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The Durbin Amendment: Consumer Payment Network Interchange Fees and Rules

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act") is landmark legislation that represents the most profound restructuring of financial regulation since the Great Depression. With the primary goal to "restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them," the Dodd-Frank Act will have broad impact on the financial services industry for years to come.

Born out of the financial crisis that erupted in early 2008, the Dodd-Frank Act, composed of a series of new laws, is, in the aggregate, breathtaking in its scope. Highlights of the law include: 1) creation of the Bureau of Consumer Financial Protection, a new independent consumer watchdog agency housed with the Federal Reserve Board ("Board"), 2) the U.S. Department of Treasury, FDIC and the Board are granted broad new powers to seize, close and wind down "too big to fail" financial (including non-bank) institutions in an orderly fashion, 3) establishes a new Financial Stability Oversight Council, charged with identifying and responding to emerging risks throughout the financial system, composed primarily of federal financial services regulators and chaired by the Treasury Department, 4) restructures the federal regulatory jurisdiction over banks and their parent companies, and abolishes the Office of Thrift Supervision, 5) adopts new federal oversight of the insurance industry, 6) adopts new standards and rules for the mortgage business, 7) adopts new bank, thrift and holding company regulation, 8) adopts new federal regulation of the derivatives market, 9) adopts the so-called Volcker rule, substantially restricting proprietary trading by depository institutions, 10) imposes requirements for "funeral plans" by large, complex financial companies, 11) establishes new regulation of the securitization market through "skin in the game" and enhanced disclosure requirements, 12) establishes new regulation of interchange fees, 13) establishes new and enhanced compensation and corporate governance oversight for the financial services industry, 14) enhanced oversight of municipal securities, 15) provides a specific framework for payment, clearing and settlement regulation, 16) new federal hedge fund regulation, 17) new fiduciary duties and regulation of broker dealers, investment companies and investment advisors, 18) tasks the federal banking agencies with adopting new and enhanced capital standards for all depository institutions, 19) significantly narrows the scope of federal preemption for national banks and federal thrifts, and 20) places a moratorium on ownership of industrial loan banks by non-financial companies.

Furthermore, the Dodd-Frank Act provides broad and substantial delegations to various federal agencies to implement its many provisions through regulation. Hundreds of new federal regulations

addressing all of the major areas of the new law will be required, ensuring that federal rules and policies in this area will be further developing for years to come.

The Dodd-Frank Act profoundly impacts all major segments of the financial services industry, including 1) banks, 2) thrifts, 3) bank, financial savings with loan holding companies, 4) mortgage lenders, 5) insurance companies, 6) industrial loan companies and their parent companies, 7) investment mortgage and broker-dealer and investment advisor firms, and 8) hedge funds and private equity funds.

This *StayCurrent* bulletin addresses the impacts on payment card issuers and networks from the Dodd-Frank Act's provisions for regulation of interchange fees and other fees that financial institutions charge or pass on to retailers in connection with the acceptance of payment cards. Other provisions also prohibit certain network rules relating to merchants' debit and credit card acceptance practices.

Background

Entitled "Reasonable Fees and Rules for Payment Card Transactions[1]," these provisions of the Dodd-Frank Act, called informally the "Durbin Amendments," give the Federal Reserve Board (the "Board") authority to regulate major elements of the prices charged to retailers for debit card and reloadable general-use gift card acceptance. The Durbin Amendment specifically targets "interchange fees" that are set by payment networks and passed on to the card issuing financial institutions and also network fees, which are retained by the networks. Technically, these fees are charged by the networks to the financial institution that contracts with retailers (the "acquirer") for acceptance of the network's branded cards, but in practice, these fees are passed on to the retailers as a substantial portion of the fees charged by the acquirers for card acceptance. The acquirers may "bundle" the interchange and network fees with their own charges in their total price to the retailer or may explicitly pass the network and interchange fees to the retailer in addition to their own charges. The legislation does not mandate a specific price for interchange fees. Instead, it mandates price regulation by the Board, which now must determine a "reasonable and proportional" price in relation to certain costs incurred in delivering debit card transactions to the retailers. Regulation of network fees is limited to ensuring that network fees are not used to complement interchange fees in compensating issuers for transactions.

This legislation may be better understood with some explanation of the complex structure of the consumer payments industry. There are essentially two distinct business models by which card based payments, both credit and debit, are provided to cardholders. In one model, sometimes called the "monolithic" model, a single company, such as American Express, Discover Card Services and JCB among others, both issues cards to consumers and contracts directly with retailers (called "merchants" in the payments industry) to accept the cards. In that model, the issuer of the card directly determines its fees that will be charged to each merchant. These card issuers typically issue credit cards rather than debit cards because they do not hold consumer deposit accounts. However, they may issue general-use prepaid cards that could fall under the regulations. They might also license financial institutions to issue debit cards or reloadable prepaid cards carrying their brands to access their merchant acceptance networks. Alternatively in the "association" [2] model, typified by card networks such as MasterCard and Visa, cards are not issued by the network directly to consumers but instead are issued by thousands of financial institutions that are licensees of the networks. These institutions may issue both credit and debit cards, the latter accessing the consumer's asset accounts held by the institution. Merchants accepting these cards also contract with the acquirer financial institutions, which may be the same or different institutions than those that issue cards. (Financial institutions may perform either or both functions in the association model.) In this context, a MasterCard or Visa transaction involves five parties: 1) the consumer cardholder; 2) the card-issuing institution; 3) the network; 4) the acquirer institution that contracts with the merchant; and 5) the merchant. [3]

In the association model, the networks face "two-sided" competition, in that they compete for card issuance by the issuing institutions and also they compete for consumer usage of the cards, which includes competition for merchant acceptance as well as consumer choice. The financial institutions that issue cards may issue either or both MasterCard and/or Visa debit cards and some institutions also may have the opportunity to issue American Express cards. A very important, perhaps the most important, element of competition among networks for card issuers' brand decisions is the interchange fee rate, which comprises a large element of the issuing institutions' revenues.[4] This is particularly true for debit cards for which the issuer has little if any opportunity to charge interest to the consumer, since interest would only be charged if the underlying deposit account is in an "overdraft" condition. This competition puts pressure on the networks to increase interchange fees to attract issuers. Small differences in interchange fee rates between brands result in very large revenue differences and are often persuasive in issuers' brand choices. Unlike in the credit card market, where consumers may carry several credit cards obtained from different issuers, it is more typical for a consumer to carry only one debit card, because typically they access only one deposit account for purchases. Increasingly however, consumers may also carry prepaid cards that are not directly linked to deposit accounts. MasterCard and Visa branded prepaid cards are accepted where their respective debit cards are accepted and the acceptance charges are generally the same as for traditional signature debit cards.[5] These prepaid cards are called "general-use" cards in the Act because they may be used for purchases from many unrelated retailers (as well as for cash from ATMs in some cases). The network branded cards prepaid cards may be either "loaded" with funds only once or reloadable prepaid cards which can be loaded several times. Examples of the latter include payroll cards and healthcare cards, as well as reloadable prepaid cards that consumers buy from retailers selling the cards which access prepaid funds held by a financial institution. On the merchant side, the networks compete for merchant acceptance, frequently entering into agreements with some large merchants to provide financial incentives to promote card acceptance.[6] The Durbin Amendment provisions apply to both signature and PIN-based debit cards and to general-use gift cards, but not initially to payroll cards and other reloadable prepaid cards that are not marketed as gift cards.[7] In addition to MasterCard and Visa debit cards, the Amendment would apply to American Express brand (and other brands) debit cards and any brand of general-use prepaid cards issued by an issuer with over $10 billion in assets.[8]

Besides requiring fee regulation, the Durbin Amendment also addresses certain rules imposed by the networks on retailers' card acceptance practices.

Discussion

Section 1075 of the Dodd-Frank Act, amends the Electronic Fund Transfer Act[9] by adding a new Section 920, entitled Reasonable Fees and Rules for Payment Card Transactions.

Regulation of Debit and General-use Prepaid Card Transaction Fees

The primary thrust of the Durbin Amendment is to regulate fees charged retailers for acceptance of debit and general-use prepaid cards[10] representing interchange fees, i.e., fees that are passed through by the networks to compensate card issuers. Network' fees would also be regulated as necessary to prevent circumvention of the restrictions on interchange fees. Acquirers' fees would not be regulated.

With regard to interchange fees on debit card and reloadable general-use gift card transactions, the new Section 920 --

- authorizes the Board to prescribe regulations "regarding any interchange transaction fee" and "to prevent circumvention or evasion" of such regulation;[11]

- prescribes that interchange fees for electronic debit transactions be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction";[12]

- authorizes the Board to collect information from issuers and their agents or networks as necessary to this rule-making function and requires public disclosure of information in aggregate or summary form twice yearly of costs incurred and interchange transaction fees charged or received by issuers or networks in connection with the authorization, clearance or settlement of electronic debit transactions "as the Board considers appropriate and in the public interest";[13]

- prescribes that in setting "reasonable" interchange fees, the Board must consider the "functional similarity" between electronic debit transactions and paper check transactions "that are required within the Federal Reserve bank system to clear at par" and prescribes that the Board must disregard costs incurred by issuers that are "not specific to a particular electronic debit transaction";[14]

- permits the Board to adjust "reasonable fees" to offset issuers' 'reasonably necessary" costs incurred in preventing fraud, taking into account any fraud related reimbursements that issuers receive from consumers, merchants and networks and specifically prescribes several factors that the Board must consider in determining the reasonableness of adjustments for fraud prevention;[15] and

- requires issuers to take "effective" steps to reduce the occurrence and costs of fraudulent debit transactions, including by developing and implementing fraud prevention technology.[16]

The Act exempts issuing financial institutions that have assets (including affiliates' assets) less than $10 billion.[17] This effectively permits differential rates charged retailers depending on the asset size of the issuing financial institution. The Act also provides one-year exemptions for debit or general use prepaid cards issued in connection with and limited to use of funds provided by government benefit programs and all general purpose reloadable prepaid cards that are not linked to asset accounts and are not marketed as gift cards. After one year this exemption will not apply to prepaid cards on which the cardholder is charged overdraft fees or to reloadable non-gift prepaid cards on which the consumer is charged a fee for the first ATM transaction each month conducted on ATM machines in the issuer's network or in a network designated by the issuer that provides "reasonable and convenient access to the issuer's customers." [18]

The Act authorizes the Board to regulate network fees only as necessary to ensure that a network fee is not used to compensate an issuer with respect to electronic debit transactions or to circumvent the regulation of interchange fees.[19]

The Board is required to issue fee regulations within 9 months from enactment of the Dodd-Frank Act and the fee regulations are to take effect one year after enactment. [20]

Regulation of Network "Restrictions"

With regard to network "restrictions," effective one year from enactment of the Dodd-Frank Act, Section 920 –

- requires the Board to issue regulations prohibiting an issuer from restricting the processing of its electronic debit transactions to networks it owns or networks affiliated with the issuer and prohibits rules or measures "inhibiting" retailers' ability to route debit transactions to the issuer over any debit card network;[21]

- prohibits networks from inhibiting retailers from providing discounts and incentives for payments by cash, checks, debit cards or credit cards so long as (i) a discount for use of debit or credit cards does not discriminate on the basis of the issuer or network and (ii) any discount insofar as required by other applicable law is offered to all customers and is conspicuously disclosed and prohibits networks for penalizing retailers for providing discounts that are permitted by federal and state law;[22]

- prohibits networks from (i) inhibiting retailers from setting minimum purchase amounts for use of credit cards so long as the minimum does not discriminate among issuers or networks and is not greater than $10 and permits the Board to increase the maximum amount that retailers may set as their minimum purchase amounts; and (ii) inhibiting federal agencies and institutions of higher education from setting minimums for credit card usage at any level so long as the minimum does not discriminate among issuers or networks.[23]

Enforcement of the Durbin Amendment is delegated to each issuer's or network's prudential regulator, although civil and criminal penalties otherwise applicable under the Electronic Funds Transfer Act do not apply.[24]

Action Plan for Clients Impacted by the Durbin Amendments

- Debit Card and reloadable gift card issuers with assets of over $10 billion should consider participation in the rulemaking process relating to how the Board should determine what interchange transaction fees amounts should be deemed "reasonable and proportional to the costs incurred" in connection with transactions, how the factors enumerated in the statute for consideration should be interpreted and what other factors and cost elements should be taken into account by the Board, such as for example, potential impacts on competition in the consumer payments industry.

- Debit and gift card issuers may wish to consider what modifications to pricing policies may be required for compliance with regulations and other changes that may be advantageous in response to potentially negative impacts on revenues from interchange transaction fee regulations to be issued by the Board.

- Networks should consider participation in the Board's determination of reasonable interchange transaction fees as well as in the Board's rulemaking process for determining whether network fees are being used to compensate issuers for debit card transactions or to evade the restrictions on interchange transaction fees.

- Networks should consider the feasibility of implementing differing interchange fee rates depending on an issuing institution's asset size and based on other exemptions from the interchange fee provisions.

- Issuers and networks should consider operational requirements necessary to support compliance with the reporting requirements that the Board may impose as necessary to the rule-making process and to meet its bi-annual disclosure requirements.

- Networks and issuers should consider participation in the Board's rulemaking process regarding fraud-related standards, including the efficacy of current fraud reduction measures and additional measures and technology that the Board may require.

To view other thought leadership pieces on how this landmark legislation and the myriads of implementing regulations will affect your industry, please follow this link.

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1 Dodd-Frank Act, §1075

2 Until recently, MasterCard and Visa were membership corporations owned by member banks. Their ownership gave them certain licensed rights to market the network branded card products. Both "associations" have recently changed their corporate structure to become publicly held stock corporations and in practice, the formerly "member" banks are purely licensees. Despite the change in corporate form, the networks still do not contract directly with cardholders and retailers.

3 The issuers perform card issuance, consumer related services, consumer transaction processing and account maintenance. The networks provide the interbank transaction processing infrastructure through which payments are authorized, cleared and settled and also the rules that apply to transactions to govern the respective rights of the parties to the transaction and to provide for the quality of the consumer and merchant experience delivered in connection with the network brand. The networks also perform a number of other functions such as development of new network based payment services and risk management and also conduct marketing to promote the network brand. Some networks, such as MasterCard and Visa, also act as financial intermediaries, bearing the payment risk in case of a licensee's settlement failure, such as when a licensee issuer fails to provide funds sufficient to pay merchants for the amount of its cardholders' purchases. PIN-based debit card and ATM networks and the ACH networks do not guarantee payment of settlement obligations. The acquirer takes the risk for the merchant's obligations in connection with payment card acceptance as well as providing merchant services. Services may include network connectivity, accounting and reconciliation, chargeback processing, risk management and other services.

4 Since this measure potentially would reduce revenues to the banks, thrifts and credit unions that issue debit cards and thus possibly impacting negatively their financial strength, it is difficult to see how the Durbin Amendment serves the stated purposes for the Wall Street Reform and Consumer Protection Act. If the rule-making process results in reductions of interchange fees, the card issuing financial institutions might replace the lost revenue by charging consumers more for deposit accounts or for using the cards, although competitive pressures among these institutions for consumer business may not permit such increases. On the other hand, there is no requirement in the legislation that retailers pass on to consumers any of the lower costs that they may realize from the legislation. For example, the benefit of the Board-set "reasonable and proportional" rates is not conditioned on the retailer's not charging a fee to the consumer making a purchase with a debit card nor does it prohibit retailers from charging a fee for debit card use. The net economic result might be a transfer of funds from consumers and their financial institutions to retailers' stockholders.

5 "Signature" cards refers to cards where the transaction is completed by the cardholder's signature instead of by entering a PIN. Signature debit cards are processed like credit cards and typically incur interchange fees more similar to credit card transactions than the much lower interchange fees typically associated with PIN debit card acceptance.

6 On the consumer side, the networks compete heavily through advertising and promotion to influence consumers to use their respective cards, since cardholders may carry cards branded by several of the networks and make a choice of which card to use with every purchase.

7 §920(c)(2)(b) defines debit card by reference to EFTA §915(a)(2)(A) but does not incorporate the exclusions from that definition stated in EFTA §915(a)(2)(D). It is clear that the omission of these exclusions was intentional because §920(a)(7) includes certain exclusions that would be redundant if the exclusions in §915(a)(2)(D) were incorporated.

8 §920(a)(6)(B) defines "issuer" as the "person holding the asset account that is debited through an electronic debit transaction." An "electronic debit transaction" is defined as one in which a debit card is used. §920(c)(5).

9 15 U.S.C 1693 et seq.

10 The fee restrictions are aimed at network branded reloadable gift cards, but not other general-use reloadable pre-paid cards, such as payroll cards. "General-use prepaid card" is defined by reference to Section 915(a)(2)(A) of the Electronic Funds Transfer Act ('EFTA"), 15 U.S.C. 1693m(a)(2)(A), added by the Credit Card Accountability, Responsibility and Disclosure Act of 2009 ("Credit CARD Act") regulating cardholder fees on gift cards and implemented in Regulation E, Section 205.20(a)(3) (effective August 22, 2010), where it is defined as a card, code, or other device that is: (a) Issued on a prepaid basis primarily for personal, family, or household purposes to a consumer in a specified amount, whether or not that amount may be increased or reloaded, in exchange for payment; and (b) redeemable upon presentation at multiple, unaffiliated merchants or service providers for goods or services, or usable at ATMs. As noted above, this definition does not include the statutory exclusions to the definition stated in the Credit CARD Act amendments to the EFTA, now EFTA Section 915(a)(2)(D).

11 §920(a)(1)-(2)

12 Ibid

13 §920(a)(3)(B)

14 §920(a)(4)

15 §920(a)(5)(A)-(B)

16 §920(a)(5)(A)(ii)(II)

17 §920(a)(6)

18 §920(a)(7)

19 §920(a)(8)

20 §920(a)(3)(A); (a) (8)(c); (a)(9)

21 §920(b)(1)

22 §920(b)(2)

23 §920(b)(3)

24 §920(d)