February 22, 2011

Comments of the National Taxpayers Union
To the Board of Governors of the Federal Reserve
On Proposed Interchange Fee and Routing Standards for Debit Cards (R-1404)
In Connection with Section 1075 of the Wall Street Reform and Consumer Protection Act

Dear Chairman Bernanke and Members of the Board of Governors:

It is my pleasure and an honor to submit the following brief comments on behalf of the National Taxpayers Union (NTU) and its 362,000 members nationwide. NTU was founded in 1969 as a nonprofit, nonpartisan citizen group that works for lower taxes, less wasteful expenditures, economic freedom, and accountability at all levels of government. As part of this mission, NTU has actively participated in numerous and diverse debates affecting policy toward the financial industry, including reforms to Government-Sponsored Enterprises such as Fannie Mae and Freddie Mac, taxpayer-backed schemes for natural disaster and terrorism risk insurance, multistate taxation of banking and other institutions, the Troubled Asset Relief Program, and the Wall Street Reform and Consumer Protection Act (a.k.a., the Dodd-Frank bill). Additional information on our work is available at www.ntu.org.

Because of NTU's involvement and experience with issues such as these, we are greatly concerned that the proposed directions for the Federal Reserve's regulatory implementation of the Dodd-Frank bill threaten to make an already dire situation for taxpayers and consumers even worse.

Price Controls Are Historically Ill-Advised.

In a 1999 video interview with NTU's past President, John Berthoud, the late Nobel Laureate economist Milton Friedman warned of a "suicidal instinct" among some American businesses, which seek to "call in the government" on their side rather than compete in a free and open marketplace with products or services that earn consumer loyalty. We believe that many portions of the Dodd-Frank legislation, specifically Section 1075, reflect this flawed line of thinking.

To be clear, in a limited number of instances carefully crafted regulatory policies can set sensible guidelines that help the marketplace to flourish. However, once the heavy hand of government intrudes so far into the private economy as to begin micromanaging price decisions, it becomes indiscriminate and eventually exerts a stifling grip on all actors. From telecommunications to air travel, consumers have witnessed firsthand the lack of choice, innovation, and (ironically) more affordable long-term services that excessive government price and demand manipulation can aggravate. Likewise, they have enjoyed tremendous benefits when such manipulation ceases.

The Federal Reserve's currently proposed alternatives, which effectively establish price caps on interchange of between 7 and 12 cents per transaction, are emblematic of the dangers described above. Based on the current average interchange fee of 44 cents, the level of distortion and damage to payment networks' pricing decisions will be dramatic, leading to numerous unintended consequences which are already unfolding.

The range within which these would-be price controls are set to operate – between 7 and 12 cents – suggests that somehow the latter level would be more helpful to payment networks in partially recovering their costs. This may not be the case, however, in that under the first alternative card issuers could be forced to incur heavier (and costlier) burdens of proof if they sought the higher fee. Under the second, less complex alternative, the cap would be 12 cents total, which would still fall far short of the current average. For these reasons and others that follow, neither price-cap alternative has appeal to NTU.

Companies must invest time and resources toward their services, which are then priced accordingly. When government steps in and arbitrarily rules that the product price must be fixed at some point other than where supply meets demand, distortions (such as shortages) result. The consumer debit card industry is no different; competing networks have invested large sums in creating electronic payment processing systems that many Americans utilize every day. Deprived of the ability to fund these systems with market-priced fees, the networks – and eventually consumers and retailers – suffer.

Government Price Controls – Not Market-Determined Interchange Costs – Are the Real Threat to Consumers.

Self-styled consumer advocates have branded the market-based transaction fees that banks charge a "tax on consumers." As a grassroots organization that has identified and struggled against numerous overt tax increases (and other schemes that function like taxes), we find this characterization to be grossly offensive. Just as the payment transactions themselves are voluntary, so are those between a merchant's bank and the credit card's issuing bank. Indeed, many retailers choose which cards they will accept based on such fees. The card issuers must respond to this choice by lowering transaction costs, offering a better product, or suffering a loss of market share. This is precisely the way our system is intended to function.

Contrast this arrangement with government-levied taxes, where Americans must pay what they owe by law (and sometimes by administrative or judicial fiat) under penalty of civil fines or even imprisonment. We know of no situation where a consumer, bank executive, or for that matter a retailer can be locked away for deciding not to do business because of dissatisfaction with transaction costs.

The voluntary connection between willing providers and willing customers is what drives our economy. Yet, the proposed regulations would, at the behest of the previous Congress, provide an artificial substitute for this mechanism with far less promise of success and the very real threat of failure.

Unintended Consequences Are Already Unfolding.

What would such failure look like? Sadly, consumers and taxpayers already have some disturbing indications. Where regulators have micromanaged the fees associated with these bank-to-bank financial transactions – such as in Australia and part of the European Union – the upshot has been fewer choices for consumers. Services like cash-back bonuses or no annual fees cannot be made available to cardholders if issuers are to remain in business while delivering the returns their shareholders demand.

But Americans need not look only overseas for examples of the adversity about to befall them. Citing *The Wall Street Journal* in an article he wrote for Huffington Post on the proposed interchange rules, NerdWallet CEO Tim Chen noted that "… [I]ssuers aren't waiting around to see how it's going to turn out. …[B]anks all over the country have already started adding new fees to services that most of us have long taken for granted as free." Chen's observation certainly comports with other accounts, such as a report in *American Banker* from January 7 that Visa had decided to roll out a two-tiered fee schedule in response to the interchange rules.

For all these new burdens, consumers have little hope they will see passed along to them any of the savings merchants stand to reap from having lobbied Congress for interchange price controls. In a February 8 article for *Legal Intelligencer*, Glen Trudel, who leads the financial services team for Connolly, Bove, Lodge, & Hutz, eloquently described a growing consensus of opinion:

> A further widely held belief is that, notwithstanding that the debit interchange regulation portion of the Dodd-Frank Act was touted at the time of its passage to be pro-consumer, in fact consumers will be very unlikely to see any real cost savings from what is often perceived as a shift of profit revenue from the issuers of the covered debit cards to the merchants who will benefit from the reduction in the interchange fees charged to such merchants. This presumes that the acquirers' pricing systems are such that the interchange fee component reduction would be passed on to the merchant – though to the extent that such acquirers presently would not be required to pass such costs on, competitive pressures from other acquirers willing to pass some or all such savings down to their merchants should make any acquirer windfall resulting from lower interchange fee expenses relatively short-lived.

Furthermore, in its examination of Australia's experience with interchange regulation, Congress's Government Accountability Office was hard-pressed to find any "conclusive evidence" in favor of lower prices on products.

The Proposed Rule Could Generate a Net Economic Loss.

Aside from additional up-front expenses with little prospect of offsetting savings, consumers and the economy in which they participate could face hidden "opportunity costs" from the proposed regulations. As Chen, Trudel, and others recount, there are widespread worries that the effect of making debit cards less appealing will shift some financial transactions toward check-writing or other forms of payment. This may cause some alarm for policymakers seeking to address what they perceive as the problem of "the unbanked," or to address what they believe are considerable costs for money orders or short-term loans.

To clarify, NTU does not necessarily share such alarm. We believe that consumers should be free to choose from a full range of options – whether they are credit cards, debit cards, credit unions, so-called "payday loans," or other services – *based on their own circumstances and preferences.* However, through the proposed interchange regulations, the hand of government referred to earlier would tip the scales, and in so doing create an imbalance that detrimentally influences consumers' decisions. The result would, in many cases, be deadweight losses to the economy, as individuals and businesses choose less efficient payment methods because debit transactions are no longer as attractive to them.

Other losses could arise from unexpected quarters. According to the Federal Reserve's notice, "The Board also is requesting comment on possible frameworks for an adjustment to the interchange fees to reflect certain issuer costs associated with fraud prevention." This statement in itself raises concerns that neither of the fee alternatives being proposed can possibly account for these issuer costs. Indeed, both proposals do little to even encourage their recovery, while other improvements – such as more personalized customer service – seem far less feasible for companies to afford.

Supporters of Section 1075 claim that forcing issuers to create functionality for their cards within unaffiliated networks will meet these challenges, because merchants will be able to choose from a greater number of less expensive but perhaps also less-proven networks. Will consumers be made sufficiently aware of this fact, and the possible threats to the confidentiality of transactions? What economic damages could they incur as a result? Will the compliance costs that card issuers incur offset or exceed any benefit merchants gain? Should lawmakers or regulators be so intimately engaged in picking economic winners and losers? In our opinion, neither option the Federal Reserve presented for implementing these "exclusivity" rules adequately answers the preceding questions.

These considerations cannot exist in a vacuum, because our economy is already hampered by numerous government-generated impositions. According to statistics compiled in *A Taxing Trend*, NTU's annual study of tax system complexity, Americans spend some 7 billion hours annually in attempting to comply with the federal personal and corporate income tax systems. On the personal income tax side alone, the value of this time, plus out-of-pocket costs for software and other services, exceeds $100 billion. Meanwhile, the Competitive Enterprise Institute's 2010 report, *Ten Thousand Commandments*, provided one rough estimate that all forms of government regulation inflicted approximately $1.2 trillion of costs on the U.S. economy in 2009.

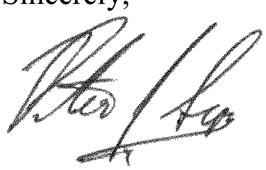
Conclusion – Scrap These Regulations.

Not all of these tax and regulatory compliance costs can be erased. Nonetheless, given the toll they already exact on our nation's competitiveness, policymakers have a special responsibility to avoid enlarging the problem and endangering a nascent economic recovery.

For all the foregoing reasons, we urge the Board of Governors to abandon this rulemaking process entirely. At the very least, more deliberations from elected and appointed officials are necessary to consider the full impact of Section 1075 and other provisions of the Wall Street Reform and Consumer Protection Act. In separate hearings before Congress last week, both you and Governor Raskin raised thoughtful points about the interaction of the regulations with smaller financial institutions, and about other portions of the proposal. Still more exploration of the law is necessary on numerous counts. To name just one, the effect of these regulations on the availability and utility of debit cards in government purchasing – and the potential effect on overhead costs to taxpayers – deserves further examination.

Advocates of the current regulatory process argue that the Board of Governors has no power to delay it, and must move ahead with final rulemaking by April. Although regulators do perform their duties under a somewhat different set of circumstances than lawmakers, it is entirely appropriate for you and your colleagues to engage Congress and the Administration when you believe that certain laws could lead to untenable regulatory outcomes. For the sake of consumers, taxpayers, and the economy, we urge you to do so now.

Sincerely,



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