve System (2013).

¹⁸ *Ibid.*

¹⁹ *Ibid.*

The Relationship of Debit System Costs and Interchange Fees

The two largest debit card networks, Visa and MasterCard, insist that their interchange fees are determined by objective economic criteria. Visa, for example, claims that “dynamic and highly competitive market forces” determine its interchange rates.²⁰ MasterCard insists that its interchange fees are determined by costs, merchant incentives, and new payment card programs and technologies, among other factors.²¹ Recent Federal Reserve data suggest otherwise. From 2009 to 2011, the costs of authorizing, clearing and settling a debit purchase declined 34 percent.²² (Table 2A, below) With the exception of fraud prevention, card issuers’ other costs also declined, and those total costs fell more than 23 percent. All told, the costs borne by debit card issuers declined from \$0.29 per-transaction in 2009 to \$0.21 in 2011, down 26.1 percent. Yet, from 2009 to 2011 (prior to the new rule), Federal Reserve data show that the average interchange fee increased from \$0.43 to \$0.48 per transaction.²³ (Table 2B, below) Moreover, many of the costs are also covered by other charges such as late fees and interest fees.

Table 2A. Debit Card Issuers’ Costs, Per Transaction, 2009 and 2011, Pre-Regulation II

	2009	2011	Difference
Authorization, Clearance and Settlement	0.076	0.05	-34.2%
Other Costs	0.211	0.162	-23.2%
Network Fees	0.061	0.044	-27.9%
Fraud Losses	0.02	0.018	-10.0%
Fraud Prevention	0.01	0.019	90.0%
Cardholder Inquiries	0.07	0.044	-37.1%
Rewards and Other Incentives	0.04	0.03	-25.0%
Nonsufficient Funds Handling	0.01	0.007	-30.0%
Total	0.287	0.212	-26.1%

Table 2B. Debit Card Issuers’ Interchange Revenues, Per Transaction, 2009 and 2011, Pre-Regulation II

	2009	2011	Difference
Per Transaction	\$0.43	\$0.48	\$0.05
Signature Debit	\$0.55	\$0.57	\$0.02
PIN Debit	\$0.23	\$0.33	\$0.10
Prepaid	\$0.40	\$0.44	\$0.04
As Percentage of Transaction’s Value	1.13%	1.24%	0.11%
Signature Debit	1.49%	1.52%	0.03%
PIN Debit	0.58%	0.80%	0.22%
Prepaid	1.27%	1.26%	-0.01%

While the debit card issuers’ costs do not appear to significantly influence the interchange fees they charge merchants, the card networks often explain their rising fees by

²⁰ Visa USA. “Interchange: What it is. How it works.”

²¹ MasterCard. “U.S. Merchant Interchange Lawsuit.”

²² Board of Governors of the Federal Reserve System. 2013A.

²³ *Ibid.*

pointing to cardholder benefits. There is no empirical evidence, however, of a clear relationship between interchange fees paid by merchants and cardholder benefits, including membership fees. The Federal Reserve data show that the recent increases in interchange fees were accompanied by *lower* spending on cardholder benefits: From 2009 to 2011, spending on rewards and other incentives by debit card issuers declined from \$0.04 to \$0.03 per-transaction, while interchange revenues increased from \$0.43 to \$0.48 per-transaction. A study conducted by the Directorate-General for Competition at the European Commission covering 2000 to 2004 reached a similar conclusion.²⁴ The survey collected data on average cardholder fees and interchange charges collected by the Visa and MasterCard networks in 23 European countries, looking for evidence that cardholder fees fell as interchange fees rose. The authors found instead, “no strong negative relationship between the level of the cardholder fee and the level of the interchange fee.”²⁵

The Impact of Industry Concentration on Interchange Fees

There is considerable evidence the card-issuing industry has raised interchange fees mainly because it can: The industry is so highly concentrated that normal competition has not constrained its fees. To begin Visa and Mastercard control more than half of all PIN debit charges and nearly all Signature debit charges.²⁶ Even more important, the three top debit card-issuing banks account for 56 percent of the market, and seven issuers claimed 70 percent of the market. (Table 3, below) The impact of this concentration was examined in a 2005 study which concluded that “the average interchange fee is highly correlated with issuer concentration over this period.”²⁷ A 2010 study similarly found that 58 percent of the increases in interchange fees from 1996 to 2006 could be explained by greater issuer concentration, and that concentration in the card issuing market is a “main driving force of rising interchange fees.”²⁸ Finally, the European Commission survey found that “the persistence of high profit ratios over a relatively long period of time suggests that this might be the result of having and exerting market power.”²⁹

Table 3. Eight Largest Debit Card Issuers, by Transaction Value, 2010³⁰

Card Issuer	Transactions (billions)	Market Share
Bank of America	\$244.73	23%
Wells Fargo	\$195.79	18%
JP Morgan Chase	\$160.98	15%
U.S. Bank	\$41.33	4%
PNC	\$38.07	4%
Regions Bank	\$27.19	3%
Citibank	\$27.19	3%
SunTrust	\$25.02	2%
Others	\$326.31	30%
Total	\$1,087.7	100%

²⁴ European Commission (2006).

²⁵ *Ibid.*

²⁶ Finkle (2012).

²⁷ Weiner and Wright (2005).

²⁸ Rochet and Wang (2010).

²⁹ European Commission (2006).

³⁰ Nilson Report (2011).

IV. The Regulation of Interchange Fees

The Experience of Australia and Spain

Concerns about unreasonably high interchange fees are not limited to the United States. More than a decade ago, Australia implemented a series of reforms for the credit and debit card markets. In August 2002, the Reserve Bank of Australia (RBA) introduced new rules, including a cap on interchange fees based on the “eligible costs” incurred by card issuers, covering the processing and authorization of transactions, preventing and identifying fraud, and funding interest-free periods. These reforms went into effect for credit card interchange fees on July 1, 2003 and quickly reduced average charge from 0.95 percent of a transaction’s value to 0.55 percent. By 2006, the RBA benchmark further reduced these fees to 0.50 percent.

In April 2006, the RBA extended its reforms to cover interchange fees for PIN and signature debit card transactions. The new standards went into effect November 1, 2006 and reduced average interchange fees for PIN debit transactions from \$0.20 to between \$0.04 and \$0.05 per transaction. The new standards also reduced the average interchange fee for Visa and MasterCard signature debit transactions from \$0.44 per transaction to \$0.12. In April 2008, the RBA released its review of the reforms: It found that they improved price signals in the Australian payments system, increased transparency and access, and enhanced competition and efficiency. The reforms also did not reduce card use: Card payments had continued to grow at a 10 percent annual rate despite the much lower interchange fees.³¹ Taking account of increases in annual fees for credit cards and reduced benefits for loyalty programs, the Bank estimated that the reforms produced annual net welfare gains of AU \$100 million to \$150 million.³²

Similarly, Spain’s Ministry of Industry, Tourism and Trade negotiated an agreement in 2005 between the payment card networks and business associations to gradually reduce interchange fees. In November 2006, the card networks agreed to set their interchange fees based on their actual authorization and processing costs, and differentiate between credit and debit cards in setting those fees. From 2006 and 2009, the maximum interchange fee on debit cards fell 34 percent from €0.53 to €0.35, and the maximum interchange fee for credit cards fell from 1.4 percent of a transaction’s value to 0.35 percent.³³ As in Australia, there is no evidence that lower interchange fees slowed the growth of credit and debit transactions or payments.

European Union Regulation

The European Union is also engaged in addressing rising interchange fees and promoting a competitive market for debit and credit card services. In December 2007, the European Commission ruled that MasterCard’s cross-border interchange fees for debit and credit cards violated European antitrust rules and “inflated the cost of card acceptance by retailers without leading to proven efficiencies.”³⁴ MasterCard eventually complied with the ruling and agreed in

³¹ “Over time we would expect a reduction in total credit-card use on the regulated side as a result of the decrease in the number of cardholders” from Chang *et. al* (2005).

³² Reserve Bank of Australia (2008).

³³ Bank of Spain.

³⁴ European Commission, 2007.

April 2009 to cap its weighted average cross-border interchange fees at 0.2 percent of the value of debit transactions and 0.3 percent of the value of credit card purchases.³⁵ Similarly, Visa agreed in December 2010 to cap its weighted average cross-border interchange fees at 0.2 percent for debit transactions.³⁶ In July 2013, the Commission proposed to cap domestic as well as cross-border interchange fees at 0.2 percent for debit transactions and 0.3 percent for credit cards.³⁷ The average EU debit card transaction is €47.18 (\$63.18), implying a debit interchange fee under the current proposal of €0.094 (\$0.13). The average EU credit card transaction is €60.71 (\$81.28), implying a credit card interchange fee under the proposal of €0.182 (\$0.24).

U.S. Regulation

American merchant and retail associations have long argued that high interchange fees and various restrictions imposed on merchants by the payment card networks and the card-issuing banks harm consumers. The restrictions included exclusivity agreements barring the banks from issuing debit cards on competing card networks – a practice ruled illegal for credit cards in 2001 on competition grounds.³⁸ Until the 2011 reforms, each issuer could still restrict its debit card transactions to a single card network, such as Visa for signature transactions and its affiliated Interlink network for PIN transactions.³⁹ The Durbin Amendment ended network exclusivity arrangements for debit cards by directing the Fed to set new regulations prohibiting an issuer or payment card network from restricting the processing of debit transactions to a single payment card network. It also directed the Federal Reserve to end certain other restrictions set by the card network and/or card-issuing banks.

The Durbin Amendment also directed the Fed to set rules for debit card interchange fees to ensure fees proportional to the costs of processing debit card transactions. In December 2010, the Federal Reserve Board issued a proposed rule for the fees, creating two alternative standards for determining if an interchange fee is reasonable and proportional to the costs of authorizing, clearing, and settling an individual debit card transaction. These standards were based on the results of a survey conducted by the Fed in September 2010, which found that the “allowable costs” for debit card issuers averaged \$0.04 per transaction in 2009, with the median issuer reporting costs of \$0.07 per transaction and issuers at the 80th percentile reporting costs of about \$0.12.⁴⁰ The Board concluded that a “safe harbor” interchange fee set at the median issuer’s variable costs of \$0.07 and a top fee set at \$0.12 would allow “a large majority” of issuers to recover their variable costs. The Board did not consider network processing fees, fraud losses, transaction monitoring costs, or other fraud-prevention costs in setting these proposed standards, noting that the Amendment directed that the costs to be taken into account in setting interchange fees be limited to those incurred in processing debit transactions.

³⁵ European Commission, 2009.

³⁶ European Commission, 2010.

³⁷ European Commission, 2013B, 2013A.

³⁸ *U.S. v. VISA USA, et al.*, 2001.

³⁹ The card network rules also allowed issuers to specify that all transaction using their cards be routed over a preferred network, even if another network was available at a lower cost.

⁴⁰ In 2009, the average variable costs per-transaction were \$0.04, plus \$0.01 fixed costs and \$0.03 in network fees, for a total \$0.08. The median variable costs per transaction were \$0.06, plus \$0.01 fixed costs and \$0.04 network fees for a total \$0.11. Board of Governors of the Federal Reserve System, 2010. In 2011, the variable processing costs for covered issues average \$0.05 per transaction. Board of Governors of the Federal Reserve System, 2013A.

Under Alternative 1 proposed by the Fed, issuers would be limited to the “safe harbor” interchange fee of \$0.07 per debit card transaction, or a fee of up to \$0.12 depending on the issuer’s “allowable costs.” Under its Alternative 2, the Fed limited the interchange fees charged by card issuers to \$0.12 cents per debit card transaction, with no \$0.07 safe harbor interchange rate. As required by law, the Fed solicited comments on its proposed alternative rules.

On June 29, 2011, after what the *Washington Post* described as “an aggressive campaign” by the financial services industry,⁴¹ the Fed issued its final rule capping debit interchange fees at much higher levels than either of the proposed alternatives. The final rule limits these fees to \$0.21 cents per transaction, plus 5 basis points (0.05 percent) of a transaction’s value and a \$0.01 fee if the card issuer meets certain fraud-prevention standards. For an average debit card transaction of \$38, the new standard is equivalent to a \$0.24 charge or twice the fee under the Board’s original proposal. The *Financial Times* described the final rule as a “victory” for the card-issuing banks and networks.⁴² In any case, based on the Fed’s September 2010 survey, the new rates were not proportional to the costs of authorizing, clearing and settling a transaction, as the Durbin Amendment seems to direct. On July 31, 2013, U.S. District Court Judge Richard Leon concurred, holding that the final rule did not follow the language of the law on this point.⁴³

As directed by the Durbin Amendment, the new rules also are limited to transactions with debit cards issued by financial institutions with \$10 billion or more in consolidated assets, referred to as “covered” or “nonexempt” issuers. In 2011, this provision limited the rule’s application to 109 large commercial banks or 1.5 percent of the 7,494 commercial banks in the United States.⁴⁴ The rule also affects only three large credit unions while exempting 6,911 smaller ones.⁴⁵ In 2012, this limit exempted 34 percent of debit transactions, totaling \$664 billion, from the terms of Regulation II.

V. The Impact of the New Regulation of Interchange Fees on Debit Card Transactions

Analysis of the impact of the new regulations shows that they have reduced interchange charges overall to a significant degree. However, the rules also lead to relatively high interchange fees for small purchases, fees which often exceed the profit margins on those purchases. Moreover, the Fed’s shift from the rules it originally proposed has entailed substantial additional costs for merchants and consumers. As we will see, consumers and the overall economy would benefit substantially from the application of the original proposed rules.

The Value and Average Interchange Fees Applied to Debit Card Transactions

To calculate the costs and benefits of the new rules, we begin with data on the level of debt card transactions. Transactions by debit card have grown faster than any other form of payment over the last ten to 15 years. The annual dollar value of these transactions increased from \$311 billion in 2000 to over \$1.9 trillion in 2012, growing at an average annual rate of 15.5

⁴¹ Mui. June 29, 2011.

⁴² Baer, *op. cit.*

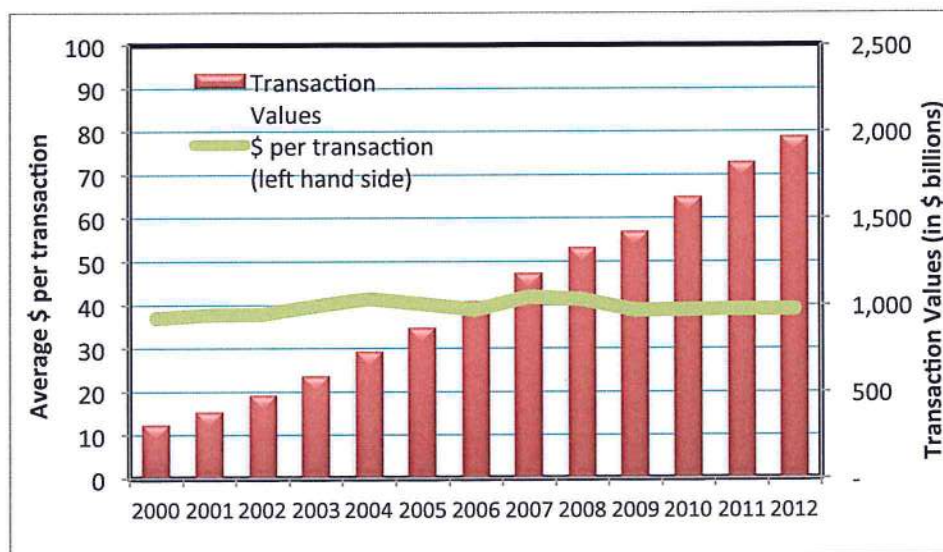
⁴³ NACS et. al, v. Board of Governors of the Federal Reserve System. July 31, 2013.

⁴⁴ GAO. 2012.

⁴⁵ Current data show that Regulation II now covers 558 financial institutions and exempts 13,725 institutions. <http://www.federalreserve.gov/paymentsystems/regii-interchange-fee-standards.htm>

percent, compared to 4.2 percent annual growth in personal consumption. (Figure 2, below) Most of this growth reflects greater use of debit cards, as the average value of a transaction ranged between \$37.02 and \$41.84 from 2000 to 2012, or just over one percent annually.

Figure 2. Debit Card Transactions: Total Value and Average Value Per Transaction, 2000-2012⁴⁶



The Federal Reserve Board’s new regulation of interchange charges went into effect on October 1, 2011. The Board has collected data covering the first three quarters of 2011, before Regulation II was implemented, along with the last quarter of 2011 and all of 2012, under the new regulation.⁴⁷ It is clear from these data that the fee regulation did not reduce the use of debit cards nor affect the distribution of debit transactions between the large financial institutions subject to the regulation and the smaller institutions exempt from it. (Table 4, below) However, there was some slowdown in the growth rate of debit transactions, from annual increases of 12 percent preceding Regulation II to an 8 percent increase in 2012. The slower growth rate of debit transactions is evident in the monthly average values presented in Table 4.

Table 4. Debit Transactions, Their Total Value, and Average Transaction Value, Monthly Averages Pre- and Post-Regulation II, 2011 (billions)⁴⁸

	Monthly, Jan-Sept 2011		Monthly, Oct-Dec 2011		Monthly, Jan-Dec 2012	
	Number of Transactions	Total Value	Number of Transactions	Total Value	Number of Transactions	Total Value
All Transactions	3.835	\$149.5	4.03	\$158.3	4.19	\$163.4
Covered	2.49	\$97.2	2.6	\$102.7	2.77	\$108.1
Exempt	1.36	\$52.3	1.43	\$55.6	1.43	\$55.3

⁴⁶ The Nilson Report for 2000-2009 data; Board of Governors of the Federal Reserve System. 2013A; 2013B for 2011-12 data; Data for 2010 extrapolated from 2009 and 2011.

⁴⁷ Board of Governors of the Federal Reserve System. 2013A.

⁴⁸ *Ibid.*; Board of Governors of the Federal Reserve System. 2013B, 2011A.

Regulation II and Its Effects on Debit Card Interchange Fees

The data also show that the card-issuing institutions and networks raised their debit interchange fees in the period from 2010 through the third quarter of 2011, while the Durbin Amendment was debated and adopted, and the Federal Reserve proposed and finalized the regulation mandated by the Amendment. In 2009, before this process began, debit interchange fees averaged \$0.43 per transaction, or 1.13 percent of the value of an average transaction. (Table 5, below) In the three quarters preceding the implementation of Regulation II, those fees averaged \$0.48 per transaction, a 9.1 percent increase and equivalent to 1.24 percent of the average value of those transactions.

Table 5. Debit Card Interchange Fees in 2009 and January–September 2011⁴⁹

	2009			January – September 2011		
	Interchange Fees (billions)	Fee per Transaction	Fees as a Share of Purchase	Interchange Fee (billions)	Fee Per Transaction	Fee as Share of Purchase
All Transactions	\$15.7	\$0.43	1.13%	\$16.7	\$0.48	1.24%
Signature	\$12.5	\$0.55	1.49%	\$12.5	\$0.57	1.52%
PIN	\$3.2	\$0.23	0.58%	\$4.2	\$0.33	0.80%

To assess the impact of Regulation II on interchange charges and revenues, the Federal Reserve surveyed covered and exempt debit card issuers for the periods of October-December 2011 and January-December 2012.⁵⁰ The Board found, first, no significant differences in the results for the last quarter of 2011 and for 2012. The average debit card interchange fee per-transaction, covering both covered and exempt institutions, dropped by \$0.18 or 37.5 percent, from \$0.48 in January-September 2011 (pre-regulation) to \$0.30 in the last quarter of 2011 and \$0.31 in 2012. As expected, all of the decline occurred in transactions using debit cards covered by Regulation II, while interchange fees on purchases with debit cards issued by institutions exempt from the regulation did not decline. (See Table 6, below) The average fee for debit purchases covered by Regulation II fell more than 50 percent, from \$0.50 to \$0.24. As a share of the value of the purchases, the fee declined by more than half, from 1.29 percent to 0.62 percent.

Table 6. Debit Card Interchange Fees for Covered and Exempt Issuers, Per Transaction and as a Share of Purchases, Before (2011) and After (2012) Regulation II⁵¹

	January-September 2011		January-December 2012	
	Fee per Transaction	Fee as a Share of Purchase	Fee per Transaction	Fee as a Share of Purchase
All Transactions	\$0.48	1.24%	\$0.31	0.79%
Covered	\$0.50	1.29%	\$0.24	0.62%
Exempt	\$0.45	1.16%	\$0.43	1.12%

⁴⁹ Data on prepaid signature and PIN debit systems are not available for 2009, so we present data for only non-prepaid cards. Total prepaid interchange fees were \$0.5 billion in 2009 and \$1 billion in 2011. Board of Governors of the Federal Reserve System. 2013A.

⁵⁰ Board of Governors of the Federal Reserve System. 2013B; 2011A.

⁵¹ Board of Governors of the Federal Reserve System. 2013A, 2013B.

VI. The Benefits of Regulation II

The benefits of Regulation II for consumers and merchants can be measured by estimating the cost savings per transaction in the post-regulation period compared to the preceding period. Since Regulation II caps only the interchange fees paid on purchases with debit cards issued by large financial institutions, we begin by examining fees paid to covered signature and PIN debit card issuers. In 2012, Americans made 33.14 billion covered debit card purchases totaling \$1,297.3 billion, \$808.7 billion in 21.94 billion covered signature purchases and \$488.6 billion in 11.94 billion covered PIN purchases. (Table 7A, below) Merchants and consumers paid \$8.01 billion in interchange fees on these covered purchases, \$5.19 billion to covered signature card issuers and \$2.82 billion to covered PIN card issuers. Regulation II closed most of the gap in per-transaction interchange fees between signature and PIN debit cards: The average fee paid to covered debit card issuers was \$0.242 per-transaction, \$0.245 on covered signature transactions and \$0.236 on covered PIN purchases. (Table 7A, below)

To estimate the benefits of Regulation II, we calculated “counter-factual” interchange fees by estimating the fees that would have been paid in the absence of the new regulation. We constructed these counter-factual fees by applying the per-transaction interchange charges collected in the first nine months of 2011 to the 2012 purchases. We found that without Regulation II, covered debit card issuers would have collected interchange fees totaling \$16.5 billion in 2012, \$12.4 billion from covered signature card purchases and \$4.1 billion from covered PIN card transactions. (Table 7A, below) The cost savings for consumers and merchants are the difference between the actual and counter-factual interchange fees. Therefore, those savings came to \$8.5 billion in 2012, \$7.21 billion saved on covered signature debit purchases and \$1.29 billion on covered PIN debit purchases. This represents average interchange fee savings of 51.5 percent. These savings were equal to 0.66 percent of the value of covered debit card purchases.

Table 7A. Cost Savings from Lower Interchange Fees on Covered Debit Card Purchases, 2012⁵²

	Covered Debit Card Transactions	Covered Signature Transactions	Covered PIN Transactions
Transactions (\$ billions)	\$1,297.3	\$808.7	\$488.6
Number of Transactions (billions)	33.14	21.194	11.94
Interchange Fees Paid (\$ billions)	\$8.01	\$5.19	\$2.82
Interchange Fees Per Transaction Paid	\$0.242	\$0.245	\$0.236
Pre-Regulation Interchange Fee, Per-Transaction	\$0.503	\$0.585	\$0.344
Counter-Factual Fees, at Pre-Regulation Rates (billions)	\$16.51	\$12.40	\$4.11
Cost Savings from Covered Transactions (\$ billions)	\$8.50	\$7.21	\$1.29
Savings as a Share of Counter-Factual Fees	51.5%	58.0%	31.7%
Savings as a Share of the Value of Transactions	0.66%	0.89%	0.26%

The same analysis applied to covered debit card transactions in the fourth quarter of 2011 shows savings of \$2.06 billion in October-November-December of that year, most of it again

⁵² Figures may not add up due to rounding.

from covered signature debit card purchases. (Table 7B, below) This represents average interchange fee savings of 52.7 percent, equivalent to 0.67 percent of the value of the covered debit transactions.

Table 7B. Cost Savings from Lower Interchange Fees on Covered Debit Card Purchases, Q4-2011

	Covered Debit Card Transactions	Covered Signature Transactions	Covered PIN Transactions
Transactions (billions)	\$308.2	\$192.7	\$115.5
Number of Transactions (billions)	7.810	5.070	2.740
Interchange Fees Paid (billions)	\$1.850	\$1.210	\$0.640
Interchange Fees Per Transaction Paid	\$0.2369	\$0.2386	\$0.2336
Pre-Regulation Interchange Fee, Per-Transaction	\$0.5034	\$0.5852	\$0.3442
Counter-Factual Fees, at Pre-Regulation Rates (billions)	\$3.910	\$2.967	\$0.943
Cost Savings from Covered Purchases (billions)	\$2.060	\$1.757	\$0.303
Savings as a Share of Counter-Factual Fees	52.7%	59.2%	32.1%
Savings as a Share of the Value of Purchases	0.67%	0.91%	0.26%

We estimate, therefore, that Regulation II produced interchange fee savings of \$10.56 billion in its first five quarters on 40.95 billion debit card purchases totaling \$1,605.5 billion.⁵³

The Burden of Interchange Fees on Small Debit Card Purchases

Regulation II, as intended, significantly reduced the average interchange charge on purchases with debit cards issued by covered institutions. However, many small transactions actually entail higher interchange fees under Regulation II. Before Regulation II, the interchange fees on Visa and Mastercard signature debit card transactions of less than \$15 were calculated based on a fixed fee of \$0.04 per transaction plus 1.55 percent of the value of the transaction.⁵⁴ Under the terms of Regulation II, merchants and consumers now pay a fixed charge of \$0.21 on every covered debit transaction regardless of size, another fixed charge of \$0.01 for fraud prevention, plus a charge of 0.5 percent of the sales price. The result is lower fees on large purchases – but also higher fees on small transactions. Our analysis shows that the regulation imposes this new burden on merchants processing debit transactions of less than \$15. In many cases, the new fees as a share of the transaction are greater than the merchants’ profit margins, effectively forcing them to absorb losses on billions of small debit card purchases.

⁵³ These benefits do not include interchange fees paid on purchases by debit cards issued by financial institutions with assets of less than \$10 billion, exempt from Regulation II. The interchange fees on transactions with the exempt cards did not decline. Federal Reserve data show that in 2012, there were 17.1 billion purchases with debit cards issued by exempt institutions, totaling \$664 billion. Those institutions collected \$7.4 billion in interchange fees on those purchases based on fees averaging \$0.433 per-transaction. If those transactions had been covered by Regulation II, the interchange charge would have been \$0.242 per transaction. Based on these calculations, the exemptions to Regulation II resulted in interchange charges in 2012 that were \$3.26 billion greater than they would have been in the absence of those exemptions. Using the same approach, we calculate that in the fourth quarter of 2011, the exemption from Regulation II for smaller financial institutions applied to 4.33 billion debit card purchases totaling \$166.8 billion. The exemption, therefore, resulted in interchange charges in the fourth quarter of 2011 that were \$816 million greater than they would have been in the absence of those exemptions.

⁵⁴ Wang, 2012.

While the average debit card transaction involves a purchase of between \$37.02 and \$41.84, the Federal Reserve found that in 2009, 46.7 percent of all signature debit card transactions and 32.8 percent of debit PIN transactions involved less than \$15. (Table 8, below) To be sure, debit transactions of \$15 and more account for 90 percent or more of the total value of all signature and PIN debit transactions, and Regulation II imposes a smaller relative burden on these larger purchases than on smaller ones.

Table 8. Distribution of Debit Card Purchases by the Value of the Transactions, 2009⁵⁵

Transaction	Signature Debit Cards				PIN Debit Cards			
	Number (billion)	Share of Total	Value of Transactions (\$ billion)	Share of Total Value	Number (billion)	Share of Total	Value of Transactions (\$ billion)	Share of Total Value
Under \$5.00	3.6	15.4%	\$9.46	1.1%	1.3	8.7%	\$4.13	0.7%
\$5.00~\$14.99	7.3	31.3%	\$67.94	7.9%	3.5	24.1%	\$33.04	5.6%
Total	10.9	46.7%	\$77.4	10.0%	4.8	32.8%	\$37.17	6.3%
\$15.00 +	12.4	53.3%	\$782.6	90.0%	9.8	67.2%	\$552.83	93.7%
Total	23.3	100.0%	\$860.00	100.0%	14.6	100.0%	\$590.000	100.0%

To gauge the impact on consumers and merchants with large numbers of small debit card transactions, we apply the 2009 distribution of small and larger purchases to covered debit transactions in 2012 and the last quarter of 2011. Using this approach, we estimate that in 2012, merchants processed 13.8 billion covered debit card transactions of less than \$15, totaling \$103.6 billion. (Table 9A, below) Similarly, in the fourth quarter of 2011, merchants processed 3.27 billion covered debit transactions of less than \$15, totaling \$24.6 billion. (Table 9B, below) The average value of these transactions was \$7.50.

Table 9A. Number and Value of Covered Debit Card Transactions under \$15, 2012⁵⁶

	Signature		PIN		Total	
	Number of transactions (billions)	Value of Transactions (billions)	Number of transactions (billions)	Value of Transactions (billions)	Number of Transactions (billions)	Value of Transactions (\$ billions)
Under \$5.00	3.262	\$8.891	1.040	\$3.423	4.302	\$12.315
\$5.00~\$14.99	6.630	\$63.857	2.880	\$27.387	9.510	\$91.244
Total under \$15	9.892	\$72.749	3.920	\$30.810	13.812	\$103.559

Table 9B. Number and Value of Covered Debit Card Transactions under \$15, Q4-2011

	Signature		PIN		Total	
	Number of transactions (billions)	Value of Transactions (billions)	Number of transactions (billions)	Value of Transactions (billions)	Number of Transactions (billions)	Value of Transactions (\$ billions)
Under \$5.00	0.781	\$2.120	0.238	\$0.890	1.019	\$2.928
\$5.00~\$14.99	1.587	\$15.223	0.660	\$6.468	2.247	\$21.691
Total under \$15	2.368	\$17.343	0.899	\$7.276	3.266	\$24.620

⁵⁵ Board of Governors of the Federal Reserve System, 2011B.

⁵⁶ *Ibid.*

Most of these small debit charges occur at supermarkets and groceries, convenience stores, fast food restaurants, coffee shops, parking lots and garages, movie theaters, laundries and dry cleaners, newsstands, printing and copy shops, car washes, and for commuter transport and taxicab rides. Before Regulation II, debit card networks and issuers charged lower fees for small transactions. As noted earlier, a Federal Reserve study, published in the *Economics Quarterly Journal*, found that prior to Regulation II, Visa and MasterCard had charged interchange fees on debit card sales of less than \$15 that averaged 1.55 percent of the transaction’s value plus a fixed fee of \$0.04.⁵⁷ In October 2011, they raised their interchange fees of smaller transactions to the maximum level allowed under the new regulation.

Next, we estimate the interchange fees applied to small transactions, as a share of the value of those transactions, and compare the results to those for an average transaction of \$40, before and after Regulation II took effect. (Tables 10A and 10B, below) This analysis shows that after the new regulation was in place, the interchange fee on a \$2 debit purchase increased from 3.6 percent of the value of that transaction to 11.1 percent. Similarly, the interchange fee on a \$7.50 debit purchase increased from 2.1 percent of the value of that transaction to 3.0 percent. The breakeven point is just under \$15: Under Regulation II, the interchange charge for a \$15 debit purchase actually fell slightly, from 1.8 percent of the value of the transaction to 1.5 percent. The cost savings from Regulation II, therefore, all involve larger purchases: The interchange fee for a typical \$40.00 covered debit card transaction fell from 1.65 percent of the value of that transaction before Regulation II to 0.6 percent once it took effect.

Table 10A. Debit Interchange Fees by Transaction Value, Under Regulation II

Transaction	\$0.21 Fixed Fee	\$0.01 Fraud Prevention Fee	0.05% of the Transaction	Total Interchange Fee	Total Fee as a Share of the Transaction
\$2.00	\$0.21	\$0.01	\$0.00	\$0.22	11.1%
\$7.50	\$0.21	\$0.01	\$0.00	\$0.22	3.0%
\$15.00	\$0.21	\$0.01	\$0.01	\$0.23	1.5%
\$40.00	\$0.21	\$0.01	\$0.02	\$0.24	0.6%

Table 10B. Debit Interchange Fees by Transaction Value, Before Regulation II

Transaction	\$0.04 Fixed Fee	1.55% of the Transaction	Total Interchange Fee	Total Fee as a Share of the Transaction
\$2.00	\$0.04	\$0.03	\$0.07	3.6%
\$7.50	\$0.04	\$0.12	\$0.16	2.1%
\$15.00	\$0.04	\$0.23	\$0.27	1.8%
\$40.00	\$0.04	\$0.62	\$0.66	1.65%

The sharp rise in interchange rates for small purchases is significant for merchants, large and small, that depend on small transactions. For example, the average purchase in convenience stores in 2010 involved transactions of \$7.47.⁵⁸ Before Regulation II, convenience store merchants paid interchange fees of \$0.16 on such a typical debit card purchase, equal to 2.1 percent of the value of the transaction. Under Regulation II, convenience stores now pay \$0.22

⁵⁷ Wang, 2012.

⁵⁸ Convenience Store News Market Research 2011, http://www.csnews.com/article-out_of_control-1868.html.

on that same debit purchase, equal to 3.0 percent of the transaction’s value or twice the 1.5 percent average profit margin for convenience stores. (Table 11, below) Similarly, the average cost of a movie ticket is \$7.93.⁵⁹ Under Regulation II, theater owners pay \$0.22 in interchange fees on tickets paid for with covered debit cards, equal to 2.8 percent of the ticket price, compared to fees of \$0.16 or 2.1 percent of the price before Regulation II. The current interchange fee on such a transaction is equal to two-thirds of the 4.2 percent average profit margin for movie theaters.

Based on industry data published by IBISWorld, we can calculate the profit margins of those sectors and merchants that typically depend on small transactions. Profits are defined here as profits before tax, plus interest, as a percentage of sales. Six types of business -- grocery stores and supermarkets, bookstores, convenience stores, gas stations, pharmacies and drug stores, and museums – report profit margins of less than 3.0 percent, the interchange rate on covered debit card transactions of \$7.50 under Regulation II. (Table 11, below) This rate is also equal to between 50 percent and 83 percent of the profit margin for nine other lines of businesses, including fast food restaurants, movie theaters and car washes.

Table 11. Profit Margins of Selected Sectors, 2012⁶⁰

Sector	Profit Margin
Supermarkets & Grocery Stores	1.3%
Bookstores	1.3%
Convenience Stores	1.5%
Gas Stations	1.8%
Pharmacies and Drug Stores	2.8%
Museums	2.9%
Fast food Restaurants	3.6%
Car wash Shops	4.0%
Movie Theaters	4.2%
Laundromats	4.9%
Business Service Centers	5.0%
Vending Machine Operators	5.0%
Shoe Repair Shops	5.3%
Dry Cleaners	5.8%
Coffee & Snack Shops	5.9%

Next, we estimate the dimensions of these effects. Before Regulation II, the interchange fee for transactions of less than \$15.00 averaged about \$0.18 per-transaction. After the regulation took effect on October 1, 2011, covered debit card issuers raised their interchange fees on small purchases to an average of some \$0.23 per-transaction. The adverse effect, therefore, is equal to \$0.05 per transaction, or an increase of 27.8 percent over the average pre-regulation fees. We calculate that in 2012, merchants paid nearly \$3.2 billion in interchange fees on 13.8 billion debit transactions of less than \$15. (Table 12A, below) Similarly, in Q4 2011, they paid \$751.3 million in interchange fees on 3.27 billion of such small transactions. (Table 12B, below) If covered debit card issuers had charged on small transactions what they used to charge before

⁵⁹ National Association of Theater Owners <http://www.natoonline.org/statisticstickets.htm>.

⁶⁰ IBISWorld Industry Research Reports, various reports.

Regulation II, merchants and consumers would have paid less than \$2.5 billion in interchange fees on these small transactions in 2012 and \$588 million in interchange fees on those transactions in Q4-2011. The difference between those counter-factual fees and the fees actually paid on small transactions is a measure of this adverse effect of Regulation II: \$690.6 million in additional interchange fees in 2012, plus \$163.3 million in additional fees paid in Q4-2011.

Table 12A. Additional Interchange Fees on Small Debit Card Transactions, 2012

Number of Covered Debit Transactions of Less than \$15.00	13.81 billion
Total Value of Covered Debit Transactions of Less than \$15.00	\$103.56 billion
Interchange Fees Paid on These Transactions Under Regulation II	\$3,176.8 million
Estimated Interchange Fees for These Transactions at Pre-Regulation Rates	\$2,486.2 million
Additional Interchange Charge, Pre-Transaction, Under Regulation II	\$0.05
Additional Charge as a Share of Pre-Regulation Fee, Per Transaction	27.8%
Additional Charge as a Share of the Value of the Average Small Transaction	0.066%
Additional Interchange Fees Paid on Small Purchases Under Regulation II	\$690.6 million

Table 12B. Additional Interchange Fees on Small Debit Card Transactions, October – December 2011

Number of Covered Debit Transactions of Less than \$15.00	3.27 billion
Total Value of Covered Debit Transactions of Less than \$15.00	\$24.62 billion
Interchange Fees Paid on These Transactions Under Regulation II	\$751.3 million
Estimated Interchange Fees for These Transactions at Pre-Regulation Rates	\$588.0 million
Additional Interchange Charge, Pre-Transaction, Under Regulation II	\$0.05
Additional Charge as a Share of Pre-Regulation Fee, Per Transaction	27.8%
Additional Charge as a Share of the Value of the Average Small Transaction	0.66%
Additional Interchange Fees Paid on Small Purchases Under Regulation II	\$163.3 million

In addition to raising the interchange fee burden on many merchants that specialize in small transactions, other factors also contribute to an uneven distribution of benefits from Regulation II. For example, merchants relatively more reliant on debit transactions with cards issued by exempt institutions have received relatively less relief. (See Table 6, above) Merchants and industries that depend on PIN debit transactions also received much less relief than those more dependent on Signature debit purchases. (Table 5, above) For a combination of these reasons, data from major PIN networks suggest that large grocery stores such as Kroger, Safeway, and SuperValu saw their average interchange fees rise from \$0.18 per PIN debit transaction before the reforms to about \$0.24 per transaction, an increase of 33 percent.

VII. The Distribution of Interchange Cost Savings to Consumers and Merchants

Returning to the overall cost savings arising from lower interchange rates, we next examine how those savings affect consumers. Many economists have assessed the extent to which firms and industries pass through to their customers certain cost reductions or cost increases. One recent study analyzed a large, time-series database of cost changes incurred by more than 1,000 retail grocery and drug stores in more than 30 states at multiple points in their

distribution networks.⁶¹ The researchers estimated the “elasticity” for the pass-through – how much retail prices change in response to merchants’ cost savings – based on 23,147 cases of promotions which reduced costs for grocery and drug store merchants. They found a distribution of pass-through rates, ranging from 0.25 for the 10th percentile to 1.14 for the 90th percentile, with an average pass-through rate from retailers to customers of 0.69: When a merchant’s costs were reduced by \$1.00, they responded by cutting prices for customers by \$0.69. The study also found that market structure and competition have only modest effects of pass-through rates. The study’s results were consistent with theoretical work in this area and other empirical studies using smaller databases.⁶²

Using the average pass-through rate of 0.69, we can estimate the benefits of Regulation II for consumers and merchants. As noted earlier, Regulation II produced \$2.06 billion in cost-savings from lower average debit interchange charges in Q4-2011 and savings of \$8.5 billion in 2012. With this pass-through rate of 0.69, we estimate that Regulation II saved consumers \$1.42 billion in Q4-2011 and \$5.87 billion in 2012. (Table 13) The pass-through to consumers in the form of lower prices also affects employment: Consumers increase their demand by a comparable amount, resulting in \$5.87 billion in additional spending in 2012. The Census Bureau reports that labor accounts for 16.4 percent of all revenues for all manufacturing and non-manufacturing sectors.⁶³ Therefore, the pass-through to consumers could support \$962 million in additional labor costs. Using the 2012 average annual wage of \$44,600 for all sectors, the cost-savings from Regulation II in 2012 would support up to 21,566 additional jobs.⁶⁴ The \$2.42 billion retained by merchants in 2012 presumably was used to improve their profitability, which in turn would increase their spending which consequently would lead to new jobs. Here, we assume that half of the retained cost-savings flow through to higher spending by merchants, and again use the Census Bureau estimate that 16.4 percent of revenues for all sectors go to labor. Merchants also would use their retained savings to directly hire additional workers or raise wages, as well as to purchase new equipment and otherwise expand their businesses, also stimulating additional employment. We assume that one-quarter of the remaining retained earnings ultimately went to labor, and apply the 2012 average annual wage for all retail businesses of \$29,700. We estimate, therefore, that the savings for merchants could finance an additional 15,935 jobs.⁶⁵ All told, therefore, the reduction in overall interchange fees arising from Regulation II was sufficient in 2012 to support the creation of 37,501 jobs.

⁶¹ Nijs et al. 2009.

⁶² For example, Werden et al. (2006) and Besanko et al. (2005). Many economic studies have also found evidence that retailers do not change their prices quickly in response to cost changes which they believe may not be lasting ones. For example, a 2008 study estimated the frequency of price changes using confidential databases of price data for 1998 to 2005 from the Bureau of Labor Statistics. (Nakamura and Steinsson. 2008). They found that prices for all products change, on average, once every 11 months, with average periods ranging from two weeks for vehicle fuel to 27.3 months for apparel. In the case of interchange fees, however, we would expect the price adjustment to occur fairly quickly, since it reflects a “permanent” change in Federal law and Federal Reserve regulation.

⁶³ U.S. Census Bureau, Industry Statistics Sampler; <http://www.census.gov/econ/industry/def/d44-45.htm>

⁶⁴ Bureau of Labor Statistics, Occupational Employment Statistics.

⁶⁵ For example, we calculated these estimate as follows. Consumers: \$8.50 billion * 0.69 = \$5.87 billion * 0.164 = \$962.68 million / \$44,600 = 21,585 jobs; Merchants: \$8.50 billion * 0.31 = \$2.64 billion, * 0.5 * 0.164 = \$216.48 million / \$44,600 = 4,854 jobs) + \$2.64 billion * 0.5 * 0.25 = \$330.0 million / \$29,700 = 11,111). 4,864 + 11,111 = 15,965 jobs.

The same analysis for Q4-2011 finds that the savings from lower average interchange rates in October-November-December of 2011 would support 5,227 additional jobs from the pass-through to consumers, and an additional 3,862 jobs from half of the savings retained by merchants. All told, the reduction in interchange fees arising from Regulation II was sufficient in Q4-2011 to support the creation of 9,088 additional jobs. (Table 13, below)

We also examined the impact under Regulation II of the high fixed fee which sharply increases the interchange charge for purchases of less than \$15. We estimate that if the interchange fee on small transactions had not increased under Regulation II, the additional cost savings of \$690 million in 2012 could have supported an additional 3,044 jobs. (Table 13, below) This change also would have increased the savings in Q4-2011 by \$163 million, which could have supported an additional 719 jobs.

All told, the reduction in interchange fees under Regulation II was sufficient to support 46,589 additional jobs over the first five quarters of its implementation (October 1, 2011 – December 31, 2012). In addition, if the regulation had not raised interchange charges on small purchases, the associated additional cost savings could have supported 3,763 more jobs over the same period. For the period from October 2011 through December 2012, therefore, the actual and potential cost savings under Regulation II could have supported some 50,352 additional jobs.

Table 13. Actual and Potential Cost Savings from Regulation II and the Additional Jobs those Savings Could Support

	2012	Q4-2011
Savings from reductions in average interchange fee, per transaction, from \$0.50 before Regulation II to \$0.24 in Q4-2011 and 2012 (\$ billion)	\$8.50	\$2.06
Savings passed through to consumers (\$ billion)	\$5.87	\$1.42
Additional jobs supported by higher consumer spending	21,566	5,227
Savings retained by merchants (\$ billion)	\$2.64	\$0.64
Additional jobs supported by merchants' savings	15,935	3,862
Total additional jobs supported by lower interchange fees:	37,501	9,088
Potential savings from reducing interchange fees for transactions of less than \$15 to pre-Regulation II levels (\$ billions)	\$0.690	\$0.163
Savings passed through to consumers (\$ billion)	\$0.476	\$0.112
Additional jobs supported by higher consumer spending	1,751	414
Savings retained by merchants (\$ billion)	\$0.214	\$0.051
Additional jobs supported by merchants' savings	1,294	306
Total additional jobs supported by lower fee on small transactions	3,044	719
Total actual and potential additional jobs	40,545	9,807

VIII. The Benefits of Reasonable and Proportional Interchange Fees: The Federal Reserve's Original Version of Regulation II

The Durbin Amendment directed the Federal Reserve Board to develop a set of standards for debit card interchange fees that would produce fees “reasonable and proportional” to the costs of processing individual transactions. The evidence supporting such a reform was stark: In

2011, before Regulation II went into effect, the costs of authorizing, clearing and settling debit transactions averaged \$0.05 per-transaction, compared to interchange fees averaging \$0.48 per transaction. For setting new rates, the Board was instructed to consider the “incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction,” and an adjustment to cover “costs incurred by the issuer in preventing fraud in relation to electronic debit transactions.”⁶⁶ Congress also directed the Board to *not* include or consider any costs not “specific to a particular electronic debit transaction,” such as card member rewards or other incentives.

As noted earlier, in December 2010, the Federal Reserve Board issued a proposed rule providing two alternative standards for determining whether an interchange fee was “reasonable and proportional” to the costs of processing a debit card transaction. Under Alternative 1, debit card issuers could charge a safe harbor interchange fee of \$0.07 per transaction or a fee of up to \$0.12 depending on the issuer’s “allowable costs” for authorizing, clearing and settling debit transactions. Alternative 2 simply capped interchange fees at \$0.12 per transaction. These options were drawn from a September 2010 Fed survey which found that debit card issuers in 2009 had incurred authorization, clearance and settlement costs averaging \$0.04 per transaction and median costs of \$0.07, with issuers in the 80th percentile reporting costs of \$0.12 per transaction. The Board concluded that a safe harbor set at the \$0.07 median cost and a \$0.12 cap would ensure that almost all issuers would cover their variable costs. In so doing, the Board determined to *not* consider other expenses incurred by card issuers, such as network processing, fraud, fraud prevention, and transaction monitoring, as well as cardholder benefits and rewards.

The proposed rule drew thousands of comments and what the *Washington Post* described as a massive and aggressive lobbying campaign by the financial services industry.⁶⁷ On June 29, 2011, following that campaign, the Board issued a final rule that differed markedly from the original proposal. The final rule caps debit card interchange fees at \$0.21 per transaction, plus 5 basis points of the value of the transaction, and an additional \$0.01 fee for card issuers that meet certain fraud-prevention standards. Under the new standard, the interchange fee on an average debit card transaction of \$38 is \$0.24, twice the cap under the Board’s original proposed rule.

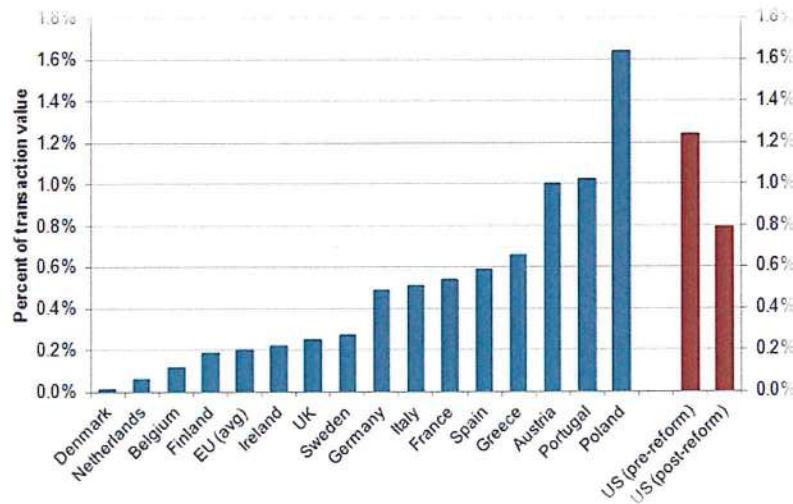
In propounding the final rule, the Board said it had “revisited” its previous interpretation of the Durbin Amendment as requiring that the Board distinguish between the incremental costs of processing a debit transaction and other expenses by card issuers not specific to a particular transaction. Under its new interpretation, the Board took into account a card issuer’s network processing fees and transaction monitoring costs as well as fraud and fraud prevention costs. The Board said that these additional expenses, while not “incremental” costs, are nevertheless “specific to a particular transaction” and thus could be considered under the Durbin Amendment.

The results are U.S. debit card interchange fees which remain among the highest in the world. A recent survey of 15 European nations and the United States found that the debit interchange fees under the new American standard are four times the European Union average. (Figure 3, below) Across Europe, only card issuers in Poland, Portugal and Austria charge higher interchange fees than their American counterparts under Regulation II.

⁶⁶ Dodd-Frank Act (2010).

⁶⁷ Mui (2011).

Figure 3. Interchange Rates in Europe and the United States, 2013⁶⁸



Estimated Savings under the Federal Reserve’s Original Proposed Rule

Finally, we examine the consumer and merchant savings, and associated job creation, that could have occurred if the Fed had issued its final regulation based on the rules it initially proposed. Regulation II reduced the average debit interchange fee by half, from \$0.48 per transaction to \$0.24; the Board’s original proposal would have capped those fees at \$0.12 per transaction, a 75 percent reduction from pre-regulation levels and half the rate under Regulation II. We estimate that the original \$0.12 cap on debit interchange fees covered under Regulation II would have saved consumers and merchants \$12.54 billion in 2012, \$4.04 billion more than the savings under Regulation II. (Table 14A, below) Similarly, if the Fed’s original proposed cap had been applied to debit transactions covered under Regulation II in the fourth quarter of 2011, it would have saved consumers and merchants an additional \$0.91 billion. (Table 14B, below)

Table 14A. Cost Savings under the Federal Reserve Original Proposal on Interchange Fees, Compared to Regulation II, 2012⁶⁹

	Covered Debit Card Transactions
Transactions (\$ billions)	\$1,297.3
Number of Transactions (billions)	33.14
Interchange Fees Under Regulation II (\$ billions)	\$8.01
Interchange Fees Per Transaction Paid	\$0.242
Proposed Interchange Fee Per Transaction	\$0.12
Interchange Fees Under Proposed Rate (\$ billions)	\$3.98
Additional Cost Savings, Relative to Regulation II (\$ billions)	\$4.04
Additional Savings as a Share of Current Interchange Fees	50.4%

⁶⁸ European Commission (2013).

⁶⁹ Figures might not add up due to rounding errors.

Table 14B. Cost Savings under the Federal Reserve’s Original Proposal on Interchange Fees, Compared to Regulation II, Q4-2011

	Covered Debit Card Transactions
Transactions (\$ billions)	\$308.2
Number of Transactions (billions)	7.81
Interchange Fees Under Regulation II (\$ billions)	\$1.85
Interchange Fees Per Transaction Paid	\$0.24
Proposed Interchange Fee Per Transaction	\$0.12
Interchange Fees Under Proposed Rate (\$ billions)	\$0.94
Additional Cost Savings, Relative to Regulation II (\$ billions)	\$0.91
Additional Savings as a Share of Current Interchange Fees	49.3%

These additional cost savings from applying the Fed’s original proposal, when passed through to consumers and used by merchants, would have supported additional job creation. We estimate that the additional \$4.04 billion in savings in 2012 derived from applying the original proposed cap to all covered debit transactions would have supported an additional 17,824 jobs. (Table 15A, below) Compared to pre-regulation interchange rates, the savings from applying the original proposed cap on interchange fees to all covered debit transactions would have supported 55,325 jobs in 2012.

Table 15A. Estimated Job Creation in 2012 under the Federal Reserve’s Original Proposed Cap on Interchange Fees

	Covered Debit Card Transactions
Additional Cost Savings, Relative to Regulation II (\$ billion)	\$4.04
Savings to Consumers (\$ billion)	\$2.79
Additional New Jobs Supported by Those Savings	10,250
Savings to Merchants (\$ billion)	\$1.25
Additional New Jobs Supported by Those Savings	7,574
Total New Jobs, Compared to Regulation II	17,824
(New Jobs Supported by Regulation II Reforms)	37,501
Total New Jobs, Compared to Pre-Regulation Period	55,325

Similarly, if the Fed’s original proposed cap had been applied to debit transactions on cards issued by institutions covered under Regulation II in the fourth quarter of 2011, they would have saved consumers and merchants an additional \$0.91 billion in that quarter. (Table 18B, above) These additional savings could have supported the creation of 4,015 more jobs in Q4-2011, on top of the 9,088 jobs supported by the savings produced by Regulation II, for a total of 13,103 new jobs in that quarter.

Table 15B. Estimated Job Creation in Q4-2011 under the Federal Reserve's Original Proposal on Interchange Fees

	Covered Debit Card Transactions
Additional Cost Savings, Relative to Regulation II (\$ billions)	\$0.91
Savings to Consumers (\$ billion)	\$0.63
Additional New Jobs Supported by Those Savings	2,309
Savings to Merchants (\$ billion)	\$0.28
Additional New Jobs Supported by Those Savings	1,706
Total New Jobs, Compared to Regulation II	4,015
(New Jobs Supported by Regulation II Reforms	9,088
Total New Jobs, Compared to Pre-Regulation Period	13,103

Estimated Savings from Applying Regulation II to Credit Card as well as Debit Card Transactions

Finally, we conduct here a brief thought experiment, in which we consider the savings and potential employment gains that could have followed, if the average interchange charge under Regulation II had also been applied to the credit card transactions carried out over four-party payment networks by Visa and MasterCard in 2012. We begin with the volume and value of all U.S. credit card transactions in 2012. We estimate that Americans in 2012 undertook 25.4 billion credit card transactions with a total value of \$2.4 trillion.⁷⁰ According to the Nilson Report, the merchant fees on these 2012 credit card transactions totaled \$51.1 billion.⁷¹ We estimate that interchange fees accounted for approximately 80 percent of those merchant fees, or \$41.2 billion in 2012.⁷² On this basis, the interchange fees applied to credit card transactions in 2012 averaged \$1.62 per transaction, or more than six times the \$0.24 interchange fee applied in 2012 to transactions with debit cards issued by large financial institutions. This average interchange fee for credit card transactions is also 13 times the \$0.12 rate proposed for debit transaction by the Federal Reserve in its original rule.

Here, we focus on those credit card transactions carried out over four-party payment networks by the dominant Visa and MasterCard systems. In 2012, these transactions accounted for \$1.515 trillion of the total \$2.4 trillion in credit card charges, with interchange fees totaling \$26.2 billion. Capping at \$0.24 the interchange fees for the four-party payment network credit card transactions, compared to the actual average of \$1.62 per transaction, would have generated some \$22.4 billion in additional savings for American consumers and merchants in 2012. We estimate that consumers would have captured \$15.4 billion of those savings through lower prices, while merchants would have retained the remaining \$6.9 billion in cost savings. Using the methodology described earlier, we estimate that these consumers' savings in 2012 could have supported an additional 56,733 jobs, while the savings retained here by merchants could have supported another 41,918 jobs. All told, applying Regulation II limits on interchange fees for

⁷⁰ Bank for International Settlements (2013), "Statistics on payment, clearing and settlement systems in the CPSS countries," January 2013; Federal Reserve System. 2011. "The 2010 Federal Reserve Payments Study, Noncash Payment Trends in the United States: 2006-2009.," PaymentsSource (<http://www.paymentsource.com/statistics/>).

⁷¹ The Nilson Report (2013). "Merchant Processing Fees Down in the U.S.," July, 2013.

⁷² This calculation is based on Schuh *et al.* (2012), which estimates that interchange fees account for between 70 percent and 90 percent of merchant fees.

Visa and MasterCard credit card transactions in 2012 would have produced \$22.4 billion in cost savings, which in turn could have supported 98,651 additional jobs.

IX. Conclusion

After cash, debit cards are the most common form of payment used by American consumers. In 2012, Americans used their debit cards more than 50 billion times in transactions totaling nearly \$2 trillion. The fees associated with the use of debit cards, therefore, are matters of real import and effect. This study has focused on the interchange fees charged by the debit card networks and the banks issuing the cards every time a customer uses a debit card. In 2010, a provision of the Dodd-Frank financial reforms sponsored by Senator Richard Durbin directed the Federal Reserve Board to set new limits on these fees that would reflect the actual costs of processing a debit card transaction. In 2011, before these new limits took effect, the interchange fee on debit purchases averaged \$0.48 per transaction. Yet, the Federal Reserve found that the actual processing costs borne by the card networks and card-issuing banks averaged just \$0.05 per transaction, with a \$0.12 per transaction cost at the 80th percentile of issuers. In December 2010, the Board proposed to cap future interchange fees at \$0.12 per transaction, reflecting the processing costs per transaction for issuers at the 80th percentile at that time. After intense lobbying by financial service companies, however, the Board agreed to take account of other costs as well; and its final rules, Regulation II, limited interchange fees to \$0.24 per transaction starting October 1, 2011. This study has analyzed the impact of these new rules on consumers, merchants and potential employment.

There is no question that Regulation II has produced substantial savings for American consumers and merchants – nor should there be any doubt that better-crafted rules which more closely followed the terms of the Durbin Amendment would have produced substantially greater benefits. We found, first, that the new rules saved merchants and consumers an estimated \$8.5 billion in 2012. We calculate that \$5.87 billion of those first-year savings were passed along to consumers in lower prices, while merchants retained the remaining \$2.64 billion. Next, we found that the lower prices for consumers supported sufficient additional consumption to support 21,566 new jobs in 2012. The higher retained earnings of merchants also supported additional consumption by those merchants and their shareholders, as well as additional investment and hiring. We estimate that those first-year benefits for merchants were sufficient to support an additional 15,935 jobs. All told, therefore, the first full year of the Durbin Amendment (2012) produced savings for consumers and merchants sufficient to support an additional 37,501 jobs.

Regulation II, however, has significant flaws. Its terms cap debit card interchange fees at \$0.21 per transaction, plus 5 basis points of the value of the transaction and an additional \$0.01 fee for card issuers that meet certain fraud-prevention standards. The \$0.21 fixed fee per debit transaction imposes a disproportionate burden on transactions of \$15 and less, one that is actually greater than the average fee applied to small purchases before Regulation II took effect. In 2012, consumers used covered debit cards for purchases of \$15 or less some 13.8 billion times, in transactions totaling \$103.6 billion. The average small debit transaction involved a purchase of \$7.50, so the associated interchange fee under Regulation II equals 3 percent of the transaction's value. This actually exceeds the profit margins of six types of businesses which depend disproportionately on small transactions, including grocery stores and supermarkets,

bookstores, convenience stores, gas stations, pharmacies and drug stores, and museums. The interchange fee on covered debit transactions of \$7.50 is also equal to between 50 percent and 83 percent of the profit margins for nine other lines of businesses, including fast food restaurants, movie theaters and car washes. We found that if Regulation II had left the interchange fees on small debit transactions unchanged, merchants and consumers would have saved an additional \$690 million in 2012; and those additional, first-year savings could have supported 3,044 more jobs in 2012. The Durbin Amendment surely was not intended to force merchants to take losses on billions of purchases every year, and Congress or the Federal Reserve Board should reduce the current high fixed fee.

We also analyzed the benefits which American consumers and merchants would have derived if the Federal Reserve Board had not revised its original proposed rule, which had capped interchange fees at \$0.12 per covered debit card transaction based on the actual costs of processing those transactions. We found that this original rule would have produced additional first-year cost savings of \$4.04 billion (2012). Some \$2.79 billion of that total would have been passed through to consumers in lower prices, and we found that the consequent additional consumption would have been sufficient to support 10,250 new jobs. We further estimate that merchants would have retained the remaining \$1.25 billion in cost savings; and the additional consumption, investment and hiring based on those savings could have supported 7,574 more jobs. The Board's original proposal for covered debit card interchange fees, therefore, would have generated sufficient first-year savings to support an additional 17,818 jobs, on top of the 37,501 jobs supported by the savings from Regulation II. Therefore, the Federal Reserve's original proposal capping debit card interchange fees to reflect the actual costs of authorizing, clearing and settling these transactions, as directed by the Durbin Amendment, would have produced first-year savings for consumers and merchants sufficient to support 55,325 jobs.

Finally, we considered the potential savings and employment benefits from capping interchange fees for those credit card transactions carried out over four-party payment networks, by Visa and MasterCard, at the \$0.24 per-transaction level applied to covered debit transactions. Since current interchange fees for credit card transactions are much higher than the fees for debit transactions before the Durbin Amendment, extending the \$0.24 cap under Regulation II to most credit card transactions would generate large savings. We found that if the Regulation II cap had covered these credit card transactions in 2012, American consumers and merchants would have saved some \$22.4 billion in interchange fees. Consumers would have captured an estimated \$15.4 billion of those first-year savings through lower prices, which would have been sufficient to support 56,733 more jobs. Similarly, the \$6.9 billion in first-year cost savings retained by merchants could have supported another 41,918 jobs. Analysis shows, therefore, that applying Regulation II limits on interchange fees to all credit card transactions in 2012 would have produced sufficient cost savings for consumers and merchants to support an estimated 98,651 new jobs.

The Congress was right to direct the Federal Reserve Board to regulate debit card interchange fees to closely reflect the costs of authorizing, clearing and settling debit transactions. Regulation II produced substantial savings for American consumers and merchants, which in turn were sufficient to support significant employment gains. However, the new rules remain flawed: They cap the interchange fee for covered debit transactions at twice

the amount they originally recommended and raise the fee on small transactions. Congress and the Federal Reserve Board should revisit the matter of interchange fees to address these deficiencies.

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About the Author

Robert J. Shapiro is the chairman of Sonecon, LLC, a private firm that provides advice, analysis and support to senior officials of the U.S. and foreign governments, senior executives of U.S. and foreign firms, and directors and managers of non-profit organizations. He is an internationally-known economist who has advised, among others, President Bill Clinton, Vice President Al Gore, Jr., British Prime Minister Tony Blair, U.S. Treasury Secretaries Timothy Geithner and Robert Rubin, British Foreign Minister David Milliband, U.S. Senators Barack Obama and Hillary Clinton, as well as senior executives at many Fortune 100 companies. Currently, he is also a Senior Policy Fellow of the Georgetown University McDonough School of Business, an advisor to the International Monetary Fund, chairman of the U.S. Climate Task Force, and director of the Globalization Initiative at NDN. Prior to founding Sonecon, Dr. Shapiro was Under Secretary of Commerce for Economic Affairs from 1998 to 2001. Prior to that post, he was co-founder and Vice President of the Progressive Policy Institute and, before that, Legislative Director and Economic Counsel for Senator Daniel Patrick Moynihan. He also was the principal economic advisor to Bill Clinton in his 1991-1992 campaign and a senior economic advisor to Vice President Gore and Senator John Kerry in their presidential campaigns. In 2008 and 2012, he advised the campaigns and transition of Barack Obama. Dr. Shapiro has been a Fellow of Harvard University, the Brookings Institution, and the National Bureau of Economic Research. He holds a Ph.D. and M.A. from Harvard University, a M.Sc. from the London School of Economics and Political Science, and an A.B. from the University of Chicago.

July 15, 2016

The Honorable Jeb Hensarling
Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Hensarling:

The Retail Industry Leaders Association (RILA) appreciates the opportunity to comment on the discussion draft for the Financial CHOICE Act. We commend the Chairman and the Financial Services Committee for their work to produce a substantive policy proposal to address a number of regulatory issues facing the U.S. economy. However, the inclusion of Section 335 to fully repeal the debit swipe fee reforms contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act—more commonly known as the Durbin Amendment—is an unfortunate decision. RILA is strongly opposed to this draft in its current form.

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.

The facts being presented by the banking and credit union communities for the insertion of Sec. 335 into the discussion draft—especially the facts coming from the largest financial institutions in the country—simply do not add up. It is important to remember the Durbin Amendment only covers banks with more than \$10 billion in assets. This means 98.6% of financial institutions in this country do not have to comply with the swipe fee reforms.

There has also been a false argument that the Durbin Amendment has been harmful to smaller banks. The recent study by the Philadelphia Federal Reserve in the first quarter of 2016 indicated that, after the debit reforms went into place, “the volume of transactions conducted with cards issued by exempt banks grew faster than it did for large banks.”¹ The study concluded, “The evidence does not support the claim that competitive forces have effectively imposed the interchange fee ceiling on small banks.”

The banks have also claimed that the Durbin Amendment has resulted in consumers losing the benefit of free checking. However, the American Bankers Association's (ABA) own study shows more Americans have free checking today than they did before the Durbin Amendment passed. In 2010, the ABA reported that 53%² of consumers had free checking compared to 61%³ last year.

¹ James DiSalvo and Ryan Johnston, Federal Reserve Bank of Philadelphia Research Department, Banking Trends: How Dodd-Frank Affects Small Bank Costs (1st Quarter 2016)

² ABA Survey Shows Majority of Bank Customers Pay Nothing for Monthly Bank Services (Oct. 7, 2010), <http://www.pmcnewswire.com/news-releases/aba-survey-shows-majority-of-bank-customers-pay-nothing-for-monthly-bank-services-104516904.html>.

³ American Bankers Association, Survey: Most Americans Pay Nothing for Bank Services (Aug. 18, 2015) <http://www.aba.com/Press/Pages/081815SurveyonBankCosts.aspx>.

The dire predictions by the largest banks have never come to fruition. In fact, the only full comprehensive study done on this issue by economist Dr. Robert Shapiro shows the Durbin Amendment saves consumers six billion dollars⁴ per year and has created 37,000 jobs in the first year alone.

If the Financial Services Committee is intent on bringing substantial change to the payment ecosystem, RILA encourages the Chairman and Members of the Committee to consider the challenges of today and tomorrow and not re-litigate an issue from the past.

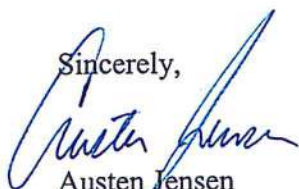
Visa and MasterCard's current dominance in the credit and debit markets prevents new players—who would offer robust competition and new technological advancements—from entering the payments world. This is one of the key reasons why RILA recently supported two pieces of legislation from the committee—H.R. 4854, the Supporting America's Innovators Act of 2016 and H.R. 4855⁵, the Fix Crowdfunding Act. These types of policies have the ability to bring significant change and competitive disruption to the marketplace.

One of the primary pillars of the Durbin Amendment was to finally bring some competition and transparency to the debit market. This specific reform was paramount for retailers—especially small business who now have the ability to bring in other routing options outside of Visa and MasterCard and avoid their draconian fee structure. The ripple effect from this free market policy has allowed businesses to be more competitive in the economy.

RILA implores the Committee to listen to businesses of all sizes and understand swipe fee costs are second only to payroll for most businesses. Repealing the Durbin Amendment would give more control to the duopoly of Visa and MasterCard and additional revenue to the largest banks on the backs of Main Street retailers.

As this process moves forward over the coming weeks, RILA stands ready to have a thoughtful discussion on other provisions within the discussion draft but strongly encourages the Committee to remove Sec. 335 before it is introduced in the U.S. House of Representatives.

Sincerely,



Austen Jensen
Vice President,
Government Affairs

⁴ Robert J. Shapiro, Sonecon, LLC, *The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees* (Oct.1, 2013).

⁵ RILA Statement on H.R. 4854 and H.R. 4855 (July 7, 2016) www.rila.org/news/topnews/Pages/Retailers-Welcome-Bipartisan-Bills-to-Promote-Innovation.aspx

Issue Background: Establishing Free Market Policies for Card Network Rules

Description:

For competition and innovation to flourish throughout the payment ecosystem, we believe there must be an independent standard-setting body to develop principles and guidelines for credit, debit and prepaid payments in the United States that balance the legitimate interests of all market participants.

Impact on Consumers & Market Participants:

An independent body to oversee the creation of the rules of the road would alleviate the impact of a handful of companies using their proprietary technology to maintain market dominance and stifle innovation. The recent failure by EMVCo, an entity controlled by the card networks, to foster a smooth transition to EMV technology in the United States, highlights the flaws in the current governing structure. For example, one global card network used the EMV implementation process to attempt circumvention of the DFA routing requirements. The Federal Reserve Board issued guidance to address this unlawful action from continuing, and the Federal Trade Commission also conducted an investigation. Establishing an accredited commission that focuses on security and payment processing, over loyalties to business interests, will allow innovation and competition to thrive throughout the payment ecosystem that benefits all participants.

Legislative Language:

The draft language below crosses multiple committees in the United States Senate, but it is important for the Banking Committee to exercise their jurisdiction in the payments arena on this important legislative proposal.

SEC. 1. STANDARDS SETTING ENTITY.

(a) DESIGNATING AN ENTITY TO DEVELOP STANDARDS.—Within one year of the date of enactment of this Act, the Consumer Financial Protection Bureau/Federal Trade Commission shall designate one entity to develop standards for credit and debit cards and associated transactions and may designate such entity to develop standards for additional forms of payment. The Bureau/Commission shall seek the input of interested parties in making its designation.

(b) QUALIFICATIONS FOR DESIGNATION.— The entity designated pursuant to paragraph (a) must be one that:

(1) has demonstrated the capability and expertise to develop and establish security and processing standards for electronic payment transactions;

(2) is qualified as a not-for-profit organization under section 501(c)(3) of the Internal Revenue Code; and,

(3) has been accredited as a standard-setting body by the American National Standards

Institute.

(c) AUTHORITY TO CREATE AND UPDATE STANDARDS.—The entity designated pursuant to paragraph (a) shall have the authority to create and revise standards designed to secure payment transactions, including credit card and debit card transactions. Such standards and revisions of such standards shall be presented to the Bureau/Commission for review.

(d) PURPOSE OF STANDARDS.—The purpose of the standards created pursuant to paragraph (c) shall be to secure the payment system such that payment card fraud is reduced while also ensuring that standards facilitate competition and international interoperability in the credit card, debit card, or other applicable payment markets.

(e) REPORT TO BUREAU/COMMISSION.—Within six months after being designated pursuant to paragraph (a) and every 12 months after such designation, the entity designated pursuant to paragraph (a) shall report to the Bureau/Commission on the status of its efforts to develop and issue standards.

(f) BUREAU/COMMISSION MEMBERSHIP IN DESIGNATED STANDARDS ENTITY.—The Bureau/Commission may become a member of the entity designated pursuant to paragraph (a) in order to participate in and monitor the development of standards pursuant to this section.

(g) BUREAU/COMMISSION OVERSIGHT OVER STANDARDS ENTITY.—The Bureau/Commission shall monitor the development of standards pursuant to this section to ensure that the designated standards entity is complying with all the requirements of this section. Should the Bureau/Commission determine that the standards entity is not complying with the requirements in this section, the Bureau/Commission shall direct the standards entity to comply with this section.

(h) BUREAU/COMMISSION REGULATIONS.—The Bureau/Commission shall promulgate regulations requiring payment card networks and financial institutions to comply with standards promulgated pursuant to paragraphs (a), (c), and (d).

(i) DEFINITIONS.

(1) CREDIT CARD— The term ‘credit card’ has the same meaning as in section 103 of the Truth in Lending Act.

(2) DEBIT CARD— The term ‘debit card’—

(a) means any card, or other payment code or device, issued or approved for use through a payment card network to debit an asset account (regardless of the purpose for which the account is established), whether authorization is based on signature, PIN, or other means;

(b) includes a general-purpose prepaid card, as that term is defined in section 915(a)(2)(A); and

(c) does not include paper checks.

(3) PAYMENT CARD NETWORK—the term ‘payment card network’ means an entity that

directly or through licensed members, processors, or agents, provides the proprietary services, infrastructure, and software that route information and data to conduct debit card or credit card transactions authorization, clearance, and settlement, and that a person uses in order to accept as a form of payment a brand of debit card, credit card or other device that may be used to carry out debit or credit transactions.

(i) The purpose of this Section 1 is to benefit all parties relevant to credit card and debit card transactions. Any such party shall have standing to seek injunctive relief against either the Consumer Financial Protection Bureau/Federal Trade Commission or the entity designated pursuant to paragraph (a) to ensure that the intent of this Section 1 is adequately enforced.

(ii) A payment card network shall not, directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition, penalty, or otherwise, require acceptance of any credit card or debit card that fails to comply with payment standards and technology prescribed by the entity designated pursuant to paragraph (a).

###

Other Background Materials:

-Retail Coalition Letter to Visa CEOs Charles Scharf & Al Kelly on violation of Regulation II, November 2016

-Federal Trade Commission, Bureau of Competition Letter to Visa on EMV Transition, November 2016

November 16, 2016

Charles W. Scharf
CEO

Al Kelly
CEO-Designate
Visa Inc.
900 Metro Center Blvd
Foster City, CA 94404

Dear Mr. Scharf and Mr. Kelly:

We write on behalf of millions of American merchants and our customers who have been enormously impacted by both the undermining of competition and the confusing transition to EMV chip card acceptance. We write seeking information on the immediate steps that Visa will take in response to a declaration from the Federal Reserve Board of Governors that the technical specifications and rules provided to merchants as part of the EMV migration violate federal law.

As you are aware, on November 2nd the Federal Reserve clarified that no payment card network can directly or indirectly force retailers to deploy a technology or enforce a rule that inhibits merchant routing choice, and that any technical specifications that inhibit merchant routing choice do not comply with Regulation II (Appendix A). *

The declaration came in response to willful steps taken by Visa to circumvent merchants' legal right to choose the network over which a debit transaction will travel.

This free market principle of merchants choosing network services and providers is critical to ensuring competition in the debit market. Visa should compete for merchant routing preference in the way that businesses do in a competitive market—by offering superior benefits, lower costs and better security, such as chip and PIN. Visa used its overwhelming market share to impose their proprietary EMV chip technology that stifles competition.

The Federal Reserve's recent clarification calls into question the continued legality of a host of Visa's rules and practices that compelled merchants to install and configure terminals that presented cardholders with a routing option that was limited to Visa and would eliminate merchant control of routing. Those unlawful rules, such as Visa's Selection of Payment System rule (Visa Core Rule 1.5.4.6), compel merchants to offer consumers a prompt to select Visa, even if the merchant prefers to route over a competitor network. Similarly unlawful are Visa's rules that compel terminal manufacturers to ship EMV devices with routing prompts—either a Visa Debit prompt or a Credit prompt—that can only be routed to Visa.

The routing provision of Regulation II is critical to ensuring competition in the marketplace. Now that the Federal Reserve has made clear that Visa's network rules are a violation of the law, we request information on your immediate plans to address the following:

- Make EMV smart card technology open and competitive instead of segregating your network on a chip application that is separate from that of all domestic debit networks (other than MasterCard) in order to gain a market advantage.

- Rescind any rule that leads terminal manufacturers to ship devices that include a prompt that can be routed only to Visa.
- Rescind any rules that require merchants to give up their uninhibited ability to select the debit network of their choice that is active on the card being used.
- Suspend the EMV liability shift while merchants reconfigure point of sale terminals to comply with federal law.
- Ensure merchants are aware of their rights regarding EMV deployment & routing service choice.
- Ensure hardware and software providers are aware that any network-required checkout screen that requires a selection that can only be routed to Visa is against the law.
- Ensure merchants who deployed EMV while the rules that violate Regulation II were in place are able to remove them without fear of EMV chargeback liability while the technology update takes place.
- Make changes to your network operating rules and EMV transaction acceptance guide to ensure merchants are not fined for their EMV deployment decisions.
- Ensure issuers are prioritizing only the technologies on the EMV card that have multiple routing options available for every transaction.
- Ensure innovation is not stifled by, and consumers are not harmed by, the practices your companies have employed to date during the EMV transition.


The roll out of EMV technology has been woefully mismanaged by the card networks. The Federal Reserve declaration is the latest in a long list of examples of that mismanagement.

On behalf of millions of merchants and their customers across the United States, we urge you to present a clear and speedy process for resolving this issue that ensures merchants face no additional costs while they remove these non-compliant, confusing customer checkout screens. And we urge that, moving forward, Visa strictly adhere Regulation II including the declaration laid out by the Federal Reserve.

Sincerely,



Sandy Kennedy
President
Retail Industry Leaders Association



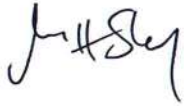
Mark Horwedel
CEO
Merchant Advisory Group




Robert A. Walton
CEO
National Association of College Stores



Peter Larkin
President & CEO
National Grocers Association



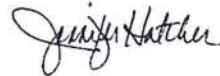
Matt Shay
President & CEO
National Retail Federation



Rob Underwood
President
Petroleum Marketers Association of
America



Hank Armour
President & CEO
National Association of Convenience Stores



Jennifer Hatcher
Chief Public Policy Officer
Food Marketing Institute

***Appendix A:**

Q4. After a debit card with an EMV chip is inserted into a point-of-sale terminal, some terminals prompt the cardholder to choose between applications, one that routes to at least two unaffiliated networks and another that routes to a single network. Does a payment card network comply with section 235.7 of Regulation II if it requires the merchant to allow the cardholder to make the choice of EMV chip application, one of which routes only to a single network?

A4. No. Section 235.7(b) of Regulation II implements the requirement in section 920(b)(1)(B) of the Electronic Fund Transfer Act that a "payment card network shall not, directly or through any agent, processor, or licensed member of the network, by contract, requirement, condition, penalty, or otherwise, inhibit the ability of any person that accepts or honors debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions." A payment card network inhibits a merchant's ability to route electronic debit card transactions if it, by network rules, standards, specifications, contractual agreements, or otherwise, requires the merchant to allow the cardholder to make the choice of EMV chip application on a debit card, where one application routes only to a single network. Such a requirement is not compliant with section 235.7 of Regulation II because it prevents the merchant from directing the routing of electronic debit transactions. (Added November 2, 2016)

Available at <https://www.federalreserve.gov/paymentsystems/regii-faqs.htm>



UNITED STATES OF AMERICA
Federal Trade Commission
Washington, D.C. 20580

James W. Frost
Office of Policy & Coordination
Bureau of Competition
Phone: (202) 326-2189
Email: jfrost@ftc.gov

November 22, 2016

Via Email

Julie B. Rottenberg, Esq.
SVP, Deputy General Counsel, Chief Counsel, North America, Risk and Merchant Solutions
Visa Inc.
P.O. Box 8999
San Francisco, CA 94128-8999

Dear Ms. Rottenberg:

I write to inform you that the FTC's Bureau of Competition (the "Bureau") has closed its investigation into whether the conduct of Visa Inc. ("Visa") in relation to the EMV transition in the United States improperly inhibited merchant routing choice in violation of the Durbin Amendment (Electronic Funds Transfer Act, 15 U.S.C. § 1693o-2) and its attendant regulations (12 C.F.R. § 235.7(b)).¹ As you are aware, the FTC has enforcement authority under the Electronic Funds Transfer Act² and a violation of the Act would be a violation of the Federal Trade Commission Act, 15 U.S.C. § 45, as amended.

As we have discussed, Visa's existing rules told merchants to present a selection screen to customers paying with a debit card. This screen asked customers to select which application would process their transaction, but only one of these applications permitted merchants to access every competing payment card network enabled on the card. Our investigation addressed concerns that these customer selection requirements inhibited the merchant routing choice guaranteed by the Durbin Amendment.

To address our concerns and to prevent any future recurrence of these issues, Visa has taken several actions including revising Visa Core Rule 1.5.4.6, revising its Transaction Acceptance Device Guide and revising its Acquirer Implementation Guide. These actions make clear that merchants can continue to route debit transactions to any payment card network enabled on the card for that transaction and that merchants are not required to display these application selection screens to their customers.

¹ See also recent updates to the Federal Reserve FAQs on this issue.

² see 15 U.S.C. § 1693o(c).

Based on Visa's remedial actions, the recent update to Regulation II by the staff of the Federal Reserve Board further clarifying these issues, and the pressing need to resolve this matter expeditiously due to the pendency of costly EMV conversions by many retailers, staff has decided not to pursue this investigation further. The circumstances presented here are unique, and justify the expeditious resolution of this matter.

Just as the pendency of an investigation does not indicate that a violation of law has occurred, you should also not construe today's action as a determination that Visa has not violated the Federal Trade Commission Act. The Commission reserves the right to take any further action the public interest may require.

Should you have any questions, please contact me directly.

Very truly yours,

/s/ James W. Frost

James W. Frost
Attorney

Issue Background: Mobile and the Evolution of Payments

Description:

As the United States moves toward mobile commerce, it is critical that stakeholders build new products and services geared toward the digital environment. This provides an opportunity to develop products and services that utilize authentication and interactive tools that are only available in a digital environment, enabling better functionality and security than are available with paper or plastic payments.

Impact on Consumers & Market Participants:

Retailers, fintech companies and other non-bank entities have the potential to be innovators in the mobile commerce space. RILA members understand the wants and needs of our customers, and driving a positive customer experience is paramount to running a successful retail business. The payment portion of mobile commerce is almost an afterthought for most of our customers, and our goal is to make the payments process as frictionless as possible.

As the trajectory of mobile payments ascends through the market, there are concerns among the merchant community that the financial services industry approach to innovation in payments is inadequate. The largest global payment card networks and financial institutions are demonstrating that their interest is in fitting their traditional products into the digital environment instead of building new and innovative products that maximize the potential of the digital environment.

As it pertains to legacy technology systems, many retailer wallet providers and fintech companies are able to start with fresher and more innovative platforms for mobile commerce than other stakeholders in the system. RILA members encourage the Committee to work with the primary regulators to prevent any additional regulation that could hinder or impede innovation by non-bank entities. As actors in the payment system, we invite additional oversight into how stakeholders can work more closely together to achieve the common goal of responsible innovation, as well as oversight as to how existing legacy banking systems and network rules may inhibit breakthrough technologies from coming to market.

Other Background & Materials:

-RILA & Merchant Advisory Group letter to the Office of the Comptroller of Currency on Innovation, May 2016



May 31, 2016

The Honorable Thomas J. Curry
Comptroller of the Currency
United States Treasury Department
400 Seventh Street, SW
Washington, DC 20024

Submitted Via Email: innovation@occ.treas.gov

Dear Mr. Curry:

The Retail Industry Leaders Association (RILA) and Merchant Advisory Group (MAG) very much appreciate the opportunity to submit feedback to the Office of the Comptroller of the Currency (OCC) in regard to responsible innovation in the federal banking sector. As you note in the OCC paper, "mobile payment services and mobile wallets are changing the way consumers make retail payments." As the primary acceptors of mobile payments, the retail industry is a critical stakeholder in this space. Additionally, as commerce continues to evolve, many traditional retail companies are beginning to offer their own mobile wallet solutions and consumer-facing retail applications.

By way of background, RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufactures, 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 distributions centers domestically and abroad.

The Merchant Advisory Group (MAG) was founded in 2008 by a small visionary group of merchants in the payments field dedicated to driving positive change in payments through multi-stakeholder collaboration. Today, the MAG represents over 100 of the largest U.S. merchants who account for nearly \$2.6 trillion in annual sales at over 430,000 locations across the U.S. and online. Roughly \$1.5 trillion of those sales are electronic representing over 41 billion card payments. MAG members employ nearly 11.5 million associates.

Background:

We all have a shared goal of ensuring both business and consumer transactions are faster and safer. This is particularly pressing in the United States, which accounts for just under 25% of worldwide card payments volume, but nearly 50% of the worldwide

payment card fraud.¹ In order to achieve the goal of faster and safer transactions, it is critical to have an open market for innovation and advancement in mobile commerce. Responsible innovation will only flourish in an environment that fosters vigorous competition for faster, more secure, and more efficient payment.

In many instances, we believe fintech companies, retailers, and other non-bank entities have the potential to be some of the greatest innovators in the mobile commerce space. As retailers, we are very in tune to the wants and needs of our customers, and driving a positive customer experience is paramount to running a successful business. The payment portion of mobile commerce is almost an after-thought for most of our customers, and it should be. Our goal is to make the payments process as frictionless as possible because ultimately, the way a customer can pay is not the reason they're shopping in our store, dining in our restaurant, or flying our airline.

As the United States moves toward mobile commerce, it is critical that stakeholders build new products and services geared toward the digital environment – products and services that utilize the added authentication and interactive tools that are available in a digital environment compared to those available for paper or plastic payments. We do think this is a potential shortfall of the financial services industry approach to innovation in payments as some of the largest global payment card networks and financial institutions have demonstrated an interest in bringing legacy analog products into the digital environment instead of building new and innovative products within the digital environment.

As the OCC paper notes, “Start-ups do not have legacy technology systems or large brick-and-mortar infrastructures that can be costly to maintain or change.” In this regard, especially as it pertains to the legacy technology systems, many of the fintech companies and retail wallet providers are able to start with fresher and more innovative platforms for mobile commerce than other stakeholders in the system. We strongly believe any additional regulation in this space could hinder or impede innovation by non-bank entities; however, we would invite additional oversight into how stakeholders can work more closely together to achieve the common goal of responsible innovation, as well as oversight as to how existing legacy banking system and network rules may be inhibiting such innovation.

Again, we very much appreciate the opportunity to provide feedback on responsible innovation in the United States banking sector. We will seek to answer question #'s 1, 4, 5, and 9 in greater detail below.

1. What challenges do community banks face with regard to emerging technology and financial innovation?

¹ *Nilson Report*. July 2015.

It is our observation community banks, and even mid-size financial institutions, may struggle to obtain equal footing with the larger financial institutions with the rollout of digital wallets. This is particularly true when global credit card networks, such as Visa and MasterCard, are at the center of a major deal with digital wallet providers because those companies have historically favored their biggest clients, who are the very largest card issuers.

As long as traditional card networks are central to any wallet product launch, community banks and mid-size financial institutions are unlikely to get equal treatment and access compared to larger financial institutions. In the decade since Visa and MasterCard – previously bank-owned associations – became for-profit entities, this trend has accelerated. The OCC would likely gain valuable feedback on this dynamic by inquiring with small banks about how they were treated during the launch of specific wallet products, and whether or not they received fair and timely access to both the contracts and technology to participate in those roll outs, as well as whether or not they had any real input into the wallet deployment to ensure the product could be successfully incorporated into their business.

4. How would establishing a centralized office of innovation within the OCC facilitate more open, timely, and ongoing dialogue regarding opportunities for responsible innovation?

We would support the establishment of a centralized Office of Innovation within the OCC to facilitate a more open, timely and ongoing dialogue regarding responsible innovation. Such an office could serve as a clear entry point for voluntary, non-bank communication and dialogue with the OCC.

A current example of an area in which non-bank entities are interested in opening a dialogue with the OCC is surrounding signature payment card fraud chargeback² rules, practices, and procedures. With the U.S. transition to EMV chip card technology – one of

² “When consumers make purchases with a credit, debit, or prepaid card at merchants, the merchants typically receive funds of those payment card transactions a few days after the transaction date. However, even after merchants received the funds, those funds are not necessarily guaranteed for the merchants due to chargebacks. Chargebacks are full reversal of transactions by card issuers. When a card issuer initiates a chargeback to the merchant, the merchant processor, which is an entity that provides payment card processing services for the merchant, returns the funds to the issuer from the merchant’s account. The funds may again be deposited to the merchant account if the merchant successfully reclaims the funds by disputing the chargeback. When a cardholder disputes a transaction on his payment card statement, either his card issuer or the merchant at whom the transaction was made typically incurs the loss.” See “Chargebacks: Another Payment Card Acceptance Cost for Merchants.” Kansas City Federal Reserve Bank. January 2016. <https://www.kansascityfed.org/~/-/media/files/publicat/resvkwkpap/pdf/rwpl6-01.pdf> at pg. 2.

the most recent payment innovations in the United States – there is a tremendous need by a variety of payment system stakeholders for added transparency in the payment card chargeback process. This is even more critical as U.S. consumer’s adoption of mobile commerce and e-commerce/Internet shopping continues to grow. The policies that exist today in legacy card payment acceptance rules between those m-commerce and e-commerce transactions and in-store transactions will become even more opaque in regard to chargeback liabilities, fraud and overall cost and efficiency. An Office of Innovation at the OCC would provide a venue for non-bank stakeholder to begin a dialogue surrounding this and other key issues.

5. How could the OCC provide guidance to nonbank innovators regarding its expectations for banks’ interactions and partnerships with such companies?

As noted in question #4, we believe an Office of Innovation could help foster an ongoing dialogue for non-bank innovators, bank partners, and the OCC. Having a centralized point of contact within the OCC to manage the dialogue between voluntary stakeholder participants in the innovation space will help promote a forum to discuss the challenges and opportunities that arise in the mobile commerce marketplace.

The current environment is a challenging one for non-bank providers to participate in, especially when faced with an emerging issue that perhaps benefits the banking stakeholders in the system at the expense of other stakeholders and the overall efficiency of the payments or mobile commerce ecosystem. For example, supra-competitive payment card acceptance fees – revenue to financial institutions – may disincentivize those parties from moving away from the current system toward faster, lower fee, more secure, and overall more efficient payments.

This is evident in the recent activity by NACHA where the large financial institutions agreed to move toward same-day ACH payments, but only with the promise of a fixed interbank fee that will effectively become a price-fixed market floor even though fintech companies could likely offer the same service faster and cheaper. Not to mention, in order to remain competitive in a 21st century economy, the United States should focus efforts toward near real-time consumer-to-business payments, which are already prevalent in many other countries around the world, including Mexico, India, the UK, Sweden, and Poland.

The U.S. Federal Reserve Faster Payments Task Force is a sound example of a forum in which multiple system stakeholders – including the merchant community – have voluntarily coalesced around exploring solutions to bring faster and more secure payments to the United States. While the outcome is still forthcoming, the Federal Reserve should be commended for their efforts to drive an open and inclusive dialogue, and we believe the OCC has the potential to play a similar stakeholder organization role.

9. What should the OCC consider with respect to innovation?

One item we would highlight with respect to innovation is the recent failure of EMVCo³ and its governing card networks to foster a smooth transition to EMV smart card technology in the United States. We believe the EMV transition, which has come under scrutiny by several lawmakers, demonstrates the inadequacy of EMVCo as an organization, and its member companies, to successfully deploy new technologies in the United States. We would encourage the OCC to heavily scrutinize any efforts by EMVCo to play a role in bringing mobile payment innovations to the United States until the plastic chip card transition is fully carried out.

We would also caution that payment card network acceptance rules and business practices are an inhibitor to innovation in the mobile commerce space. Currently, merchants are not receiving enough transaction detail to know which mobile wallets are being presented for payments in their store with Near Field Communication or NFC wallets. As such, many merchants are reluctant to turn on NFC contactless acceptance technology at the point-of-sale, inhibiting the growth and innovation of contactless payments.

Additionally, Visa rules say if a merchant accepts any type of plastic swipe or dip Visa credit card, that merchant has to accept any type of contactless or digital Visa credit card, including a contactless Visa credit card presented inside ANY digital wallet if the merchant has turned on NFC contactless technology at the point-of-sale. This prohibits a merchant from choosing to accept just one NFC wallet without accepting them all. So effectively, if a merchant wants to accept Android Pay (an NFC wallet), Visa acceptance rules require that merchant to also accept Apple Pay (another NFC wallet). Given the choice a merchant may choose to accept either or both wallets, but it is critical to competition and innovation that merchants have the flexibility to choose, and are able to have a direct business relationship with that wallet provider to ensure the best experience for the joint customer.

There are many business ramifications of forced wallet acceptance, including tremendous uncertainty about the security of the wallet, cost of acceptance inside the wallet - including the cannibalization of retail private label bank or gift card programs - and the access, use and management of data. The last item, in particular, could result in significant harm to merchants, networks, and banks as it could result in sales

³ EMVCo exists to facilitate worldwide interoperability and acceptance of secure payment transactions. It accomplishes this by managing and evolving the EMV^{®1} Specifications and related testing processes. This includes, but is not limited to, card and terminal evaluation, security evaluation, and management of interoperability issues. Today there are EMV Specifications based on contact chip, contactless chip, common payment application (CPA), card personalisation, and tokenisation. This work is overseen by EMVCo's six member organisations—American Express, Discover, JCB, MasterCard, UnionPay, and Visa—and supported by dozens of banks, merchants, processors, vendors and other industry stakeholders who participate as EMVCo Associates. https://www.emvco.com/about_emvco.aspx

information and transaction volume details being sold to competitors.

In particular, as it pertains to transaction volume details being sold to or obtained and utilized by competitors, the OCC should investigate the EMVCo organization's tokenization specifications. The tokenization specifications are already deployed at market as the back-end security feature of certain mobile wallets; yet, there is no clear path for the majority of domestic debit networks or smaller financial institutions to manage the tokenization technology on their own without going through Visa, MasterCard or one of the other EMVCo global payment card brands. The way the EMVCo tokenization solution is set-up and currently deployed, it has tremendous potential to severely disadvantage U.S. domestic debit card networks, and mid-size and small financial institutions over the long-term. Meanwhile, it can reduce the overall efficiency and security for other stakeholders in the payments chain, including merchants and our customers.

Conclusion:

In conclusion, as both acceptors of mobile payments and providers of wallet apps and services, the merchant community would welcome an ongoing dialogue with the OCC regarding innovation in mobile commerce and payments.

We look forward to the opportunity for further dialogue on these important industry issues. Please feel free to contact Liz Garner at liz.garner@merchantadvisorygroup.org or Austen Jensen at austen.jensen@rila.org with any additional follow-up questions or concerns.

Thank you again for the opportunity to provide feedback on the important topic of responsible innovation.



Liz Garner
Vice President
Merchant Advisory Group



Austen Jensen
Vice President
Retail Industry Leaders Association



Issue Background: Expanding Reforms to the Credit Card Market

Description:

The current dynamic between the key participants in the credit card market should be reviewed and reformed. Interchange fees on the credit card side have consistently grown here in the United States without any justification from the global card networks or the issuing banks. Governments throughout the European Union, Australia and China have sought to bring transparency and reforms to their markets. Allowing interchange fees to grow unabated will force the merchant community to raise prices, harming consumers—particularly those in lower income brackets.

Impact on Consumers & Market Participants:

Establishing modest reforms in the credit card arena should be a goal of all market participants. The merchant community competes every day on prices and services—no matter the size and complexity of the retailer. The American consumer can view the prices of multiple merchants online or in physical stores, and they can make a clear and informed decision about what and where to purchase. Unfortunately, what the consumer can't see on the price tag is the cost for interchange built into that product. In addition, the merchant doesn't have the freedom to choose the best price for its participation in the payments market. As interchange fees continue to rise unchecked, the ripple effects force merchants to raise the prices of goods and services for all consumers, whether they use credit cards or not. Issuing banks and the global card networks should be equally concerned with this problem and how it could disrupt other areas in their business model.

Even with incremental reforms in the credit card market, the United States would most likely maintain average interchange fees higher than other advanced economies. RILA supports the Committee's efforts to review the drastic rise in interchange fees and the effect on American consumers—especially those who are most vulnerable to price increases.

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The Leading Brands in Retail

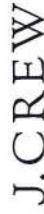
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