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1. **Proposed debit card regulation in the U.S.**
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3. **French banks oppose proposed end-date regulation**

1. Proposed debit card regulation in the U.S.

On December 16, 2010 the Federal Reserve Board proposed a new regulation for debit card payments.[1] The proposal is based on the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Dodd-Frank Act").[2] It contains proposals regarding the setting of interchange fees and a prohibition of network exclusivity arrangements. In line with the Dodd-Frank Act, the proposed regulation applies to issuers that have assets of $10 billion or more (together with their affiliates). Government-administered payment programs and prepaid cards are exempt.[3]

The Board proposes two alternative interchange fee standards:

- a cost-based approach with a minimum of 7 cents per transaction and an maximum (a "cap") of 12 cents per transaction
- a cap at 12 cent per transaction

As the Board notes, if enacted, the new rules would reduce interchange fees by more than 70 per cent. The Board has not yet decided how to deal with issuer's fraud prevention costs and invites interested parties to comment on this topic.

There are also two proposals with respect to network routing rules:

- requiring at least two unaffiliated networks per card
- requiring at least two unaffiliated networks per type of authorization method (PIN or signature).

[1] Federal Reserve Press Release, December 16, 2010 (http://www.federalreserve.gov/newsevents/press/bcreg/20101216a.htm).The full text of the proposal has been published in: Federal Register, Tuesday, December 28, 2010, Part II, Federal Reserve System, 12 CFR Part 235, Debit Card Interchange Fees and Routing; Proposed Rule.

[2] The Dodd-Frank Act is discussed in the June/July 2010 edition of our newsletter.

[3] Starting July 21, 2012, these two exemptions do not apply if one of the following conditions is met: "(i) A fee for an overdraft, including a shortage of funds or a transaction processed for an amount exceeding the account balance. (ii) A fee imposed by the issuer for the first withdrawal per month from an automated teller machine that is part of the issuer's designated automated teller machine network." (Sec.920 (a)(7)(B))

In both cases, merchants would have the right to select their preferred network.

The Federal Reserve Board requests comments of interested parties until February 2011. After that, it will decide on the final rules which will take effect on July 21, 2011.

The proposal has met fierce opposition of the banking industry. Bankers are lobbying the Federal Reserve and congress to soften the proposal. Moreover, one bank, TCF Financial Corp. filed a lawsuit against the part of the Dodd-Frank Act that addresses debit cards (the Durbin Amendment).[4] The courts now have to decide whether the Durbin Amendment is constitutional or not.

Our comment

The Fed has come up with the regulatory proposal that would lead to drastic cuts of interchange fees – if implemented. In both of the proposed options, there is a maximum fee of 12 per cent per transaction. This compares to the current level of 44 cents per transaction (see Table 1).

Current debit card interchange fees in the U.S.

	Sign. debit	PIN debit	Prepaid	Total
Fees ($ billion)	12.5	3.2	0.5	16.2
Fee/trx. (cent)	56	23	50	44
Fees in %	1.53	0.56	1.53	1.14

Source: see footnote 1.

Such a cap would position US interchange fee close to European fee level for intra-EU x-border transactions (maximum average rate of 0.2% for debit cards).[5] For transactions below the value of $60, the 12 cents fixed fee per transaction would translate into a percentage higher than 0.2%. For a value above $60, the US fee would be lower (see Figure 1). If the minimum value of 7 cents per transaction is used, the break-even would be $35.

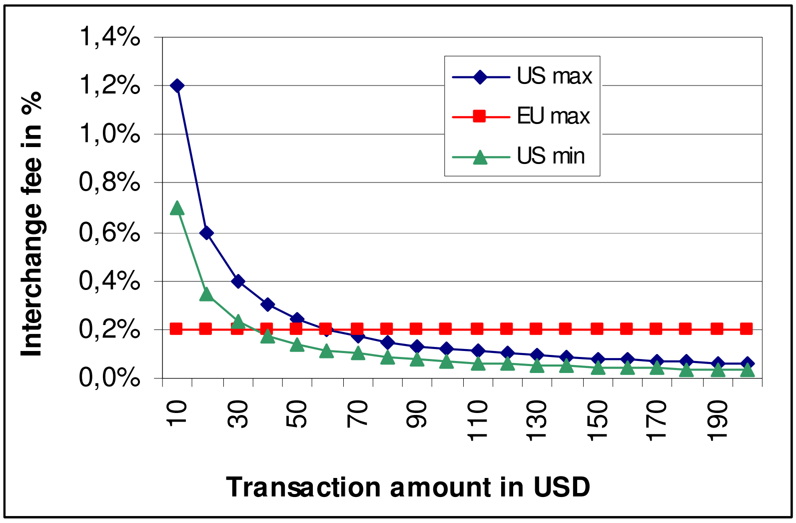
It does not come as a surprise that the financial industry is not very happy with the proposal. However, the text of the Dodd-Frank Act is very explicit and leaves little room for interpretation. It requires fees "reasonable and proportional to the cost incurred by the issuer with respect to the transaction" *and it explicitly states that "costs" should only include* "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance or settlement of a particular electronic debit transaction". Thus, the relatively low fees proposed by the Fed should not come as a surprise. There still is an open door for

[4] See: Banks Launch Multi-Pronged Assault On Debit-Interchange Restrictions, PaymentsSource, January 20, 211.

[5] See our newsletter editions of April/May 2010 and April 2009.

future rate rises, however. The Fed still has to come up with a proposal how to incorporate the costs of fraud-prevention. But current Fed estimates of these costs are not very high (an average of 1.8 cents per transactions).[6] Thus, the potential for upward revisions of the cap seems limited.

Figure 1 Debit card interchange: Comparing the EU Comm and the Fed approach



US max: Maximum of 12 cents per transaction (Federal Reserve proposal)

US min: Minimum of 7 cents per transaction (Federal Reserve proposal)

EU max: Maximum average interchange fee of 0.2% (Agreement between EU Comm and Visa / MasterCard)

From a European point of view, it is particularly interesting that the Fed chose a fixed fee per transaction rather than a percentage of the payment amount. At least when it comes to PIN debit such a fee structure seems to reflect costs much better than a percentage.

The other important point is the treatment of the topic “network selection” (or “application selection at the POS”).[7] This topic is still hotly debated in Europe and it will be interesting to see how it will eventually be regulated in the U.S. The rule proposed by the Fed consists of two elements and is very “merchant-friendly”. First, the Fed contemplates to prescribe that there should be at least two unaffiliated brands on a card. Such a rule could be described as “prescribed co-badging”. It forces issuers to put at least two competing brands on the card.

[6] See http://www.federalreserve.gov/boarddocs/meetings/2010/20101216/20101216_InterchangeFee ProposedRuleStaffMemo.pdf

[7] This controversial topic has been an evergreen in our newsletter. See topic 1 in edition 9/2010, topic 4 in edition 6-7/2010, topic 2 in edition 11//2009, topic 2 in edition 1/2009, topic 1 in edition 6/2008, topic 2 in edition 2/2008. See also Malte Krueger, On the Importance of Application Selection, Presentation at the EPSM Meeting, Frankfurt, January 26, 2010.

Second, when it comes to the selection of brands, the merchant may decide. Neither the issuer, nor the network (scheme) may inhibit merchants' decisions.

Thus, this regulation basically rules that merchants may carry out the application selection and that they must have at least two brands to choose from. Such a regulation would fundamentally alter the dynamics of the debit card market. Market power would shift from the issuing side to the acquiring side. If merchants have the choice, they will choose the cheaper brand and the more expensive brand would be hardly used. Thus, the more expensive brand would have to lower prices. Overall, there would be a fierce price competition between networks. Thus, even though the proposed interchange rule has, so far, received much more attention, the decision regarding network selection may be more important.

2. Estimating payment costs

Recently, there have been a lot of activities of government institutions collecting data on the costs of payment. The EU Commission is conducting a study of cash costs in order to set interchange rates based on the Tourist test methodology. The Eurosystem, as well, is conducting a large payment cost study. In order to come up with a cost-based price regulation, the Fed also surveyed debit card costs. The main aim of these endeavours is to provide a basis for the regulation of the payment system. Central banks and other regulators try to regulate prices and steer the behaviour of users towards the "efficient" use of payment instruments. These activities are driven by the optimistic view that cost data are, indeed, good enough to form a sound basis for regulatory action – sometimes even fairly heavy regulatory action. In the light of the before said it is not a small surprise that the Bundesbank, has cancelled its efforts to estimate payment costs in Germany on the grounds that it is impossible to get sufficiently reliable data.[8]

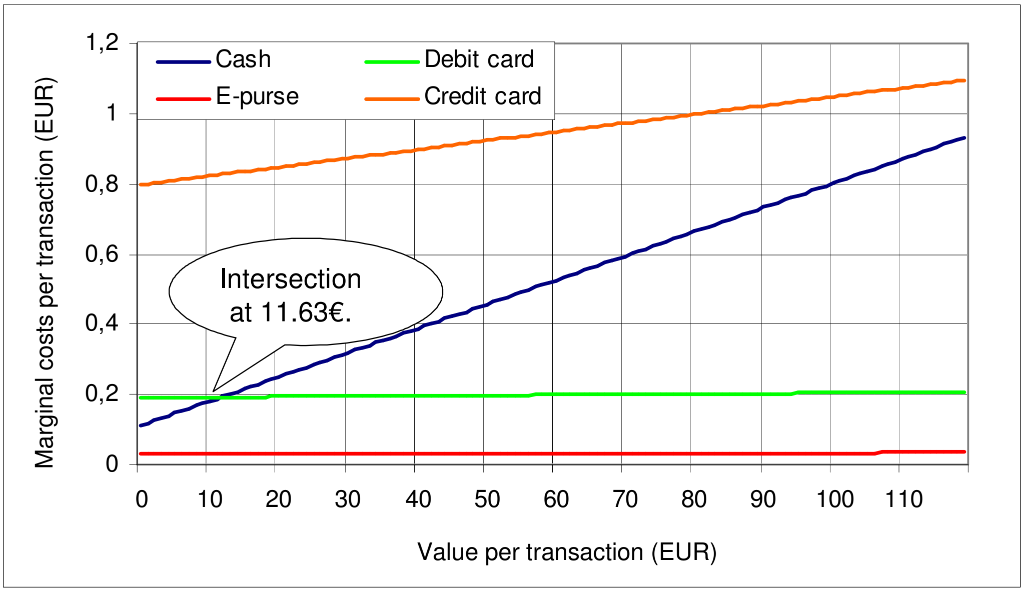
Our comment

Norway has been one of the front runners in guiding the market towards the efficient use of payment systems.[9] The Netherlands has been another. We have always been bewildered by the accuracy of the Dutch cost figures. The National Forum on the Payment System calculates marginal costs (nor just average costs) for a number of payments instruments

[8] Deutsche Bundesbank, Bundesbank stellt Beteiligung an Kostenstudie ein, Newsletter Zahlungsverkehr & Wertpapierabwicklung, 4. Ausgabe, Dezember 2010.
[9] See Norges Bank, Annual Report on Payment Systems, various issues.

(see Figure 2).[10] *Thus, it is capable to determine that up to a payment value of 11.63 EUR it is more efficient to pay with cash and for higher value it is more efficient to pay by debit card. What a precision!*

Figure 2 Payment costs in the Netherlands



Source: National Forum on the Payments System (2004)

Given the problems usually encountered when trying to estimate payment costs, the precision of these figures is striking. For instance, the supplementary information provided by the Fed in connection with its proposal for a regulation of debits cards proposal (see article above) points to such data problems. In order to prepare the current regulatory proposal, the Fed has carried out a survey of the US debit market. As it notes “most respondents provided cost data at an aggregate level, but some were unable to provide cost data at the level of granularity requested in the surveys. In addition, there were inconsistencies in some data that were reported within individual responses and across responses. Therefore, each of the summary statistics reported below may be based on a subset of the responses received for each of the three surveys”.[11] *This points to a problem that is encountered by anyone regularly dealing with payment data: missing data and poor quality of data. Given these problems, the Bundesbank seems to have decided that it is better to have no data at all than*

[10] See: National Forum on the Payments System (2004): The Costs of Payments. Survey on the Costs Involved in POS Payment Products, Working Group on Costs of POS Payment Products, March 2004.
[11] See Federal Register, Tuesday, December 28, 2010, Part II, Federal Reserve System, 12 CFR Part 235, Debit Card Interchange Fees and Routing; Proposed Rule, 81725.

to have bad and possibly misleading data. The interesting questions is: Do the other payment data collectors have better cost data or are they simply more confident (maybe over-confident)? 10 years of experience collecting market data on the German card market and benchmarking studies in the fields of credit card issuing and acquiring have taught us to be sceptical when it comes to payment data.

In order to substantiate its regulation of interchange fees, the EU Commission plans to conduct a cost study covering payment costs of merchants (as input for the "Tourist test").[12] If it is already difficult to estimate banks' payment costs, it will be interesting to see whether merchants can come up with better figures.

3. French banks oppose proposed end-date regulation

The proposed end-date regulation of the EU Commission[13] (published December 22, 2010) meets stiff resistance. The French Banking Federation (FBF) opposes core elements of the proposal.[14]

The FBF criticises the use of a "technical annex" rather than a clear commitment for SCT and SDD ("*Certain details which had already been defined are now called into question.*") and is unhappy with the power of the EU Commission to amend the technical annex (Exercise of delegated powers, Art. 12). Last but not least, the French banks, once again, demand an interchange fee for direct debits.

Our comment:

Given anti-trust concerns the EU Commission has not proposed to mandate EPC schemes outright but rather has defined technical criteria that SEPA products have to apply. However, such an approach seems to make no one happy. It does not really allow competition of schemes since the criteria are closely following the rule books of SCT and SDD) and it does not provide complete certainty for market players.

The critique of the French banks also points, once again, to the problem that it may still be too early to impose a common business model on the European payment landscape. In some countries direct debit has functioned well without interchange. But this does not

[12] A first study was commissioned in 2008.

[13] A preliminary assessment of the proposal can be found in the December 2010 edition of this newsletter.

[14] The French Banking Federation (FBF) asks for an interchange mechanism for the development of SEPA direct debit, FBF Press release, January 14, 2011.

necessarily mean that it will do so also in other countries. As the Blue Book figures demonstrate, year after year, payment use of particular instruments differs significantly between countries. The different attitudes, incomes and institutions that may explain such differences may also call for different pricing models.

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