REMAPPING DEBATE
Asking "Why" and "Why Not"

To comply or to defy

Original Reporting | By James Gardner | Banking

March 23, 2011 — In its first major effort to roll back part of last year's Dodd-Frank financial-reform law, the banking industry is going after that statute's attempt to sharply reduce the so-called interchange or "swipe" fees that banks collect with every debit-card purchase.

> "The government shouldn't be in the business of setting prices, and they especially shouldn't be in the business of setting prices between two businesses," Charles Kim, the chief financial officer of Commerce Bank of Missouri told Remapping Debate, echoing the view of many of his industry peers.

The swipe-fee provision, originally an amendment championed by Senator (and majority whip) Richard Durbin (D-IL), ended up as one of the few provisions of Dodd-Frank actually to threaten an important banking-industry revenue stream. Swipe fees, which now average 44 cents per transaction, would be capped at 12 cents under a draft rule developed by the Federal Reserve to carry out the law's requirement that fees be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." The final rule is expected next month.

If the Fed sticks with its proposed cap (and if the Durbin amendment stands), banks could lose some $11 billion of the estimated $16 billion in swipe fees that they currently receive from America's retailers, according to The Nilson Report, a trade journal that covers the industry. (JP MorganChase alone could see its fees cut by roughly $1 billion a year.)

Last week, eight senators launched an effort to impose a two-year freeze on implementing the amendment. The Senators, like the banks, paint a picture of growing remorse — of policymakers and others belatedly waking up to the perils of a measure that was "hastily enacted" without due consideration of "the complexity of the entire system and how it's all woven in together," as Nessa Feddis, senior counsel of the American Bankers Association, said in a phone interview. Introducing the freeze proposal last week, Sen. Jon Tester (D-MT) issued a statement stressing the need for more time to study the "impact on consumers, credit unions, community banks, and the small businesses and jobs they sustain."

Most of the objections being raised now, however, are the same ones aired when the amendment was unexpectedly approved by the Senate last May. And the firepower for the resistance is coming mainly from the banking industry, which has taken a hard line all along.

Durbin and the retailer and consumer groups supporting his amendment had hoped to prod the industry into some fundamental rethinking of its debit-card practices; in particular, they were trying to convince the banks and card companies to deemphasize types of cards and transactions associated with higher rates of fraud. Rather than use the intervening months to make major changes, however, banks have largely declined to move away from riskier “signature” (as opposed to PIN) debit transactions, and they have continued not only to dispute evidence of anti-competitive pricing, but to insist that there is no way for them to adapt to a world of lower fees except at a heavy cost to their own interests and those of some of their customers.

Shot across the bow

Defending the fairness of the current fees, the banks portray them as an inseparable part of the way they finance a broad range of account services, so that, as Feddis put it, if “you push down one place, it comes out somewhere else.” To compensate for the lost revenue, Feddis and others warn, banks will have no choice but to raise customer charges, reduce services, or both — especially for the non-affluent account-holders whose balances don’t generate enough income to cover the banks’ costs.

In what could be seen as a shot across the bow of political and public opinion, Chase last week floated the idea of a $50 cap on debit transactions, while experimentally hiking ATM withdrawal fees for non-customers to $4 in Texas and $5 in Illinois. “The banks are clearly using scare tactics, painting a worst-case scenario, “ said Ed Mierzwinski, consumer program director of the Public Interest Research Group, which supports the Durbin amendment.

Card-company takeover

Debit cards arose in the early 1980s as a spinoff of the ATM technology that banks had deployed in order to cut down on customer waiting time and teller and back-office expenses. The first cards were issued directly by banks, with cooperating retailers paying little or nothing for the ability to accept them. Interchange fees entered the picture only when Visa and MasterCard (then organized as non-profit bank consortiums, now as profit-making companies in their own right) moved in with nationwide debit-transaction clearance networks that piggy-backed on their credit-card infrastructure, know-how, and brand-name credibility.

It is the card companies that set the fees on the banks’ behalf; and it was the card companies that came up with the idea of signature debit as a way to appeal to businesses that had grown accustomed to credit cards but were initially reluctant to pay for PIN-reading machines. Today, while PIN-debit predominates across Europe, U.S. banks remain committed to — and, in many cases, actively promote —

the signature alternative, which makes a lost or stolen card far easier to use but generates higher swipe fees, besides being more likely to trigger overdraft charges because of the delay between purchase and bank verification (see sidebar).

Other ways to do business?

With the deadline for a final Fed rule looming, the banks say the Fed's tentative fee cap makes no allowance for the need to invest in debit-card innovation. But retailers and consumer groups assert that Visa and MasterCard, having achieved market dominance through what Mierzwinski calls "anti-competitive practices," aren't properly motivated to innovate. "They're complaining about [fraud], but they never fixed the problem."

The amendment creates "tremendous potential for innovation" — higher fees are "just one way the banks could respond," Mierzwinski said in a phone interview. If banks were thinking seriously about how to comply, he went on, they would seize the opportunity to follow Europe's lead by discouraging the signature transactions responsible for much of the fraud that the banks cite as a core argument for keeping fees at or near their current levels.

The banks reject that claim, which Feddis called "shortsighted." Fraud is "always changing," she said. If the industry committed itself to a more PIN-centric system, which it has not yet done, "the fraudsters [would] have a heads-up." They would know that "this is where you need to focus." Nevertheless, Feddis did acknowledge that, so far, PIN-debit has been less susceptible to fraud.

PIN VERSUS "SIGNATURE" DEBITS

There are two ways to make a debit-card purchase: by entering a personal identification number (or PIN) or by signing a receipt as you do with a credit card. The latter type of transaction, known as "signature debit," is possible only with cards that carry the Visa or MasterCard logo, as do most cards nowadays. Signature transactions are also known in the trade as "offline," because the retailer does not immediately verify them with your bank. That process, which can take up to 48 hours (depending on the retailers' habits) is part of what makes them riskier.

PIN debit transactions have been significantly safer up to now. That is because, in the first place, they call for a piece of information that (unlike a signature or the security code often used in e-commerce) cannot be found on the card itself. PIN transactions are known as "online" transactions, because verification occurs right away, which also cuts down on the risk. (The terms "offline" and "online" have nothing to do with the Internet. Europe has developed PIN systems for e-commerce; the U.S. is just beginning to do so.)

Some U.S. banks promote debit cards that are signature-only. A small fraction of debit cards, which don't carry the Visa or MasterCard logo, are PIN-only.

PIN transactions generally involve a smaller swipe fee than do signature transactions; and the swipe fee for a signature debit purchase is lower than for a credit-card purchase.

"Let's step back for a second," said David Balto, a Washington antitrust lawyer and former policy director for the Federal Trade Commission. At least a dozen countries in addition to the twenty-seven that comprise the European Union have decided to regulate interchange fees, “and what you see is… greater innovation abroad than there is the United States,” Balto said. A number of countries, he added, “have no interchange fees at all.” They include New Zealand, Iceland, Finland, Norway, Denmark, the Netherlands, and Canada, which make up “seven of the eight nations [the eighth is Sweden] with the highest per-capita use of debit cards.”

Market forces or captive market?

The two sides hold utterly opposing views of the Durbin amendment. Bankers portray it as an effort to substitute “government price controls” for market pricing. “The government shouldn’t be in the business of setting prices, and they especially shouldn’t be in the business of setting prices between two businesses,” Charles Kim, the chief financial officer of Commerce Bank of Missouri told Remapping Debate, echoing the view of many of his industry peers.

> Swipe fees have risen or remained flat despite huge increases in transaction volume, said a representative of retailers, and despite trends that have seen “the price of computers and computing power and telephones and everything else keep going down.”

By contrast, retailers and their allies see an attempt to correct a market in which prices are already fixed by the banks and the card networks. In this view, it is the card networks — acting on bank’s behalf — that decide where within a complex pricing matrix to place each merchant and transaction.

Despite that alleged pricing control, the banks insist that normal market forces are operating: retailers “have the absolute ability to influence the interchange fee,” Feddis said, pointing out that, for starters, retailers “don’t have to take cards, and many don’t.”

That form of leverage generally “doesn’t pass the laugh test in the modern economy,” J. Craig Shearman, a spokesperson for the National Retailers Federation, responded. Most substantial retailers, he explained, would have trouble staying in business if they adopted a no-card policy.

Signs of duopoly?

Like several of the bank lobbyists interviewed by Remapping Debate, Shearman pointed out that supermarkets, after a long period of resistance to debit and credit cards alike, managed to secure preferential rates, with Visa offering a 35-cent ceiling on swipe fees for supermarket PIN purchases. But while the banks cite that story as evidence of retailers’ power to negotiate, Shearman sees it as a historical anecdote about a bygone era when the banks and card companies were working feverishly to bring more merchants into the system.

"I'm sure at the time there may have been some give-and-take to get into a range that was acceptable," he said. "They did the same thing with the restaurant industry. But once they have gotten into that range, that's it — they set the rates, and you take them or leave them… It's kind of like — I know this is a little over the top," he said, "but drug dealers: what do they do? They give the stuff away to young kids and to people who aren't customers yet, and then they start charging."

The card networks were "acting as a duopoly…setting rates [averaging between 1.5 and 2 percent of the dollar value of a transaction in recent years] that were non-negotiable and until very recently — and still largely — nontransparent," Mierzwinski said. The proof of something amiss, he and others on the retailer side argue, can be found in the simple fact that swipe fees have risen or remained flat despite huge increases in transaction volume, and despite trends that have seen "the price of computers and computing power and telephones and everything else keep going down."

Congress, in its legislation, and the Fed, in its planned implementation, have taken an unrealistically narrow view of the costs of debit transactions, bank lobbyists argue.

But this is another argument that the banks dismiss. Electronic payment networks don't benefit from the same economies of scale as "manufacturer of widgets," Jason Kratovil, a lobbyist for the Independent Community Bankers Association, said in a phone interview. "You could make the argument that if anything, interchange should be significantly higher than it is today," he said, "because issuers are bearing a dramatically higher amount of risk exposure than they were when debit cards were new and fewer consumers were exposed to them." On further questioning, Kratovil conceded that more transactions don't add up to more per-transaction risk. Greater volume, he was saying, means only greater aggregate risk (and presumably greater aggregate benefit, though Kratovil did not mention it).

Will the banks be unfairly forced to bear too much cost?

Congress, in its legislation, and the Fed, in its planned implementation, have taken an unrealistically narrow view of the costs of debit transactions, bank lobbyists argue. They fault the Fed for not considering the need for a return on investment and for funds to plow back into research and development. That point is echoed by several consumer and civil rights groups that have recently joined in calling for at least a brief period of further study.

Some supporters of the amendment agree that the Fed might be justified in raising the fee cap by a few pennies. The banks, however, have not come forward with any data about actual costs and revenues to support their arguments for either a freeze in implementation or a modification of the draft Fed rule. Remapping Debate was unable to find an industry representative willing to say just how the Fed ought to go about calculating debit-transaction costs.

Bank lobbyists do say that if debit cards fail to generate enough income to cover their costs, banks will have to subsidize them by other means. Feddis, having made that point, added that every bank operation ought to be profitable in its own right as "a matter of general economic theory."

Many things don't pay for themselves, Balto countered. "I think the banks have an incorrect notion of what the costs are," he said. "I mean, what we're talking about is access to the consumer's own account. We're not talking about some grandiose benefit that they're providing; they're just providing access to the account that the consumer possesses. By having debit cards, that means they're not writing checks, which are far more expensive than debit cards, and so debit cards result in substantial savings for banks. I don't think that fact should be lost."

> Most of the objections being raised now are the same ones aired by the banks when the amendment was unexpectedly approved by the Senate last May.

Remapping Debate asked Feddis about instances in which existing pubic policy arguably calls on banks to do things for reasons other than pure profit: the Community Reinvestment Act, for example, asks them to serve low- and moderate-income neighborhoods. Wouldn't such services normally be less profitable than bank operations in more well-off areas? Arguing that community development advocates have never demanded that banks engage in unprofitable activities, Feddis went on to dispute the premise of the question. "I don't know whether branches in low-income areas are more or less profitable," she said.

In the end, Kratovil, Feddis, and others in the banking camp fall back on the argument that merchants are trying to duck their share of the expense of a system that benefits them in multiple ways. Over the past half-decade, McDonald's, Burger King, and most of the other giants of fast food have embraced debit and credit cards, the Commerce Bank CFO, Charles Kim, pointed out. "Those restaurants were doing just fine," Kim said. "They could have continued to do just fine; but they made a choice. They said, 'We want to pay to install the machines and to allow debit to be accepted in our restaurants.'" They did so, according Kim, because businesses that decide to accept debit and credit cards "find that their average ticket on a food purchase goes up, their lines move faster, and they have less cash-handling" and employee theft.

Lower swipe fees will be a "windfall" for retailers, the banks say. (Visa and MasterCard, despite their huge stake in this battle, have remained largely behind the scenes.) But why are the banks pushing back so hard? They are battling against the Durbin amendment, Feddis said, for "the same reason" that the merchants are battling for it: there's a lot of money at stake.