Meeting Between the Board of Governors
and the Federal Advisory Council
February 4, 2011

Board members: Chairman Ben Bernanke, Vice Chair Yellen, Governor Warsh, Governor Duke, Governor Tarullo, and Governor Raskin

Council members: Joseph Hooley, Robert Kelly, Bharat Masrani, James Rohr, Richard Fairbank, Daryl Byrd, David Nelms, Bryan Jordan, Richard Davis, Richard Evans, Russell Goldsmith

Summary: The Federal Reserve met with the Federal Advisory Council ("the Council"), a statutorily created advisory group that is composed of twelve representatives of the banking industry (one member from each Federal Reserve District). The Council ordinarily meets four times a year to provide the Board with information from the banking industry's perspective.

During the meeting, the Council discussed the implementation of the Dodd-Frank Wall Reform and Consumer Protection Act ("the Act") and presented its views on the following topics: the Board's proposed rule on debit-card interchange fees, routing, and payment-network exclusivity; proposed liquidity standards in the Basel III capital framework; the potential effect of the so-called Volcker rule; communication and disclosure issues associated with the stress tests required by the Act; and the cumulative effect of the new regulations promulgated under the Act and the need for coordination among the federal financial institution regulatory agencies in rulemakings and other areas of the Act.

The information collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

Federal Reserve Board Interchange Proposal

What is the Council's view of the Federal Reserve Board's proposal concerning debit card interchange fees, routing, and network exclusivity?

We have gathered unprecedented feedback from across the financial services industry and there is broad and deep opposition to the Federal Reserve's proposed approach, which we strongly believe misinterprets and misapplies the Durbin Amendment. If enacted as proposed, the results would be extremely damaging to consumers, the U.S. payment systems and financial institutions of all sizes. Given the serious flaws in the Proposed Rule, we urge the Board to withdraw the current proposal, fundamentally revise its overly narrow interpretation of the Durbin Amendment and issue a new proposed rule that takes fully into account both the requirements of law and the significant consumer and economic considerations at stake.

- Debit card transactions have become the most popular means of purchasing goods and services in the United States.
- Millions of consumers and merchants benefit from the debit card infrastructure that has been developed at a great cost by banks and credit unions.

The Durbin Amendment authorizes the Board to establish interchange fee standards that will largely preserve the benefits of the debit card payment system by enabling issuers to recover a broad array of their costs plus a reasonable rate of return.

- Rather than encouraging the continuing development and use of debit card transactions, the Proposed Rule goes well beyond the requirements of the Durbin Amendment and would disrupt the market process by imposing price controls which would severely curtail the growth of one of the most popular and efficient means of transacting day-to-day purchases for American consumers.
- The statute does not require the Board to cap interchange fees nor does it require the Board to restrict fees to issuers' incremental costs of authorization, clearance, and settlement.
- To the contrary, the statute requires the Board to establish *"standards for assessing"* whether an interchange fee "*is reasonable and proportional to,"* broadly, *"the cost incurred by the issuer with respect to the transaction."* The Board misconstrues this requirement in three crucial respects:

    - First, the Board fails to accept the normal meaning of "standards for assessing," which connotes an evaluative process, and instead reads this phrase as requiring pre-determined caps.
    - Second, the Board wrongly interprets "reasonable and proportional" to mean equivalent to some "costs," contrary to the clear statutory language.
    - Third, contrary to the Board's view, Durbin does not prohibit the consideration of incremental costs beyond those associated with authorization, clearance or settlement of a particular transaction. Incremental costs not included as allowable costs under the Proposed Rule include fraud losses, fraud prevention, network processing fees, customer service inquiries and disputes and debit card production and delivery.
- By wrongly interpreting the phrase "reasonable and proportional" to mean equivalent to some costs, the Board fails to give effect to the courts' long-standing construction of similar phrases like "just and reasonable" in ratemaking schemes to require the inclusion of

all costs and a reasonable rate of return, in large part to conform such statutes to constitutional norms.

- After reciting several economic definitions of "incremental costs", the Fed has disregarded all of them. In contrast, commonly-used economic definitions of "incremental costs" would have resulted in a broader range of allowable costs.
- The Proposed Rule thus raises serious constitutional concerns to the extent it is likely to be confiscatory in precluding issuers from recovering their costs plus a reasonable rate of return. The Proposed Rule's suggestion that issuers can recover sufficient revenue from "other sources" to cover all the costs of debit-card systems plus a reasonable rate of return is far from demonstrable, and, in any event, it does not cure the constitutional flaws in the Proposed Rule.

Price controls are disfavored because they invariably lead to unintended and harmful consequences and distort markets. This sound public policy concern is reflected, in part, in Section 904 of the EFTA, which requires the Federal Reserve to consider the effect of any Proposed Rule on the following: (i) "costs and benefits to financial institutions, consumers, and other users of electronic fund transfers"; (ii) "competition in the provision of electronic banking services among large and small financial institutions and the availability of such services to different classes of consumers, particularly low income consumers"; and (iii) to the extent practicable, "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions". Had the Proposed Rule considered statutorily mandated factors, we believe the Proposed Rule would have reached a different result.

- Consumers will bear the brunt of the Proposed Rule, with the benefits accruing mainly to the largest retailers in the form of a windfall wealth transfer that could exceed $12B.
    - Banks cannot operate debit programs at a loss and will have no option but to try to recover costs in other ways, including fees on depositors and the limitation or withdrawal of services that are now provided free or at low cost. Early commentary suggests that some of the banking population will be driven into the ranks of the unbanked by such changes to bank pricing.
    - Any benefits to consumers are highly speculative. Merchants are not required to pass on any cost savings, and experiences in foreign markets suggest that they will not. Furthermore, small merchants may see little benefit due to the bundled pricing they are typically charged by merchant acquirers, with the gains accruing almost solely to the very largest retailers.
- Small banks and credit unions, though nominally exempt from the specific legal restriction on interchange fees, are nevertheless likely to be harmed significantly through the reduction of their interchange fees as the markets and payments infrastructure respond to pressures generated by the Proposed Rule.
- The debit card payment system itself also will suffer. Barred from recovering through interchange the costs of maintenance and innovation of the system, such expenditures are likely to be reduced, stifling future investment and innovation that would benefit consumers and merchants and reduce the risk of system failures and security breaches. Likewise, the general availability and specific benefits of the current debit card payment system, including debit availability for high transaction amounts or for certain kinds of

transactions (e.g., internet), may be eliminated or curtailed, potentially replaced by higher risk payment methods (e.g., cash and check).

Additionally, Congress directed the Board to prescribe regulations *"providing that an issuer or payment card network shall not, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to (i) 1 such network; or (ii) 2 or more such networks which are owned, controlled, or otherwise operated by (I) affiliated persons; or (II) networks affiliated with such issuer.*

- The Board's proposal for network exclusivity restriction Alternative B also exceeds the statutory requirements and results in unjustifiable harm to consumers, issuers and networks.
- Alternative A provides merchants with adequate transaction routing choices except where merchants have voluntarily elected not to support multiple methods of transaction authorization (e.g., not deploying PIN pads).
- Alternative B will require networks, issuers, merchants and processors to incur substantial costs to modify current infrastructure that, in many instances, does not support the processing of transactions from a particular method of authorization over multiple networks, and may spur greater consolidation within the debit network market, ultimately resulting in less competition and less choice for all participants.
- Emerging payment technologies, such as mobile payments and biometrics, should not be subject to the statute's network exclusivity restrictions. For the foreseeable future, all consumers with a mobile phone will also have a traditional plastic debit card, thus preserving choice to consumers and merchants.

Notes on economic impact

- From the Federal Reserve Board's commentary, total industry debit interchange revenue in 2009 was $16.2 BN.
- If all transactions for all issuers are priced at $0.12, industry revenue will fall to $4.4 BN, a decline of $11.8 BN.
- If interchange pricing to smaller issuers (under $10 BN in assets) does not change, industry revenue will drop to approximately $8.3 BN.
- If interchange rates for many large issuers cluster around the safe harbor rate of $0.07, then total industry revenue will drop to approximately $3.3 BN, an 80% reduction.

<u>Basel III</u>

[W]hat is the Council's view of the liquidity standards proposed in the Basel framework?

Liquidity Standards

- Council Members are generally supportive of the Basel III framework for liquidity
- Concerns specific to the Liquidity Coverage Ratio (LCR) include:
    - The proposed 40% cap on U.S. Agency securities held as a component of a financial institution's liquidity buffer will make it difficult to maintain an appropriately diversified portfolio of low-risk assets and may result in reduced demand for these securities, impacting the ability of the GSEs to provide low-cost liquidity for the mortgage market.

- Credit should be given for borrowing capacity at the Federal Home Loan Bank.
- Certain proposed run-off, draw-down or repayment factors used in the LCR are not supported by empirical market evidence, including:
    - The run-off factors for retail and wholesale deposits generally and specifically, for deposits from financial institutions and non-relationship corporate entities;
    - The draw-down factors for retail and wholesale commitments generally and specifically, for liquidity facilities and commitments to financial institutions;
    - Repayment rates on consumer credit card receivables;
    - Draw-down factors on unconditionally revocable unused credit facilities, such as consumer credit card receivables.
- In general, current guidance is too ambiguous in many areas and cannot always be applied due to the complexity of certain deposit relationships and/or credit structures
- Additional refinement will be necessary throughout the proposed observation period before the LCR is ready for scheduled implementation in 2015

- Given the longer observation period for the Net Stable Funding Ratio (NSFR) relative to the LCR and acknowledgement by regulators that the NSFR in its current form needs to be refined, the NSFR has received less industry attention

<u>Implementing the Dodd-Frank Legislation</u>

(A)[W]hat does the Council expect to be the effect of the implementation of the "Volcker rule"?

"Volcker" rule

- The Volcker Rule is a good example of how a reasonable concern (financial institutions engaging in speculative investment and risky trading activities) was addressed first by legislative fiat thru the Volcker Rule and then by international regulatory guidelines in Basel III capital rules for trading books.
- We strongly support the view expressed by the FSOC in its Volcker Rule Study that banks' asset and liability management ("ALM") activities, including use of investment portfolios, are an important risk mitigation tool and serve important safety and soundness objectives. If regulators implement the proprietary trading ban in a manner so that ALM activities are impermissible under the Volcker Rule, we agree with the FSOC that banks' liquidity and interest rate risk management capabilities will be adversely impacted.
- Proprietary trading of a scale and nature that the Volcker Rule is concerned with only occurs at a small percentage of the banking entities. There should be bright line criteria that triggers its application in order to focus both regulatory and bank management's attention where it is most needed and not have regulatory requirements and associated costs imposed on those banking entities whose activities do not create systemic risk or risk to their own enterprise.

(B) What is the Council's view about how communication and disclosure issues should be handled during and after the "stress tests" required by the Dodd-Frank legislation?

Background:

- While the Dodd-Frank Act mandates stress test disclosure annually by the Federal Reserve and at least annually for financial companies with over $10 billion in assets, the Act is silent with respect to content of the required disclosures. (Appendix II includes a summary of Dodd-Frank stress test mandates). The Council believes that the industry and the market will benefit from clarity on a disclosure framework that minimizes the risk of unintended consequences resulting from the content and timing of public disclosures of stress tests.
- Because the 2009 Supervisory Capital Assessment Program (SCAP) was conducted during an historic economic and financial crisis, an unprecedented degree of public disclosure was appropriate. Further, the nature of the SCAP lent itself to a very standardized approach of disclosure for all the SCAP institutions. However, as those conditions do not exist today, the framework for mandated disclosures related to future stress testing should focus on key principles that reflect the intent of the Dodd-Frank reforms and not use the SCAP disclosures as the default model.

Suggested key principles:

- The disclosure framework for stress test results should:
  - Clearly demonstrate that regulators are applying appropriate rigor and consistency to the supervision of capital adequacy.
  - Preserve the confidentiality of supervisory, competitively sensitive or proprietary information.
  - Provide jurisdictional clarity regarding the agencies and regulations that govern specific disclosures. As many of the institutions subject to stress testing are SEC-registered financial companies, regulatory guidance should give careful consideration to existing securities law requirements and the role of the SEC concerning public disclosure of information.
  - Promote and enhance the impact of "market discipline" on how financial institutions manage their capital.
  - Avoid market disruptions.

Disclosure Approach:

- We support a disclosure approach for Dodd-Frank stress tests with the following components:
  - Regulators create a high level of transparency of the stress test process and engender market confidence by publicly sharing criteria of stress test scenarios.
  - Regulators emphasize that a financial company's capital adequacy as measured under stress scenarios is as important a metric as capital adequacy as measured against a static, headline target.
  - With respect to Federal Reserve-conducted stress tests, the Federal Reserve should publish a general summary of results (i.e., no individual company results) to show broad conclusions about the capital adequacy of the financial system.
  - With respect to company-performed stress tests, regulators explicitly leave public disclosure of results to the discretion of each financial company, as governed by existing securities law.

Ongoing Stakeholder Dialogue

- Given the many stakeholders with an interest in this issue, we believe that, in addition to soliciting written input, the Federal Reserve should foster ongoing discussions among the Federal Reserve, the SEC, the OFR, the appropriate financial regulatory agencies, financial companies and the investor community. Such discussions could help regulators and the financial industry achieve the optimum disclosure framework for stress test results.

(C) Are there any other issues with regard to Dodd-Frank implementation that the Council would like to bring to the Board's attention at this time?

- The Council is concerned not only about the implementation of individual new rules, but also about the combined impact of all of the new regulations, and their interaction with each other and exiting regulations. The cumulative effect and potential conflicts and complexity arising from multiple, significant new rulemaking efforts could create additional and unintended burdens that make it very difficult for financial institutions to serve customers. While the work to date of the regulators has generally been commendable, there remain opportunities for enhancements.
    - The CFPB is an example of an area where close coordination on rule writing, examinations and enforcement is critically needed across all the regulatory agencies in order to provide efficiency and market certainty prior to, and after, the Board's transfer of consumer authority to the CFPB.
- Beyond specific implementation issues, the Council believes there are two opportunities for the Board, as a regulator and a member of the Financial Stability Oversight Council, to take even more of a leadership role, which are:
    - to increase coordination among the regulators and among the rules in a variety of areas; and
    - to ensure that the appropriate amount of time is taken to study these complex issues well before publishing proposed or final rules.

<u>Appendix II</u>

Summary of Dodd-Frank Stress Test Requirements

- Stress Tests by the Federal Reserve: Under the Dodd-Frank Act, the Federal Reserve must conduct and publish a summary of the results of annual stress tests for systemically important financial institutions. In addition, the Federal Reserve may conduct stress tests for other bank holding companies and nonbank financial companies and must also publish a summary of those results.
- Stress Tests by the Company: The Dodd-Frank Act requires systemically important financial institutions to conduct semi-annual stress tests and financial companies with assets over $10 billion to conduct annual stress tests. Regulations implementing these provisions must require companies to publish a summary of the results of their stress tests.
- Office of Financial Research (OFR): The Research and Analysis Center of the OFR must evaluate and report on stress tests.
- Content of Disclosures: The Dodd-Frank Act is silent with respect to content of the required stress test disclosures.