VIA E-MAIL TRANSMISSION

regcomments@federalreserve.gov

Ms. Jennifer J. Johnson, Secretary February 22, 2011

Board of Governors of the

Federal Reserve System

20th Street and Constitution Avenue, NW

Washington, DC 20551

Re: Debit Card Interchange Fees and Routing

Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson:

As non-profit public interest groups that support consumer choice and competition and oppose price controls in any sector of the economy, we are pleased to respond to the Federal Reserve Board's (Fed) proposed rules regarding debit card interchange fees and routing.

We understand that section 1075 – also known as the Durbin Amendment – of the Dodd-Frank Wall Street Reform and Consumer Protection Act imposes a nine-month deadline for implementation. We believe, however, that slightly missing a deadline is less consequential than rushing through a regulation that unnecessarily burdens banks, credit unions, and, most importantly, consumers, and that will even be detrimental in the long run to the retailers poised to reap short-term benefits.

Although the statute itself is flawed, the Fed in its proposed rule has gone beyond what the law requires in an **arbitrary and capricious manner** that, as noted in comments by the Illinois Credit Union League[1], will likely not survive legal scrutiny under the parameters set out by the Supreme Court in *Chevron v. Natural Resources Defense Council,* 467 U.S. 837 (1984). Among other reasons, the rule is arbitrary and capricious because in interpreting the language of the law, it disregards standard regulatory interpretations of the word "reasonable" in setting prices – which not only encompass cost but a rate of return -- and disregards the standard economic definitions of "incremental cost" -- which include a business' fixed costs.

As a result, the proposed rule creates an unprecedented price control scheme that not only outlaws profit, but forces pricing below cost. It sets a firm price cap of 12 cents per transaction, reducing interchange revenue for banks and credit unions by as much as 90 percent. If the rule goes through, the results would not only be a substantial reduction in investment and innovation in payment card technologies that benefit both retailers and consumers, but a massive shifting of the costs of debit card transaction from some of the nation's wealthiest retailers to middle- and lower-income consumers. Media reports already indicate that banks are eliminating free checking and requiring customers to maintain much higher balances to avoid such a fee.[2] Given the experience of other nations with interchange caps, such as Australia, the imposition of other fees and reduction of payment card rewards are likely on the horizon if the rule goes through.[3]

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[1] Available at http://www.federalreserve.gov/SECRS/2011/February/20110214/R-1404/R-1404_021111_65537_571534914598_1.pdf

[2] See, for instance, "Survey: Fed Debit Card Rule Will Harm Community Bank Customers," Benzinga.com, Feb.15, 2011
available at http://www.benzinga.com/press-releases/11/02/p862794/survey-fed-debit-card-rule-will-harm-community-bank-customers

[3] Australia's experience, and the fact that consumers experience no document decrease in retail prices, is describe in Government Accountability Offi ce (GAO), "Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges," November 2009. http://www.gao.gov/new.items/d1045.pdf. Also summarized in John Berlau and Ryan Radia, "Payment Cards Uner Assault, *Competitive Enterprise Institute Issue Analysis*, December 2009, http://cei.org/cei_files/fm/active/0/John%20Berlau%20and%20Ryan%20Radia%20-%20Payment%20Card%20Networks%20Under%20Assault.pdf

Furthermore, the rule as applied -- if not the law itself as contended in the pending lawsuit from TCF National Bank[4] -- deprives debit card issuers of their property rights to a return on investment **in violation of the Due Process and Takings clauses of the Fifth Amendment of the U.S. Constitution**.

It is our hope that the Fed will give full consideration to our explanation of why:

The Fed's proposed rule on interchange fees is arbitrary and capricious and, as applied, unconstitutional

Introduction: Collectively, our organizations have decades of experience educating, advocating and litigating on behalf consumers, entrepreneurs, investors and seniors.

The **Competitive Enterprise Institute** is a national non-profit public policy organization dedicated to advancing the principles of limited government, free enterprise, and individual liberty. Founded in 1984, CEI has grown into an effective advocate for freedom on a wide range of critical policy issues, including energy, environment, business and finance, technology, telecommunications, and food and drug regulation.

CEI also pursues public-interest litigation on behalf of consumers and small businesses to ensure that federal agencies follow the requirements of the underlying laws and, when applicable, the Administrative Procedures Act, and that agencies act within the constraints of the U.S. Constitution. In 2010, CEI counsel and other attorneys garnered a Supreme Court victory in *Free Enterprise Fund v. Public Company Accounting Oversight Board*, in which the court found organization of the board in violation of the Constitution's "separation of powers" and made the board's members subject to at-will removal by the President's officers.

Founded in 1992, the **60 Plus Association** is a non-partisan seniors advocacy group with a free enterprise, less government, less taxes approach as well as a strict adherence to the Constitution**.** 60 Plus has set ending the federal estate tax and saving Social Security for the young as its top

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[4] The complaint in *TCF National Bank v. Bernanke* is available at https://docs.google.com/fileview?id=0B_ShETZYawQENjJkNGNjZGYtZTM5YS00ZDM2LWJhOWUtY2NmYWFjZTYxMjY4&hl=en

priorities. 60 Plus has been called, "an increasingly influential senior citizen's group" which calls on support from over 7 million activists.

The **Minnesota Free Market Institute** is a non-partisan, non-profit educational organization dedicated to the principles of individual sovereignty, private property and the rule of law. It advocates for policies that limit government involvement in individual affairs and promote competition and consumer choice in a free market environment. It conducts research, publishes studies and reports and conducts public forums to involve Minnesotans in free market reforms enhancing the quality of life for all citizens of the state.

The institute is very concerned that about the impact the proposed rule – which would slash interchange revenue for financial institutions by as much as 90 percent – would have on regional banks such as TCF as well as on the state's community banks and credit unions that are technically subject to the exemptions but would still suffer due to the rule's effects on payment card networks.

Americans for Tax Reform (ATR) is a non-profit taxpayer advocacy group that promotes individual liberty and free-market public policy. In support of these goals, ATR opposes heavy regulation and taxation of financial services. ATR was founded at the request of President Ronald Reagan in 1985.

"Legislative intent" means the intent of *all* members who voted for Dodd-Frank, not just the sponsor or supporters of the Durbin Amendment.

In drafting the rules, the Fed seems to have been unduly swayed by beneficiaries of this rule such as retailer trade associations that argue for "debit at par," meaning that retailers should have to pay very little if any of the costs for processing debit card transactions. The Fed has interpreted ambiguous language, as well as misinterpreting clear language, in the law to preclude consideration of fixed costs and even many variable costs in setting the interchange fee price caps.

If this is being done to fulfill what the Fed believes to be "legislative intent," this is a mistaken way to discern such intent. Legislative intent represents the intent of *every* legislator who voted for the underlying legislation.

The language of the Durbin Amendment is ambiguous, but to a great extent this ambiguity expresses Congress' will. If the strongest proponents and beneficiaries of this measure had submitted language making explicit their desire for such wholesale cost-shifting retailers to consumers, the Senate would likely not have approved the amendment, or it likely would have been stripped from the conference report.

In the case of Dodd-Frank, the U.S. House of Representatives never approved a measure similar to the Durbin Amendment, and only signed on to the Senate measure after it was included in a House-Senate conference report. In addition, 131 members of the House signed a letter[5] to the conferees asking for the removal of the Durbin Amendment, citing the concerns about cost-shifting from retailers to consumers that could result. The letter was signed by more than 70 House Democrats, most of whom voted for the final legislation despite their reservations about this amendment. It is difficult to argue that these members' "intent" is reflected by a Fed rule that goes even further than the statute calls for in shifting costs from retailers to consumers.

Furthermore, as the Fed knows from correspondence[6] it has received, even some Senators who voted for the Durbin Amendment believe the measure allows and even requires the Fed to consider an issuer's fixed costs in setting the standards. In December, then-House Financial Services Committee Chairman Barney Frank wrote to the Fed with his concerns about "unintended consequences for consumer choice" if the rule was not "properly crafted."[7]

Unfortunately, the rule was far from properly crafted and, if it goes through, the worst fears of Frank and other for consumers, community banks and credit unions will come true. We urge the Fed to not go one step beyond what the plain language of the Durbin Amendment, or section 1075, requires.

[5] Available at http://wassermanschultz.house.gov/2010/06/interchange-letter.shtml
[66] Description of letter available at http://www.extracreditcards.com/news/2010december/senatorssendltrto.htm
[7] Letter available at http://federalreserve.gov/SECRS/2011/January/20110107/R-1404/R-1404_122110_59562_558263796213_1.pdf

“Reasonable” should mean covering costs, plus a rate of return. All cost of a “particular transaction” should be considered, including fixed costs

As written, Section 1075 requires the Fed to “establish standards for assessing” whether an interchange fee “is reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”

As the Illinois Credit Union League notes it its comments, “’Reasonable and proportional’ is undefined; this is a statutory gap.” Under the Supreme Court’s instructions in *Chevron,* when there is a “statutory gap,” it is not an obligation of an administrative agency to hazard a guess as to what the bill’s sponsor or biggest proponents had in mind. It is, however, the obligation of the agency under *Chevron* not to interpret the undefined terms in a manner that is “arbitrary” or “capricious.” We agree with the League that “as proposed, the regulations are arbitrary [and] capricious”

The Fed, for instance, *arbitrarily* disregards traditional definitions of “reasonable” from financial literature and even other regulations. Financial observers have remarked that on its face, “reasonable and proportional” does not seem to require price controls that outlaw profit. Writing in the Columbia Journalism Review in response to a critique of the Durbin Amendment published before the Fed issued its proposed rule, columnist Ryan Chittum argued, “’Reasonable and proportional’ fees means ‘basically outlawing profit.’ I don’t think so.”[8]

In its discussion of the proposed rule the Fed notes in Footnote 44 that even in statutes governing utilities, considered to be “natural monopolies” with the advantage of a lack of competition, a “reasonable rate” usually means that the public utility be able to “compensate its investors for the risk assumed.” Yet for competing debit card issuers, the Fed is *arbitrarily* interpreting “reasonable” to mean that a firm cannot make a profit, cannot cover its fixed costs, and cannot even cover many variable costs.

The Fed also cites language in Section 1075 such as “incremental cost” and cost of a “particular transaction,” to establish price controls that force issuers to price below cost, without consideration of fixed costs or even variable costs not specified by the law. But such phrasing should not lead the Fed to such a draconian result. The Fed notes that a common economic definition of “incremental cost” includes fixed costs as part of the costs of per transaction. This is

[8] Ryan Chittum, “Leave It to the WSJ Op-Ed Page,” *Columbia Journalism Review*, Oct. 26. 2010, available at http://www.cjr.org/economic_crisis/leave_it_to_the_wsj_op-ed_page.php

also common sense, because a business – be it a retailer or a bank – would likely not engage in many "particular transactions" if such transactions could not help defray operational costs such as that of renting or owning space in a building. But once again, the Fed ***arbitrarily*** disregards this standard definition to produce a result that is more harmful than necessary to banks, credit unions, and consumers.

The Fed also should not be bound to disregard an issuer's costs due to the statute's mandate to consider the "functional similarity between electronic debit transactions and checking transactions." Such a consideration must also encompass the differences between debit cards and checks, including the costs for merchants of bounced check that debit cards relieve and the convenience of debit cards that translate into increased sales.

In addition to being arbitrary and capricious, the proposed rule likely violates both the Due Process and Takings Clauses of the 5th Amendment because it deprives banks and credit unions that issue cards of their property rights to a return on capital invested. The Supreme Court case *Duquesne Light v. Barasch*, 488 U.S. 289 (1989), affirmed 8-1 that a government-set "rate is too low if it is so unjust as to destroy the value of the property for all the purposes for which it was acquired."

The Fed cites *Duquesne*, but asserts that this case is different because "the interchange fee standard would not limit the ability of an issuer to earn revenue from other sources, such as by charging fees to its cardholders." In addition to this rationalization being yet more evidence of how the proposed rule is arbitrary and capricious in enabling a massive cost-shifting to consumers, it also likely will not survive constitutional muster by the courts. As Justice Oliver Wendell Holmes stated in *Brooks-Scanlon Co. v. Railroad Commission*, 251 U.S. 396 -- a precedent that has been cited in many modern federal court cases involving rate regulation[9], a firm "cannot be compelled to carry on even a branch of business at a loss … for the benefit of others who do not care to pay for it."

Conclusion:

For sound public policy and constitutional reason, American banks, credit unions, and particularly consumers should not be forced to pay the full costs of a sophisticated electronic payment transaction system for retailers who, in Justice Holmes's phrasing, "do not wish to pay for it." American families and seniors face enough rough economic waters without losing their

[9] See, for instance, *Michigan Bell Telephone v. Engler*, 257 F.3d. 587 (6th Cir. 2001)

free checking, and financial institutions should not be forced to lose capital they could be lending and investing to keep the economy growing. We recognize that retailers, like all businesses, are faced with excessive levels of taxation and regulation, but that does not give them the right to use the instrument of the state to victimize their customers and financial suppliers. We urge the Fed to go back to the drawing board, and craft a rule that does no unnecessary harm.

Sincerely,

John Berlau

Director, Center for Investors and Entrepreneurs

Competitive Enterprise Institute

jberlau@cei.org

Kim Crocket

President and General Counsel

The Minnesota Free Market Institute

kimc@mnfreemarketinstitute.org

Grover Norquist

President

Americans for Tax Reform

kcobb@atr.org

James Martin

Chairman

60 Plus Association

jmartin@60plus.org

CEI

60 PLUS

Minnesota FREE MARKET INSTITUTE

AMERICANS for TAX REFORM ATR