How the Merchants Could (Unintentionally) Help out the Banks

Eric Grover

The Fed's lenient implementation of the Durbin Amendment's debit rules has provoked a lawsuit by merchants. They're right to sue, but their action may hasten the amendment's repeal.

Merchants filed a righteous suit in November against the Federal Reserve, contending it didn't implement the letter or the spirit of Section 1075 of the Dodd-Frank Act—also known as the Durbin Interchange Amendment.

U.S. Sen. Richard Durbin's legislation, which took effect Oct. 1, aimed to substantially eliminate fees debit card issuers and networks earn from merchants, and ensure issuers and networks charge virtually all their fees directly to cardholders. As wrongheaded as that law is, the merchants were right to sue. And their suit could lead to repeal of the Durbin Amendment, though that is not, of course, their intended result.

Here's why.

The Fed's implementation of Durbin moderated the damage Durbin and Congress intended. It: (1) set debit-interchange price caps much higher than any literal reading of the law's text would have permitted; (2) charitably permitted issuers to comply with the network-exclusivity ban by aligning payment cards with a single signature-debit network and one unaffiliated PIN-debit network, (3) ruled three-party debit networks are not covered; and (4) presumed no synthetic debit interchange so long as issuer network fees and rebates don't net to less than zero.

But a narrow reading of the legislation suggests a debit interchange price cap of not more than a few cents. It mandates a debit interchange price control reasonable and proportional to debit issuers' incremental transaction processing cost. A reasonable argument can be made that incremental debit transaction-processing costs for banks like Bank of America Corp., JPMorgan Chase & Co., and Wells Fargo & Co. are zero or at least not more than a few pennies.

Tortured Logic

Viewed in the context of the legislation's punitive text, the Fed's first pass at implementing Durbin—released in December 2010 as preliminary rules for public comment—was generous. And it proposed debit-interchange price caps of 7-to-12 cents.

In the runup to Dodd-Frank banks were complacent and in many cases backed its supporters. For instance, BofA management gave candidate Obama, who railed against banks, $2.35 for every $1 they contributed to McCain in 2008. However, the prospect of losing 80% to 90% of their debit-interchange revenue jolted some back to their businesses.

Their lobbying of the Fed paid dividends. The Fed expanded the pool of debit-issuer costs recoverable through interchange, adding fixed software and hardware costs, fraud losses, and network fees, and increased from 50% to 80% the recovery of the median of costs issuers reported in the Fed's survey.

The Fed's contention that fixed hardware and software costs are recoverable because they are "particular" to a transaction as the transaction couldn't occur without them was tortured logic.

What the Fed wound up with in its final rule, released in June, was a debit-interchange price cap of 21 cents plus 5 basis points for fraud losses and tentatively 1 cent for fraud-prevention costs.

Its ruling that issuers could comply with the network-exclusivity ban by aligning payment cards with a single signature-debit network and a single PIN-debit network, while arguably flouting the spirit of merchants enjoying routing choice for each debit transaction, is within the letter of the law, which doesn't distinguish between signature and PIN debit.

Issuers and networks are prohibited from restricting payment cards to fewer than two unaffiliated debit networks. It's not a problem however if merchants or consumers restrict routing. Six and half million merchants accepting only signature could accept PIN.

Copyright 2012 Boland Hill Media LLC. All rights reserved.
Reprinted with permission of the publisher.

While the Fed entertained mandating at least two networks each for signature and PIN, which would have completely upended debit-network competition, many merchants accepting signature and PIN debit will nonetheless still exercise debit routing choice transaction by transaction, putting powerful and systematic pressure on regulated and unregulated interchange and network fees. Henceforth, signature and PIN-only networks will compete to route each other's transactions.

Saying they don't "route" transactions, the Fed decided closed-loop debit networks such as PayPal aren't subject to the Durbin Amendment. If the e-commerce phenom and other three-party debit networks had been covered, it would have increased pressure to amend or repeal Durbin's price controls.

While merchants wanted more, the Fed's benign implementation of the ban on synthetic interchange—net rebates networks pay to issuers out of network fees—is not at odds with the legislation and will be administratively more straightforward to police than the alternatives.

Rule of Law

So while courts afford regulators latitude implementing legislation, the merchants have a legitimate case.

Why did the Fed take such license? It decided to mitigate the harm eliminating $14 billion to $15 billion in debit-interchange revenue would inflict on banks, which were already hurting because of the financial crisis and had already been pummeled by the Dodd-Frank regulatory tsunami.

But Fed chairman Ben Bernanke is not a beneficent king. The Fed's job is to follow Congress's instructions, no matter how destructive. Laws should be objectively, impartially, and reasonably enforced.

The way to fix bad laws is for Congress to amend or repeal them. To be motivated to act, however, Congress needs to feel the heat from banks, networks, and, most important, voting cardholders.

Notwithstanding the Fed's charity, banks still stand to lose billions of debit-interchange revenue.

To offset some of the $1.5 billion plus in debit-interchange revenue it's losing BofA announced a highly visible $5 per month debit-card fee. This created a propitious environment for U.S. Reps. Jason Chaffetz (R-Utah) and Bill Owens (D-N.Y.) to introduce the Consumer Debit Protection Act, which would repeal the Durbin Amendment.

But new debit fees proposed by BofA, Wells Fargo, SunTrust, Chase, and Regions provoked a firestorm. U.S. PIRG's Ed Mierzwinski decried BofA's new fee, saying, "Kicking your customers in the head with a $5 fee is an overreach—and perhaps a fee too far."

Grover: If the merchant suit succeeds, it will increase the Durbin pain and therefore the chances of repeal.

On the Senate floor, Durbin blasted BofA, urging its customers to "vote with your feet, get the heck out of that bank. Find yourself a bank or credit union that won't gouge you for $5 a month ... What Bank of America has done is an outrage."

Pusillanimous banks beat a swift retreat, dropping plans to hit consumers with new, and visible, debit fees. While understandable, banks' throwing in the towel lessened pressure on Congress to repair the damage it's done.

Chances of Repeal

While the Durbin Amendment causes the most immediate and direct harm, other sections of the Dodd-Frank Act will adversely impact the payments industry. The Consumer Financial Protection Bureau will have unfettered authority, a $500 million to $800 million budget, and by the end of the year, 1,200 regulators. Inevitably it will erode the economics of credit cards, general-purpose prepaid cards, and any consumer financial services it puts in its crosshairs.

But in the House there's appetite to repeal Dodd-Frank in its entirety or piecemeal, perhaps starting with the Durbin Amendment.

With so much on the House's plate, Congressman Chaffetz's challenge is getting a hearing and a vote. Even if he does, though, there still aren't 60 votes in the Senate for repeal. That was shown by the experience of Sen. Jon Tester (D-Mont.), who last spring won 54 votes to defer and study the Durbin Amendment,

The 113th Congress, however, may be another matter.

While positions on interchange price controls don't break down purely on party lines, significantly more Republicans are against them.

Republicans look likely to hold their House majority. With Obama's poll numbers at historic lows, the economy languishing in the doldrums, only 10 GOP Senate seats in play, and 23 seats caucusing with the Democrats up, the GOP is likely to capture the Senate and has good prospects of taking the White House.

If they win a solid majority in the Senate and capture the Presidency, repeal of the Durbin Amendment and Dodd-Frank is a real possibility.

The greater the Durbin pain, the greater the chances of repeal.

If the merchants prevail in their suit, it will increase the Durbin pain and therefore the prospects of returning to a world in which voluntary transactions and relationships in a free market rather than Washington determine debit-network fees and bases of competition. DT

Copyright 2012 Boland Hill Media LLC. All rights reserved.
Reprinted with permission of the publisher.