Economic Analysis of Claims in Support of the "Durbin Amendment" to Regulate Debit Card Interchange Fees

By

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Abstract

Section 1075 of the 2010 Dodd-Frank Act requires the Federal Reserve Board to regulate the debit card industry including the interchange fee banks and credit unions receive from merchants. This paper reviews the arguments in support of this regulation put forward by Senator Durbin, who proposed the amendment that led to Section 1075, large retailers, and merchant trade associations. Contrary to their claims, the leading government entities that have examined interchange fees specifically reject the approach taken by the Durbin Amendment; no US antitrust authority or court has found that MasterCard or Visa have engaged in price fixing with regard to debit interchange fees; debit card interchange fees have not increased materially over time in the US; Canadians have not benefitted from zero debit interchange fees in that country since they pay more for using cards, and retail banking accounts, than Americans and since Canadians cannot use their zero-interchange fee debit cards to pay online or internationally; and consumers and small businesses will not benefit from the planned reductions in interchange fees, in fact they will lose hundreds of millions of dollars a year.

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I. Introduction and Summary

This paper examines the economic rationales for the imposition of price controls on the debit card industry.

Over the last several decades Congress has overturned laws that resulted in price controls in industries ranging from airlines to trucking.[1] It was widely recognized that government price setting causes more problems than it corrects. Consumers have benefited from lower prices, greater choice, and more competition as a result of the elimination of these controls.[2]

Bucking this trend, the U.S. Senate adopted the Durbin Amendment to the Dodd-Frank Act in 2010.[3] The final legislation included a seven-page section that requires the Federal Reserve Board to regulate the prices that banks and credit unions that issue debit cards to their checking account customers can receive from merchants when those customers pay merchants with these cards.[4] This so-called "interchange fee" is established by payment card systems such as Visa, MasterCard, Star, Pulse, and others that manage the networks that ultimately move money between merchants and cardholders.[5] Interchange fees have been a major source of revenue for banks and credit unions for providing debit cards.[6]

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[1] Clifford Winston (1998), "U.S. Industry Adjustment to Economic Deregulation," Journal of Economic Perspectives, 12:3, pp. 89 – 110 ("Winston 1998").

[2] See Winston 1998.

[3] "US Senate Lawmakers Approve Durbin Interchange Amendment," Dow Jones Capital Markets Report, May 13, 2010

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

[5] We adopt the oversimplified terminology used by proponents of the Durbin amendment that merchants pay interchange fees to issuers. In fact, merchants contract with acquirers to provide them with card services at specified prices and conditions. Payment card systems typically require merchant acquirers to pay an

The Government Accountability Office ("GAO"), Congress's investigative arm, and the Federal Reserve Board staff conducted studies of interchange fee regulations during 2009.[7] Both reports expressed strong reservations about price regulations. In addition, the U.S. Department of Justice stated that it was opposed to regulation of interchange fees and that attempts to legislate lower credit card interchange fees may harm consumers.[8]

Although Congress had held hearings on various aspects of credit card interchange fees, there were no hearings concerning the proposal to impose price controls on debit cards and relatively little discussion of the proposal. As a result, there are two primary sources of explanations of the economic rationales for regulation of the debit card industry. First, there are the statements by Senator Durbin and other congressional proponents of the legislation that were made during the abbreviated Senate floor discussion and in other venues prior to passage of the bill. Senator Durbin, in particular, has been a vocal defender of the law in the months after its adoption. Second, the Federal Reserve Board established a rulemaking procedure for

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interchange fee to a card issuer when a consumer uses a card from that issuer to pay a merchant serviced by the acquirer. It is then up to the merchant acquirer to determine the extent to which it will seek to recover the costs of those interchange fees from the merchants. The largest merchants typically have contracts that specify that they pay the acquirer the applicable interchange fees, which can vary by transaction, plus additional fees for processing and other services ("interchange fee plus" contracts). Smaller merchants typically pay a "blended fee" that is the same for all cards (debit, credit, and prepaid) used at the merchant regardless of the applicable interchange fee on each transaction.

[6] So-called "three party" systems such as American Express and Discover charge a merchant discount that accounts for their role combined role as merchant acquirer and network and earn a considerable portion of their revenue from these merchant discounts. In recent years, these 3-party have also permitted financial institutions to issue cards in their systems (including, for Discover, signature debit cards) and to, in effect, share a portion of the merchant discounts with them.

[7] See "Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges," United States Government Accountability Office, November 2009 ("GAO 2009") and Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski (2009). "Interchange Fees and Payment Card Networks: Economic, Industry Development, and Policy Issues," Federal Reserve Finance and Economics Discussion Paper, 2009-23 ("Prager et al.").

[8] Letter dated June 23, 2008 from the U.S. Department of Justice to Congressman Lamar Smith, available at http://www.electronicpaymentscoalition.org/downloads/letter_DOJ.pdf ("DOJ June 2008 Letter").

developing its regulations, during which trade groups representing merchants have submitted comments that articulate the rationales they see for the price controls.

A review of these statements finds that the proponents of debit interchange fee regulations have advanced several major justifications for government intervention.[9] The trade associations and their supporters in Congress claim that:

- MasterCard and Visa have engaged in price fixing in violation of the antitrust laws.
- Interchange fees have increased over time, resulting in merchants incurring costs that force them to increase prices to consumers.
- Canada and some other countries have zero interchange fees on domestic debit cards so that the merchant does not pay anything to the cardholder's bank when she swipes.
- Consumers would save more than $1 billion a month from reduced prices if merchants did not have to pay these fees, and small businesses, in particular, would benefit if they did not have to pay interchange fees.

Upon close review, we find that these claims are not supported by serious evidence or analysis, are factually incorrect, or are misleading.[10]

- Despite knowing that payment card systems have been setting interchange fees for four decades, no U.S. antitrust authority has ever charged these systems with

[9] See below for citations for these claims.

[10] See below for discussion and support.

price fixing violations of the antitrust laws. The courts have in fact rejected that allegation thus far.

- It is not true that the interchange fee rates established by card systems have increased materially over time. As documented by Federal Reserve Board economists, the rates that merchants pay when cardholders swipe have been roughly steady for most payment card networks for the last six years; in fact the average debit card interchange fee has declined over the last decade.

- It is true that Canadian merchants generally pay a zero interchange fee for debit cards, but what has been left unsaid by the price control proponents is that Canadian consumers pay more and get less for their debit cards than American consumers. Canadians effectively cannot use their debit cards to make purchases over the Internet, and they pay higher fees for using their cards and for checking account services in general, compared to American consumers.

- The claim that consumers will benefit ignores the likelihood that merchants will not pass along what are penny cost savings for the typical products they sell fully or quickly to consumers. One large merchant has acknowledged the business reality that these cost savings will go to its bottom line.

- Most small businesses do not accept debit cards and will not benefit from the price controls. They will in fact be harmed because their checking account fees will go up.

II. Debit Card Price Fixing and Anticompetitive Practices

According to Senator Durbin, "This system of price-fixing by Visa and MasterCard on behalf of thousands of banks has gone entirely unregulated."[11] The Merchants Payments Coalition, represented by the law firm of Constantine Cannon, claims that "Visa and MasterCard conspired with their members to fix prices and leverage their power in the credit card market to dominate the debit market."[12] One of the economists retained by the merchants has stated that MasterCard and Visa have monopoly power over merchants, which have no choice but to accept cards.[13]

A. The View of U.S. Antitrust Authorities and Other Regulators

These are serious allegations. Price fixing is subject to criminal penalties under Section 1 of the Sherman Act. Monopolistic practices are unlawful under Section 2 of the Sherman Act. The U.S. Department of Justice is responsible for taking companies that engage in these practices to court. The Federal Trade Commission also has the power to attack price fixing and monopolistic practices.

The U.S. Department of Justice and Federal Trade Commission have scrutinized the practices of the payment card systems for about four decades. They have known during this period of time that all of the four-party payment card systems were setting interchange fees.

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[11] Senator Durbin's April 12, 2011 Letter to Jamie Dimon.

[12] See the February 22, 2011 submission to the Federal Reserve by Constantine Cannon on behalf of the Merchant Payments Coalition at p. 1. We also note that to the extent the merchants believe the increases in PIN debit interchange fees were the result of what they claim were MasterCard and Visa's actions in leveraging power in the credit card market into the debit card market, they had the opportunity to seek redress in the settlements of the class action litigation that they negotiated with MasterCard and Visa.

[13] See James C. Miller, "Addressing the Debit-Card Industry's Market Failure," February 2001, appended to the February 22, 2011 submission to the Federal Reserve by the Retail Industry Leaders Association, at p. 3 ("Miller Report").

Merchants have complained about these fees on numerous occasions during this period and have even brought antitrust lawsuits against the card systems. Yet neither antitrust authority has ever concluded that setting interchange fees was unlawful price fixing or a monopolistic practice.

Under current U.S. case law, interchange fees are not considered to be a violation of the antitrust laws against price fixing or monopolistic practices and in fact have been found to be lawful and necessary. Visa was sued in the 1980s for engaging in price fixing in establishing an interchange fee. The Eleventh Circuit Court of Appeals affirmed a lower court ruling that these fees were reasonable and essential for a payment card system.[14] The Court found that "[a]n abundance of evidence was submitted from which the district court plausibly and logically could conclude that the [interchange fee] on balance is procompetitive because it was necessary to achieve stability and thus ensure the one element vital to the survival of the VISA system—universality of acceptance."[15] Other courts have reviewed and reached similar decisions rejecting antitrust claims regarding interchange fees.[16]

Merchants are trying to get the U.S. courts to reach a different decision, as is their right. Various groups of merchants filed antitrust lawsuits against MasterCard and Visa, and these lawsuits, most of which were consolidated into a single proceeding in 2005, remain pending. At this point in time, however, no court has ruled on any substantive aspect of the merchants' price fixing claims.

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[14] *National Bancard Corp. (NaBanco) v. Visa U.S.A., Inc.,* 779 F.2d 592 (11th Cir. 1986) ("*NaBanco v. Visa U.S.A., Inc.")*.

[15] *NaBanco v. Visa U.S.A., Inc.*, 779 F.2d 592, 605.

[16] See Reyn's Pasta Bella v. Visa U.S.A., 259 F. Supp. 2d 992 (N.D. Cal. 2003) and Kendall v. Visa U.S.A. Inc., Slip. Op., 2005 WL 2216941 (N.D. Cal. 2005).

The U.S. Department of Justice, a research report by Federal Reserve Board economic staff, and the General Accountability Office of the U.S. Congress have all examined the desirability of interchange fee regulation and, despite knowing the market structure of this industry and how payment systems set interchange fees, have all cautioned against regulation.

The Federal Reserve Board is the primary regulator focused on payments and payment systems in this country, and has extensive experience overseeing Federal Reserve Bank payments services. It has also been aware that the payment card networks set interchange fees. The Board has not advocated regulation of these fees. The Federal Reserve Board staff released a detailed report on interchange fees in May 2009.[17] While the staff acknowledged that market-set interchange fees might not maximize economic efficiency, the report explained that it was uncertain whether interchange fees were set higher than they should be and that regulation of these fees was subject to a number of practical problems.[18] The Federal Reserve Board staff research report strongly rejected cost-based regulation.

The GAO was directed under the Credit Card Accountability Responsibility and Disclosure Act of 2009 ("CARD Act") to conduct a study of credit card interchange fees and was also asked by members of the Senate Small Business Committee to review the market for interchange fees.[19] The GAO found that proposals to regulate credit card interchange fees would have uncertain effects on consumers, as the extent to which merchants would pass on cost savings was uncertain, cardholder fees could increase, and it would be very difficult to

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[17] Prager et al.

[18] Ibid.

[19] The GAO did not address debit card interchange fees. However, many of its conclusions are relevant to debit as well as credit card interchange fees.

determine the optimal level of interchange fees that effectively balances the costs and benefits among the networks, issuers, merchants, and consumers.[20]

During the congressional debate over credit card interchange fees, the U.S. Department of Justice was asked for its views regarding proposed legislation that would have provided antitrust immunity to merchants to form a buyer cartel to negotiate interchange fees with MasterCard and Visa.[21] The Justice Department concluded "[C]redit card networks forced by regulation to collect less from merchants may well respond by charging more to cardholders in fees, or reducing card rewards programs and other features that are attractive to consumers." It noted that, "Notwithstanding the best of intentions and goals, the regulator will be imperfect in its attempt to replicate the terms that would be reached in a free market."[22]

The merchants disagree with the conclusions of the U.S. Department of Justice, the Federal Reserve Board staff research report, and Government Accountability Office. They are pursuing a private antitrust case against MasterCard and Visa. The arguments they have made in favor of the Durbin Amendment echo their claims in this private litigation. But, as noted above, no federal antitrust authority or court has to date agreed with their claims that MasterCard and Visa are engaging in anticompetitive behavior in establishing interchange fees.

B. The Role of Interchange Fees in Payment Systems

Payment systems must have rules in place concerning what happens when a consumer that has been issued a card by a bank pays a merchant that has agreed to accept a card. The merchant has to know how much it is getting when the consumer pays with the card and the

[20] See GAO 2009, at pp. 44-46.

[21] See the DOJ June 2008 Letter.

[22] Ibid.

bank that issued the card has to know how much it needs to pay to the merchant. The merchant that takes the card and the bank that issued the card also have to know what happens if, for example, there is fraud or the consumer disputes the charge. Some of the merchant trade associations have argued that the payment systems should have an interchange fee of zero, which would require banks to pay the merchant 100 cents on the dollar. Other proponents of regulation have argued that the interchange fee should be set at a level that reimburses the bank for some of its costs. Regardless, though, it is necessary for payments systems to "fix" some interchange fee, whether it is zero or some other amount. It is not practical to have a system in which the many banks that issue cards negotiate individually with the many merchants that accept cards. That is what the Eleventh Circuit concluded in 1986 when it found that interchange fees were lawful and necessary for the survival of the four-party payment system.

All four-party payment systems set interchange fees. In doing so, these payment systems face a number of competing economic factors. Higher interchange fees encourage more banks to issue cards on their system. These higher fees encourage banks to provide increased benefits to consumers to get and use cards, which in turn increases the amount of transactions going through the system. Lower interchange fees encourage more merchants to accept cards.[23] The ATM networks were able to persuade merchants to install PIN pads at the point-of-sale to route transactions through their systems by charging very low interchange fees in the 1990s, and all payment card systems reduced interchange fees to supermarkets, fast food retailers, and other merchant categories to persuade merchants in these categories to accept

[23] These statements do not account for the feedback effects between merchants and consumers. Lower interchange fees encourage merchants to take cards given the demand by consumers to use those cards at merchants; to the extent a lower interchange fee reduces the demand by consumers to use cards to pay for goods and services with those cards—because banks for example issue fewer cards or promote them less heavily—then merchant demand will fall as well.

cards. Ultimately, the interchange fee is an element of the competition that takes place among different card brands. Payment card systems must set interchange fees with an understanding of what merchants are willing to pay to accept cards and what banks need to issue cards or consumers to use cards. They also have to pay attention to the level of interchange fees that competing payment systems have established, as well as the cost, value, and features of all other payment methods available to consumers and merchants including cards from three-party systems, cash, checks, and store cards. The fact that payment card systems have established interchange fees mainly in the 1-2 percent range in the United States reflects the fact that higher fees would discourage merchant acceptance and lower fees would not provide enough inducement to banks to issue cards or consumers to use them.

In the United States there is competition among at least five payment systems for debit card transactions on a national basis.[24] That contrasts with many countries, including Canada, in which there is only one national debit card scheme. Banks can typically enable consumers to use their cards using a signature or a PIN.[25] They can choose between MasterCard and Visa for signature and between Interlink (owned by Visa), Star (First Data), Pulse (Discover Card), NYCE (FIS), and Maestro (MasterCard) for PIN. They can then encourage their consumers to use signature or PIN when they pay with their debit cards. Merchants can decide which payment card systems to accept. They can also decide whether to install PIN pads at the point

[24] There are two major signature debit systems, Visa and MasterCard, and Discover has announced signature debit issuers on its system. Interlink, Star, Pulse, NYCE, and Maestro are PIN debit systems that we understand operate on an effectively national basis. Interlink is owned by Visa and Maestro is owned by MasterCard, so we do not count them as additional systems. In addition, there are approximately 15 other PIN debit systems, including, Jeanie, Accel, Shazam, Credit Union 24, AFFN, and Alaska Option that operate on at least a regional basis; they may in fact operate on a national basis but we have not verified that they do.

[25] We use “signature” and “PIN” as shorthand. In fact, the industry has evolved to be far more complex and the traditional lines between networks blurred, with a variety of authentication methods typically available on most cards such as “no signature required,” remote/internet use with or without PIN or a designated password, so-called “PINless debit,” contactless functionality, etc.

of sale so that consumers can pay with a PIN and thereby use the PIN debit network(s) the bank has chosen to put on the card. In the past some merchants have provided various kinds of encouragement to consumers to use their PINs rather than signature since PIN had lower interchange fees.

The competition among debit card systems has resulted in systems choosing somewhat different interchange fees as they balance merchant, issuer and cardholder demand. Payment card systems also engage in negotiations with a number of large merchants concerning their rates. These negotiations result in such merchants receiving significant discounts off of the interchange fees they would otherwise pay.[26] Generally, there is significant variation in the interchange fees across systems, merchant size, and merchant categories.[27] This variation is what one would expect from competition among systems over banks, merchants, and cardholders.[28]

The Durbin Amendment requires the Federal Reserve Board to regulate debit interchange fees and as a result the Board has proposed price controls on these payment systems. Rather than having interchange fees determined by the market forces described above, the Federal Reserve Board was mandated to devise standards for how much banks that

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[26] See James M. Lyon (2006), "The Interchange Fee Debate: Issues and Economics," Federal Reserve Bank of Minneapolis, The Region, available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3235. There may be other terms associated with these agreements, such as an agreement to promote a particular card brand.

[27] MasterCard's published debit card rate schedule, for instance, has 41 different categories; see http://www.mastercard.com/us/merchant/pdf/MasterCard_Interchange_Rates_and_Criteria.pdf, at pp. 74-89. Also, see http://usa.visa.com/download/merchants/april-2011-visa-usa-interchange-rate-sheet.pdf.

[28] One of the economists who submitted a report on behalf of the merchants has argued that this "price discrimination" demonstrates monopoly power. See the Miller Report at p. 3. In fact it is well known that this sort of price variation is routine in competitive markets and is not evidence of monopoly power. See William J. Baumol and Daniel G. Swanson (2003), "The New Economy and Ubiquitous Competitive Price Discrimination: Identifying Defensible Criteria of Market Power," *Antitrust Law Journal*, 3:70; and Illinois Tool Works Inc. v. Independent Ink, Inc., 126 S. Ct. 1281 (2006), rev'g 396 F.3d 1342 (Fed. Cir. 2005).

issue cards can receive in interchange fees. On December 16, 2010, the Board proposed two alternatives. Under one alternative, debit card issuers could not receive interchange fees of more than 12 cents, compared to an average market rate of 44 cents as of 2009. A second proposal would place the cap at 7 cents but allow banks to demonstrate on the basis of cost that they should receive a fee of up to 12 cents. In effect, the setting of interchange fees would be taken out of the hands of the payment card systems and put in the hands of the Board. The ability of debit card networks to compete for merchants and issuers using interchange fees would be largely eliminated and replaced with a rigid fee.

Senator Durbin has claimed that his amendment does not prevent banks from charging an interchange fee for the use of cards they issue to pay merchants so long as the networks do not set that fee. In his letter to the CEO of JPMorgan Chase, Jamie Dimon, the Senator says, "It is important to make clear that if Chase wants to set and charge its own fees in a competitive market environment, the amendment does not regulate those fees. The only regulated fees are those fees that banks let card networks fix on their behalf." [29]

In fact, it is clear that the purpose of the Durbin amendment, and its apparent effect given the Board's interpretation to date, is to have the Federal Reserve Board "fix prices" at a level that is most favorable to merchants and thereby replace the free-market price with a regulated price that mimics the price that a merchant cartel would seek to negotiate. Several points are noteworthy.

- It is hard to know what method Senator Durbin envisions for the "competitive market" to determine the interchange fee. Banks could negotiate with merchant

[29] See Senator Durbin's April 12, 2011 Letter to Jamie Dimon.

acquirers or with merchants. Either way, in a four-party system, bilateral negotiation would lead to a massive number of negotiations. That, in fact, is why it has been found to be efficient for the card system to establish this fee on behalf of participants in the system. Small banks and credit unions would be particularly disadvantaged, as they are unlikely to have much bargaining power with major merchants or acquirers.

- We do not believe that it is clear that the Federal Reserve Board agrees that banks could bypass its regulations and negotiate their own fees. According to the Federal Reserve Board: "An issuer could not receive an interchange fee above the cap regardless of its allowable cost calculation."[30] The Board focuses on the magnitude of the receipt of interchange fees by the issuers regardless of how those interchange fees are determined.
- Although Senator Durbin might envision banks negotiating with acquirers over the interchange fee, we think it is more likely that he is conjecturing that banks would negotiate with merchants since the thrust of the legislation has been about merchant choices. Even if we focused on the largest 100 banks and the largest 10,000 merchants that would require 1,000,000 separate negotiations. Obviously smaller banks could not afford to negotiate with merchants.
- It is unclear how bilateral negotiations among issuers and merchants could result in a valuable, or viable, payment card system for consumers, issuers, acquirers,

[30] "Debit Card Interchange Fees and Routing; Proposed Rule," The Federal Reserve System, *Federal Register*, 75:248, December 28, 2010, at p. 81736, available at: http://edocket.access.gpo.gov/2010/pdf/2010-32061.pdf ("The Proposed Rules"). This statement is regarding the 7 cent "safe harbor" alternative (under which issuer could recover their variable costs of authorization, clearing and settlement, up to a 12 cent, by showing that their costs were greater than 7 cents). There is a similar statement in connection with the other alternative rule of a 12 cent cap on interchange fees: "Each issuer's supervisor would verify that an issuer does not receive interchange revenue in excess of the cap." See The Proposed Rules at p. 81738.

> or merchants. If the payment card system required merchants to accept the cards from all issuers—which is necessary to ensure consumers their cards would be accepted—then merchants would have no choice but to pay whatever fee the bank issuer demands since the merchant has to take the card for payment. If the payment card system prevented issuers from disabling their cards for individual merchants then the issuer would have to take whatever the merchant is willing to offer (either the system-set rate or the regulated rate), stop issuing debit cards, or start its own system. Yet if the payment system allowed merchants to refuse to accept cards from particular issuers consumers would lose, and if the payment system allowed issuers to disable particular merchants both consumers and merchants would face uncertainty.

In the end, the Durbin Amendment prevents the four-party card systems from establishing an interchange fee through competition and replaces it with government price controls.

III. Trends in Interchange Fees

The proponents of debit card interchange fee regulations have claimed as evidence of monopoly power that the fees have increased over time. According to Senator Durbin, "Visa and MasterCard have incentive to constantly increase interchange rates and there is no countervailing market force to temper these fee increases. There is no naturally-occurring market force in today's interchange system that would ever lead rates to go down."[31] Others have pointed to increasing interchange fees as evidence of market failure.[32]

In fact, the published interchange fee rates have not changed much for most payment card systems. A May 2009 report by the Federal Reserve Bank summarized the interchange fee rates for the signature and PIN debit networks and the credit card networks from 2001 to 2008.[33] It showed no material increase between 2005 and 2009. A study prepared by an economist for the Merchants Payments Coalition presented similar estimates of interchange fee rates for the signature and PIN debit networks.[34] We have reproduced these estimates below in Figure 1 for the past decade, which shows the interchange fees for non-supermarket merchants (interchange fees for supermarkets are generally lower).[35]

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[31] See Senator Durbin's April 12, 2011 Letter to Jamie Dimon.

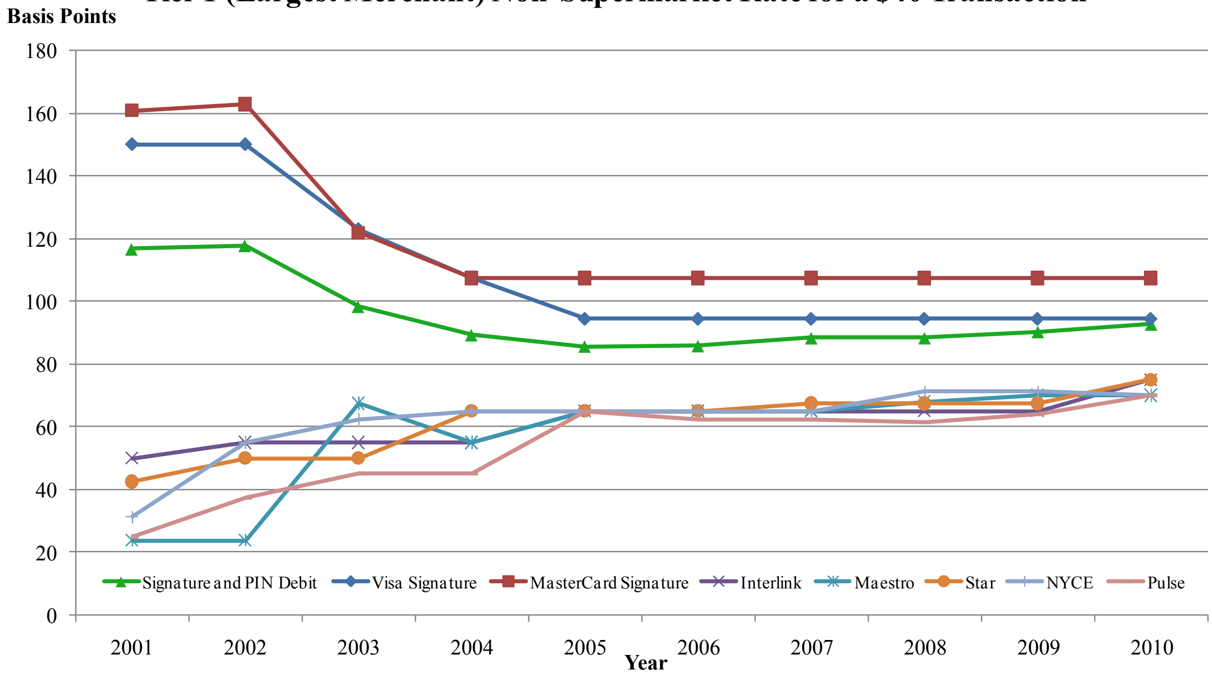
[32] Steven C. Salop et al., Economic Analysis of Debit Card Regulation Under Section 920, Oct. 27, 2010, submitted to the Federal Reserve as part of prepared materials for a meeting between the Federal Reserve Staff and Merchants Payments Coalition on November 2, 2010, at p. 1 ("Salop et al.") and the February 22, 2011 submission to the Federal Reserve by Constantine Cannon on behalf of the Merchants Payments Coalition (including appended reports by James Miller and Steve Salop) ("Merchants Payments Coalition Report").

[33] Prager et al., at Figure 3.

[34] Salop et al., at Exhibits 1(a)-(d).

[35] Salop et al. presented four different estimates of interchange fees: largest non-supermarket merchants, largest supermarket merchants, smaller non-supermarket merchants, and smaller supermarket merchants. We believe the characterization of large non-supermarket merchants is not fully accurate. While MasterCard and Visa have tiered interchange rates that depend on merchant volume (as well as other factors), for at least some years, the PIN debit networks have had non-supermarket rates that depend on the size of the acquirer, not the size of the merchant. See "EFT Data Book," ATM & Debit News, September 15, 2005, at pg. 9 ("EFT Data Book, 2006 Edition"). It would therefore appear that even smaller merchants would qualify for the lower interchange tiers if they used a major acquirer. We have therefore reported the data series for what are called the largest merchant rates, as it is likely that major acquirers account for the majority of volume in the system. We have also chosen to report the interchange fee rates for non-supermarket merchants to be more broadly representative.

Figure 1 - Interchange Fee for Signature and PIN Debit
Tier 1 (Largest Merchant) Non-Supermarket Rate for a $40 Transaction



Source: Steven C. Salop et al., at Exhibit 1c, EFT Data Books 2002 - 2009, The Nilson Report
Notes: The combined signature and PIN debit interchange rate is a weighted average rate based on each network's share of the total debit purchase volume. Data was not available at the time of this report to calculate purchase volume shares for 2009 and 2010. The combined rate for those two years is based on 2008 purchase volume. Maestro's share of volume is reported as part of MasterCard Signature. Rate information for a number of PIN debit networks (representing approximately 10% of PIN volume) were not included in Salop et al.'s data. For the purpose of creating a combined signature and PIN rate we assumed the PIN networks included in Salop et al.'s analysis combine to make up the entire PIN volume.

Figure 1 shows that the average interchange fee for debit cards declined over the past decade, from about 1.17 percent to 0.91 percent taking a weighted average across signature and PIN debit. PIN debit interchange fees increased in the early part of the decade and then have been largely flat since with a slight uptick towards the end of the decade. Signature debit interchange fees declined in the early part of the decade and then have been flat since.[36] The data clearly show that (1) claims of "ever increasing" debit card interchange fees are incorrect, for debit overall or for either PIN or signature debit taken alone; and (2) average interchange fees for debit card transactions have actually declined in the past decade.[37] In fact, the

[36] Signature debit card rates declined between 2002 and 2004 largely as a result of the settlement of the WalMart litigation. However, since that decline they have not increased materially.

[37] Merchant claims that debit card interchange fees have increased are based on comparing current rates to those in the mid to late 1990s, which was around the time debit cards started taking off in the United States. There were

weighted average debit interchange fee declined by about 20 percent over the decade and the weighted average debit interchange fee has been roughly constant since 2004.

Some of the discussions about increases in interchange fees confuse increases in the interchange fee rate with the total amount of fees that merchants pay for accepting debit cards. The total amount that merchants pay for debit cards has increased over time because this form of payment has become more popular with both consumers and merchants. Businesses spend more money on many inputs as their businesses expand and as inputs become more desirable so this is hardly unusual. Businesses, for example, are spending more money on information technology today than they were 10 years ago despite the fact that most information technology prices have declined.[38]

Consumers have come to like debit cards because of the convenience of paying with them rather than a check and because unlike credit cards, the money comes from their current funds and therefore does not present any risk that they will incur debt. The Federal Reserve Bank of Boston's 2009 Survey of Consumer Payment Choice found that 68 percent of consumers used debit cards, and the Federal Reserve Board Payments Study found that between 2000 and 2009 the proportion of non-cash transactions made with debit cards increased from 11 percent to 35 percent, making debit the preferred electronic payment option

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significant increases in PIN debit interchange fees between 1995 and 2005. The ATM networks initially set interchange fees very low to persuade merchants to spend money installing PIN pads. Like many businesses that engage in penetration pricing, they increased those rates over time. As Figure 1 shows, interchange fees for PIN debit have been essentially flat since 2005.

[38] See the Consumer Price Index, U.S. City Average Information Technology and Peripheral Equipment, Bureau of Labor Statistics, available at http://data.bls.gov/pdq/querytool.jsp?survey=cu, "Survey: IT spending to recover in 2010," Cnet, November 25, 2009, citing Goldman Sach's 2010 IT Spending Survey.

for consumers.[39] Since consumers are making more transactions with debit cards, the total fees that a merchant pays with cards has also increased, even if the amount per transaction has been relatively stable. Much of this increase has come from consumers replacing check payments with debit cards. It is beyond the scope of this paper to discuss all of the benefits to merchants from reduced check use (such as the advantages of guaranteed payment found with debit cards). However, they have been well documented elsewhere.[40]

Merchants are paying more debit card fees because of two decisions that have made it easier for people to swipe and harder for people to pay with checks. Many merchants have installed point-of-sale equipment that makes it very easy for consumers to pay with a credit or debit card, and they have installed equipment that makes it very easy for consumers to pay by entering their PINs..[41] Merchant innovations include self check-out lanes and automated fuel dispensers, which take advantage of the speed and efficiency of card payments while helping reduce merchant infrastructure costs. Indeed, both merchants and consumers appear to have a much stronger preference for debit card payments over check payments. From the consumer's perspective, merchants are making it difficult for consumers to pay with checks. Over half of

[39] For the percentage of consumers with debits cards in 2009 see Kevin Foster, Erik Meijer, Scott Schuh, and Michael A. Zabek (2011), "The 2009 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston, Public Policy Discussion Papers, at table 14, available at http://www.bostonfed.org/economic/ppdp/2011/ppdp1101.pdf ("2009 Survey of Consumer Payment Choice"). For the proportion of non-cash transactions in 2000 see "The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2000 – 2003," The Federal Reserve System, December 2004, at exhibit 2, available at http://www.frbservices.org/files/communications/pdf/research/2004PaymentResearchReport.pdf and for 2009 see "The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006 – 2009," The Federal Reserve System, December 2010, at exhibit 8 http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf.

[40] See, for example, Daniel D. Garcia-Swartz, Robert W. Hahn, and Anne Layne-Farrar (2006), "The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics," Review of Network Economics, 5:2.

[41] See EFT Data Book, 2006 Edition and "First Data Survey Finds Consumers Want Variety of Electronic Payment Choices," Payment News, July 4, 2005 citing First Data's Consumer Usage Study, available at http://www.paymentsnews.com/2008/02/gartner-says-co.html.

consumers report that debit cards are almost always accepted, while less than one-fifth of consumers report that for checks.[42] As shown in Table 1, just between 2008 and 2009 the fraction of consumers who reported that checks were rarely or occasionally accepted increased from 13.9 percent to 19.9 percent; the fraction of consumers who reported that debit cards were rarely or occasionally accepted decreased from 3.0 percent to 2.8 percent. Over the last decade merchants have also expressed their preference for debit payments. Entire merchant categories such as fast food have embraced debit cards, thereby increasing the use of these cards and the total fees received by the banks for providing debit cards as a method of payment. Despite the heated rhetoric in the political arena about the cost of acceptance, efforts to use the courts and regulation to pay less, and assertions that they have no choice, actual merchant behavior shows a desire to encourage electronic payments.

Table 1 - Trends in Acceptance for Payment

	Rarely Accepted	Occasionally Accepted	Often Accepted	Usually Accepted	Almost Always Accepted
Checks					
2008	1.6%	11.3%	31.5%	36.3%	19.3%
2009	3.8%	16.1%	27.7%	33.5%	19.0%
Debit Cards					
2008	1.4%	1.6%	12.4%	36.6%	47.9%
2009	2.0%	0.8%	12.6%	32.0%	52.8%

Source: 2009 Survey of Consumer Payment Choice.

IV. Zero Interchange Fee Countries and Foreign Regulation

Senator Durbin has argued that Canada and other countries have zero interchange fees yet vibrant debit card markets. He says that, "[M]any other countries enjoy vibrant debit systems with interchange fees strictly regulated or prohibited entirely" and that "banks … can easily continue to offer debit card services without the excessive subsidy of high interchange

[42] 2009 Survey of Consumer Payment Choice.

fees."[43] He also points to Canada as an example: "Do you know what the interchange fee is in Canada? It is zero. The same companies that are offering debit cards here in the United States do not charge an interchange fee in Canada."[44] The Merchants Payments Coalition and their economic expert also highlight the fact that seven of the eight countries with the highest debit card penetration have zero interchange fees.[45]

In total, eight countries have been identified by the proponents of debit card price controls as having zero interchange fees. They are Canada, Denmark, Finland, Iceland, the Netherlands, New Zealand, Norway, and Luxembourg. We do not believe one could seriously infer anything by cherry picking eight countries from the more than 120 countries around the world and concluding they should provide the model for the American debit card system. These countries are small and together account for only 1.2 percent of the world's population. The largest one, Canada, has one-ninth the population of the United States, and the smallest, Luxembourg, has about the same population as Fresno, California. In many of them, there are only a handful of banks providing checking account services and they have a monopoly debit card system owned by these banks.[46] There is no logical basis for pointing to these countries—

[43] Senator Durbin's April 12, 2011 Letter to Jamie Dimon.

[44] Richard Durbin, "Swipe Fee Reform," March 16, 2011, available at http://durbin.senate.gov/public/index.cfm/statementscommentary?ID=4cc823e7-c232-44f2-bfc0-b80b31e2561a. It should be noted that U.S. debit card systems—such as MasterCard, Visa, Star and NYCE—are not part of the Interac system in Canada, and that Visa's debit interchange fees in Canada is above zero (we have not confirmed the MasterCard rate).

[45] See Steven C. Salop et al. and the Merchants Payments Coalition Report.

[46] For instance, in Canada the top five banks (Royal Bank of Canada, Toronto Dominion Bank, Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce) account for 85 percent of the total bank assets, see http://www.osfi.gc.ca/osfi/index_e.aspx?ArticleID=554 and the organization that operates Canada's debit card system was founded by four of these top five banks (see "Interac: Changing for the Future," Interac, 1997, available at http://neumann.hec.ca/~p119/gif/interac1.pdf). For information on Dankort in Denmark, see Payment Systems in Denmark, Denmarks NationalBank, September 2005, available at http://www.nationalbanken.dk/DNUK/Publications.nsf/d8a9f2b39990e07880256a3e004157b5/1e8fec8f259e61ffc125706c003d4409/$FILE/kap08.html, and for information on Interpay and bank concentration in Netherlands

rather than China, France, Singapore or many other countries around the world that have debit card interchange fees similar to those in the US—as models for our county. The economic submissions that claim that the existence of countries with a zero interchange fee demonstrates that the US should follow this model, or regulate its fees, are simply not credible.

Although we do not believe that comparisons with countries that differ in so many dimensions[47] from the United States are reliable, we have investigated the experience of these countries in some detail. The results should provide significant caution to those who advocate sharply reducing interchange fees paid by merchants. All of these countries offer only PIN based debit cards to their citizens and it is not possible to use those cards in most places to purchase goods over the Internet or in other situations in which the consumer cannot tap her PIN into a terminal. These cards are therefore largely useless for modern e-commerce, which is growing rapidly around the world. Citizens of these countries cannot use their debit cards to buy books on Amazon, play games on Facebook, buy applications on their smart phones, or to pay almost anywhere else on the Internet; they have to turn to credit cards and other payments, such as PayPal, that can link directly to their checking account.

We have conducted a detailed analysis of Canada, which is the largest of these zero-interchange fee countries, the one most proximate to the US, and the one most frequently mentioned by the merchant associations as a model for the US. Let us begin with some background detail on Canada. It has a population of 34 million people, of whom approximately

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see Fumiko Hayashi and Stuart E. Weiner (2005), "Competition and Credit and Debit Card Interchange Fees: A Cross-Country Analysis," Federal Reserve Bank of Kansas City, available at http://www.kansascityfed.org/publicat/psr/rwp/Weiner-HayashiWorkingPaper11-30-05.pdf.

[47] Aside from being very small economies these countries differ from the United States in a number of ways that influence the economics of the debit card business. These include consumer credit card penetration, the intensity of competition in retail banking, and the presence of monopoly acquirers and/or processors owned by issuers (which may provide payments from merchants to issuers that are equivalent to interchange fees).

half are concentrated in 10 metropolitan areas.[48] Five banks account for 85 percent of the total bank assets in Canada,[49] and there are a total of 77 banks in the country.[50] Canada had one of the highest rates of check use in the world up until 1995.[51]

The Canadian banks decided jointly in 1984[52] to establish a PIN debit network, in part to defray the very high costs of check use they were incurring. They agreed on a zero interchange fee to encourage merchants to install the necessary technology. Until recently Interac has been the only debit card scheme in Canada.[53]

The debit cards offered by Canadian banks are very different from the debit cards offered by American banks.

- Until 2004 Canadian consumers could use their cards only to pay in Canada. Starting in 2004, they could use them to pay at merchant locations in the United States that were connected to the NYCE debit card system—only about 1.5 million of the over 8 million locations that accept signature debit. Today, it is not possible for Canadians to use their cards at all outside of Canada and the United States. By contrast, Americans can pay with their debit cards anywhere in the world where MasterCard and Visa are accepted.

- Canadians by and large cannot use their cards to pay for goods and services at the vast number of merchants and content providers on the Internet. Americans can use their debit cards to pay for Internet purchases as well as use them with PayPal and other

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[48] See "Canada's population estimates," Statistic Canada, available at http://www.statcan.gc.ca/daily-quotidien/110324/dq110324b-eng.htm and "Population and dwelling counts, for census metropolitan areas and census agglomerations, 2006 and 2001 censuses," Statistics Canada, available at http://www12.statcan.ca/english/census06/data/popdwell/Table.cfm?T=201&S=3&O=D&RPP=150.

[49] "Financial Data – Banks," Office of the Superintendent of Financial Institutions Canada, as of February 28, 2011, available at http://www.osfi.gc.ca/osfi/index_e.aspx?ArticleID=554.

[50] There were 77 deposit taking financial institutions regulated by the Office of the Superintendent of Financial Institutions Canada listed on April 23, 2011, http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=568.

[51] "Statistics on Payment Systems in the Group of Ten Countries," Bank for International Settlements, December 1998, available at http://www.bis.org/publ/cpss29.pdf.

[52] "About Us," Interac, available at http://www.interac.ca/about.php.

[53] Visa and MasterCard started offering signature debit in Canada in 2009.

electronic wallets used in eCommerce.[54] Through 2004 it was not possible for Canadians to pay with their debit cards for Internet purchases or for card-not-present transactions such as telephone and mail orders. Today, it is possible for Canadians to pay with their cards at 600 Internet merchants[55] -- but not by simply entering their debit card number as people do in the United States. Internet consumers selecting the Interac Online payment option are redirected to their financial institution's website where they log in to their online bank account and select the amount to debit. Consumers are then redirected back to the merchant's website where they receive the confirmation details of the transaction.[56]

- Many Canadians have to pay to use their cards. The fees are as much as CDN$0.60 to CDN$0.65 per transaction for consumers that have exceeded their monthly threshold for accounts without unlimited transactions.[57] Most Americans pay nothing to use their cards. We discuss this in more detail below.

Canadian retail banks offer two main types of checking accounts, which offer different pricing for "consumer debits"—transactions that debit the checking account, including debit card transactions, but also including checks, ATM withdrawals, and Internet bill payments. There is a basic account which has a monthly service fee and transaction fees for consumer debits in excess of a monthly threshold. There is also a premium account which has a higher monthly service fee than the basic account and allows users to make an unlimited number of consumer debits at no extra charge.

[54] A 2010 Javelin study reports that debit's share of online purchases grew from 26% in 2008 to 28% in 2009 and debit cards ranked only behind credit cards as the most common payment method selected by consumers, see http://www.marketingcharts.com/topics/e-commerce/consumers-favor-credit-cards-online-12090/. The Federal Reserve Bank of Boston reported in their 2009 Survey of Consumer Payments that debit cards were the most commonly used payment method for Internet payments – accounting for 36% of all transactions. See 2009 Survey of Consumer Payment Choice, at Table 22, available at http://www.bostonfed.org/economic/ppdp/2011/ppdp1101.pdf .

[55] That is a very small fraction of Internet merchants. Based on a review of these merchants they do not include many of the largest Internet merchants including Amazon, Wal-Mart, E-bay, etc. Many of the merchants appear to be relatively small websites. A full list of merchants accepting Interac Online is available at http://www.interac.ca/consumers/productsandservices_ol_search.php.

[56] "Products and Services," Interac, http://www.interac.ca/consumers/productsandservices_ol_main.php.

[57] Canadian and US dollars have a roughly equivalent exchange rate. As of May 6, 2011, a CDN$1.00 dollar could be exchanged for US$1.035.

Table 2 shows the features and pricing for basic and unlimited transaction accounts at the top five Canadian banks.[58] The table reports the average cost per debit card transaction based on 20, 30, and 40 consumer debits per month. Depending on the consumer's bank, the type of account, and the number of debit transactions in the month, the average cost per debit transaction is between CDN$0.27 and CDN$0.65.[59]

With this information in hand it is useful to compare the cost of debit cards and checking accounts for Americans and Canadians. Americans almost never pay for using a debit card.[60] In 2009, prior to changes in Regulation E and the passage of the Durbin Amendment, 76 percent of U.S. checking accounts were free of monthly service fees, and the minimum balance needed to qualify for free checking was only about $185. Therefore the typical American did not pay anything for paying with a debit card and did not pay anything

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[58] Table 2 reports a hypothetical effective cost per debit transaction by allocating total monthly service fees and per transaction fees across the total number of debit transactions. We note that the table does not reflect that unlimited transaction accounts may also offer some services and fee waivers (such as fee waivers on number of out of network ATM transactions, waivers on email money transfers, check imaging, and discounts on other banking services) that are additional to the features of the basic transaction accounts. For example, at Bank of Montreal unlimited checking account customers receive one free non-BMO ATM transaction per month, AIR MILES rewards on debit card purchases (1 per $40 spent), check imaging, and two free Interac email money transfers per month (see http://www.bmo.com/pdf/plans_en.pdf) and at RBC Royal Bank unlimited account customers receive two free Interac email money transfers per month, a fee waiver of CDN$3 per month for overdraft protection, a CDN$35.00 rebate on certain eligible credit cards, check imaging, two free cross border transactions per month, and three free non-RBC ATM transactions per month (see http://www.rbcroyalbank.com/products/deposits/banking-compare.html).

[59] The cost to the consumer will depend on the number of consumer debits she makes. For example, the cost per debit for a consumer making only 1 or 2 transactions a month will be very high, about CDN$2 or more even on the basic plans, while the cost per debit for consumer making hundreds of monthly debit will be low on a per transaction basis on the unlimited plans, under CDN$0.05. We believe the range of consumer debit reported in Table 2 covers usage by typical Canadian consumers. The cost to the consumer will also depend on how accurately she is able to choose the plan that is lowest cost and how much her usage patterns changes from month to month. These calculations assume that that monthly fee is entirely related to the number of debit transactions; they could tend to inflate the average cost per transaction to the extent the fee includes other services provided by the banks for which it would charge a fee.

[60] They do pay overdraft fees when they do not have enough funds in their account.

significant for having a checking account so long as she had sufficient funds.[61] The Canadian Bankers Association reports that 30 percent of accounts pay no service fees; however, the minimum account balance for a "free" account was usually CDN $1,000.[62] Thus the typical Canadian pays between CDN $131 and $167 a year for a premium account and CDN $84 and $125 a year for a basic account with 240 debit transactions annually.

Table 2 - Monthly Checking Accounts Fees at the Top 5 Canadian Banks

					Number of Consumer Debits Per Month					
					20 Transactions		30 Transactions		40 Transactions	
Bank	Account Type	Monthly Fee	Number of Debits Included	Additional Transactions Fee	Total Cost	Effective Cost Per Transaction	Total Cost	Effective Cost Per Transaction	Total Cost	Effective Cost Per Transaction
RBC Royal Bank	Basic	$4.00	15	$0.60	$7.00	$0.35	$13.00	$0.43	$19.00	$0.48
	Unlimited	$10.95	Unlimited	n/a	$10.95	$0.55	$10.95	$0.37	$10.95	$0.27
Bank of Montreal	Basic	$4.00	10	$0.60	$10.00	$0.50	$16.00	$0.53	$22.00	$0.55
	Unlimited	$13.95	Unlimited	n/a	$13.95	$0.70	$13.95	$0.47	$13.95	$0.35
Toronto Dominion Bank	Basic	$3.95	10	$0.65	$10.45	$0.52	$16.95	$0.57	$23.45	$0.59
	Unlimited	$12.95	Unlimited	n/a	$12.95	$0.65	$12.95	$0.43	$12.95	$0.32
CIBC	Basic	$3.90	10	$0.65	$10.40	$0.52	$16.90	$0.56	$23.40	$0.59
	Unlimited	$12.95	Unlimited	n/a	$12.95	$0.65	$12.95	$0.43	$12.95	$0.32
Bank of Nova Scotia	Basic	$3.95	12	$0.65	$9.15	$0.46	$15.65	$0.52	$22.15	$0.55
	Unlimited	$11.95	Unlimited	n/a	$11.95	$0.60	$11.95	$0.40	$11.95	$0.30

Sources:
RBC Royal Bank: http://www.rbcroyalbank.com/products/deposits/banking-compare.html
Bank of Montreal: http://www.bmo.com/pdf/plans_en.pdf
Toronto Dominion Bank: http://www.tdcanadatrust.com/accounts/accounts-fees.pdf
CIBC: http://www.cibc.com/ca/chequing-savings/chequing-accts.html
Bank of Nova Scotia: http://www.scotiabank.com/cda/files/d2d/d2dcb_e.pdf

[61] A minority of consumers paid overdraft fees for when they paid but did not have sufficient funds in their account. See "NSF, Overdraft-Protection Fees Drawing Greater Fire," US Banker, September 2007, available at http://www.americanbanker.com/usb_issues/117_9/-329016-1.html and "FDIC Study of Bank Overdraft Programs," FDIC, November 2008, available at http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf.

[62] Banks and Consumers, Canadian Bankers Association, http://www.cba.ca/en/media-room/50-backgroundeers-on-banking-issues/127-banks-and-consumers.

V. Consumers and Small Business Would Not Benefit

Senator Durbin has said the amendment would benefit consumers.[63] The merchant trade associations have made similar claims that consumers would save more than $1 billion a month.[64] These figures correspond to the average amount of debit interchange fee revenue that merchants would not pay if the Federal Reserve Board's proposal to reduce interchange fee rates to 12 cents per transaction was implemented. The claim that consumers would save more than $1 billion a month is based on two false assumptions.[65]

The first false assumption is that merchants would reduce the prices they charge consumers by the full amount of any savings they receive. Economic studies of how merchants respond to cost changes demonstrate that merchants would not reduce prices quickly or fully in response to the reduction in debit interchange fees. Debit interchange fees would fall by about $0.016 cents for a $10 purchase. Studies have found that merchants typically do not reduce prices in response to small cost changes. Prices are sticky. Merchants will eventually reduce prices, but other economic studies have found that they reduce prices only by about 40-70

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[63] See "Durbin: Interchange Reform will Take Effect as Planned on July 21," Congressional Documents and Publications, March 29, 2011, available at http://durbin.senate.gov/public/index.cfm/pressreleases?ID=c9a55fa4-c91a-4ec5-b2ac-cdbde32826ef and also see 157 Cong. Rec. S1780 (daily ed. Mar. 17, 2011) see the statement of Sen. Dick Durbin, available at http://www.gpo.gov/fdsys/pkg/CREC-2011-03-17/html/CREC-2011-03-17-pt1-PgS1778.htm.

[64] According to the National Association of Convenience Stores "[d]elaying swipe fee reform has consequences that will cost merchants and their customers $1 billion each month…" See "Durbin Amendment in Danger of Delay," Convenience Store Decisions, March 17, 2011 quoting National Association of Convenience Stores Senior Vice President of Government Relations Lyle Beckwith. And, "[t]he consequences of inaction are clear; the dominant networks (and their banks) will continue to impose supracompetitive interchange fees on all merchants — more than $1 billion per month of fees that are ultimately borne by consumers." See the "Merchants Payment Coalition Submission to the Board of Governors of the Federal Reserve System," Merchants Payment Coalition, February 23, 2011, available at http://www.federalreserve.gov/newsevents/files/MPC_Consumer_Meeting_20110223.pdf

[65] For more details see David S. Evans, Robert L. Litan, and Richard Schmalensee, "Economic Analysis of the Effects of the Federal Reserve Board's Proposed Debit Car Interchange Fee Regulations on Consumers and Small Businesses," Submission to the Board of Governors of the Federal Reserve System, February 22, 2011 ("Evans et al.").

percent of the reduction in cost. While it is likely under economic theory that merchants in highly competitive segments will eventually be forced to pass through the cost savings in the form of lower prices, many merchants that accept debit cards do not operate in highly competitive markets. For example, based on the Federal Trade Commission's definitions of grocery store and big box retailer markets, which account for a significant portion of debit card use, consumers in many metropolitan areas have a choice between few competitors in these industries.[66] In fact, big box retailer Home Depot's CFO reported in providing guidance on their earnings estimate that the company expected that the bottom line benefit to the company would be $35 million a year.[67]

The second false assumption is that banks and credit unions will not raise the fees for checking accounts and debit cards as a result of the reduction in interchange revenues. To the extent banks and credit unions raise fees, such increased fees would offset any savings consumers receive from lower merchant prices. The average bank or credit union would lose roughly $60 of revenue from the average consumer checking account.[68] Banks and credit unions reduced checking account fees and dropped debit card transaction fees as the use of debit cards by consumers increased dramatically (and therefore interchange fee revenues

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[66] In Staples/Office Depot the FTC argued and a court agreed that these office superstores faced little competition from other stores that sold office supplies and that the geographic markets were local. In 15 metropolitan areas, Staples and Office Depot were the only competitors. The FTC has also reviewed a number of supermarket mergers and in the course of doing so determined that there is a relevant product market for large supermarkets that can provide a full array of grocery and related products to consumers and that this market includes the grocery portion of supercenters. Based on examining data for a number of cities and admittedly casual inspection, it appears that most people have the choice between a few supermarkets as defined by the antitrust authorities. A downtown resident of Boston, Massachusetts would find 4 supermarket chains within the city limits (5 if we included Whole Foods, which the FTC would not); based on the experience of one of the authors, most people would find only one or two of these convenient to use on a regular basis for major shopping.

[67] "Event Brief of Q4 2010 Home Depot Inc Earnings Conference Call – Final," CQ FD Disclosure, February 22, 2011.

[68] See Evans et al., at p 28.

increased also) during the 2000s and help offset the costs operating retail checking account. As the banks lose these revenues under the proposed price caps, they will be significantly more challenged to recoup the costs of operating their retail checking accounts and earn a fair rate of return. Therefore, the same process that took place during the 2000s and reduced account fees and debit card fees will work in reverse. Retail banking is the kind of highly competitive business in which economists would expect that firms would pass on most of the cost savings to consumers in the form of lower prices and most of cost increases in the form of higher prices. The history of banking in the last decade reflects this, as do the announcements by banks that they are increasing their fees in anticipation of the debit card interchange fee reductions.

Evans, Litan and Schmalensee have estimated that banks would likely increase their fees to consumers over the first 24 months of the proposed regulations by far more in total than merchants would decrease their prices to consumers. In fact, they estimate that merchants would receive a windfall of between $17.2-$19.9 billion dollars in the first 24 months the rules are in effect, depending on which proposal the Federal Reserve Board adopted of the two advanced in December 2010. Lower-income consumers will be particularly impacted by higher fees, pushing some of them out of the banking system. Such consumers would lose the many benefits of checking account and debit card services and would be pushed toward higher cost check-cashing services and payday lenders.

Senator Durbin has also claimed that small businesses would benefit from the legislation.[69] But this is not true. Virtually all small businesses have checking accounts with

[69] "Durbin Responds to OCC Chief on Interchange, Meets with Small Business About Benefits of Reform," Congressional Documents and Publications, March 10, 2011, available at http://durbin.senate.gov/public/index.cfm/pressreleases?ID=6886cb40-cd16-4d83-a0d4-5363324a9abc.

debit cards. They will pay more for these accounts as a result of banks losing debit card interchange fee revenue, which is usually greater for small business accounts than for consumer accounts. Although precise statistics are not available, most small businesses do not accept debit cards for payments and therefore would not benefit from reduced debit card interchange fees.[70] We tend to think of small businesses as the local shopkeepers, many of whom do take debit. But most small businesses are manufacturers, tradespeople, or in other lines of work that do not involve being paid with credit or debit cards. Only 10 percent of small businesses are in retail where card payments are most common. Therefore, most small businesses would lose as a result of the Durbin Amendment.

VI. Conclusion

The Durbin Amendment goes against the views expressed by the General Accountability Office, a Federal Reserve Board staff research report, and the Antitrust Division of the U.S. Department of Justice—all of which effectively raised red flags about the possible adverse effects of interchange fee regulation on consumers. It was adopted with surprisingly little discussion given that it results in the imposition of price controls and the elimination of the free market for a significant American industry. The trade groups that promoted this legislation obviously had the interests of merchants in mind in shifting the costs of debit cards from merchants to consumers. However, they have also claimed that imposing price controls on the debit-card industry would serve the public interest. We disagree. The best evidence shows that the imposition of the price controls described by the Federal Reserve Board on

[70] As discussed in Evans, Litan and Schmalensee, because small businesses that accept payment cards have blended fee contracts with their merchant processors, and have little bargaining power with these processors, it is likely that these small businesses will not receive the full benefits of the reduction in interchange fees or receive these benefits quickly.

December 16, 2010 would cost consumers billions of dollars over the next two years. If Canada is any example, a dramatic reduction in interchange may well result in consumers here also paying more, but getting less.