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SPECIAL REPORT

Historic Wall Street Reform and Consumer Protection Act Changes the Banking Industry

On July 21, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. As the President said at the signing ceremony, “Over the past two years, we have faced the worst recession since the Great Depression.” The government responded to the Great Depression with a wave of financial reform legislation; the breakdown of the financial system in 2008 has been the catalyst for a second wave. History repeats itself. The scope of the Dodd-Frank Act is enormous and impacts every segment of our financial system.

This special report focuses on the consumer protection components of the Act. They create a Consumer Financial Protection Bureau. The new federal watchdog has “just one job, which is to look out for people as they interact with the federal government,” the President emphasized. The statute establishes a framework for consumer protection on the federal level. Dodd-Frank adds another layer to the existing supervisory and enforcement powers of the prudential regulators. Consumer protection joins safety and soundness as a guiding principle for federal regulation.

What does the law say? What are the legal issues and their implications for the financial services industry? The arena now shifts from Congress to the federal regulators. Dodd-Frank creates the “strongest consumer protections in the nation’s history.” Whether the President’s proclamation proves true will depend on how the Consumer Financial Protection Bureau crafts the rules, and how they are enforced. In a similar manner, the Fed and the rest of the federal banking regulators will now turn their attention to the regulatory arena in many areas other than consumer protection.

Here is a first look at consumer protection under financial reform. It is going to take years to figure it all out.

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Powerful Consumer Protection Bureau Is Centerpiece of New Financial Reform Law

On July 21, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act, thus ending 13 months of intense legislative activity. It all started on June 16, 2009, when the Treasury Department issued a White Paper entitled "Financial Regulatory Reform: Rebuilding Financial Supervision and Regulation." This document provides important legislative history of the new law. The White Paper stressed the need for strong medicine to prevent a recurrence of the financial meltdown that swept the country

in the fall of 2008. It became the blueprint for the new legislation.

During the fall of 2009, bills based on the White Paper were introduced in Congress. After healthcare reform was passed, the push to enact financial reform legislation quickly picked up steam. Legislative maneuverings and big-time lobbying were everywhere. Finally, after both houses of Congress passed bills, a Conference Committee hammered out a compromise that was approved by the narrowest of margins in the Senate. There was just enough bipartisanship (three Republican Senators joined the Democrats) to get the bill past cloture. All in all, it was a complicated case study of the legislative process.

The gorilla in the room. In this article, we focus on Title X of the new law, which establishes the Bureau of Consumer Financial Protection. This is an area where very few changes were made from the administration's blueprint set forth in Treasury's White Paper. Ironically, although

this new federal agency is the centerpiece of the legislation, it is the part that is least connected to "Wall Street reform." This is reflected in the bifurcated title of the bill. Now that the bill has been signed, the focus shifts from the legislative arena to the enormous amount of rulemaking that is required to implement the statute. Arguably, nowhere is that hand-off to the regulators more important than in Title X. That's where the lobbying will take place from now on. From the perspective of the financial services industry, the gorilla in the room is the Consumer Protection Bureau, armed with its broad rulemaking and supervisory authority. The Senate Minority Report on the bill puts it this way: "Title X creates a massive new entity whose power and autonomy have no current equivalent anywhere else in the Federal government."

Implementation timeline. Not later than 60 days after President Obama signs the bill, the Secretary of the Treasury must designate a date for the transfer of consumer protection functions from the various prudential regulators. That date must not be earlier than six months, nor later than one year, after the date of enactment. At the six-month mark, the Bureau will begin to set policy. Section 1062. If the Treasury Secretary determines that orderly implementation is not feasible within one year of enactment, he can extend the deadline for up to another six months. Until the Senate confirms a full-time director of the Bureau, the Treasury Secretary has interim authority to provide administrative services and to run the agency. Section 1066. This means that Secretary Geithner will have a golden opportunity to shape the Bureau, just as he shaped the blueprint for the legislation in the 2009 White Paper.

Broad scope of the Bureau's authority: two tracks. Section 1011 of the bill establishes within the Federal Reserve System an independent "Bureau of Consumer Financial Protection" (Bureau) which "shall regulate the offering and provision of consumer financial products or services under the Federal consumer laws." The term "financial products or services" means "extending credit and servicing loans" and includes "acquiring, purchasing, selling, brokering, or other extensions of credit."

The term "Federal consumer laws" includes not only the Bureau's broad-brushed power to protect consumers from "unfair, deceptive or abusive acts or practices" under Section 1031 of the new law, but also its exclusive authority over 18 federal consumer laws that are already on the books. These federal laws date back to the enactment of Truth-in-Lending in 1968, and also include the Electronic Funds Transfer Act (Reg. E); the Equal Credit Opportunity Act (Reg. B); the Fair Credit Billing Act; the Fair Credit Reporting Act; and the Fair Debt Collection Practices Act. A number of the inherited laws involve real estate home mortgages, such as the

Homeowners Protection Act; the Home Mortgage Disclosure Act (HMDA); the Home Ownership and Equity Protection Act (HOEPA); and the Real Estate Settlement Procedures Act (RESPA). Nearly all of these consumer protection statutes are implemented by detailed regulations—mostly from the Federal Reserve—which the Bureau inherits.

This means the Bureau will be doing its rulemaking on both a broad track (new rulemaking) and narrow track (inheritance of rules already on the books). The coordination of these two tracks will be a huge challenge for the agency, particularly at the beginning. Subtitle F of the bill contains detailed rules for the transfer of consumer protection functions and personnel to the Bureau from the various prudential regulators: the Federal Reserve Board, the OCC, the OTS (folded into the OCC), the FDIC, the FTC (which retains a good slice of its current authority), and HUD. Though these current regulators—particularly the FRB—will lose much of their consumer protection authority, many of their personnel will end up with desks at the Bureau. Though the new law has been criticized by some for failing to consolidate the federal prudential bank regulators more radically, it certainly does that job with respect to the consumer protection role of those regulators.

From the perspective of the financial services industry, the gorilla in the room is the Consumer Protection Bureau, armed with its broad rule-making and supervisory authority.

Six primary functions. Under Section 1021 of the new law, the Bureau has six primary functions: (1) conducting financial education programs; (2) responding to consumer complaints; (3) collecting, researching, monitoring, and publishing information relevant to the functioning of markets for consumer financial products; (4) identifying risks to consumers and the proper functioning of markets; (5) supervising covered persons for compliance with federal consumer financial law and taking appropriate enforcement action to address violations; and (6) issuing rules, orders, and guidance implementing federal consumer financial law.

Autonomy of the Bureau: a declaration of independence. In the June 2009 White Paper, the Obama administration emphasized the need for an **independent** consumer protection bureau, separate from the prudential regulators, who, it was believed, were more concerned with safety and soundness than consumer protection. The administration was seeking an agency that would eat, drink,

and sleep consumer protection. This was the model in Rep. Frank's House bill. Prodded by Republican Senators wary of a gorilla running free, the Senate bill compromised by "housing" the Bureau in the Federal Reserve. This was really a fiction to facilitate passage of the legislation, but it worked. The final bill provides that the Bureau is "established in the Federal Reserve System," but stresses that it is an "independent bureau." Section 1012(c), which is entitled "Autonomy of the Bureau," is a strong declaration of independence. The Federal Reserve may not:

- intervene in any examination or enforcement actions of the new agency
- intervene in any matter involving personnel
- merge any of the functions of the Bureau with any division or office of the FRB

No rule or order of the Bureau is subject to approval or review by the Fed. Of great importance, Section 1017 provides that the funding of the new agency is completely outside the Fed's control. Every year the Board of Governors is required to transfer to the Bureau an amount determined by the director to be necessary to carry out its consumer protection functions. There is an annual funding cap tied to a percentage of the Fed's total operating expenses. For fiscal year 2011, the cap is 10 percent, and it rises to 12 percent in fiscal year 2013. This means that the Fed will write a check to the Bureau in the neighborhood of \$650 million for the first fiscal year. This is the kind of "robust" funding that the White Paper contemplates. Fortunately, the Fed can write any check it wants, and it is unlikely to bounce.

All-powerful director. The director of the Bureau has great power. He or she is appointed by the President, with the advice and consent of the Senate, for a five-year term. The director does not report to any board of directors. The director is authorized to employ "attorneys, compliance examiners, compliance supervision analysts, economists, statisticians, and other employees as may be deemed necessary to conduct the business of the Bureau." The Federal Reserve is required to transfer its consumer protection functions to the new Bureau. A large number of Fed employees will migrate to the Bureau, as contemplated by Section 1064. Given the huge job that awaits the new agency, and the extraordinary expertise that already exists within the Fed staff because of the consumer protection laws it has been enforcing since 1969, this migration and consolidation seems crucial.

Consumer protection meets safety and soundness—sort of. During the debate on the financial reform legislation,

one of the hottest policy disputes was the proper relationship between safety and soundness and consumer protection. To what extent should consumer protection rules issued by the Bureau be required to go through a “safety and soundness” filter? For example, bankers have argued that elimination of numerous sources of fee revenue in the name of “consumer protection” could cause safety and soundness problems for some banks, particularly in a time of restricted lending. Consumer advocates contend that prudential regulators, who rightly focus on safety and soundness concerns, give short shrift to consumer protection.

The Bureau will be doing its rulemaking on both a broad track (new rulemaking) and narrow track (inheritance of rules already on the books). The coordination of these two tracks will be a huge challenge for the agency, particularly at the beginning.

In the final bill, there was some compromise, but the consumer advocates appear to have prevailed. At least on paper, two sections of the bill deal with the issue. Section 1022 provides that, prior to proposing a rule and during the public comment period, the Bureau must consult with the appropriate prudential regulators or other federal agencies “regarding consistency [of the proposed rule] with prudential, market, or systemic objectives administered by such agencies.” If a prudential regulator objects to the proposed rule, the Bureau must include a description of the objection and the basis for the Bureau’s decision to overrule it. These safety and soundness teeth are not sharp.

Section 1023 provides a somewhat stronger check on the independent rulemaking of the Bureau. Upon the petition of one of its members, the Financial Stability Oversight Council (which manages systemic risk) may set aside a final regulation of the Bureau if it decides, by a two-thirds vote, that the rule “would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.” The Secretary of the Treasury, as chairperson of the Council, can issue a temporary stay of the proposed rule until the Council has an opportunity to consider a petition.

Although this mechanism does provide some review of Bureau regulations, the standard to overrule a regulation based on safety and soundness concerns seems very high indeed. In the example above, the fact that some community banks may face financial difficulties because of a loss of

fee income based on a Bureau rule may well not meet that standard. The Bureau is only one member of the Council; the other members control more than two-thirds of the votes, depending on how they throw their weight around. On the other hand, there is nothing in the new law that prohibits vigorous lobbying against a proposed Bureau rule, based on safety and soundness concerns. We expect regulatory lobbying in abundance over the next years. Of course Congress could always step in and overturn a wayward rule. In the most extreme scenario, congressional power could shift radically to the Republicans, giving them the clout to pass a veto-proof mandate that safety and soundness always trumps consumer protection.

Special divisions within the Bureau. Section 1013 of the bill requires the director to establish a number of “specific functional units” within the Bureau. These units tell us a great deal about the areas of emphasis we will be seeing:

- The *research unit* will research, analyze, and report on developments in markets for consumer financial products or services, including market areas of alternative products or services with high growth rates and areas of risk to consumers.
- The *consumer complaint unit* will establish a single, toll-free “hotline” telephone number, a website, and a database for the monitoring of, and response to, consumer

Voting Members of the Financial Stability Oversight Council

- **Secretary of the Treasury (Chair of the Council)**
- **Chair of FRB Board of Governors**
- **Comptroller of the Currency**
- **Director of the Consumer Protection Bureau**
- **Chair of the SEC**
- **Chair of the FDIC**
- **Chair of the Futures Trading Commission**
- **Director of the FHFA**
- **Chair of the Board of the NCUA**
- **An Independent Member, Appointed by the President, with Insurance Expertise**

complaints about financial products or services. This unit will also coordinate with the FTC or other federal agencies to route complaints. The consumer complaint unit will also route calls to the state attorneys general in appropriate cases, which could lead to enforcement under state deceptive practice statutes.

- The *fair lending unit* will focus on enforcing statutes such as the Equal Credit Opportunity Act (ECOA) and the Home Mortgage Disclosure Act (HMDA). The term “fair lending” is defined to mean “fair, equitable, and nondiscriminatory access to credit for consumers.” Thus, “consumer protection” will include a strong civil rights mission.
- The *financial education unit* will be responsible for developing and implementing initiatives “intended to educate and empower consumers to make better informed financial decisions.” Financial literacy was a big issue in the White Paper. This unit is expected to provide financial counseling and information to assist consumers with the evaluation of credit products and the understanding of credit scores.
- The *military service member unit* is responsible for “educating and empowering service members and their families to make better informed decisions regarding consumer financial products and services.” This has been a big issue in the past, particularly when the Department of Defense issued a report in 2006 slamming predatory payday and car title lending practices near military bases.
- The *older Americans unit* is designed to facilitate the financial literacy of seniors and to protect them from unfair, deceptive, or abusive practices. This unit will also educate seniors on current and future financial choices through dissemination of materials on these topics. Like military service members, seniors see more than their fair share of scams.

In the final bill, there was some compromise, but the consumer advocates appear to have prevailed.

In addition to the six units described above, the director must establish a Consumer Advisory Board to advise and consult with the Bureau on “emerging practices” in the consumer financial industry, including regional trends. The drafters of the bill undoubtedly hope that this Consumer Advisory Board will be more active than a similar unit that has existed for some years as a silent backwater within the Federal Reserve System.

Rules prohibiting unfair, deceptive, or abusive acts or practices. Central to the role of the Bureau is its authority, under Section 1031, to enact rules prohibiting unfair, deceptive, or abusive acts or practices. Under this broad-track authority, the Bureau could limit or outlaw a wide range of consumer financial products and practices—just like the Consumer Product Safety Commission can outlaw physical products it finds to be “unsafe.”

There is nothing in the new law that prohibits vigorous lobbying against a proposed Bureau rule, based on safety and soundness concerns. We expect regulatory lobbying in abundance over the next years.

The statute contains two definitional guidelines: (1) An act or practice is “unfair” if the Bureau has a reasonable basis to conclude that “the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers” and “such substantial injury is not outweighed by countervailing benefits to consumers or to competition.” (2) An act or practice is “abusive” if it “materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service,” or takes “unreasonable advantage” of a consumer’s lack of understanding the risks, costs, and conditions of the product or service, the inability of the consumer to protect himself or herself in selecting the product or service, or the reasonable reliance by the consumer on a supplier of the product to act in the interests of the consumer. The definition of “unfair” roughly coincides with what courts applying state law have called “substantive unconscionability,” while the definition of “abusive” roughly coincides with “procedural unconscionability.” We would make this brave prediction: these definitions will generate some litigation in years to come.

Exclusion of the “Main Street merchant.” When the Bureau enacts a rule, it will apply to a broad range of “covered persons.” It will apply to depository institutions (banks, thrifts, and credit unions) of all sizes, whether carrying federal or state charters. It will also apply to nondepository institutions that provide financial services and products. However, the Bureau’s rulemaking authority does **not** extend to a merchant, retailer, or seller of non-financial goods or services who is not otherwise engaged in providing financial products or services. This “Main Street merchant”

carve-out was added to the bill at the insistence of a number of Senators who were aghast at including the local dentist or optometrist who offers deferred payment plans to consumer customers.

In this spirit, Section 1027 of the bill excludes merchants who only provide credit as an incident to the sale of other goods or services. Such merchants lose their protection if they routinely sell their receivables before default, but not if they just sell delinquent obligations to a debt collector. Protected Main-Streeters not only escape the Bureau's rules, but are also excluded from any of its supervisory or enforcement powers.

Other exclusions. Section 1027 also excludes a number of other players from the Bureau's rulemaking, supervisory, and enforcement power:

- real estate brokers
- mobile home retailers
- accountants and tax preparers
- attorneys
- persons covered by a state insurance regulator
- persons covered by a state securities commission or the SEC
- persons regulated by the Commodity Futures Trading Commission
- persons regulated by the Farm Credit Administration
- persons engaged in activities relating to charitable contributions

The biggest fight over exclusion involved auto dealers. In the end, they were excluded, as described in a later story.

Supervisory and enforcement authority. In addition to rulemaking authority, the Bureau has primary supervisory and enforcement authority over big banks, thrifts, and credit unions—those with assets exceeding \$10 billion. Section 1025. In a major compromise that reflects the lobbying power of community banks, supervisory and enforcement authority over depository institutions below the \$10 billion threshold remains with those institutions' primary federal prudential regulators—the OCC (which will digest the OTS and its thrifts), the Federal Reserve, and the FDIC. Section 1026. The prudential regulators will also have back-up consumer compliance enforcement authority over large institutions if they recommend action and the Bureau defers. But the converse is not true—the

Bureau is not granted any back-up enforcement authority over smaller institutions.

In addition to big depository institutions, the Bureau has supervisory and enforcement authority over many nonbank companies that provide consumer financial products and services. Section 1024. This includes originators, brokers, and servicers of home mortgages, as well as loan modification or foreclosure relief services, where many fly-by-night operators have surfaced since the collapse of the home mortgage market in 2008. The Bureau also has supervisory authority over any company that is “a larger participant of a market for other consumer financial products or services,” as will be defined in consultation with the FTC. Likely targets are payday lenders, student loan lenders, debt collectors, and consumer reporting agencies.

In a major compromise that reflects the lobbying power of community banks, supervisory and enforcement authority over depository institutions below the \$10 billion threshold remains with those institutions' primary federal prudential regulators.

Broad civil enforcement powers. Subtitle E of the bill sets forth the various enforcement powers of the Bureau. These include:

- the power to undertake investigations and administrative discovery
- the power to hold hearings and adjudication proceedings
- the power to issue cease and desist orders
- the power to commence civil litigation “to impose a civil penalty or to seek all appropriate legal and equitable relief including a permanent or temporary injunction as permitted by law”

Relief is available in administrative proceedings or court actions. Section 1055 sets forth a wide range of sanctions, including rescission of contracts, refund of money, restitution, payment of damages, public notification regarding the violation, and limits on the further activities of the offender. Hefty civil penalties are authorized in three tiers of \$5,000, \$25,000, and \$1 million, depending on the gravity of the violation, but punitive damages are not recoverable. In Section 1057, there is special protection for whistleblowers.

In This Story:

- Arbitration/Class Action Waivers
- Simplified Disclosures for Home Mortgages and Credit Cards
- Overdraft Protection Products
- Debt Collection Practices
- Payday Lending
- Credit Cards

Prediction: Likely First Targets of Bureau Rulemaking

Now that Dodd-Frank has become law, what issues can we expect the Bureau to tackle first when it begins its rulemaking? What are the Bureau's top priorities in defining products or services as "unfair, deceptive or abusive"?

The two untouchables: interest rate caps and exportation. Before we make our predictions, we would start with two closely related topics that Congress has forbidden the Bureau to touch. Section 1027(o) of the bill provides: "No provision of this title shall be construed as conferring authority on the Bureau to establish a usury limit applicable to an extension of credit offered or made by a covered person to a consumer, unless explicitly authorized by law." During congressional consideration of the bill, an amendment was offered that would cap consumer interest rates at 36 percent across the board. This amendment was primarily aimed at the payday lending industry.

Not only did Congress reject the amendment, but it expressly prohibited any interest rate caps, including those that might be imposed by Bureau rulemaking. This prohibition of interest rate caps makes good policy sense, since small, short-term extensions of credit found in products like payday loans and overdraft programs don't lend themselves to translation into an astronomical APR for usury purposes. It's a square peg in a round hole. On the other hand, the Bureau clearly has the power to require **disclosure** of APRs for these products through an amendment to Reg. Z, if not through its "deceptive practice" rulemaking. But the covered parties will still argue that it is a square peg in a round hole.

Section 1044 of the bill provides that the Bureau can't tamper with interest rate exportation, particularly with respect to national bank issuance of credit cards. The federal usury law, 12 USC § 85, has long been construed to allow a national bank to charge nationwide interest at the rate allowed by the laws of the state where the bank is located. This principle was established in 1978, when the Supreme Court decided *Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299. The High Court later expanded

the doctrine by treating late fees as "interest" for purposes of exportation. *Smiley v. Citibank (SD), NA*, 517 U.S. 735 (1996). There is some question about whether state-chartered banks, thrifts, and credit unions are protected. Of course interest rate exportation is crucial to the credit card industry, and the Credit CARD Act of 2009 did not tamper with it.

First targets. Here are our predictions of the Bureau's early priorities:

- **Coordination of transferred authority with general rulemaking.** As a threshold matter, under Subtitle F of the bill, the Bureau will need to accept transfer of the rulemaking function from the present regulators. Then, in pursuing any new rulemaking on a particular topic, it must decide whether to tackle it by amending a regulation that is currently on the books or by issuing an independent rule under its broad authority to restrict or outlaw "unfair, deceptive or abusive products or practices." This will be an ongoing issue for the Bureau.
- **Consumer arbitration/class action waivers.** We have no doubt that one of the first rules out of the box will restrict or prohibit pre-dispute arbitration clauses coupled with class action waivers in consumer financial services contracts. This issue has been ablaze over the last several years. About a year ago the Minnesota attorney general settled a big class action against the National Arbitration Forum, based on the unfair and deceptive manner in which the NAF ran its "arbitration mill." In the wake of that settlement, some of the big banks simply removed the arbitration clauses from their agreements. Then, in its last term, the Supreme Court decided two cases that give strong protection to arbitration/class action waiver clauses under the Federal Arbitration Act. *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, 130 S. Ct. 1758 (4/27/10); *In re American Express Merchants Litigation*, 554 F.3d 300 (2d Cir. 2009), *vacated and remanded*, 130 S. Ct. 240 (May 3, 2010).

Pre-dispute arbitration/class action waivers were highlighted as a consumer protection problem in the White Paper. Section 1028 of the Dodd-Frank bill picks up on this topic by requiring the Bureau to conduct a study of such clauses and provide a report to Congress. Then the Bureau is given authority to prohibit or impose conditions or limitations on the use of arbitration agreements/class action waivers if it finds such a rule to be "in the public interest and for the protection of consumers." The findings in the rule must be consistent with the study. In light of the congressional mandate and the recent Supreme Court decisions, it seems likely that we will soon see a study, followed by a regulation that will outlaw or severely restrict consumer arbitration clauses that contain class action waivers.

- **Simplified disclosures for home mortgages.** Another top priority for the Bureau will be more effective disclosure for consumer financial products, particularly home mortgages. The 2009 White Paper emphasizes the need for mortgage disclosures to be “balanced in their presentation of benefits, and clear and conspicuous in their identification of costs, penalties and risks.” The key statutes presently on the books—TILA, HMDA, and RESPA—have been pilloried for their opaque complexity and their failure to warn subprime consumer borrowers of huge risks such as the resetting of the APR in adjustable rate mortgages. In response to these concerns, Section 1032 of the bill authorizes the Bureau to prescribe new disclosure rules, adopt model forms, and subject the forms to consumer testing. Perhaps most important, not later than one year after the designated transfer date for rulemaking, the Bureau must propose for public comment rules and model forms that combine the disclosures required under TILA and RESPA into a single, integrated disclosure for mortgage loan transactions.

Transparency in consumer contract documents is everybody’s goal. An effective single-page disclosure for home mortgages is probably a pipe dream, but we suspect that the Bureau will be working toward that goal as it produces the integrated TILA/RESPA form.
 - **Overdraft protection products.** A theme running through the White Paper and the Dodd/Frank bill is “consistent regulations for similar products.” With that model in mind, we predict that an early priority of the Bureau will be to go beyond what the Federal Reserve Board has recently done with respect to overdraft protection products. The FRB’s amendments to Reg. E impose an “opt-in” requirement for overdraft fees generated by debit card transactions, but will probably be seen by the Bureau as too weak. We predict new initiatives such as:
 - subjecting overdraft fees to APR disclosure under TILA and perhaps capping overdraft fees under a “safe harbor” approach. This would put overdraft products on a par with payday loans—“consistent regulation for similar products.”
 - prohibiting setoff of social security direct deposits against overdrafts, as allowed by two leading judicial decisions. *Lopez v. Washington Mutual Bank, FA*, 302 F.3d 900 (9th Cir. 2002); *Miller v. Bank of America*, 207 P.3d 531 (Cal. 2009).
 - outlawing high-to-low debit posting as a method of increasing the number of overdrafts and related overdraft fees.
 - **Debt collection practices.** The Senate Report on the bill highlights numerous consumer complaints to the FTC regarding various practices employed by debt collectors, particularly failure to verify the debt before initiating collection activities and heavy reliance on default judgments. Recently the FTC has released that study to the general public. The Bureau could not deal with this problem directly under the inherited Fair Debt Collection Practices Act because that law has no authority for rulemaking. However, the Bureau could attack the problem under its power to outlaw “unfair, deceptive or abusive” practices. We can expect debt collectors to argue that a **failure to do something** like better debt verification is neither “unfair” nor “deceptive” nor “abusive.”
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- During congressional consideration of the bill, an amendment was offered that would cap consumer interest rates at 36 percent across the board. This amendment was primarily aimed at the payday lending industry. Not only did Congress reject the amendment, but it expressly prohibited any interest rate caps, including those that might be imposed by Bureau rulemaking.
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- **Payday lending.** Many states have enacted special laws that govern payday lending products. Some of these laws are stronger than others. We suspect that the Bureau will seek a tough rule that draws from some of these state statutes. For example, it might label excessive rollovers as “deceptive” or “abusive.” On the other hand, as discussed earlier, any attempt to place a 36 percent cap on payday loan interest rates would probably run afoul of Section 1027(o) of the bill.
 - **Credit cards.** It seems likely that the Bureau will seek to simplify and clarify credit card disclosures. This disclosure priority will probably rank just below home mortgages. Many of the substantive provisions in credit card agreements were limited by the Credit CARD Act of 2009 and the recent amendments to Reg. Z, so we don’t expect to see much activity in that realm. But will the Bureau attempt by rule to impose caps on credit card late fees beyond what is provided by the Credit CARD Act? We doubt it, particularly because such fees have been held by the Supreme Court to constitute “exportable interest” under 12 USC § 85.

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Exclusion of Auto Dealers: A Case of Effective Lobbying

Section 1029 of the Dodd-Frank bill excludes “a motor vehicle dealer that is predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both.” Thus, licensed auto dealers escape the embrace of the gorilla and remain under the regulation of the FTC, which

was given enhanced rulemaking authority over dealers. This was a major victory for these important players in the consumer credit arena.

If the auto dealer retains the financing of its customers in-house and does not “routinely assign” the installment contract to an “unaffiliated third-party finance or leasing source,” it loses the exclusion. Approximately 80 percent of auto financing in this country is done on an “indirect” basis, where an installment contract is originated by the dealer, then assigned to an unaffiliated third-party financing source. So, most auto dealers are safe. (Interestingly, the auto dealer rule is the converse of the “main street merchant” exclusion, where the merchant escapes Bureau regulation only if it finances the sale of its nonfinancial products for its customers and does *not* sell the debt to a third party.)

The auto dealer exclusion is broad. The term “motor vehicle” includes not only autos, but also pleasure boats, motorcycles, motor homes and recreational vehicles, and any other vehicles that are titled and sold through licensed dealers.

A somewhat curious trip. The auto dealer exclusion had a somewhat curious trip through Congress. It was added as an amendment to the House bill during its consideration by the House Financial Services Committee, and was passed by the House on December 11, 2009. The exclusion was not in the companion Senate bill. An amendment sponsored by Senator Brownback (R-KS) was offered during Senate floor consideration but was withdrawn, in spite of substantial Senate backing for the auto dealer exclusion. The Senate bill was passed without the Brownback amendment. However, the Senate did pass, by a vote of 60-30, a motion to instruct conferees to exclude dealers from the jurisdiction of the Bureau. When the bill was considered by the House-Senate Conference Committee, the exclusion ended up in the final version due to its broad bipartisan support in both houses of Congress.

The scathing Senate report on dealer mark-up. The

Senate Banking Committee Report on S. 3217 is scathing in its treatment of dealer auto financing, even though the subject was never even mentioned in any Senate hearing. The Report criticizes dealer financing practices on many grounds, but the primary criticism relates to the “dealer mark-up” of interest rates. The Report says this:

Auto loans constitute the largest category of consumer credit outside of mortgages. Today, there is more outstanding auto debt (\$850 billion) than there is credit card debt in this country. Auto dealers finance 79% of the purchases of cars in the United States. Auto dealers actively market and price borrowers’ loans. They also routinely mark up loan rates that are higher than the borrower would need to pay to qualify for the credit and, like mortgage brokers and bankers, the auto dealers collect a significant portion of the excess finance charges that result from that markup, similar to a yield spread premium [for home mortgages]... As with mortgages, borrowers are simply unaware of the incentives pushing the auto dealers to charge buyers higher interest rates.”

Although this negative description of indirect auto financing would lead the reader to believe that the Senate was strongly against any exclusion, that was not the case.

The NADA response. In response to the attack in the Senate Report, the National Automobile Dealers Association provided both the Senate and House with a trenchant position paper challenging the Senate Report’s thesis that auto dealers who sell their installment contracts “routinely mark up loan rates that are higher than the borrower would need to pay to qualify for the credit.” The position paper says:

This statement is incorrect in that consumers do not “qualify” for the wholesale buy rate that financial institutions offer to dealers for a retail installment sales contract any more than consumers qualify for the wholesale price that milk wholesalers offer to supermarkets for a gallon of milk. All wholesalers sell their products to their retail distribution outlets at a price below what the wholesalers would need to charge consumers if they had to develop their own retail distribution network to sell their products to consumers. Every year, millions of consumers choose to obtain optional financing through auto dealers because the rates dealers offer are more competitive than the rates those consumers can obtain directly from banks or credit unions. This is because banks and credit unions that lend directly to consumers must build both their loan distribution costs and the return on investment on those costs into the retail rates they offer to consumers. As stated by the Federal Reserve Board, “the dealer’s participation

in the finance charge may serve as compensation for the work done in arranging the financing and for the risk of loss which is shared with the lending institution. Therefore, the Board believes that, in many instances, the portion of the finance charge which represents the dealer's participation is not an amount which the consumer could save by obtaining a direct loan from a lending institution."

Apparently this argument was influential in both houses of Congress. Combined with effective grass roots lobbying by car dealers around the country, the exclusion made it into the final legislation. The bottom line is that, in the huge indirect auto financing arena, the Bureau will have no jurisdiction over auto dealers, which moots the Senate Report attacking third-party financing.

The auto dealer exclusion is broad. The term "motor vehicle" includes not only autos, but also pleasure boats, motorcycles, motor homes and recreational vehicles, and any other vehicles that are titled and sold through licensed dealers.

Indirect rulemaking? But will the Bureau be able to do indirectly what it can't do directly? It will have rulemaking authority over the sales finance companies and banks that purchase dealer paper, and supervisory and enforcement authority over many of those assignees. Therefore, it could shape the terms and conditions of installment sales contracts, making it a prohibited practice to purchase a contract with "unfair, deceptive or abusive" terms and conditions as defined by rule.

This indirect method of rulemaking is reminiscent of the 1976 FTC Rule (16 CFR § 433) that made it a deceptive trade practice for an installment contract to contain a "cutoff clause" under which any assignee of the contract could take it free of all the consumer's defenses; instead, the contract is required to include a conspicuous statement that any assignee takes subject to all the consumer's defenses. Even though the FTC had no jurisdiction over the banks that bought the paper, the banks as assignees were made subject to its terms as a matter of contract law.

Although this type of "indirect regulation" could be used for installment contracts originated and sold by auto dealers in the future, it seems unlikely that the Bureau would craft a rule that prohibited finance sources from buying a contract containing a "dealer mark-up" interest rate. But that is certainly a possibility. Moreover, since the new law gives

the FTC enhanced rulemaking authority over auto dealers, including the power to identify "unfair and deceptive" dealer practices, it is also possible that the FTC could go after dealer mark-up.

Unintended consequences? Like most major legislation, the auto dealer exclusion in Dodd-Frank may have some unintended consequences. For example, in order to gain exclusion, the dealer must have a sales or leasing function and a servicing function. Not many independent dealers maintain a servicing department, which appears to limit the exclusion to franchise dealers in most instances. Nor do most used car dealers offer servicing of vehicles. Nor do dealers who only lease vehicles, or operate on a "rent-to-own" model. Will we be seeing these dealers hiring a part-time mechanic and offering on-site "servicing"?

For this story, the editors appreciate the input of the attorneys at Hudson Cook, L.L.P.

In This Story:

- Tougher Preemption Standard: Back to *Barnett*
- National Bank Subsidiaries: Overruling *Watters*
- Visitorial Powers: Codifying *Cuomo*

Dodd-Frank Weakens Federal Preemption, Strengthens State Consumer Protection Function

Federal preemption in the consumer protection area is not dead, but it's certainly weaker than it was before the Dodd-Frank Wall Street Reform and Consumer Protection Act. During congressional deliberations on the new law, preemption was always one of the most contentious issues.

Consumer advocates cited preemption as one of the causes of the financial meltdown because it allowed the OCC and OTS to de-emphasize consumer protection and preclude the states from filling the gap. The high-water mark for federal preemption was 2004, when the OCC greatly strengthened preemption for national banks by occupying the field. 12 CFR § 4007. The OTS enacted an even broader version of preemption for federal thrifts. 12 CFR § 557. Then came the go-and-blow era.

To the banking industry, strong federal preemption is critical because of the need for uniformity in handling consumer credit compliance. Consumer financial service

providers don't like the cost and complexity of complying with 50 separate state laws. The current jumbled legal landscape for gift cards is a good example. Moreover, the banking industry argued that a strong Consumer Protection Bureau could enact strong uniform rules, reducing the need for state legislation.

The 2009 Treasury White Paper that became the template for the new legislation embodied an anti-preemption slant, with a strong emphasis on "state's rights" in the consumer protection area, particularly through state attorneys general. This anti-preemption slant is clearly present in Sections 1041-1047 of Dodd-Frank, which are collectively titled "Preservation of State Law" rather than "Preemption of State Law." Yet some elements of federal preemption for national banks remain.

Allowing more restrictive state laws. Section 1041 of Dodd-Frank confirms that the rules issued by the new federal agency won't automatically preempt state laws that provide greater protection for consumers. This is not really a radical proposition, since many federal consumer protection laws expressly allow the states to go further, often subject to procedural requirements. A good example is Truth-in-Lending.

In answer to concerns about lack of uniformity, the Senate Report makes the case that "a strong and independent [federal] Bureau with a clear mission to keep consumer protections up-to-date with the changing marketplace will reduce the incentive for State action and increase uniformity." The Report notes that the Gramm-Leach-Bliley Act of 1999 set federal financial privacy standards, yet gave the states the authority to go further. "Only three states have used that power and bank operations have not been impaired." The theory is that if states can provide new consumer protections as new products and problems arise, the federal Bureau will be in a better position "to set a strong, consistent standard that will satisfy the States. Additionally, State initiatives can be an important signal to Congress and Federal regulators of the need for Federal action. States are much closer to abuses and are able to move more quickly when necessary to address them. If States were not allowed to take the initiative to enact laws providing greater protection for consumers, the Federal Government would lose an important source of information and reason to adjust standards over time."

In an interesting experiment in federalism, Section 1041 requires the Bureau to propose a rulemaking when a majority of the states have enacted a legislative resolution requesting a new or modified consumer protection regulation by the Bureau. As part of the rulemaking, the Bureau is required to consult with federal banking agencies to determine whether the proposed regulation presents an unacceptable "safety and soundness" risk.

Preserving enforcement powers of the states. Section 1042 allows state attorneys general to enforce Bureau rules against both national and state-chartered banks and thrifts (and nonbank covered persons) in either federal or state court. The AGs can use the remedies available under the new law (including civil penalties), but can't seek damages in a "class-action-like" lawsuit to benefit the citizens of a state. State bank regulators can only move against state-chartered banks for violation of a Bureau rule. Before filing enforcement suits, both AGs and state regulators must notify the Bureau and the appropriate prudential regulator. The new law has no impact on the authority of state securities or insurance regulators regarding their rulemaking and enforcement powers.

Preserving existing contracts. Section 1043 protects contracts entered into by banks or thrifts that rely on current preemption standards. The Bureau is forbidden from construing OCC or OTS regulations, orders, guidance, or interpretations in a manner that would undercut preexisting contracts entered into by national banks, federal thrifts, and their subsidiaries. One example would be contracts arising out of securitization transactions.

Federal preemption in the consumer protection area is not dead, but it's certainly weaker than it was before the Dodd-Frank Wall Street Reform and Consumer Protection Act.

State law preemption standards for national banks: back to *Barnett*. Section 1044 amends the National Bank Act to clarify preemption standards for national banks and their subsidiaries. (Section 1046 gives parallel treatment to federal thrifts.) State laws of general applicability to all businesses can't be preempted even though they also apply to national banks. A good example are the rules in a given state governing contracts or property rights.

"State consumer financial laws" are defined as laws that don't discriminate against national banks and that "directly and specifically regulate the manner, content, or terms and conditions of any financial transaction [as may be authorized for national banks to engage in]," or any related consumer account. These consumer financial laws are preempted only if (1) their application would have a discriminatory effect on national banks as compared to state-chartered banks; (2) they are expressly preempted by a federal statute; or (3) they fit within the standard established by the Supreme Court in *Barnett Bank of Marion County, N.A. v. Nelson*, 517 U.S. 25 (1996) in that they "prevent or significantly interfere with the exercise by the national bank of its powers."

The “significant interference” standard set forth in *Barnett* replaces the “occupation of the field” standard used by the OCC and OTS in their more recent preemption regulations. A preemption determination under the *Barnett* standard can be made by either a court or by the OCC on a “case-by-case basis.” The new law prohibits the OCC from drafting any “global” preemption rule, as it did in 2004. When making a case-by-case determination, the OCC must first consult with the Bureau. An OCC case-by-case ruling is subject to judicial review as to whether the *Barnett* standard is satisfied.

Tricky legal questions. One of the tricky legal questions posed by codifying the *Barnett* standard is whether the crucial phrase “significant interference” is free-floating and can be applied without any reference to the facts or other language in the Supreme Court case. In *Barnett*, the High Court held that a Florida statute couldn’t prohibit the branch of a national bank from selling insurance in a small town when a federal statute gave it express permission to do so. This was an easy case, one in which the Court found an “irreconcilable conflict” between federal and state law. The decision, written by Justice Breyer, was unanimous.

Does that mean that the OCC will now be unable to show any “significant interference” by a state law unless that law flatly prohibits something that a federal statute expressly allows? Or should that term be read more broadly? To take a recent example, in *Monroe Retail, Inc. v. RBS Citizens, N.A.*, 589 F.3d 274 (6th Cir. 2009), the Sixth Circuit held that an Ohio statute prohibiting banks from deducting “garnishment service fees” before handing over deposit account funds to a garnishing creditor was preempted by an OCC regulation (12 CFR § 7.4002) giving banks the power to impose service fees as part of their core depository function. In reaching its decision, the Sixth Circuit relied in part on *Barnett* and the court gave deference to the OCC regulation.

Under the new law, the Sixth Circuit decision would probably come out differently because Section 1044 precludes courts from giving strong deference to a regulation issued by the OCC or other prudential regulators to the extent that the regulation deals with preemption; for non-preemption rules, the court may still defer to the expertise of the OCC, under the so-called *Chevron* standard. Moreover, a court could downplay the facts in *Barnett* and find that the Ohio garnishment statute did not “significantly interfere” with the bank’s depository function. That’s basically what the dissenting judge held in the Sixth Circuit case.

Subsidiaries, affiliates, and agents of national banks won’t enjoy preemption. In *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2007), the Supreme Court held that an operating subsidiary of a national bank enjoys the same preemption as the bank itself. In *State Farm Bank v.*

Reardon, 539 F.3d 337 (6th Cir. 2008), the Sixth Circuit extended the *Watters* decision to third-party agents of a bank. Section 1045 of the new law directly reverses these decisions. State law will now apply to nonbank affiliates, subsidiaries, and agents of national banks in the same way it would apply to any other nonbank entity. This new rule proceeds on the theory that these nonbank entities are chartered by state law and so should be subject to it.

This rule has great practical implications for national banks. Based on *Watters*, national banks were encouraged to create and develop new products that were offered and distributed through operating subs and agents. In doing so, they were protected from a welter of conflicting state laws that could apply to the product. Fifty-state surveys were avoided and compliance costs were reduced. Consumers benefited through lower fees and interest rates. Under the new law, that protection is gone. Uniformity is compromised. Consumers will suffer from the higher cost of complying with varying terms in different states. The result is likely to be (1) increased compliance costs, (2) withdrawal of the product (especially by smaller banks), or (3) a decision to bring the activity into the bank itself, if the bank’s balance sheet permits.

Visitorial standards for national banks and thrifts. Section 1047 makes it clear that “visitorial” powers of the OCC don’t preempt the authority of a state attorney general to file a lawsuit against a national bank or thrift (or their operating subsidiaries) to enforce any applicable state or federal consumer protection law. This rule codifies *Cuomo v. Clearing House Ass’n, LLC*, 129 S. Ct. 2710 (2009), where the Supreme Court gave the green light to the New York attorney general to enforce state fair housing laws against a national bank.

Preservation of interest rate exportation. Another variation on the preemption theme is interest rate exportation, particularly for credit cards. This is one area where the new law retains strong federal preemption. Section 1044 provides that nothing in the new law stops national banks from charging interest, under the authority of the National Bank Act, 12 USC § 85, at the rate allowed by the state where the bank is located, even though such a rate would be usurious in the state where a credit cardholder lives. This rule is vital to the success of interstate credit card programs.

But what about exportation by federal thrifts, state-chartered banks, or federal credit unions? Curiously, Section 1044 makes no reference to other federal laws that authorize “exportation parity” for these other financial institutions. For example, 12 USC § 1831 has been construed to allow state-chartered banks to export interest rates, on a par with national banks. We suspect this is an unintended consequence of the statutory language, but it could bring challenges down the road.

In This Story:

- The Durbin Amendment Passed by the Senate
- Changes Made in Conference Committee
- Fed Gets Exchange Authority
- Where to Find Interchange Provisions
- Focus of New Law
- How a Payment Card Network Works
- Positions Taken by Merchants and Consumers
- Industry Arguments
- Politics of Passage

Fed Oversight of Debit Card Payment Networks Enacted After Durbin Forges a Surprise Compromise on Interchange

Much to the chagrin of the card payment industry, the Durbin Amendment made it into the financial reform bill. The odds in favor of getting the Amendment, sponsored by Senator Richard Durbin (D-IL), seemed pretty slim until Durbin, in a surprise move, struck a backroom deal with House members of the conference committee.

A key part of the deal gives regulatory authority to the Federal Reserve Board, not the new Consumer Financial

Protection Bureau, even though the Durbin Amendment is folded into the consumer protection provisions of the final law. Congress transferred all of the Fed's rulemaking authority over consumer protection to the Bureau, with this one glaring exception. (Later in our analysis of interchange, we question the validity of treating the Durbin Amendment as a consumer protection statute.)

Interchange rules amend the Electronic Funds Transfer Act. The President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Financial Reform Act) into law on July 21, 2010. The Durbin Amendment is incorporated into the Financial Reform Act as part of Title X. Title X creates the Consumer Financial Protection Bureau and a scattering of "regulatory improvements." (Subtitle G. Section 1075—Reasonable Fees and Rules for Payment Card Transactions) Going forward, the interchange provisions become part of the Electronic Funds Transfer Act (15 USC 1693 et seq.). Once the Fed writes the implementing rules, they will be housed in Regulation E.

Debit cards are principal focus. For the first time, the Federal Reserve Board has a green light to set interchange fees and change network operating rules established by

private agreements among network participants. Debit and credit transactions are carried on separate electronic networks. Congress targeted the debit side of the market. Signature debit, PIN debit, and open-loop reloadable prepaid cards are subject to the statute. Buried at the end of the law is one provision restricting card payment networks from setting certain trade restrictions on merchants and others who accept credit cards payments.

Interchange transaction fee caps sanctioned. The statute affects network fees as well as interchange fees. Technically, an interchange transaction fee is a payment from a merchant's bank to a card user's bank. Network fees are separate fees flowing to network carriers.

The version of the Durbin Amendment passed by the Senate defined "interchange transaction fee" to include "network fees," making network fees subject to fee caps determined by the Fed. House Conferees watered down the language. As enacted, the Fed's regulation of network fees is limited to ensuring that fees are not used to evade interchange fee regulation.

The payment card network model. In a typical system, the network determines the level of interchange transaction fees and rules of operation, including restrictions on merchant trade practices. Networks are exclusive clubs for members: issuing banks and merchant banks.

Merchants are the outsiders, yet bound by network rules as the price of doing business with networks; networks will only process debit-card drafts for merchants who play by all the rules. A large portion of interchange transaction fees is passed through to merchants by their banks as payment for processing transactions. The diagram on page 17 shows a typical transaction.

Networks and members cite business reasons for the model. Until enactment of the financial reform law, payment card networks have not been subject to federal regulation. Card networks and members defend the network model. Standardizing the terms of exchange, they argue, is necessary or the system won't operate efficiently. The level of the interchange fee received by the card issuer directly correlates to the costs and benefits offered cardholders, and acts as an incentive for market competition among card issuing banks, all the more benefiting consumers.

Merchants view the market as anti-competitive. Merchants see things much differently. Over the past several years, interchange transaction fees have gone up dramatically, increasing the cost of doing business for merchants. Merchants are angry. From their vantage point, insider banks and the networks are profiting at their expense. Skyrocketing

interchange fees push profit margins down. Merchants paint themselves as hostages, left with no choice except to pass on increased costs to consumers.

Consumers side with the merchants. Consumers joined the merchant bandwagon. All of a sudden, interchange transaction fees and network card practices turned into a consumer protection issue. Senator Durbin took up the cause. Durbin had introduced several bills; none made it through the Senate. When financial reform became the hot topic on the Hill, he decided the timing was right for another try. In a rare instance of bipartisanship, the Durbin

Amendment passed the Senate by a 64 to 33 vote.

Battle becomes Main Street vs. Wall Street. For political purposes, VISA and MasterCard were personified as villains. Durbin chaired an oversight hearing on June 16, 2010, timed to coincide with the release of a Treasury Department report concluding that the federal government would save \$40 million in taxpayer dollars if Visa and MasterCard stopped setting interchange fees at unreasonably high levels. This excerpt from Durbin's opening statement typifies the tenor of the debate orchestrated by the merchant/consumer lobby:

COMMENTARY

INTERCHANGE REGULATION ISN'T CONSUMER PROTECTION

What is the interchange statute doing in the middle of the Consumer Financial Protection Act? The new interchange law regulates business-to-business transactions and relationships. Benefits reaching consumers are an indirect consequence of oversight over interchange. Federal regulation of debit interchange is a whole different animal than direct consumer regulation of debit cards under Regulation E.

Perhaps this isn't the right way to look at things. Supporters of interchange fee regulation say that financial reform takes consumer protection to a new level. They contend that Visa and MasterCard are huge financial companies that collude with the nation's biggest banks to fix fees and stifle competition. Their expectation is that interchange fee caps will have a trickle-down effect: lower processing costs for merchants will benefit consumers in the form of lower retail prices.

Proponents view consumer protection law as an appropriate vehicle for federal regulation of purely business markets, even if consumers only benefit indirectly. Clamping down on Visa, MasterCard, Bank of America and Chase is "Wall Street reform" by way of "consumer protection," a perfect fit for the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

This way of looking at things carried the day in Congress. Unfortunately, in its haste to pass financial reform, Congress didn't think out the consequences of the interchange law it passed.

Ironically, large merchants like Wal-Mart, not small businesses, will benefit the most from the new law. Community banks and credit unions will suffer far more than the big banks or the networks. Market forces will cause the smaller financial institutions, which are very dependent on interchange fee income, to reduce fees below the level charged by the big banks. Smaller banks and credit unions opposed the law all along. Community bankers are not sure they can absorb the loss of fee income, coupled with the extra costs and burdens created by the new law.

Interchange regulation will hurt consumers in numerous ways. The new law will allow stores to set minimum dollar amounts for debit or credit cards purchases up to \$10. Buying a cup of coffee or a container of milk with a debit or credit card won't be an option everywhere. Approximately one-third of debit card transactions are for purchases under \$10, and nearly one-quarter of all credit card transactions are for purchases under \$10. (*U.S. Consumer Card Spending Study: The Impact of the Durbin Amendment*, Lightspeed Research, 2010.)

Price controls and new restrictions on debit card networks are certain to reduce profit margins for issuing banks, merchant banks, and the networks. Up-front compliance costs alone are going to be significant. Debit card issuers will make up for lost income by charging consumers in other ways for banking with them. Elimination of free checking, minimum balance requirements, and fees for monthly statements will be much more commonplace. Credit card payments are not subject to interchange regulation. Banks and nonbanks are going to move away from debit cards and shift more to the credit card side of the business.

No matter how you cut it, interchange regulation isn't consumer protection. We think regulating a business market under the guise of consumer protection is bad public policy and sets a dangerous precedent. Our preference is to let the courts decide whether card payment networks are violating the antitrust laws.

Credit and debit cards are rapidly replacing checks and cash in today's economy—they account for more than half of all retail sales in America.... Visa and MasterCard, which control 80% of the debit and credit markets, have established a system where their big bank allies take an automatic cut out of every credit and debit transaction. The card giants also block competition, prohibit discounts, and refuse to negotiate fee rates. If we don't take steps to reasonably regulate this system, a dollar won't be worth a dollar anymore—it will be worth whatever Visa and MasterCard want it to be.

(Opening Statement of Senator Durbin, Senate Appropriations Committee on Financial Services, June 16, 2010, available on the Durbin Senate website.) Politically, the whole interchange debate played to populist sentiment—Main Street vs. Wall Street.

The battle moves to the Conference Committee. Durbin modified the Senate-passed amendment enough to satisfy

the House Conferees, who had to sell industry regulation to House members—not an easy job

The industry lobby stood firm to the bitter end. Ed Yingling, president and CEO of the American Bankers Association, presented the industry's opposing view in an opinion piece published on June 17, 2010, in *USA Today*. Government meddling, Yingling argued, will raise costs for consumers, not lower them; fix prices for interchange fees below costs; and give merchants a boondoggle since they won't pay their fair share of the costs. Privately acknowledging defeat, the American Bankers Association won a last-minute concession providing adjustments for fraud control costs.

Parting thoughts as the Fed takes over. The new law puts the Fed in charge of rulemaking. Congress gave the Fed enormous rulemaking discretion. Now that the baton has passed to the Fed, the industry is gearing up for damage control. The next piece in this series focuses on the new law—big picture and fine print—the place to start for the lobbying effort ahead.

In This Story:

- ☛ Overview
- ☛ Small Issuers Under \$10 Billion Exempt
- ☛ Definition of “Debit Card” Includes Signature Debit Cards, PIN Debit Cards, Reloadable Prepaid Cards
- ☛ Paper Checks Excluded
- ☛ Conditional Exemption for Reloadable Prepaid Cards
- ☛ Conditional Exemption for Debit and Prepaid Cards Associated with Government-Administered Programs
- ☛ The “Reasonable and Proportional Standard” for Interchange Fees
- ☛ Adjustments for Fraud Prevention Costs
- ☛ Lessons from the CARD Act
- ☛ Merchant Fees
- ☛ Network Fees
- ☛ Merchants Allowed to Use More Than One Network
- ☛ Merchants Free to Offer Discounts to Encourage or Discourage Use of Cash, Checks, Debit, Credit, and Prepaid Cards
- ☛ Rulemaking and Enactment Dates

How the New Interchange Law Works, Based on Clues from Recent Fed History

Just how tough the Fed will be on the debit card industry is a big question. The question for the retail industry, the driving force behind the legislation, is whether the Fed will go all the way—creating rules that amount to price controls to push down what they believe are excessively high interchange fees.

Until the Fed releases its regulations, answering these questions is pretty much a guessing game. That's how ambiguous the new law is, and a reflection of how much latitude Congress gave the Fed. Ed Yingling, who heads the American Bankers Association, summed up the situation in a nutshell right after the House passed the legislation on June 30, 2010: “The Durbin Amendment is in,” Yingling said, “but no one knows how it works.”

Striking parallels with Credit CARD Act. Congress modeled the Interchange Law on provisions in the Credit CARD Act of 2009 relating to credit card penalties and charges. The Fed is famous for regulating through disclosure, and stopping short of setting fees. The CARD Act gave the Fed authority to cap bank fees for credit cards, a monumental extension of Fed power into the realm of substantive fee regulation.

Under the CARD Act, the amount of any penalty fee must be “reasonable and proportional” to the violation—a standard Congress used for the first time. The Interchange Law adopts the same “reasonable and proportional” language; it requires that any interchange transaction fee be “reasonable

Highlights of Interchange Law

- Provides Federal Reserve Board authority to establish rules for debit card interchange fees
- Sets limits on the ability of payment card networks to impose restrictions on merchants related to:
 - use of competing card networks for debit card transactions
 - discounts for paying by cash, check, debit card, or credit credit
 - accepting credit cards for payments \$10 or under

and proportional to the cost incurred by the issuing bank in processing the transaction.” While the two statutes are not perfectly parallel, their similarities are striking.

Some basics: citations and dates. The interchange provisions are found in the Consumer Financial Protection Act of 2009, Title X, Section 1075. They amend the Electronic Fund Transfer Act (EFTA), codified at 15 USC 1693 et seq., by inserting a new Section 920, titled “Reasonable Fees and Rules for Payment Card Transactions.”

The Senate bill included an amendment proposed by Senator Dick Durbin (D-IL) authorizing federal regulation of interchange transaction fees and payment card networks for electronic debit transactions. (H.R. 4173) The House-Senate Conference Committee completed its work on June 25, 2010. In modified form, Senator Durbin managed to slip the amendment into the Conference Report, approved by both houses of Congress. (Conference Report 111-517)

There are two distinct parts to the law. Section 920 of the amended EFTA is divided into subsections (a) and (b):

- **Section 920(a)—Reasonable Interchange Transaction Fees for Electronic Debit Transactions.** True to its name, this subsection applies only to electronic debit transactions. Subsection (a) grants the Fed authority to regulate interchange transaction fees, a distinct type of fee, paid by the merchant bank to the issuing bank based on a fee structure set by the network. This is where the “reasonable and proportional” requirement comes into play. It is a standard that applies to any “interchange transaction fee” recovered or charged by the issuer. [Sec. 920(a)(1)].

Network fees are regulated under Section 920(a), but a separate set of rules applies. [Sec. 920(a)(8)] As defined by the statute, an “interchange transaction fee” does not

include a “network fee.” This is a “switch fee” paid to the network which imposes separate assessments on the card-issuing bank and the merchant’s bank. The “reasonable and proportional” standard doesn’t apply to network fees, and network fees are not subject to price control.

- **Sec. 920(b)—Limitations on Payment Card Network Restrictions.** Merchants are subject to restrictive rules established by the network. Subsection (b) applies to debit and credit card transactions.

Roughly 98 percent of the statutory language pertains to debit cards. Nevertheless the section of the law applicable to credit cards is a significant regulation forcing increased competition into the credit card market.

PRELIMINARIES: DEFINITIONS AND EXEMPTIONS

Small issuers under \$10 billion are exempt from some regulations, but not all. The law regulates “issuers,” a term defined as any “person” who issues a debit or credit card, or any agent of that person. Consistent with the definition, banks and nonbanks are issuers. The statute, however, exempts issuers with assets less than \$10 billion, including assets of affiliates, but only from the “reasonable and proportional” requirements for interchange fees. Presumably, the small-issuer exemption includes the adjustment of interchange fees allowed for fraud-cost prevention. However, it isn’t clear just how far the exemption for the rules on fraud prevention will extend. See the discussion below. It makes sense to interpret the statute as exempting small banks from the rulemaking pertaining to network fees. The congressional intent for regulating network fees is to insure they aren’t used as a way to evade the controls on interchange fees.

Broad definition of “debit cards.” Debit cards are “pay now”; credit cards are “pay later.” Consumers use debit cards to withdraw funds from depository accounts or access money stored electronically on prepaid cards. The statute broadly defines “debit cards” to include:

- Signature debit cards
- PIN debit cards
- Reloadable prepaid cards
- Debit cards for government-administered programs
- Prepaid cards for government-administered payment programs

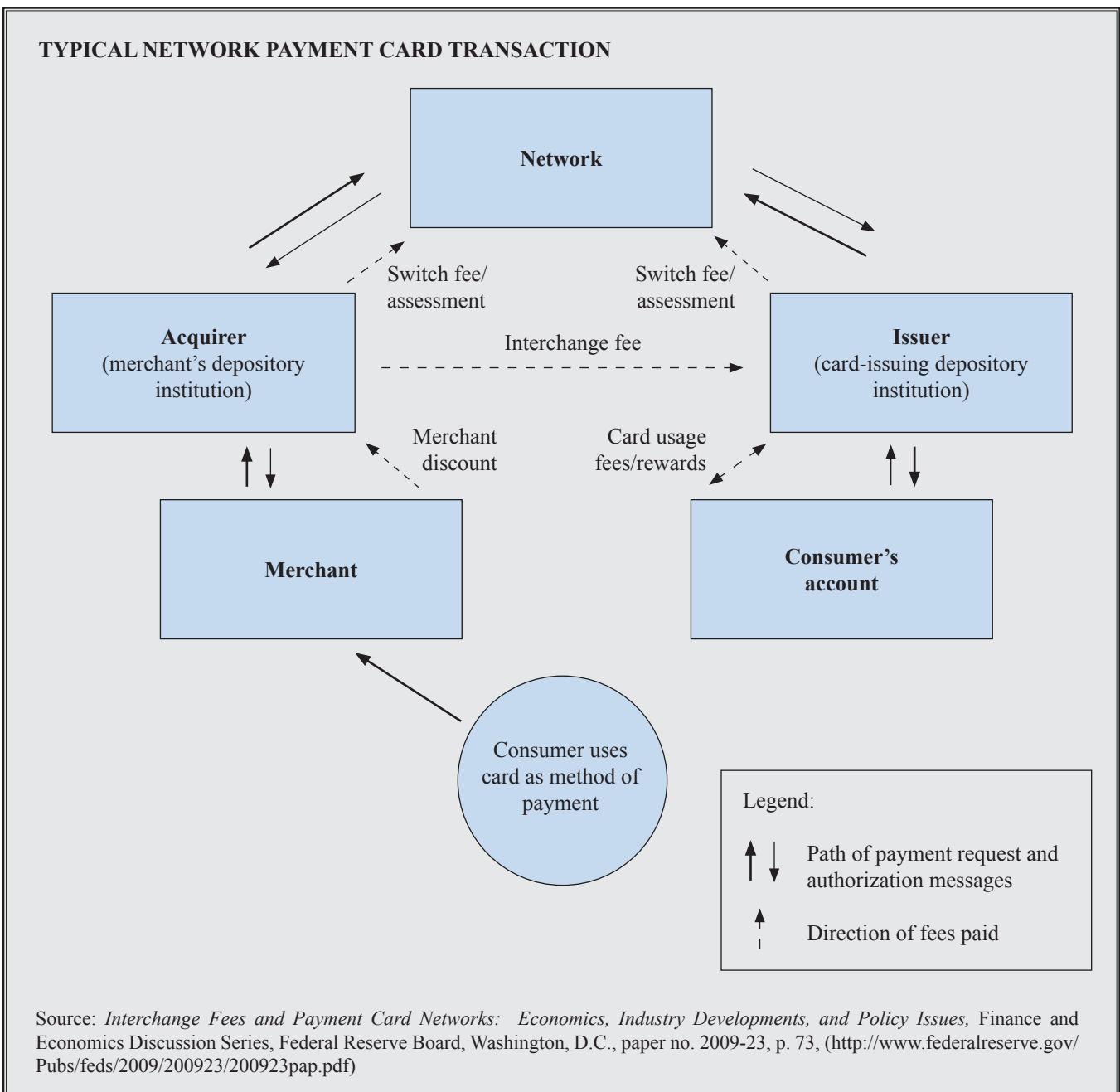
The term covers the plastic card we pull out of our wallets and any other “payment device or code.” To qualify as a debit card, the card or device must be (1) “issued or

approved” for use through a payment card network for electronic debit transactions; (2) used to debit a consumer asset account; and (3) the transaction must be subject to authorization.

Paper checks excluded from the definition of debit card. Paper checks are excluded. They are not processed through a payment card network. Should electronic checks submitted for processing through the check collection system also be excluded? Perhaps there should be a broader exclusion for

electronic payment devices not processed through debit card networks.

Conditional exemptions for reloadable prepaid cards and prepaid cards for government-administered programs. Even though included within the definition of “debit card,” reloadable prepaid cards for government-administered payment programs enjoy a limited exemption. This same exemption applies to debit cards used to access direct deposits for government-administered programs.



However, this exemption can be lost. See below for a more detailed explanation of this tricky part of the law.

More on reloadable prepaid cards. Here there are lots of confusing provisions. Congress excluded prepaid cards as a way to protect the unbanked or under-banked who rely on prepaid cards as a substitute for traditional depository accounts. Only “general-use prepaid cards” as defined by the EFTA fall within the definition of “debit cards.” The EFTA defines “general-use prepaid cards” as cards:

- 1) redeemable at multiple, unaffiliated merchants or service providers, or at an ATM,
- 2) issued in a requested amount, whether or not that amount may, at the option of the issuer, be increased in value or reloaded if requested by the holder,
- 3) purchased or reloaded on a prepaid basis, and
- 4) honored by merchants for goods or services or at an ATM.

[15 USC § 1693-1(a)(2)] The definition refers to open-loop reloadable prepaid cards, commonly bearing the Visa or MasterCard logo, issued by banks and nonbanks. This reading is consistent with the a definition of reloadable prepaid cards found in Section 910(a)(7)(A). Clarification would be helpful.

A good question is whether small issuers of this type of stored value card are exempt from the “reasonable and proportional” regulations on interchange transaction fees. This reading seems logical. Are gift cards exempt? Based on the language in Section 910(a)(7)(A)(V), we think they are. Conversely, what types of prepaid cards other than open-loop reloadable cards aren’t covered at all by the statute? For example, closed-loop prepaid cards redeemable only at an issuer’s store or website should be excluded. Stored-value cards come in many flavors and colors. It isn’t always easy to figure out what legal box they fit into.

Cards issued by government agencies or used in connection with government-administered programs are closed-loop prepaid cards and fall within the conditional exemption from the “reasonable and proportional” requirement for interchange transaction fees. Although close-looped, these prepaid cards are covered by the statute. Section 910(a)(7)(A). This is another confusing wrinkle in the statute.

PART ONE OF THE LAW

The nub of it—regulation of interchange transaction fees. Congress gives the Fed power to regulate “interchange transaction fees” in the first section of the law. (Section 920(a)) This is a transaction fee flowing from the merchant bank to the issuing bank. Interchange fees generally are

determined by the payment card network. As a result, all banks pay a uniform interchange fee. However, the industry disagrees with this assumption on the ground that bilateral negotiation occurs between card issuers and networks.

Both “interchange” and “issuer” are defined terms. Used in tandem, Congress intended the term interchange fee to be all-inclusive: It covers any fee established, charged, or received by a payment card network for the purpose of compensating the issuer for its involvement in an electronic debit transaction. And an “issuer” includes any person who issues a debit card, or the agent of such person.

Just how tough the Fed will be on the debit card industry is a big question. The question for the retail industry, the driving force behind the legislation, is whether the Fed will go all the way—creating rules that amount to price controls to push down what they believe are excessively high interchange fees.

The “reasonable and proportional” requirement for transaction fees. The Fed is vested with rulemaking authority. It can prescribe regulations insuring that the amount of any interchange fee complies with the “reasonable and proportional” requirement, i.e., any interchange transaction fee charged or received by the issuer must be “reasonable and proportional” to the “cost” incurred by the issuer for processing the transaction. This broad authority permits the Fed to cap interchange fees.

Congress didn’t include a definition of the term “reasonable and proportional.” To implement the “reasonable and proportional” requirement, the Board is required to establish standards for assessing whether the amount of an interchange fee satisfies the statutory mandate. The Fed must “consider” two factors when it establishes standards. These are:

- The functional similarity between electronic debit transactions and checking transactions that the Federal Reserve bank clears, at par; and
- The distinction between the incremental costs incurred by the issuer for its role in the interchange system and the costs incurred by the issuer not specific to a particular transaction.

Also, the Fed is required to “consult” with the federal regulators, including the director of the Consumer Financial Protection Bureau, as “appropriate.”

Problems with pegging “reasonable and proportional” to “costs.” Last year economists at the Fed released a study on interchange fees and the role they play in payment card networks. (Fed White Paper) The Fed White Paper provides “background for understanding the interchange fee debate.” “The basic economic role of an interchange fee is to affect the prices of card services for the merchant and the consumer in a transaction,” according to the Fed economists. Setting price controls on interchange fees will affect the merchant discount since “an interchange fee typically comprises a large fraction of the merchant discount for a particular transaction”. *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues*, Finance and Economics Discussion Series,

Federal Reserve Board, Washington, D.C., paper no. 2009-23, pages 18-19, (<http://www.federalreserve.gov/Pubs/feds/2009/200923/200923pap.pdf>).

The Fed White Paper explains how an “appropriately” chosen interchange fee insures that the “number of card transactions will be economically efficient.” The Paper goes on to point out that “a few characteristics of an efficient interchange system are worth noting:

- In general, an efficient interchange fee is not solely dependent on the cost of producing a card-based transaction nor is it equal to zero.
- An efficient interchange fee may yield prices for card services to each side of the market that are ‘unbalanced’

COMMENTARY

DAMAGE CONTROL AT THE FED

The banking industry isn’t done fighting interchange. The next step is to present to the Fed a true picture of how the payment system actually functions. Issuing banks and the networks do negotiate fee arrangements; there are competitive forces at work. Determining price controls based on whether the amount charged is “reasonable and proportional” to the costs incurred by issuers is much too simplistic an approach. There isn’t empirical data supporting the assumption that a lower interchange fee will make things better for merchants and consumers or increase competition in the market.

To the contrary, there is a host of factors that influence market function and efficiency other than the cost of interchange for issuers. Many are not quantifiable, and there isn’t a clear formula for figuring how it all works. The Fed’s own economists reached exactly this conclusion just a year ago in their extensive study of card payment networks and the role of interchange fees on the market. *Interchange Fees and Payment Card Networks: Economists, Industry Developments, and Policy Issues*, a staff working paper in the Finance and Economics Discussion Series, Division of Statistics and Monetary Affairs, Federal Reserve Board Washington, D.C., 2009-23, available on the website of the Federal Reserve Board.

The Fed study makes the point this way: “In order to provide appropriate incentives to parties in a transaction, an efficient interchange fee may yield prices to each side of the market that are ‘unbalanced’ in the sense that one side pays a higher price than the other. Indeed, efficiency may, in some cases, require a negative price for one side of the market.”

Approaching the Fed armed with economic analysis and market studies supporting the industry’s position has worked before. The credit card industry successfully contained some of the damage done by the CARD Act of 2009. Yes, there are Fed-imposed price caps on penalty fees for credit cards. The CARD Act restricts how often fees can be charged and hurts the bottom line. Still, the industry convinced the Fed that the existing fee structure was fair. As a result, the “safe harbors” established by the amendments to Reg. Z fall within the range of penalty fee and charges currently imposed by card issuers.

It helps that the Fed is the rulemaker for debit card interchange. It is wise that Congress didn’t put the new Consumer Protection Bureau in charge. The Fed has plenty of experience under its belt dealing with similar challenges. The Fed’s track record suggests that it will honor the congressional mandate conservatively and go out of its way not to unduly interfere with the free market.

Looking to the Fed for damage control will pay off. Lawyers are poring over the statute and anticipating the Fed’s rules. Astute bankers are a step ahead. They’ve figured out how big a hit their debit card business is going to take, and are in the process of implementing innovative ways to replace the income.

It may be that killing interchange regulation in its present form is the best option of all. The American Bankers Association is gearing up for the fight. Major stakeholders are doing the same. The upcoming November elections could tip the balance of power in Congress enough to make this a possibility.

in the sense that one side pays a higher price than the other.

- The efficient interchange fee for a particular card network is difficult to determine.”

(Fed White Paper at 3) Therefore, tying the “reasonable and proportional” standard to issuer costs, as the statute requires, may not be appropriate. In addition, the cost factor will vary from network to network and the type of payment system, e.g. PIN debit card and signature debit card.

Adjustments to interchange fees for fraud prevention.

Under a separate provision, the Act injects “fraud prevention costs” as a factor to be considered when the Fed determines “reasonable and proportional.” The Fed can adjust the rate for a specific issuer if the issuer petitions for a rate hike. In order to qualify for the adjustment, the issuer must have a satisfactory fraud prevention program in place and demonstrate that a rate hike is reasonably necessary to cover the costs of enhancing its existing program.

A practical reading is that the Fed will establish compliance standards for a secure fraud control system, using best industry trade practices as a guide, taking into account the factors listed in the statute and whatever else it considers important, and then compose standards creating a baseline for the industry. A bank asking for an adjustment must demonstrate that it has an acceptable fraud control system in place and that a rate increase is necessary to cover reasonable costs for enhanced security. Presumably, there will be separate rules governing the standards for adjusting costs.

Are small issuing banks exempt from the fraud rules?

Are small banks subject to the provision on adjustments for fraud prevention costs? Technically, the statute exempts them from the general interchange rules, but not the fraud rules. Yet, might the Fed mandate that small banks also have a security system for fraud in place that meets industry standards? This interpretation would be good policy.

Interpreting “reasonable and proportional” in light of the CARD Act penalty fee regulations. The Fed’s decision-making authority for setting the amount of interchange fees looks familiar. The Credit CARD Act uses the “reasonable and proportional” standard. Under the CARD Act, the Fed is responsible for assessing whether a credit card penalty is “reasonable and proportional” to the violation for which it is imposed and establish appropriate standards. The Fed’s rulemaking authority is comparable to its rulemaking authority under interchange: to “consider” the factors suggested in the law and devise rules using its

discretion. Like the interchange law, the CARD Act doesn’t define “reasonable and proportional.”

The Fed surmises Congress’s intent. The CARD Act amends the Truth-in-Lending Act (TILA) and is incorporated into Regulation Z. The Fed released the final rule in June; it is effective August 22, 2010. In the Commentary for the final rule, the Fed indicates that it isn’t “aware” of any “generally accepted definition” for the legal term. The Fed surmises that Congress intended the term “reasonable and proportional” to mean a:

[R]easonable and generally consistent relationship between the dollar amount of the credit card penalty fees and the violations for which those fees are imposed, providing the Board with substantial discretion in implementing that requirement.

This loose interpretation amounts to a paraphrase of the “reasonable and proportional” rule. There isn’t much meat to it.

Predictions based on the CARD Act as a history lesson. Logically, the Fed will view its mandate under the Interchange Act in the same way as the Fed viewed it under the CARD Act. It is reasonable to expect the Fed to:

- **Set and cap interchange transaction fees**
- **Establish “safe harbors” for interchange transaction fees**
- **Establish different “safe harbors” for signature debit cards and PIN debit fees**
- **Create “safe harbors” falling within the range of fees currently charged in the market, provided that the industry can justify the fee structure on a cost basis and convince the Fed that fees fairly compensate the issuer**
- **Cap the fees at the low end of the market fee structure to satisfy allegations that interchange fees are excessively high**

These predictions are based on the premise the Fed will be very conservative in the way it implements the interchange law, and go out its way not to interfere with the free market.

What about merchant fees? The Interchange Law doesn’t seem to regulate the “merchant discount” which is the difference between the face value of the draft sent by the merchant to the merchant bank and the amount the merchant

bank pays the merchant. Generally, it is equal to the sum of the (i) interchange fee, (ii) switch fee paid by the merchant bank to the network, (iii) costs incurred by the merchant bank, and (iv) merchant bank mark-up.

Conditional exemptions for government-administered debit and reloadable prepaid cards associated with government-administered transactions. There are several important exemptions relieving government-administered payment programs and reloadable payment cards from interchange fee price controls and other applicable rules. It's important to read the fine print because "exceptions to the exemptions" apply in some cases. Stakeholders need clarification from the Fed, and presumably will lobby for interpretations in keeping with their best interests. Here is a summary of the exemptions:

- **Government-administered payment programs are exempt.** Issuers of debit or general-use prepaid cards on behalf of programs administered by federal, state, and local governments are exempt from interchange fee controls. Examples of programs covered are unemployment insurance, social security, and child support. The exemption is limited to debit cards and prepaid cards allowing the cardholder to access funds deposited by the government into the recipient's depository account or loaded onto the prepaid card.

The exception to the exemption: The issuer can impose transaction and penalty fees until July 22, 2011. However, the bank issuer loses the exemption if after that date it imposes (i) an overdraft fee, or (ii) an ATM withdrawal fee for the "first withdrawal per month" if the ATM is "part of the issuer's designated network." The exemption is riddled with issues, not to mention compliance problems.

- **Certain general-use prepaid cards are exempt.** This exemption is intended to cover so-called open-loop stored value cards used by consumers as a substitute for a depository bank account. The cards are commonly used by lower-income consumers. Prepaid cards include the plastic card, payment code, or device provided it is (i) linked to funds electronically loaded on a prepaid basis, (ii) does not provide access to a depository account linked to the cardholder, (iii) are open-looped, meaning that it is redeemable at multiple unaffiliated merchants or ATMs, (iv) used to transfer or debit funds, and (v) is reloadable. Also, the prepaid card does meet the definition of a gift card or gift certificate.

The exception to the exemption: The exception is identical to the one that applies to issuers of debit and prepaid cards

for government-benefit programs. The issuer can impose transaction and penalty fees for a 12-month period dating from the enactment date of the Consumer Financial Protection Act. The grace period ends on July 22, 2011. Thereafter, the issuing bank loses the exemption if it imposes (i) an overdraft fee, or (ii) an ATM withdrawal fee for the "first withdrawal per month" if the ATM is "part of the issuer's designated network."

The Fed's power to regulate network fees. Network fees are also regulated by the interchange provision. However, the Fed's regulatory authority is circumscribed compared to its power over interchange transaction fees. Network fees accrue to the networks themselves in the form of assessments on issuing banks and merchant banks. The Senate argued in favor of treating network fees in the same way as interchange fees by defining interchange fees to include network fees. This scenario allowed the Fed to impose price controls, using the "reasonable and proportional" test. The final provision enacted into law axes the Fed's ability to set price controls. Rulemaking is limited to closing a loophole: ensuring that network fees are not used, directly or indirectly, to evade interchange fee price controls.

PART TWO OF THE LAW

The second part of the interchange law: imposing clamps on restrictive operating rules affecting merchants. Each card network establishes operating rules. The parties to the operating agreement are the network, issuing bank, and merchant bank. Merchants must comply with the network's operating rules even though they are not contract parties, or else they will be booted out of the network. Built into the operating rules are one-sided restrictions on merchants. Subsection (b)—the second half of the statute—renders network restrictions illegal or at least limits their scope. Under the statute:

- **Prohibitions against exclusivity arrangements for debit cards are eliminated.** Current network operating rules create exclusive networks. Merchants, or any other party accepting electronic debit cards, will be able to use more than one network for processing electronic debit transactions.
- **Discount restrictions for debit and credit cards are lifted.** Merchants can offer discounts tied to the payment method used by a customer. Under existing federal law, the card network cannot prohibit a merchant/seller from offering a discount to induce a customer to pay by cash, check, debit card, or credit card. A merchant offering a discount for debit and credit cards, however, cannot differentiate on the basis of a card issuer or network.

- **Restrictions on setting minimum and maximum amounts for credit card acceptance are lifted.** A merchant can set a minimum dollar amount for accepting a credit card provided the (i) dollar amount does not exceed \$10, and (ii) the minimum does not differentiate between cards issuers or payment networks. Federal agencies and colleges and universities can set a maximum dollar value for acceptance of credit cards, provided there is no differentiation between issuers or networks.

Congress's intention is to increase competition in the marketplace, leading to lower transaction costs for the merchant and consumer.

EFFECTIVE DATE AND DEADLINES FOR FED RULEMAKING

Important dates. Congress used the enactment of the Consumer Financial Protection Act as a peg for setting deadlines. The CFPA is effective on July 22, 2010. The Fed must complete its rulemaking within a nine-month period (March 2011). Usually a proposed rule is released in six months (January 2011). The final rule is effective July 23, 2011.

Wrapping up: Expect price controls and Fed intervention in the card payment system by July 23, 2011.

hurt many banks badly, in some cases raising “safety and soundness” concerns. In this article, we examine the radical change in the fee income landscape that has occurred in the last two years, and we make some predictions for the future.

The fee landscape two years ago. Based upon federal preemption, as well as legislative and regulatory latitude, national banks had the power to set their fee structure for credit cards, gift cards, debit cards, and overdraft programs pretty much the way they desired. Past attacks on bank fees in non-mortgage financial products had proved unsuccessful.

The fight began with the California Supreme Court's decision in *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503 (Cal. 1985). In that case, the class plaintiffs used a “price unconscionability” theory in challenging the bank's imposition of a \$6 fee (yes, \$6!) on NSF checks, as authorized by the deposit agreement. The court okayed the deposit agreement as a binding contract, but sided with the plaintiffs on the issue of price unconscionability. In particular, the court was impressed by the plaintiffs' claim that the six-dollar fee represented a 2000 percent profit, based on the alleged NSF processing cost to the bank of 30 cents per check.

Several days before oral argument in the *Perdue* case, the OCC issued an interpretive ruling that the setting of service charges such as NSF fees was a “business decision” for national banks, so long as they applied a number of factors listed in the ruling. The California court ignored any preemptive effect of the “shotgun” ruling and the *Perdue* case was ultimately settled. The ruling was later codified by the OCC (12 CFR § 7.4002), however, and has since been used as a bulwark of deposit-side fee preemption. For example, in *Bank of America v. City & County of San Francisco*, 309 F.3d 551 (9th Cir. 2002), the Ninth Circuit held that both OCC and OTS regulations preempted a city ordinance that prohibited “surcharges” to consumers at nonproprietary ATMs. In *Wells Fargo Bank Texas, N.A. v. James*, 321 F.2d 488 (5th Cir. 2003), the Fifth Circuit upheld check-cashing fees for noncustomers based on the same preemption theory.

With respect to overdraft protection products, bank customers were automatically enrolled and the overdraft fees automatically imposed, whether the overdraft was triggered by a check or a debit card. As a regulatory matter, the fees were not considered to be “finance charges” and were protected from attack by the Truth-in-Lending regulations. 12 CFR § 226.4. In this environment, overdraft fees continued to expand big-time. On August 9, 2009, the *Financial Times* of London reported that U.S. banks were likely to collect \$38.5 billion for customer overdraft fees in 2009.

On the consumer credit side of the ledger, the credit card “exportation” cases protected banks from attacks on

Under Multiple Attacks, Bank Fee Income Is Plummeting

The centerpiece of the new financial reform legislation is consumer protection. Going forward, financial institutions are understandably concerned about the broad powers of the new Consumer Protection Bureau. (See our lead story.) But in recent times, a big development has already occurred in the name of “consumer protection.” Over the past two years, banks have seen multiple attacks on fee income

in the name of “consumer protection.” These attacks—in the form of legislation, regulation, and litigation—have been remarkably successful. They began in late 2008. Ironically, that was precisely the time when bank lending locked up because of the financial crisis. This double whammy has

In This Story:

- Overdraft Fees
- High-to-Low Debit Posting
- Credit Card Fees
- Gift Card Fees
- Interchange Fees
- Possible New Initiatives from the Bureau

their late fees. In *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735 (1996), the U.S. Supreme Court held that late-payment fees imposed against delinquent bank credit cardholders constitute “interest” for purposes of allowing exportation of interest rates from the bank’s home state to other states where cardholders reside. In reaching this conclusion, the Supreme Court was relying on the federal usury law, 12 USC § 85. The bottom line was that bank credit card issuers were protected against state-law claims that credit card penalty fees were unconscionable. In finding federal preemption, Justice Scalia gave great deference to the OCC’s regulation (12 CFR § 7.4001) that expressly treats penalty fees as “interest” under the federal statute.

Then, in 2004, the OCC enacted expanded preemption regulations that “occupy the field” and give maximum latitude to banks in setting fees for both deposit products (12 CFR § 7.4007) and consumer loan products (12 CFR § 7.4008-4009). The OTS adopted parallel provisions. 12 CFR § 557.

The fee landscape now. In 2008, the picture began to change dramatically.

- **Overdraft fees.** In November of 2008, the FDIC published a study entitled “Bank Overdraft Programs” that highlighted the high cost of overdraft fees, as well as the lack of transparency to many consumers. In November 2009, the Federal Reserve Board published its final rule on overdraft protection programs; in the rule, the FRB suddenly shifted from an “opt-out” approach that it had originally suggested in May 2008, to an “opt-in” approach requiring the affirmative consent of the consumer. If the customer hasn’t opted in, no overdraft fee can be charged if the overdraft was triggered by a debit card or ATM charge. The rule, which amends Reg. E, trumps the OCC/OTS regulations protecting deposit-side fees. The rule took effect on July 1, 2010, and is likely to result in a huge decrease in overdraft fees for banks large and small, compared to the \$38.5 billion in fees collected in 2009. Some banks, including Bank of America, have opted to eliminate their overdraft protection programs altogether. Significantly, the new overdraft rule doesn’t put caps on overdraft fees, or require that the fee be “reasonable and proportional” to the size of the overdraft.
- **High-to-low debit posting.** Another attack on overdraft fees is coming from a recent outburst of lawsuits that challenge the common practice of posting debits in a “high-to-low” order, which has the effect of maximizing the number of overdrafts (and fees) on a given day. See, e.g., *White v. Wachovia Bank, N.A.*, 563 F. Supp.2d 1358 (N.D. Ga. 2008); *Gutierrez v. Wells Fargo Bank, N.A.*,

622 F. Supp.2d 946 (N.D. Calif. 2009); *In re Checking Account Overdraft Litigation*, 694 F. Supp. 1302 (MDL No. 2036, S.D. FLA 2010).

- **Credit card fees.** In early 2009, Congress enacted the Credit CARD Act of 2009, which for the first time imposes limits on a variety of credit card fees. Perhaps most important, the amount of any penalty fee that a card issuer may impose, including any late or overlimit fee, must be “reasonable and proportional” to the omission or violation. This important provision has been fleshed out by the FRB in amendments to Reg. Z, effective August 22, 2010. The new rule allows credit card penalty fees to be justified on a cost basis, and alternatively provides some “safe harbors” for issuers to sail into. For an initial violation of an overline limit, the credit card issuer can charge \$25; for subsequent violations, the safe-harbor amount is \$35. The Credit CARD Act also limits subprime “fee harvester” cards and requires “opting in” for overlimit fees.

Over the past two years, banks have seen multiple attacks on fee income in the name of “consumer protection.” These attacks—in the form of legislation, regulation, and litigation—have been remarkably successful.

- **Gift card fees.** The Credit CARD Act also contains limits on dormancy fees for gift cards. Such fees have long been a concern of consumer advocates. Under the new law, the issuer of a gift card must wait one year before imposing any dormancy fee. Beyond one year, only one such fee may be charged per month. The FRB has implemented the statute by amendments to Reg. E, effective August 22, 2010. Significantly, the new federal limits on fees do not affect the wide range of limits found under a variety of state laws governing gift cards.
- **Interchange fees.** In addition to new fee limits imposed by existing law, Section 1075 of the Dodd/Frank Wall Street Reform and Consumer Protection Act authorizes the FRB to set “reasonable and proportional” caps on interchange fees. These fees are charged to merchants by issuers of debit cards accepted by the merchant. For example, if a consumer makes a \$250 purchase by use of a Visa debit card, the consumer’s deposit account is electronically debited \$250 but the merchant’s account is credited only \$247. The \$3 differential is pocketed by the issuer, with a slice to the Visa card network and independent service organizations that facilitate the authorization, clearance,

and settlement of the transaction. Not surprisingly, retail merchants hate the fee and they were able to get Senator Durbin to insert the new provision into the omnibus bill. Section 1075 is part of Title X, "Bureau of Consumer Protection," indicating that the drafters believe lower interchange fees will not only aid merchants, but indirectly lower prices for goods and services bought by consumer users of debit cards.

In the past, these fees have been unregulated. In setting "reasonable and proportional" caps on interchange fees, the FRB is required to consider (1) the functional similarity between electronic debit transactions and check transactions that are required by the FRB to clear at par, and (2) the "incremental cost" incurred by an issuer for its role in the settlement process. The FRB may also consider "the costs incurred by the issuer in preventing fraud in the transaction, e.g. unauthorized use of the consumer's debit card." Bank issuers with assets of less than \$10 billion are exempt from the new rule. Some industry watchers estimate that the big banks could lose up to \$20 billion in interchange fees when the FRB is finished with its rate setting. (See our related stories on interchange fees.)

What new limits on fees can we expect from the Consumer Protection Bureau? The Bureau has broad authority to make rules identifying "unfair, deceptive, or abusive acts or practices" as unlawful. With this broad mandate, the Bureau could consider enacting rules further restricting or capping fees imposed in connection with various consumer financial products. We offer three examples:

- The Bureau might go further than the current overdraft "opt-in" rules by capping overdraft fees. For example, it might use the "reasonable and proportional" standard to stop the famous "\$40 cup of coffee at Starbucks." Or it might outlaw high-to-low debit posting, with a resultant reduction of overdraft fees for those who have opted in.
- The Bureau might try to prohibit other types of fees that have drawn the ire of consumer advocates, including surcharges on proprietary ATM transactions and check-cashing fees for noncustomers.
- The Bureau might try to regulate credit card interchange. The new Dodd-Frank law primarily regulates debit card interchange, and puts the Fed in charge of rulemaking. This creates something of a hole in federal regulation for credit card interchange that the Bureau could try to fill.

Bottom line. Attacks on bank fee income from consumer credit and deposit transactions have been very successful over the past two years. Fees previously regulated only in terms of disclosure have now been capped or flat-out eliminated. The trend is away from setting fees as a bank "business decision" to a public utility model where the fees must be cost-justified. The advent of a powerful and independent federal Consumer Protection Bureau is likely to accelerate this trend, and that is where the lobby efforts of the financial services industry are likely to focus in the future. Stay tuned.

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