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'Conspiracy Theories' Suggest Capitol Hill May Have Fed's Ear

By Kate Fitzgerald

MIAMI BEACH, Fla.-If certain "conspiracy theories" have any merit, the Federal Reserve Board might be heeding signals from Capitol Hill as it takes more time to craft final debit-interchange rules, one payment-industry analyst suggested April 28 at the Card Forum & Expo in Miami Beach, Fla.

Legal experts said it remains unclear whether legislative efforts to introduce a two-year delay in implementing the new regulations will succeed, but there are plenty of theories about why the Fed in April postponed issuing the final version of rules that will go into effect in July.

The Fed only wanted to "get it right" when Fed Chairman Ben Bernanke in March told Congress the board needed more time to review public comments, K. Craig Wildfang, a payments-industry law expert and a partner with Minneapolis-based Robins, Kaplan, Miller & Ciresi LLP, told attendees. "I don't think the Fed is thinking seriously of any dramatic change in the rule that's proposed," he said.

But Katherine Robinson, an antitrust law expert and counsel with O'Melveny & Myers LLP in San Francisco, said public comments on the proposed rule have "raised many questions" and seem to suggest that "the Fed realizes (debit-interchange regulation) is a bigger issue than we thought from the beginning."

Adam Frisch, senior analyst with equity firm Morgan Stanley, said that according to "some pretty interesting conspiracy theories out there," the Fed asked for a delay in issuing its final rules to heed signals from politicians about whether it should make substantive changes in the proposed rules. "People are wondering if there is any body language, any back-room discussions, some kind of coordination going on between the Fed and (Capitol) Hill," Frisch said.

Opinion was mixed regarding Minnesota's TCF Bank's chance to succeed in its lawsuit that seeks to block implementation of the Durbin amendment on the basis of its denying the bank its constitutional right to recoup the costs of providing debit services.

"I think most lawyers believe this is a case that's destined to fail," Wildfang said, noting that TCF's argument hinges on shaky theories that would be "a huge mountain to overcome."

Moreover, TCF's argument against the Durbin Amendment appears to conflict with what certain lawmakers are saying in their bid to enact a law that would delay implementation of the proposed rule for two years while regulators study its potential impact on community banks.

TCF argues that the amendment's exemption in the law for banks with less than $10 billion in capital means that "small banks will take over the world of debit, they'll have higher revenues and will be able to offer higher rewards and will take all of (TCF's) customers," according to Wildfang. "This is exactly the opposite of the argument taken (by lawmakers asking for an implementation delay), which says that competition will drive debit interchange fees down to the nonexempt level," Wildfang said.

Regardless of whether TCF prevails, Frisch predicted that once the Fed's new rules are implemented, many large banks will initiate their own lawsuits against the federal government.

"Banks and networks are going to come out and say that the Fed is setting prices for a competing network, the biggest payment network, at a level that's below cost," he said. "How is that constitutional? Small banks know that over time, prices will set according to free markets." The Fed operates one of the nation's two automated clearinghouse networks, which enable banks to clear debit transactions at relatively low cost through a system that competes with the card networks.

Countering that debit interchange

rates were set "by the nation's largest banks sitting around twice a year under the umbrellas of Visa and MasterCard," Wildfang contended that "that entire system still remains in place" despite Visa Inc. and MasterCard Worldwide several years spinning off through public offerings to become independently owned.

Even so, banks in a free market should not be required to provide today's level of debit services to merchants without fair compensation, noting banks could change the rules of the game further, Frisch said.

"At some point, banks could say to merchants that debit transactions will require a fee to clear, or that settlement dates might get pushed out, or that merchants may have to pay more now" to get other debit services," he said. "This is a very, very delicate ecosystem that has taken years and years to build, and when (regulators) go in and take out one piece, everything gets redefined."

Claiming it is "incongruous" to assume that opening up competition among banks in the debit market would force interchange to go down, Wildfang observed that "cash and checks have always been cheaper than cards" for merchants to accept, which could play a role in the rebalancing of the debit market.

But checks and cash are not necessarily less expensive for merchants to accept, Robinson declared. "Checks clear at par, but merchants actually pay third parties to do the fraud services, ... and the costs are not so transparent."

Also debatable is whether merchants will pocket the savings from lower debit fees or pass them on to consumers. "There is no empirical evidence that merchants have passed those savings on to consumers in Australia," whose central bank mandated debit and credit interchange rate cuts several years ago, Robinson said, adding "there is evidence that banks increased (consumer) fees. There are always two sides to this."

Saying there eventually will be "a day of reckoning" for debit-interchange rates in the U.S., Wildfang ventured that "smart people can figure out a way to make this system work and make it work better," also suggesting that "lower debit fees will lead to an explosion in the use of banks, and that's good for banks."

Not surprisingly, Frisch disagreed.

"I don't think there will be a (positive) explosion in debit," he said.

Banks may "find a way around" the new debit rules that likely would result in higher banking fees passed on to consumers, Frisch said.

"The fact is that I think people underestimated how controversial this interchange thing was going to be," and not only lawmakers "but people who work the payments industry don't fully understand it because it's so complex," he said.