USA

Durbin Law caps **Interchange** in **US** – but to what extend?

Von Duncan MacDonald

Die Zeiten, in denen europäische Kartenemittenten neidvoll in die USA blickten, wo Interchange-Regulierung kein Thema zu sein schien, sind endgültig vorbei. Und es war namentlich das Eingreifen der EU-Kommission, das auch jenseits des Atlantik zu einem Paradigmenwechsel führte. Erstmals in der Geschichte der USA hat der US-Kongress 2010 mit dem Durbin Amendment in der Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) der Interchange mit einem Gesetz Grenzen gesetzt, die die Fed im Juni 2011 betraglich auf 24 bis 25 Cents pro Debittransaktion festlegte. Die Unsicherheit über die weitere Entwicklung ist dennoch hoch, meint Duncan MacDonald. Denn in bewährter US-Tradition sei eine Flut von Prozessen zu erwarten. Red.

For decades bankcard interchange pricing in the US was a non issue. In the late nineties that changed when a global coalition of merchants challenged it before regulators in numerous countries and in antitrust lawsuits in the US. With rare exceptions, Visa, Mastercard and their issuers suffered humiliating defeats or were forced to into costly settlements. Their settlement last year with the European Commission to reduce cross border interchange fees played a pivotal role in causing the US Congress to mandate similar reductions in an amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

The author of the amendment, Senator Richard Durbin of Illinois, exploited the European Commission settlement to persuade Congress that if EU banks could accept a significant cut in debit interchange fees, so could their counterparts in the US. His amendment is now known in US banking circles as the Durbin Amendment ("Durbin").

Durbin is the first law in US to impose limits on interchange pricing. Importantly, it only applies to debit interchange fees. On June 29, 2011 the Federal Reserve Board (FRB) issued a rule to implement the new law. Although it is officially titled as "Regulation II", I am going to refer to it as the "FRB rule". In essence, its primary focus is to enable merchants to substantially reduce debit interchange fees. Whether they will succeed remains to be seen. This article will give a picture of the rule's coverage and the challenges that await it.

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The FRB Rule: fees are limited to the costs

The FRB rule covers electronic payment transactions between merchants and customers (both consumers and business people) by use of general purpose debit cards and prepaid cards that are tied to debit accounts. It limits interchange fees on those transactions to a maximum fee that is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."

Durbin instructed the Federal Reserve Bank to investigate the cost that issuers incur to process electronic debit transactions and to limit debit interchange fees to those costs. In effect, it limited the fee to the utility costs of processing the transactions. A profit therefore cannot be a component of the fee.

Although the FRB could have produced a regulation mimicking the general language of Durbin ("reasonable and proportional") – thus leaving it to issuers and their networks to calculate what the maximum fee should be – it decided that the most prudent policy was to impose a flat numerical rate. It concluded that a mimic approach would prove too difficult for the bankcard networks and their issuers to handle. Presumably, the FRB guessed that issuers would exaggerate their costs to achieve the highest possible fee.

The FRB initially interpreted Durbin to require a maximum rate cap of 12 cents per debit transaction – a drop of almost 75 percent from the industry norm of 44 cents.

The rate cap: new fees for cardholders?

Not surprisingly, issuers responded furiously. They insisted that 12 cents was confiscatory, possibly unconstitutional, terrible for consumers and too costly for banks to bear. They told the FRB that cardholders would have to cover the revenues that banks would lose because of the cap through higher account fees, account terminations, reduced services and cuts to reward programs. Some banks said their losses could put them out of business; others said the cost of compliance would force them to lay off workers.

In June, 2011 the FRB caved. It issued a "final" rule that doubled the maximum fee. Henceforth it would be 21 cents plus the sum of "5 basis points multiplied by the value of the transaction" and one extra cent per transaction for issuers that adopt fraud prevention standards approved by the FRB. In total, the cap will provide issuers with 24 to 25 cents for each debt card transaction. Although better than 12 cents, it will still cost issuers an estimated $7 billion annually in lost revenues.

Then again, maybe it won't. The cap could cost issuers much less and even nothing if they can cover the lost revenues through new cardholder fees and back-office expense reductions. Moreover, if issuers manage these tasks aggressively, it is entirely possible they could end up making more money on their debit card programs than they do today.

In any case, it is worth noting that the FRB rule exempts from the rate cap restriction issuers with less than $10 billion in assets, debit cards tied to government administered programs, and most prepaid and gift cards.

Merchant steering of cardholders and transaction processing

The FRB rule covers more than the imposition of a flat debit interchange fee. It gives merchants tools to reduce the fee even lower or to escape it totally. One such tool frees them to steer customers via advertising and urgings at the point of sale to pay for transactions by other means – with cash, checks, money orders, competing cards with lower interchange, discounts, rewards or incentives. – whatever is less costly for the merchant to accept.

But will it work? For retailers who generally sell face-to-face – like department stores, discounters like Walmart, airlines, grocers, entertainment centers and the like – maybe it won't. Most of them operate according to intense efficiency standards. They want sales events to move quickly, with minimal dialogue between their clerks and customers. They know that the cost of trying to entice customers to pay with a different payment device might prove more expensive than sticking with debit card payments. It could slow lines and frustrate customers and sales clerks alike.

In addition to cardholder steering, the rule allows merchants a limited right to steer the processing of debit transactions to an alternate network to reduce the processing fees they currently pay under network exclusivity requirements. Unfortunately for merchants, it gives issuers, not merchants, the authority to pick the alternate network. In practice, it will probably mean that Visa issuers will name Mastercard as the alternate and Mastercard issuers will name Visa. A such, the benefit to merchants could prove of modest value, because the processing fees of Visa and Mastercard generally are similar.

As good as this potential result might seem for the networks, there are other aspects of the proposition that are not so good. Effective April 1, 2012 it will require issuers to disclose the alternate network on their cards – in effect, to promote the services of a competitor. Perhaps equally troubling, it could open the door for competition between the networks to steal share from each other, not just of processing business but also of information about cardholders for solicitation purposes. Think of it this way. If a merchant exercises his right to process a debit sale on a Visa card through Mastercard's network, Visa will lose its processing fee, and Mastercard will capture the fee, as well as valuable information to entice the cardholder to switch to its brand.

Circumvention prohibitions

To prevent circumvention of the benefits of the rate cap and merchant steering, the FRB rule prohibits network schemes to reimburse issuers for their revenue losses. It tells the bankcard networks not to charge merchants higher processing fees for the purpose of distributing the additional revenues to issuers via direct payments or disguised as incentives, fee reductions, free services, volume bonuses or the like.

Unfortunately for merchants, in an appendix to the rule the FRB suggests that it will

not strictly enforce the prohibition. Instead, it says it will weigh complaints of violations on a case-by-case basis. If history is any guide, and especially if the recession and the banking crisis continues, that means merchants are going to have a hard time trying to prevent evasions of the rule.

As an example of what could happen to them, suppose a network were to increase merchant fees to raise capital or to simply fatten its corporate profits. Among the key beneficiaries of the increase of course would be the networks' majority shareholders, the issuers of their cards.

A question the FRB would have to answer is whether enriching an issuer's equity in a network and paying dividends amount to a circumvention of the rule or constitute little more than a normal business practice. To prove a circumvention a merchant would first have to persuade the FRB, and failing that, would have to appeal to a court to get its way. The process could take years before finally being decided and cost millions in legal fees.

FRB rule in litigation: Only lawyers will benefit

The complexities, ambiguities, harshness, contradictions and other failings of the FRB rule are certain to produce lawsuits calling for its repeal or reinterpretation. Virtually every party with a stake in its outcome – merchants, banks, networks, competitors, consumers and investors – disputes one or another of its parts.

Merchants think Durbin doesn't go far enough to prevent interchange abuses. The bankcard networks counter that it goes too far. Their competitors, like American Express, fear it will evolve to jeopardize the way they bill merchants. And investors hate it for limiting pricing rights and attacking corporate revenues. Consumers, of course, will insist that they are its primary victims most in need of protection. Perhaps the only class that benefits from the FRB rule is lawyers. The rule is a magnet for new clients and a key to courtrooms across the US. Here is a sampling of disputes that might enrich them.

- **Small banks:** The FRB rule exempts banks with assets under $10B. It allows them to continue to charge debit interchange rates that are determined by the bankcard networks. Arguably, it even allows them to ask Visa and Mastercard to increase those rates. It is not clear, however, if the networks have a legal obligation to honour the interchange desires of small banks. Visa and Mastercard have

indicated that they will erect a two tier rate system to comply with the rule, one tier at the network rate for small banks, the other at the 21 to 25 cents cap for large banks. It is possible that some small banks will sue to force the networks to adopt rates they prefer. And that others will sue to repeal the rule if merchant steering successfully drives their interchange revenues downward to the rate cap level and lower. They'll argue that the rule does not reflect the decision of Congress to protect them.

- **Big banks** might also sue to repeal the FRB rule, arguing that it violates the Constitution's equal protection, "Takings" and due process clauses. As a rule of thumb, the Constitution frowns on laws that favour groups within certain classes, more so when the favour involves diminishing or taking away the property one of the classes to the advantage of the other class. Durbin's bifurcation of competing banks into those under and over $10B in assets does exactly that. It devalues big bank debit card programs by its rigid price controls.

- **Merchants** will intervene in regulatory or judicial proceedings that seek to weaken the FRB rule. They will also initiate separate lawsuits to strengthen the rule, arguing that it does not reflect what Congress ordered the FRB to do. Their first target undoubtedly will be to force a return to the FRB's original proposal of a rate cap of 12 cents. They will allege that the Durbin Amendment unequivocally requires it. In the past the odds would have been against them, because courts rarely reversed the decisions of bank regulators. The banking crisis and Dodd-Frank's tough reform of bank regulators have changed the odds. But that's not to say that their lawsuit would produce an easy victory. It only predicts that for the near future judges will listen more closely to their pleas than they did in the past and more intently scrutinize the regulator's compliance with the mandates of Congress. In the end, however, like politicians, they will find it hard to go against the banks and their network agents.

- **Networks:** The rule's requirement that issuers disclose to merchants the option to process transactions on a network other than the network of the cardholder is very unsettling to the bankcard industry. As stated above, it essentially will require Visa and Mastercard to allow the promotion of the services of a competitor on their cards. It begs the question whether the requirement goes beyond the constitutional powers of Congress. Imagine a law that would require Pepsi to promote Coke, or that would force Walmart to provide notices at store entrances telling customer they might get a better deal at Target. A scary proposition for every industry, every brand.

- **Consumers:** It is unlikely they will bet on the judicial system to undo the harms they will suffer under the FRB rule. They'll instead rely on lawyers to file claims with the new Consumer Financial Protection Bureau created by Dodd-Frank (CFPB), demanding that it stop issuer efforts to increase their account fees or cut some of their services. They'll argue that the issuers' actions constitute an "abusive" practice in violation of Dodd-Frank. Many experts believe this might happen, forcing a confrontation between the CFPB and the FRB over who has the final say in enforcing conflicting consumer protection laws.

Rule risks in 2012

The elections in 2012 might pose the greatest threat to the FRB rule. If the Republicans win the presidency and take control of both houses of Congress, they will try to repeal it and might well succeed. They might even take an extra step to ensure that the rule's standards cannot come back to life through rule making by other regulators, like the Federal Trade Commission (FTC) or the CFPB. According to some legal authorities, the FTC's power to stop "unfair" business practices and the CFPB's power to stop "abusive" practices would allow them to resurrect Durbin in some form.

The earliest these repeals could happen, however, might not be until the new Congress is up and running in the summer of 2013 or later. A fear of the bankcard industry, and especially its investors, is that during this time merchants will successfully lobby other nations to adopt the Durbin standards or worse. In short, a nightmare for both camps – a refrain that repeats itself throughout the FRB rule.

The volatility of politics in Washington and the ever-growing propensity of businesses to sue each other and government agencies to overcome regulatory burdens guarantees that the alleged finality of the FRB rule will turn out to be more imaginary than real.

In the legal arena in the United States – suffused as it is with almost a million lawyers – statutes, regulations and court precedents are always up for grabs. So too shall be the fate of the FRB rule. Armies of trial, regulatory, compliance and enforcement lawyers, along with economists, lobbyists, campaign strategists and public relations agents, will pillory and praise the rule every which way. To give them their due, many of them will produce excellent arguments for and against interchange pricing.

After all, interchange is not a black and white issue. It vexes everybody who must deal with it, which means it will not go away as a legal matter even if the rule gets pushed aside in the US and elsewhere. The wars over it will end only when pragmatic and creative business leaders replace interchange with a significantly different pricing regime or a different product that doesn't rely on it.