

DEBIT INTERCHANGE REGULATION: ANOTHER BATTLE OR THE END OF THE WAR?

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As one governor of the Board of Governors of the Federal Reserve System (the “Board” or “Federal Reserve”) recently observed, “the financial crisis spawned or strengthened many reform agendas—among them consumer protection, securities and commodities market regulation, and traditional bank regulation.”¹ The crisis also created opportunities unrelated to these reform agendas. At least one group—merchants—realized a legislative goal that had been unimaginable a year earlier: giving the Federal Reserve the authority to set debit interchange rates.

Still reeling from the financial crisis and preoccupied with defending innumerable other measures in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”),² retail bankers big and small watched as an unprecedented government rate-setting amendment was approved in the U.S. Senate by a bipartisan vote of 64 to 33.³ Under the so-called Durbin Amendment, named for U.S. Senator Richard Durbin, an estimated \$7.2 billion—or roughly 45%—of interchange revenue paid to banks for facilitating debit card transactions will be eliminated.

This article explores the events that led to passage of the Durbin Amendment and describes the likely impact of this historic legislation on the banking industry, payments companies, merchants and consumers. Finally, we discuss whether the Durbin Amendment represents the final battle on debit interchange in the United States, or merely a skirmish in a long-running war.

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¹ Daniel K. Tarullo, Governor, Fed. Reserve System, Speech at the Peter G. Peterson Institute for International Economics (June 3, 2011).

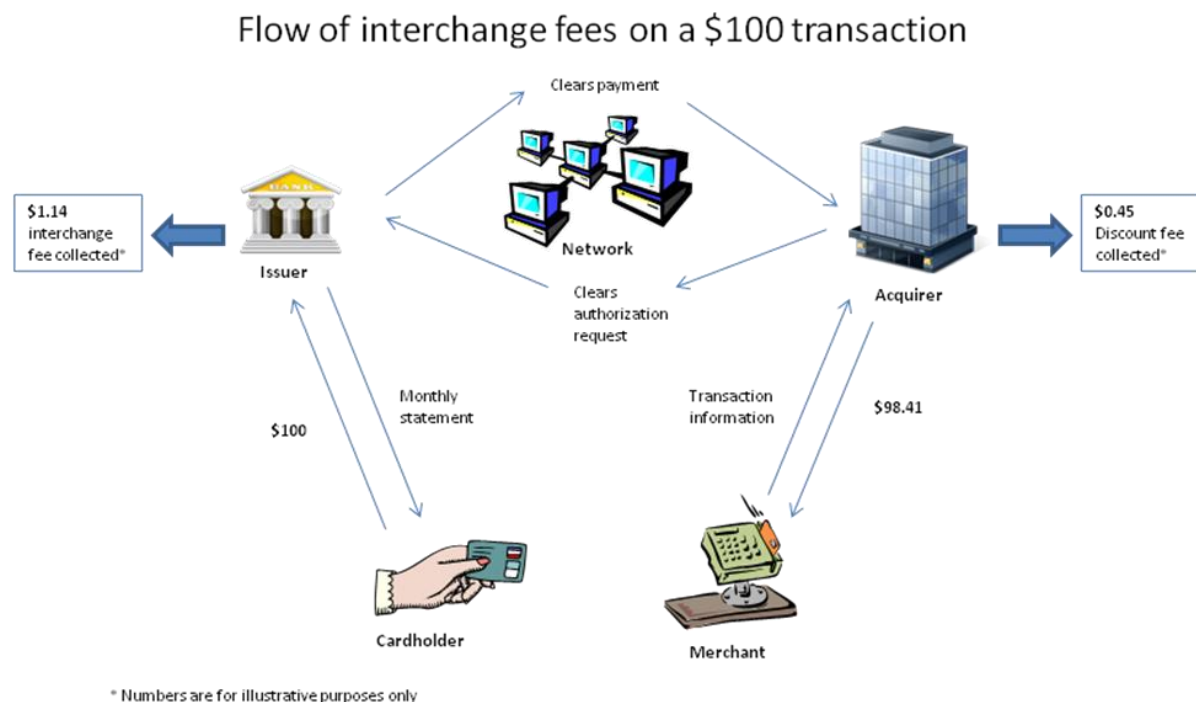
² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010)

³ Section 1075 of Dodd-Frank amends the Electronic Fund Transfer Act (“EFTA”) (12 U.S.C. § 1693 et seq.) by adding a new provision regarding interchange transaction fees and rules for payment card transactions.

The Durbin Amendment was preceded by a long-running feud over interchange, with retailers on one side, and payment networks and the banking industry on the other.

The seeds of the dispute were sown by payment processing arrangements and the success of debit cards with American consumers.

Understanding the battle over interchange begins with understanding interchange itself. When a consumer uses a debit card to make a purchase, the merchant does not receive the full purchase amount, because a portion of the sale is deducted to compensate other parties to the transaction. In particular, the merchant's bank (the "acquirer"), the bank that issued the card (the "issuer"), and the card network that processes the transaction (the "network") all receive a portion of the transaction, with the largest portion paid to the card-issuing bank as an interchange fee.⁴ This multi-party relationship is shown in the simplified chart, below.⁵



⁴ The Federal Reserve defines an "interchange transaction fee" as "any fee established, charged, or received by a payment card network and paid by a merchant or an acquirer for the purpose of compensating an issuer for its involvement in an electronic debit transaction." Debit Card Interchange Fees and Routing, 12 C.F.R. § 235.2(j) (2011).

⁵ This describes what is known as a "four-party," or "open-end" processing relationship. Processing arrangements also can involve a "three-party," or "closed-end" processing system, in which the network itself acts as both issuer and acquirer. For a more detailed description of the debit card industry, see Proposed Rule, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722, 81,723 (Dec. 28, 2010).

The level and growth of debit interchange rates became increasingly controversial. Retailers felt their costs for accepting cards were too high and increasing. The total costs to merchants who accept debit cards did rise over time, in part because of the extraordinary success of the product.⁶ Consumers rapidly substituted debit cards for cash and checks. Debit share of U.S. Personal Consumption Expenditure (PCE), for example, grew 75% in five years—it represented 9.7% of PCE in 2003 (for a total of \$585 billion), and represented 17% of PCE in 2008 (for a total of \$1.3 trillion).⁷ Payment networks report there were approximately 37.7 billion debit and prepaid card transactions in 2009, valued at over \$1.45 trillion.⁸ At the same time, interchange revenue became increasingly important to card issuers of all sizes. Smaller issuers, such as community banks and credit unions, rely on interchange fees as a significant source of revenue for their card operations, and card operations were highly profitable activities for large banks, as well.

Faced with escalating processing costs, merchants sought relief in the courthouse and in Congress.

As interchange revenues climbed in the mid-nineties, payment networks began to face antitrust litigation over their practices. Beginning in 1996, various class action and Department of Justice lawsuits were filed against Visa U.S.A. Inc., MasterCard International and issuers, in some cases, claiming violations of federal antitrust laws. In the intervening decade, most of these claims were settled, and both Visa and MasterCard became publicly-owned institutions.⁹

With judicial challenges proceeding slowly through the courts, merchants took their cause to Capitol Hill. Largely under the auspices of the Merchants Payments Coalition,¹⁰ and with the support of Senator Durbin, merchants made several unsuccessful attempts at legislation regulating interchange rates. In 2009, they were able to attach an interchange provision to a major piece of credit card legislation, the 2009

⁶ Merchants claimed processing costs also rose as a consequence of increased interchange rates since rate increases were used by payment networks to compete for issuers. *See Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. On Financial Services*, 112th Cong. 4-5 (Feb. 17, 2011) (statement of Doug Kantor, Counsel, Merchants Payments Coalition).

⁷ U.S. Consumer Payment Systems, Nilson Report #939 at 10, December 2009.

⁸ Proposed Rule, Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722, 81,725 (Dec. 28, 2010).

⁹ At least one lawsuit, which consolidated approximately 55 complaints, has been pending for the last six years. *See Second Consolidated Amended Class Action Complaint, In Re Payment Card Interchange Fee and Merchant-Discount Antitrust Litigation*, No. 1:05-md-1720-JG-JO (E.D.N.Y. Jan. 29, 2009).

¹⁰ The Merchants Payments Coalition is a merchant trade association representing over 2.7 million merchants in the challenge to interchange fees.

Credit Card Accountability, Responsibility, and Disclosure Act (the “CARD Act”). The provision directed the Government Accountability Office (“GAO”) to conduct a study of interchange.¹¹ The resulting GAO study found no competitive concerns or the need for government rate-setting.¹²

But 2010 ushered in the perfect storm for long time opponents of interchange regulation. Few in Congress understood the issues surrounding interchange, and industry leaders and members of Congress already were grappling with the complexities of other provisions of the 2,300 page bill that ultimately became Dodd-Frank. Senator Durbin’s influence in the Senate was at an all-time high, and influence (and trust) of the banking industry was at an all-time low. From the midst of this chaos, retail bankers, big and small, watched as Senator Durbin’s unprecedented government rate-setting amendment was approved in the Senate and ultimately became law.¹³

The Durbin Amendment was designed to change fundamentally the economic underpinnings of debit payment processing and shift decision-making power as to transaction processing in favor of merchants.

In adopting final interchange regulations, Federal Reserve Governors and staff believed their hands were tied by a narrow statutory mandate.

Dodd-Frank required the Board to establish its interchange fee standards no later than April 21, 2011, with final rules effective on July 21, 2011.¹⁴ Prior to issuing its rule, Board staff held numerous meetings with debit card issuers, payment card networks,

¹¹ GAO was directed to review (1) how the fees merchants pay have changed over time and the factors affecting the competitiveness of the credit card market, (2) how credit card competition has affected consumers, (3) the benefits and costs to merchants of accepting cards and their ability to negotiate those costs, and (4) the potential impact of various options intended to lower merchant costs.

¹² U.S. GOVERNMENT ACCOUNTABILITY OFFICE, CREDIT CARDS: RISING INTERCHANGE FEES HAVE INCREASED COSTS FOR MERCHANTS, BUT OPTIONS FOR REDUCING FEES POSE CHALLENGES (2009).

¹³ Opponents of the Durbin Amendment waged an unsuccessful attempt to change the law. Senator Jon Tester of Montana introduced a bill to delay implementation of the Durbin Amendment by a year. Tester’s proposal called for a study of the effect of the Durbin Amendment and the Board’s proposed rule on all costs associated with debit card programs to issuers and networks, the costs to consumers, including the impact on fraud prevention services and the cost and accessibility of debit services, and the effectiveness of the small issuer exemption. Any adverse finding would result in a withdrawal of the proposed rule and the issuance of a new rule. On June 8, 2011, Tester’s amendment received 54 votes in the Senate, but failed to obtain a filibuster-proof majority.

¹⁴ On March 29, 2011, Board Chairman Ben Bernanke wrote in a letter to Congressional banking committee leaders that the Board was unable to meet the April 2011 deadline provided in the statute for the final rule, due to the high volume of comments the Board received and the complexity of the issues raised by the comments. The final rules were approved by the Board, with one objection, on June 29, 2011, and covered issuers have until October 1, 2011 to comply with the interchange fee restrictions, as described in greater detail below.

merchant acquirers, merchants, industry trade associations and consumer groups. Interested parties also provided written submissions.¹⁵ The Board also distributed three surveys to industry participants (an issuer survey, a network survey and a merchant acquirer survey) to assist the Board in developing its rules.¹⁶

Section 1075 of Dodd-Frank and the Board's regulations fundamentally change the status quo in debit processing in three ways: introducing government regulation of interchange fees, prohibiting "exclusive" arrangements between an issuer and a network, and allowing merchants to "steer" a customer to use one type of card rather than another. Each is described below.

Regulation of Interchange Fees. Under Dodd-Frank, the amount of any interchange fee with respect to an electronic debit transaction received or charged by an issuer must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."¹⁷ Dodd-Frank directs the Federal Reserve to prescribe regulations to establish standards for assessing whether the amount of any interchange transaction fee is "reasonable and proportional" to this cost.¹⁸ Dodd-Frank permits the Board to allow in its regulation for an adjustment to the fee amount for costs incurred by the issuer in preventing fraud, provided the issuer complies with fraud-related standards established by the Board.¹⁹

In setting new interchange rates, the Board's final rule caps the maximum debit interchange fee that an issuer may receive per transaction at the sum of 21 cents,²⁰ plus 5 basis points (0.05% of the transaction amount) to account for fraud losses. The Board provides an additional allowance for fraud prevention equal to 1 cent per transaction, provided the issuer adopts fraud prevention procedures established under the regulation.²¹

¹⁵ Meeting summaries and written submissions are available on the Regulatory Reform section of the Board's web site, at <http://www.federalreserve.gov/newsevents/reform.htm>.

¹⁶ The card issuer survey was distributed to 131 financial organizations with assets of \$10 billion or more. The Board received 89 responses; it received no communication at all from 26 of the 131 organizations that were sent the survey.

¹⁷ 15 U.S.C. § 1693o-2(a)(2).

¹⁸ *Id.* § 1693o-2(a)(3). The statute notes several factors that must be considered by the Board in prescribing its regulations. The Board must consider the functional similarity between debit transactions and check transactions. In addition, the Board must distinguish between (i) "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular" debit transaction, which costs must be considered; and (ii) other costs incurred by the issuer which are not specific to a particular transaction, which costs shall not be considered. *Id.* § 1693o-2(a)(4). The latter considerations were particularly controversial during the rulemaking process.

¹⁹ *Id.* § 1693o-2(a)(5). The Board was required to establish such fraud standards within nine months of Dodd-Frank's enactment.

²⁰ In arriving at the 21 cent figure, the Federal Reserve took into account from its survey of covered issuers the average per-transaction allowable processing costs for issuers at the 80th percentile of the survey. Allowable costs are those total fixed and variable transaction processing costs related to authorization, clearance and settlement, as well as network processing fees (*e.g.*, switch fees), and the costs of processing chargebacks and other non-routine transactions, and transactions monitoring.

²¹ This additional fraud allowance was based on the median of reported issuer fraud losses from the

While a significant improvement over the proposed rule, which capped interchange rates at 12 cents, the final rule will decrease interchange revenue by about 45% for covered issuers.²²

Certain entities and programs are exempt from the rate provisions of Dodd-Frank. Issuers that, together with all affiliates, have less than \$10 billion in assets are exempt from the Board regulations, under the “small issuer” exemption.²³ In addition, prepaid cards used in connection with government-administered payment programs and certain general purpose prepaid cards are exempt.²⁴

During consideration of the final interchange regulations, the Board staff acknowledged they could not predict the impact of the statute on small banks or the effectiveness of the small-issuer exemption. Staff noted that while the major payment networks have indicated their intentions to adopt a “two-tier” pricing structure that accounts for small issuers, there is no certainty interchange rates for small banks will remain at current levels.²⁵ Moreover, Board staff acknowledged they have no authority to require networks to maintain a two-tier structure. Governor Elizabeth Duke objected to the Board’s final rules largely on the basis of the uncertainty surrounding the impact on small banks.

The statute also provides that the Federal Reserve may regulate fees charged by payment networks, but only for the purpose of ensuring that the network fee is not used to circumvent the interchange fee provisions. To prevent circumvention or evasion of the limits on interchange fees, the rule prohibits an issuer from receiving net compensation from a debit card network, excluding interchange fees. In other words, the total amount of compensation provided by the network to the issuer, such as rebates, incentives or

Federal Reserve survey.

²² Based on a comparison of the Federal Reserve survey data (which reflects debit interchange rates for all transactions of 1.14% and an average debit transaction amount of \$38.03), the Federal Reserve’s final rule on debit interchange will cause average debit interchange rates to decline about 45%, from approximately 1.14% to approximately 0.63%. Put another way, average per transaction rates will decline from around 44 cents to 24 cents.

²³ For a list of institutions qualifying as small issuers, see Interchange Fee Standards: Small Issuer Exemption, <http://www.federalreserve.gov/paymentsystems/debitfees.htm>.

²⁴ To qualify for this exemption, the payment device must be (i) linked to funds or other assets that are loaded on a prepaid basis, (ii) not used by the card holder to access the cardholder’s account (other than a recordkeeping subaccount of an omnibus account), (iii) redeemable at unaffiliated merchants or service providers, (iv) used to transfer or debit funds, and (v) reloadable and not marketed or labeled as a gift card. In addition, the card must be the only means to access the underlying funds, except when all remaining funds are provided to the cardholder in a single transaction (as when the account is closed out). In other words, transactions using prepaid cards that provide regular access to funds underlying the card through check or ACH would be subject to interchange restrictions.

²⁵ See Staff Memorandum, Final Rule on Debit Interchange Fees and Routing and Interim Final Rule on Fraud Prevention Adjustment 18 (June 22, 2011), available at http://www.federalreserve.gov/aboutthefed/boardmeetings/20110629_FINAL_RULE.BOARD_MEMO.06_22_2011.SGA.FINAL2.pdf.

payments, may not exceed the total amount of fees paid by the issuer to the network.

Elimination of “Exclusive” Arrangements. In addition to prescribing rules regarding restrictions on interchange fees, the Board also is required by Dodd-Frank to prescribe certain rules regarding transaction routing. The Board regulations must provide that neither an issuer nor a payment network may (i) restrict the number of payment card networks on which a transaction is processed to only one network, or (ii) inhibit a merchant who accepts debit cards from directing the routing of transaction processing over any payment card network that may process such transaction.²⁶

Board regulations provide that an issuer or payment card network may not restrict the number of payment card networks over which an electronic debit transaction may be carried to fewer than two unaffiliated networks. Under this approach, it is sufficient for an issuer to issue a debit card that can be processed over one signature-based network and one PIN-based network, or alternatively, two signature-based networks, provided that the networks are not affiliated.²⁷ The final rule also adopts the statutory prohibition on routing restrictions. In practice, this means issuers will choose two or more unaffiliated payment card networks over which an electronic debit transaction may be carried, and merchants (not issuers or networks) will be able to direct the routing of the transaction from among the networks chosen by the issuer.

Merchant Steering. The statute provides that a network may not keep a merchant from offering a discount or other in-kind incentive for payment by the use of cash, checks, debit cards, or credit cards, provided the discount does not distinguish on the basis of issuer or payment card network (in the case of debit or credit cards).²⁸ In accordance with Dodd-Frank, the Board prohibits issuers and payment card networks from restricting the ability of a merchant to direct the routing of electronic debit transactions over any of the networks that an issuer has enabled on its card.

Application of Interchange Fee Restrictions to ATM and “closed-loop” networks. The rule defines “payment card networks” to exclude three-party, or so-called closed-loop networks, such as American Express, and ATM networks.

Effective dates. While the statute provides that final rules should be effective July 21, 2011, the final rule takes a more practical approach. The Board rule ensures that the fraud prevention adjustment would apply at the same time as interchange fee provisions

²⁶ Exemptions for small issuers and government and prepaid cards do not apply to these routing restrictions.

²⁷ Merchants argued in favor of requiring issuers to have at least two payment card networks for each authentication method an issuer offers. This would have meant that an issuer that used both signature and PIN-based authorization would have to enable its debit cards with two unaffiliated signature-based networks and two unaffiliated PIN-based networks. In the end, the Board determined such an interpretation was beyond its statutory mandate.

²⁸ The law also allows merchants to establish minimum dollar amounts in the case of credit card sales.

become effective, and provides additional time to account for technology challenges. Specifically,

- The restrictions on interchange fees and routing restrictions will take effect on October 1, 2011 (including, on an interim basis, the fraud prevention adjustment).
- The prohibitions on network exclusivity take effect on October 1, 2011 for payment card networks and April 1, 2012 for issuers.
- A delayed effective date of April 1, 2013 applies to certain cards with particular technological challenges, such as health benefit and certain other prepaid cards.

Industry participants must weigh carefully their responses.

The Dodd-Frank interchange provisions change the economic relationships between issuers (large and small), networks and merchants, and the steps they take in response will ultimately impact consumers.

Issuers. In the short run, issuers will seek new ways to make up some of their lost revenue. Several banks have already announced plans to increase fees on other bank products and services.²⁹ Small banks should benefit from fee increases by larger banks, as they too may increase prices, while interchange rate regulation purports not to affect these institutions.

Some issuers will seek to take advantage of the exemptions. Those issuers operating within a “closed loop” system would appear to be less impacted by declines in interchange rates, although market pressure on interchange rates generally and new powers of merchants to route transactions and discount may put pressure on interchange rates of these companies, as well. At least one financial institution has introduced a new general purpose prepaid card, which would appear to be exempt from the Board’s interchange restrictions. Prepaid products need to be carefully structured to meet regulatory requirements, and as prepaid cards become more prevalent as a payment device, the industry can expect increased supervision and examination by the newly-formed Consumer Financial Protection Bureau.³⁰

Debit card issuers will need to review existing arrangements with payment card networks in light of the “exclusivity” provisions of the Federal Reserve’s regulations. They will also need to ensure that the total amount of compensation provided by the net-

²⁹ See e.g., Fee Plans Take Shape at Wells Fargo, Regions In Case Durbin Deadline Sticks, AMERICAN BANKER, May 24, 2011; U.S. Bancorp Ends Waiting Game with Durbin Debit Rule, AMERICAN BANKER, January 20, 2011.

³⁰ The Consumer Financial Protection Bureau suggested in a recent proposed rulemaking that it is considering regulating prepaid cards. Proposed Rule, Defining Larger Participants in Certain Consumer Financial Products and Services Markets, 76 Fed. Reg. 38,059 (June 29, 2011).

work to the issuer, such as rebates, incentives or payments, does not exceed the total amount of fees paid by the issuer to the network.

Issuers that wish to collect the additional fraud adjustment will need to ensure their fraud prevention activities are (and remain) consistent with standards established by the Federal Reserve regulation.

Issuers will need to rethink their debit card offers in view of “allowable costs” under the rule. Issuers might consider increasing fees for debit card transactions, or taking other measures that would have the effect of causing consumers to steer away from debit card use. A more likely scenario is the elimination of benefits: rewards on debit cards will likely be curtailed, if not eliminated altogether. The final rule also may impact issuers’ willingness to spend money on innovation with regard to payment methods that fall within the rule, as issuers will be unable to recoup their fixed development costs.³¹

Networks. The networks will need to reset interchange rates. One of the most difficult issues networks will face in this regard is whether to establish a two-tier system for large and small banks (Visa and MasterCard have both indicated their intention to do so) and where to set rates. Competitive pressure, created by merchants’ ability to direct network routing and offer consumer discounts, will be a factor.

New routing and steering powers of merchants are likely to drive change. Networks (and issuers) may need to make adjustments to network operating rules and payment processing protocols to account for the merchant routing provisions. While historically responsive to merchant needs, networks have additional incentives following Durbin to compete for merchant business.

Merchants. Merchants will receive a reduction in their processing costs and will face the question of how much, if any, of these cost savings they will pass on to consumers. Federal Reserve staff indicated that, while they cannot predict merchant behavior, they would expect merchants in highly competitive markets operating on smaller margins were most likely to pass the savings on to consumers, whereas merchants with less competition were likely to retain the cost savings.³²

Merchants must consider how to implement new routing and steering powers. Some merchants (and their acquirers) might make technological investments to allow merchants to take advantage of routing provisions. Merchants will also consider whether to offer consumer discounts for use of particular payment methods.

Consumers. The impact on consumers will depend largely on steps taken by issuers, networks and merchants, as outlined above, and consumer behavior in response to these changes. Costs of banking services generally, and debit cards in particular, may

³¹ During deliberations on the final rule, Federal Reserve staff expressed a view that the final rule could have a negative impact on payments innovation.

³² See Mark D. Manuszak, Senior Economist, Division of Research and Statistics, Federal Reserve, Remarks at the Open Board Meeting of the Board of Governors of the Federal Reserve System (June 29, 2011), *video available at* <http://bcove.me/hud5ew6j>.

increase, to the detriment of consumers. Merchants in highly competitive markets might pass on cost savings to consumers in the form of lower prices. And issuers and merchants might both take action to steer consumers to use one payment product over another. How consumers modify their behaviors in response to these changes will affect the costs and benefits associated with the products and services they ultimately receive.

Legal challenges to the Federal Reserve's rule are possible.

While the Federal Reserve carefully balanced its final decisions within the constraints of the statutory language, few are pleased with the final rule. One bank sued the Federal Reserve even before the Federal Reserve's proposed rule was released, citing a number of constitutional claims.³³ Moreover, on the day the Federal Reserve announced the final rule, the Merchants Payments Coalition publicly announced its dissatisfaction with the result and the fact that it was looking at ways to "challenge" the rule.³⁴ It would appear from these comments the final battle over interchange has not yet been fought.

³³ In October, 2010, TCF National Bank sued the Board in the U.S. District Court for the District of South Dakota to prevent implementation of the Durbin Amendment, claiming that the Amendment unconstitutionally deprived the bank of substantive due process and equal protection. *See* Complaint at 47-51, *TCF Nat'l Bank v. Bernanke*, No. CIV 10-4149, 2010 WL 3960576 (D.S.D. Oct. 12, 2010). The District Court denied a preliminary injunction to TCF, ruling that the bank was unlikely to prevail on the merits of its constitutional challenges. *See TCF Nat'l Bank v. Bernanke*, No. CIV 10-4149, 2011 WL 1578535 (D.S.D. Apr. 25, 2011) (order denying motion to dismiss and denying preliminary injunction). After the Eighth Circuit Court of Appeals affirmed, *TCF Nat'l Bank v. Bernanke*, No. 11-1805, 2011 WL 2555696 (8th Cir. June 29, 2011), and the Board issued its final rule, TCF requested voluntary dismissal of the lawsuit. In a press release, TCF Chairman and CEO William Cooper said "While we continue to believe that the Durbin Amendment is unconstitutional because it requires below-cost pricing and exempts 99% of all U.S. banks, we believe our lawsuit has served its purpose in demonstrating the unfairness of the Durbin Amendment and that it is time for us to move on. The Federal Reserve's final rule is an improvement from its initial proposal and recognizes many of the points we made in our case."

³⁴ George Zornick, *The Nation: You Swipe Card, Banks Swipe Cash*, NATIONAL PUBLIC RADIO (July 1, 2011) (quoting Mallory Duncan, Chair of the Merchants Payments Coalition), *available at* <http://www.npr.org/2011/07/01/137547730/the-nation-you-swipe-card-banks-swipe-cash>.