National Restaurant Association Comments on Debit Card Interchange Fees and Routing Proposed Rule

Docket No. R-1404

<u>Overview of Legislation</u>

This proposed rule was recently issued by the Federal Reserve to implement the Durbin Amendment, a component of the Financial Services Reform Law. It addresses interchange fees, network exclusivity, and fraud costs. The current draft of this rule is generally favorable to restaurants and merchants in general due to the following key provisions:

- Limits interchange rates on debit card transactions
  - Rule as currently drafted ***treats Signature debit and online transactions the same as PIN debit transactions***. *This is important for most restaurants, most of whose business models do not readily support the use of PIN debit transactions.*
    - Equality in pricing for both signature, online, and PIN-based debit transactions would eliminate the financial benefit of, and need for, wireless tableside settlement as a means to reduce interchange, although this technology may still make sense from a guest perspective to protect their privacy and offer more secured payment methods.
  - Interchange pricing on signature, online, and PIN-based debit transactions would be limited to a cap of 12 cents per transaction and the incremental fee based on a percentage of the transaction amount would also be eliminated.
    - The restaurant industry currently pays a per item fee as well as an additional percentage fee for each debit card transaction. Merchants annually pay approximately $18 billion in debit card interchange fees. While reducing this fee to a maximum $.12 per transaction results in a significant reduction in debit card interchange fees from an average of $.44 per transaction, we continue to believe debit transactions should be treated like checks (i.e. at par).
- Allows through our processors, to route transactions for authorization and settlement through the network of our choice, thereby giving us the choice to select the lowest cost provider.
  - Today, we are restricted by network rules to route in a specified sequence based on which networks are able to process and clear the transaction. This prevents healthy competition by requiring us to use specific networks.

<u>Comments on Specific Aspects of the Proposed Rules</u>

Reasonable and proportional fees - Alternative 1 vs. Alternative 2

- Both alternatives have favorable consequences for the restaurant industry and we would support either alternative.
- Under alternative 1, it appears as if issuers will be required to periodically calculate and validate their processing costs to ensure they are not overcharging merchants. This could be complicated. It is not clear who would monitor this to ensure they are charging within the guidelines of the legislation.
- Both alternatives provide for the rate cap of $.12 per transaction, but alternative 2 does not require the issuer to calculate and validate their costs. This alternative allows them

to charge up to $.12 per transaction. They can then attempt to improve their profit by working to reduce their costs, taking the remainder to the bottom line.

Network exclusivity and routing - Alternative 1 vs. Alternative 2

- The restaurant industry prefers the ability to choose our routing, and to have as many choices available for routing as possible. Therefore, we prefer alternative 2, as alternative 1 will not provide us with a choice of networks.
- Alternative 1 will require one signature based network and one PIN based network, each unaffiliated with the other.
- Alternative 2 will require two signature based networks and two PIN based networks.
- Alternative 1 does offer benefit to merchants in general, but not especially to restaurants.
  - Consumers typically choose whether to use their PIN or not.
  - In cases where they elect not to use their PIN, there will only be one network through which to route the transaction.
  - Because most restaurants do not accept PIN-based payments, this alternative does not offer us any flexibility.
- The network exclusivity prohibition and limits on network routing restrictions should apply to ATM networks and issuers should offer more than one unaffiliated ATM network.
  - ATM operators should be free to direct routing of ATM transactions in a manner that optimizes consumer access to cash at the lowest possible cost.
  - Routing restrictions imposed by the dominant networks increase the ATM operator's transaction costs and create upward pressure on consumer fees.
  - Routing restrictions force ATMs to use the dominant networks that charge ATM operators higher fees and pay ATM operators significantly lower ATM interchange, resulting in fewer ATMs being deployed and even the removal of existing ATMs.
  - The benefits to consumers, small issuers, and the economy would not materialize unless issuers are required to offer more than one unaffiliated ATM network.
  - It would not be burdensome on issuers who are already required to contract with more than one debit network.

Small Ticket (Under $15) Transactions

Debit card transactions of under $15 per transaction represent a large and ever growing percentage of restaurant industry sales (i.e. quick service, fast casual segments). Given the explosive use of debit cards and the number of these transactions that are small ticket, it is important that the final regulation take into account the burden placed on consumers and merchants with a large proportion of small ticket transactions and micro payments (under $5 transaction) unless the 7 to 12 cents safe harbor and cap values under the proposed rule are significantly reduced.

Such high interchange transaction fee levels would be particularly burdensome on merchants in connection with small transactions. Cost-based electronic debit transaction interchange transaction fees, which are required by the Durbin Amendment, are necessarily flat from one transaction to another, regardless of transaction amount. Such flat interchange transaction fees result in a cost per transaction that increases on a percentage basis as transaction amount decreases. We are concerned about the harm the high interchange transaction fee amounts contemplated in the proposed regulation will cause to restaurants that have a large number of small ticket transactions. Of particular concern is the negative financial impact of the high interchange transaction fees allowed under the proposed regulation on micro payments. Under current published Visa and MasterCard small ticket transaction debit interchange fee rates (both set at 1.55% + 4 cents), a $5 transaction incurs 11.75 cents in interchange transaction fees, which is below the proposed 12 cent cap contemplated in the proposed regulation. Similarly, under the same Visa and MasterCard small ticket transaction debit interchange fee rates, a $1 transaction incurs 5.6 cents in interchange transaction fees, which is lower than the proposed 7 cent safe harbor and less than half of the proposed 12 cent cap. Thus, micro payments will likely incur higher interchange transaction fees under the proposed regulation than under the existing interchange transaction fee regime, contrary to the statutory intent of the Durbin Amendment.

The Board should consider the increased burden the Proposed Regulations will place on merchants with a high proportion of small ticket transactions and micro payments unless the safe harbor and cap values are lowered significantly reduced. Implementing interchange fee restrictions that promote higher than current interchange rates will put merchants that accept a high proportion of small ticket transactions and micro payments in the difficult position of having to decide whether to discontinue accepting debit card payments for small ticket transactions and micro payments and/or whether to raise prices to continue accepting debit cards. Neither of these outcomes is desirable or appropriate in light of the rationale behind the Durbin Amendment.

Implementation Of Debit Card Fee Reforms

The Financial Services Reform law requires the Federal Reserve Board to implement the interchange fee reforms by July 21, 2011, a year after the enactment of the new law. The law does not set forth an effective date for the Network Exclusivity and Routing Restrictions, but the Board seeks comment on two possible effective dates for these restrictions, depending on which Network Exclusivity Restriction alternative is adopted. If the Board adopts Alternative 1, it proposes an effective date of October 1, 2011. If the Board adopts Alternative 2, it proposes an effective date of January 1, 2013. We believe that these deadlines represent realistic timeframes for implementing the new law and should be strictly adhered to without delay. As discussed previously, we prefer adoption of Alternative 2. Since it carries with it a proposed effective date of January 1, 2013, as an interim measure, we urge you to consider temporarily implementing Alternative 1 beginning October 1, 2011 so as to provide additional routing flexibility until Alternative 2 is implemented.

Other Comments/Concerns

- Issuers historically have unilaterally changed pricing to enhance their profit margins. This is evidenced in the rise of debit rates as the number of transactions skyrocketed over the past decade. A primary concern of the restaurant industry would be to ensure that issuers do not identify other ways to recoup their revenue as a result of this legislation, whether it be from networks, acquirers, merchants, or other product lines (i.e. raising rates on credit transactions).
- Issuers are also notorious for offering new products and promotions to attract new cardholders, and then they pass along the cost of maintaining these programs to the merchant in the form of higher interchange fees - rewards programs that offer high

rebates/cash back for spending is an example. Restaurants pay a higher interchange rate when these “premium” cards are presented by our guests as tender for a meal.

- We are generally not in favor of discounts or rebates targeted toward a specific industry, unless there is a compelling reason (i.e. the processing costs being lower). Pricing tiers, if they exist, should be comparable across all industries who process similar transactions. For example, the retail industry has been known to receive special pricing, but card associations do not consider restaurants retail, so we are unable to benefit from the favorable pricing.