Washington's Assault on Payments

Eric Grover

Congress and regulators are bent on turning payment networks into public utilities subject to political pressure rather than market forces. Can they be stopped?

Consumers and merchants have never been better served by the retail electronic payments industry than they are today, and take the surfeit of product choice, convenience, and ever-increasing value for granted. Nevertheless over the last several years Washington has launched an unprecedented, full-throated assault on the payments industry.

It attacked credit cards' business model, attempted to impose price controls on card-acceptance fees, capped debit-interchange fees, established the deceptively named Consumer Financial Protection Bureau (CFPB) to lord it over consumer financial services. And it has fresh targets in its crosshairs for 2011.

In 2009 the historic Credit Card Accountability Responsibility and Disclosure (CARD) Act curbed credit card issuers' risk-based pricing, as well as penalty and administrative fees. Issuers adapted, preemptively raising interest rates and reducing credit card availability for riskier consumers, driving many to more expensive payday lenders for credit and to intrinsically riskier cash to transact.

At the same time, Senate majority whip Dick Durbin, D-Ill., and House Judiciary chairman John Conyers, D-Mich., proposed price caps on general-purpose payment card acceptance fees. Issuers, networks, merchant acquirers, processors, and independent sales organizations all would have been squeezed. Cardholders would have faced new fees and anemic rewards and merchants reduced card acceptance.

Debate centered on credit-card acceptance fees. The networks rightly contended that issuers take credit risk on behalf of retailers and that therefore retailers had a good deal. In the Great Recession, with credit card losses running over 10% of receivables, the argument proved politically effective. Unfortunately, it also implicitly accepted the merchant lobby's public-utility, cost-recovery framework for interchange.

Echo Chamber

Seeking lower card-acceptance fees, the retailer lobby has been strategically resolute and relentless, but tactically flexible, at least since 2005, when it unsuccessfully first sought Fed intervention in interchange. With resistance on the credit card front, Durbin and the merchant lobby turned their sights on a more limited objective: taking down debit card interchange, which is well-nigh impossible to defend based on issuer costs.

The payments industry was caught wrong-footed. Durbin won 64 votes in the Senate, including 17 Republicans, attaching his interchange amendment to the financial-regulatory-overhaul bill. On July 21, 2010, President Obama signed the landmark 2,300-page Dodd-Frank Wall Street Reform and Consumer Protection Act, with Durbin's debit-interchange amendment, into law.

Banks earn \$16 billion in debit interchange per year, enabling free debit cards and checking accounts that consumers take for granted. Eighty percent of Americans have a debit card. Most have no fees. Some 45% offer rewards. That's about to change.

On Dec. 16, the Fed presented its much anticipated implementation of the Durbin interchange amendment, which mandates punitive price controls on card network's debit interchange fees and potentially gives merchants, rather than consumers and their banks, the right to pick networks.

Wall Street was stunned by the magnitude of the Fed's proposed debit-interchange reduction, and that Thursday Visa Inc. and MasterCard Inc. stock tumbled 13% percent and 11% percent respectively on the news—even though the networks aren't directly affected.

The Fed proposed reducing interchange 90%, rather than the 50% an echo chamber of analysts and industry insiders had been telling

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one another was "reasonable" (table). Their expectation, however, never had any basis in the law.

If anything, the Fed was lax with respect to the legislation's punitive intent. The law, after all, requires that interchange be "reasonable and proportional" to the incremental processing costs borne by debit card issuers, which are vanishingly minimal.

For example, incremental debit authorization, clearing, and settlement costs for large issuers such as Bank of America Corp., Wells Fargo & Co., and JPMorgan Chase & Co. are well under the 7-cent "safe harbor" cap set by the Fed's Dec. 16 proposal. (Comments on the Fed proposal are due by Feb. 22. The Durbin Amendment's interchange restrictions apply only to financial institutions with $10 billion or more in assets).

Banks will offset lost revenue by hitting consumers with a battery of new debit, checking, and account-maintenance fees, and eliminating rewards, likely spurring calls for Congress to fix a problem it created. Small-issuer, general-purpose reloadable (GPR) prepaid, and government-benefit transactions are exempt from interchange price caps and will consequently gain share.

Two Eras

Retired Senate Banking Committee chairman Chris Dodd, who supported the idea of government fixing prices, now says perhaps Congress didn't get it "right."

Indeed, at the 11th hour, on Dec. 9, 13 senators (including two—Mike Crapo and David Vitter—who voted for debit card interchange price controls) sent a letter to Fed chairman Ben Bernanke decrying government fixing prices and pleading with him to ignore key elements of the legislation.

Bankers shouldn't put too much stock in this. While the law is anti-consumer and will suppress debit card availability, use, and innovation, regulators ignoring the will of Congress as expressed in the legislation's text is more dangerous than the consequences of a bad law.

Setting all this aside, the key issue is not how high interchange fees are, but whether they're set by businesses competing in free markets or by government. Interchange is a pricing system that two-sided payment networks such as MasterCard and Visa use to balance cardholder and merchant participation to maximize transaction volume.

The Fed's Buzz Cut for Issuers
(Debit interchange fee reduction, proposed December 2010)

Transaction size	Current Visa interchange	7-cent safe harbor cap	12-cent cap
$40	58 cents	88%	79%
$70	86.5 cents	92%	86%
$100	$1.15	94%	90%

Source: Federal Reserve

Because the payment choices of cardholders, rather than those of merchants, reign at the point of sale, they pay less and retailers more. If merchant payment choices were dispositive—as for debit may soon be the case—interchange would flow to them.

Dynamic market pricing allocates resources to where they are most highly valued, in one-sided markets and holistically in two-sided payment-network markets. In contrast, price controls create shortages, suppress innovation, and drive commerce elsewhere, always.

Make no mistake: Durbin's price controls mark a watershed between two eras. The first era was one of increasing retail payment-network competition and innovation, with Visa, MasterCard, AmEx, Discover, PayPal, Star, and other networks relentlessly displacing cash and checks, and private capital funding a slew of new payments ventures, including Bill Me Later, Bling Nation, Boku, Danal, Dwolla, Isis, Mobilian, Moneta, Revolution Money, Tempo Payments, and Zong.

The second era is one in which payment networks are treated as public utilities.

Merchant Tilt

The Fed was charged with regulating network fees to prevent synthetic interchange, that is, a transfer of value from one side of the network to the other through processing and licensing fees and rebates, rather than interchange. The Fed's proposal will be easy to administer and is as benign as is consistent with the legislation. So long as issuers' fees and rebates don't net to less than zero, networks remain free to set their processing and licensing fees as they see fit.

Durbin's interchange amendment also prohibits debit-network exclusivity and gives merchants transaction-routing choice. Three scenarios are arguably consistent with the legislation. The Fed didn't propose one, but invited comment on all three.

The first: Issuers aligning with a single signature network and another unaffiliated PIN-debit network would be compliant. Each debit card would have two network options. However, practically speaking, whether the cardholder used signature or PIN, the merchant would never have routing choice. Market leader Visa would lose its exclusive signature-PIN debit-issuer relationships, putting a huge tranche of PIN business in play. Otherwise, the market impact would be modest.

The Fed's second alternative, however, would cause a tectonic shift in the debit-network market. It embodies two not expressly delineated sub-alternatives, and, while entailing work to implement, comports more closely with Congress's intent.

The legislation, and the central bank's written proposal, would

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require that issuers and networks permit merchants to pick routing between two networks, but not the payment scheme (the product's rules and interchange), for each debit transaction. Signature and PIN-debit transactions would be delivered to issuers from at least two networks.

Retailers, or merchant processors on their behalf, would pick the network processor, but not the product. Network acquirer processing fees, consequently, would be gored.

However, Fed staff comments that merchants could exert downward pressure on interchange suggest they envision merchants choosing the bundled payment product and its processing. Issuers would align with at least two signature and two PIN-debit networks. Merchants would choose their preferred (presumably cheaper) network.

This would introduce a powerful downward ratchet on network acquirer licensing and processing fees and on interchange. Network incentives would flow to retailers, rather than issuers and cardholders. It isn't anti-market but it would upend how the market works, tilting it toward merchants.

Enormous Headway

Still, in considering Washington's assault on payments, it's important not to lose sight of the CFPB, created by 400 pages of the Dodd-Frank Act. This new agency may prove even more harmful to consumers and the payments industry than the Durbin Amendment.

It will have nearly plenary authority to define, regulate, and ban financial products. In September, President Obama bypassed Congress and appointed Harvard professor Elizabeth Warren, a long-time financial-industry nemesis, as "special advisor" to set up the CFPB, be its *de facto* head, and set its tone.

The CFPB's animating idea is enlightened by the notion that many consumers should not be trusted to make product choices for themselves. The CFPB's lording it over consumers in the financial-services realm will stifle payments innovation and consumer choice.

Advocates of transforming the payments industry into a public utility have made enormous headway, and were undeterred by the results of the Nov. 2 election.

In 2011, Durbin will seek to extend to credit cards the Fed's authority to regulate network fees and interchange. It promises to be a battle royal. However, Durbin may face a tough slog. One of the two most pro credit card industry Democrats in the Senate, Tim Johnson, is now Banking Committee chairman. The GOP, leery of the state's ever-increasing role in financial services, rules the House. And the card industry, finally, is more attuned to the threat Washington poses.

But the assault won't stop with credit cards. The GPR prepaid sector, serving the unbanked and underbanked, will come under fire from Congress and the regulators. Sens. Durbin, Robert Menendez, D-N.J., and Jeff Merkley, D-Ore., have already introduced the Prepaid Card Consumer Protection Act, which would curb GPR prepaid fees.

Regulators are also closing in on prepaid. The Office of Thrift Supervision decided prepaid card specialist Meta Financial's high-interest iAdvance program was deceptive. Rather than requiring enhanced disclosure, it shut it down.

The OTS also is contemplating restricting issuers' "rent-a-BIN" programs, which facilitate more open payment systems and broader participation.

Most Americans want to manage their own financial affairs and think the private sector, not state-directed utilities, best serve them. Where the subprime and unbanked and underbanked consumers are underserved, it is because of, not in spite of, government. An example is the CARD Act's cap on annual credit card fees, other than finance and penalty fees, at 25% of the annual credit limit. It sounds compassionate but really restricts the availability of credit to the poor.

Can the regulatory blitzkrieg against the payments industry be stymied or even reversed?

There are glimmers of hope. Regional debit issuer TCF Financial is suing the Fed, claiming interchange price controls, with an exemption for smaller competitors, are unconstitutional, since they are a taking without compensation and prevent issuers from earning a reasonable return.

While courts are less disposed to uphold economic and property rights than a century ago, TCF Financial has a sound constitutional argument and a fighting chance.

Regardless of how TCF Financial's suit fares, the nine of the 13 senators who are returning in the 112th Congress and who petitioned Bernanke to disregard Durbin's interchange amendment should move to repeal it.

Audaciously, five Republican representatives propose repealing the entire Dodd-Frank Act. While that would have symbolic value, clearing the Senate and Obama's desk would be problematic.

However, with an emboldened GOP in the House and 21 Senate Democrats and two aligned Independents up for reelection in 2012, amending or repealing sections affecting payments is possible.

While pulling the CFPB out by its roots might be too much to hope for, most Americans would be comfortable with Congress circumscribing its mission to ensuring all material facts about consumer financial products were fully disclosed.

Washington is bent on determining what payment products have value and how they're priced. However, its public-utility model is light years less responsive to consumers than markets, and adjusts slowly, if at all, based on bureaucratic and political pressure. It's time to reverse course. DT

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