FOOD MARKETING INSTITUTE

Food Marketing Institute Debit Card Swipe Fee Litigation Backgrounder

Why is FMI filing the lawsuit?

The Federal Reserve Board's final swipe fee rule ignores the clear statutory language of the Durbin Amendment. If not challenged, it will result in significant increased costs for food retailers and consumers. Approximately 39 percent of all PIN debit transactions occurred at supermarkets in 2010.[1] Roughly 69.2 percent of all supermarket sales were made using electronic payments with 28.2 percent of total sales being made on debit cards.[2] Based on total supermarket sales of $563 billion, the industry paid some $1.85 billion in debit card interchange fees last year. Debit card fee usage as a percentage of supermarket sales has grown over 28 percent in the past five years**. Total fees paid by the supermarket industry to accept credit and debit cards in 2010 were roughly $5.68 Billion, 1.01 percent of sales in 2010, greater than the 0.98 percent average net industry after tax profit margin in 2010.[3]** The Federal Reserve Board of Governor's Final Rule erroneously inflates the debit card interchange fees authorized by the Durbin Amendment and FMI's members will suffer significant and irreparable monetary injury directly traceable to the Board's misconstruction of the statute.

What is an interchange fee? What is the average supermarket debit interchange fee?

Every time a customer swipes a credit or debit card at a grocery store, that store pays an interchange fee to their merchant acquirer/processor who then passes through the interchange fee revenue to the card issuing bank (i.e. Bank of America). The average supermarket debit interchange fee prior to the reform ranged from 20 to 30 cents and was a bit higher than that range for smaller grocers. In addition to interchange fees, the grocer pays network fees to Visa and MasterCard and processing fees to their merchant acquirer/processor (i.e. First Data) that constitute the total cost of accepting credit and debit cards.

Interchange Fees → Card Issuer (i.e. Bank of America, Citi) → roughly 85% of cost

Network Fees → Network (i.e. Visa, MasterCard, STAR) → roughly 10% of cost

Processing Fees → Merchant Processor (i.e. First Data) → roughly 5% of cost

There are two authorization methods for debit card transactions. The first – signature – is when a customer swipes and signs. The second – PIN – is when a customer enters a Personal Identification Number. The PIN transaction is much less fraud prone because it requires validation of the cardholder.

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[1] 2010 Pulse Debit Issuer Study Executive Summary.

[2] FMI 2011 Annual Financial Review

[3] FMI 2011 Annual Financial Review; 2011 Food Retailing Industry Speaks. Pg. 82.

How are interchange fees set?

Interchange fees are set by card networks. When a bank issues a credit or debit card, it generally has a Visa or MasterCard logo on the front, and possibly a handful of other PIN debit network marks (i.e. Star, Pulse, NYCE) on the back. Any time a payment runs over a network, the issuer gets interchange fee revenue at the level set by the network for that transaction so it is in the best interest of the networks to keep raising interchange fee rates to drive more revenue to the issuers and in turn get their network marks on a card. There are some serious competition issues surrounding whether or not networks should be allowed to set interchange fees for the banks. Any bank that would negotiate card acceptance rates directly with merchants would not be covered by the debit card fee reforms.

A Federal Reserve economist explained interchange in this way:

*"As you know, in most markets increased competition leads to lower prices. However, in payment card markets, **competition between networks tends to drive interchange fees higher**. And the reason for this is that in these markets the party that decides what method of payment will be used at the point of sale, that is, the customer, is different from the party that incurred the cost associated with that decision, the merchant. And in general customers don't tend to take into account the costs incurred by merchants as a result of their decisions. The networks want banks to issue their cards and they want customers to hold and use their cards, and they provide an incentive to the banks to issue cards by offering higher interchange fees. The banks use the revenues from these interchange fees to offer more attractive deposit account terms to their customers, including in some cases rewards for making payments with debit cards. Meanwhile, the merchants, who ultimately foot the bill for their customers' payment choices, have little or no ability to influence the customer's decision with regard to what payment method to use. In addition, given the near ubiquity of card acceptance and the expectations of customers, many merchants believe that they really don't have the option of refusing to accept card payments. So even though merchants would prefer lower interchange fees, unless the fees are extremely high, they're likely to continue to accept cards, and as a result competition in these markets tends to focus on the issuers and the cardholders, who prefer higher interchange fees, so the result of that competition is to drive those fees up rather than down."*[4]

What are historical interchange rates?

By and large, supermarkets began accepting debit cards at the point-of-sale checkout in the early in the early 1990's. "[S]ome PIN debit networks initially structured interchange fees to flow from the cardholder's bank to the merchant's bank to compensate merchants for the costs of installing PIN terminals and making necessary system changes to accept PIN debit at the point of sale. In the mid-1990s, these PIN debit networks began to shift the direction in which PIN debit interchange fees flowed." [5] Yet, while interchange fees paid by merchants increased throughout the remainder of the decade, the average PIN debit interchange rate for both small and large grocers did not exceed 10 cents

[4] Federal Reserve Board of Governors Open Meeting December 16, 2010. At Minute 18:00. http://youtu.be/IaJqZMfqXNY.

[5] **Federal Register** / Vol. 75, No. 248 / Tuesday, December 28, 2010 / Proposed Rules at **81724** http://edocket.access.gpo.gov/2010/pdf/2010-32061.pdf.

per transaction in 1999. Over the most recent decade, PIN debit rates for small grocers increased at slightly higher levels than for big merchants, but in general ranged from about 17 cents to 35 cents in 2010.

Why does the industry care about interchange fees?

Since interchange fees are set by the networks for the banks that issue the cards that we accept in our stores, we have no ability to negotiate the rates or terms of card agreements. As a result, interchange swipe fees have been one of our top three fastest rising costs over the past decade. In 2010 the total industry fees paid to accept credit and debit card products exceeded the average industry profit margins of 0.98%. Ultimately cost increases of this magnitude impacts our ability to keep prices low for our customers and hire new workers, and hundreds of pages of network rules that prohibit merchant pricing decisions keep the cost of interchange buried in the price of all goods and services. We also have significant concerns about the lack of transparency and competition on fees in the credit and debit card market.

What does the statutory language require re: debit fees and routing?

Section 1075 of the Dodd Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) [6] requires the Federal Reserve Board of Governors to prescribe rules regarding: 1) Reasonable interchange transaction fees on debit; and 2) Limitations on payment card network routing restrictions.

1) "Reasonable interchange transaction fees.--The amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction." In prescribing regulations, "the Board shall (A) consider the functional similarity between-``(i) electronic debit transactions; and``(ii) checking transactions that are required within the Federal Reserve bank system to clear at par. ``(B) distinguish between-- ``(i) the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered under paragraph (2); and ``(ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered under paragraph (2)

2) "Prohibitions against exclusivity arrangements.-- A) No exclusive network.--The Board shall, before the end of the 1-year period beginning on the date of the enactment of the Consumer Financial Protection Act of 2010, prescribe regulations providing that an issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, 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

[6] DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT. Public Law 111-203. 111th Congress. http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm at [Page 124 STAT. 2068] and [Page 124 STAT. 2072].

owned, controlled, or otherwise operated by –``(I) affiliated persons; or ``(II) networks affiliated with such issuer.”.

The reasonable and proportional debit card fee standard applies only to covered financial institutions, which are those with total assets of $10 billion or greater.

What did the Federal Reserve Board’s proposed rule say?

In their proposed rule issued in December 2010, the Federal Reserve considered two approaches on reasonable and proportional debit card fees. The first would set a safe harbor of 7 cents and a 12 cent cap and the second would set a 12 cent cap. The Federal Reserve also considered two approaches on the merchant routing choice provisions. One would have required two unaffiliated networks on a card or device regardless of the authorization type, and the other would have required two unaffiliated networks on a card or device for each debit authorization type (i.e. Signature vs. PIN).[7]

In the December 16, 2010 Open Board meeting Federal Reserve Board of Governor’s staff explained that in measuring issuer costs they considered fixed costs and common or overhead costs. They recommended that fixed costs of debit card transactions be excluded from the measurement of allowable costs because of direction provided by the statute to consider the costs of a particular transaction, and because fixed costs, as well as common or overhead costs, generally could not be avoided by ceasing production of any particular transaction.[8]

The Board of Governors unanimously approved the proposed rule and voted to have it published in the Federal Register opening the comment period.

What did the Federal Reserve Board’s final rule say?

In their final rule issued in June 2011, the Federal Reserve adopted a modified version of the stand-alone cap approach where they raised the base cap to 21 cents and added a 5 basis point ad valorem fee on the value of the transaction to cover fraud losses. [There is a separate interim final rule that allows for a one cent upward fraud prevention adjustment]. The base cap number increased due to the Federal Reserve’s interpretation that there were other costs - network connectivity; software, hardware, equipment, and associated labor; network processing fees; and transaction monitoring - that could be included in the reasonable and proportional debit card fee standard that they initially left out of their proposed rule. The final rule adopted a network exclusivity rule that only required two unaffiliated networks per card as opposed to per authorization method (Signature and PIN).[9]

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[7] **Federal Register** / Vol. 75, No. 248 / Tuesday, December 28, 2010 / Proposed Rules at **81726 and 81727** http://www.federalreserve.gov/newsevents/press/bcreg/20101216a.htm

[8] Federal Reserve Board of Governors Open Meeting December 16, 2010. Minutes 6:30 to 10:30. http://youtu.be/IaJqZMfqXNY

[9] **Federal Register** / Vol. 76, No. 139 / Wednesday, July 20, 2011 / Rules and Regulations at **43404** http://www.gpo.gov/fdsys/pkg/FR-2011-07-20/pdf/2011-16861.pdf.

The filed complaint argues that inclusion of these new costs is not in line with the statutory language in Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

What are the actual costs of processing a transaction?

The Federal Reserve found that the average weighted debit transaction cost was around 4 cents a transaction. The Fed set the safe harbor level in the proposed rule at 7 cents because they thought if they put the safe harbor down too low, it would be more unlikely that issuers would want to avail themselves of it, and since one of the purposes of the safe harbor was to enable issuers to avoid the need for calculating their costs, they would be weighing the administrative costs of doing so versus the foregone interchange revenue that they would have by relying on a low safe harbor versus, perhaps, a higher amount that they would be able to receive if they were to calculate the cost.[10]

Historical costs also show that the cost of processing a debit transaction is no more than a few cents. In a competitive market, we would expect these costs to decrease with significant technology improvements over past 20 years, as well as increases in volume that we would expect to bring economies of scale.

What does the final rule mean for supermarket rates?

The final rule means that savings to merchants and consumers from reduced debit card fees will be less than anticipated based on the proposed rule. On some transactions, debit card fees will increase for our industry because the Federal Reserve set the fee cap level higher than current rates, and as expected, the networks pushed all rates up to the cap. See attached fee charts.

What is the impact of the 5 basis point ad valorem fee that was added to the reasonable and proportional standard?

The 5 basis point ad valorem means that debit card interchange fees will continue to be more complicated than the flat transaction fees employed by the PIN networks in the 1990's, which will make it more difficult for small businesses to analyze and predict their debit card interchange rates.

We also believe it is highly inappropriate to incorporate fraud losses into the reasonable and proportional standard since the statutory language specifically addresses fraud prevention activities separately and allows for an issuer fraud adjustment to the interchange fee standard. It will also lead to higher rates than some grocers are currently paying on PIN debit transactions, which are significantly more secure than signature. Supermarkets have encouraged their customers for years to enter a PIN

[10] Federal Reserve Board of Governors Open Meeting December 16, 2010. Minutes 39:00 to 43:00. http://youtu.be/IaJqZMfqXNY

when swiping a card because it is so much more secure[11] and efficient. Use of a PIN also helps minimize data security risk helping to prevent our customers from a card compromise that may leave them without funds. As a result, supermarket sales account for 39% of PIN debit transactions in the United States.[12]

Additionally, merchants spend significant time and financial resources to protect their customers' data, secure their store infrastructure, and to comply with Payment Card Industry (PCI) Data Security Standards. However, the card networks reserve the right in their network rules to reverse payment to our stores if they believe the transaction was fraudulent even if they authorized it in the first place. So as the sale amount increases, the merchant liability increases along with that of the issuers.

The Federal Reserve has adopted an interim final rule that allows a 1 cent fraud adjustment to issuers for fraud prevention efforts if they certify with the networks. We do not believe this adjustment should increase and believe more adequate enforcement is needed to protect our nation's merchants and consumers from fraud.

Why merchant routing choice is important?

Visa and MasterCard combined have excessive market share in both the credit and debit card space and their average weighted debit interchange fee is significantly higher than PIN debit interchange averages.

Merchant Card Fees 2010

Type	Purchase Volume (billions)	Fees (billions)	Weighted Average
Visa/MasterCard (credit)	$1,288.60	$26.02	2.02%
Visa/MasterCard (debit)	$1,386.33	$22.04	1.59%
American Express	$476.25	$10.91	2.29%
Discover	$107.22	$2.01	1.88%
PIN Debit	$262.45	$1.89	0.72%
Private Label	$170.52	$1.71	1.00%
Total:	**$3,691.37**	**$64.58**	**1.75%**

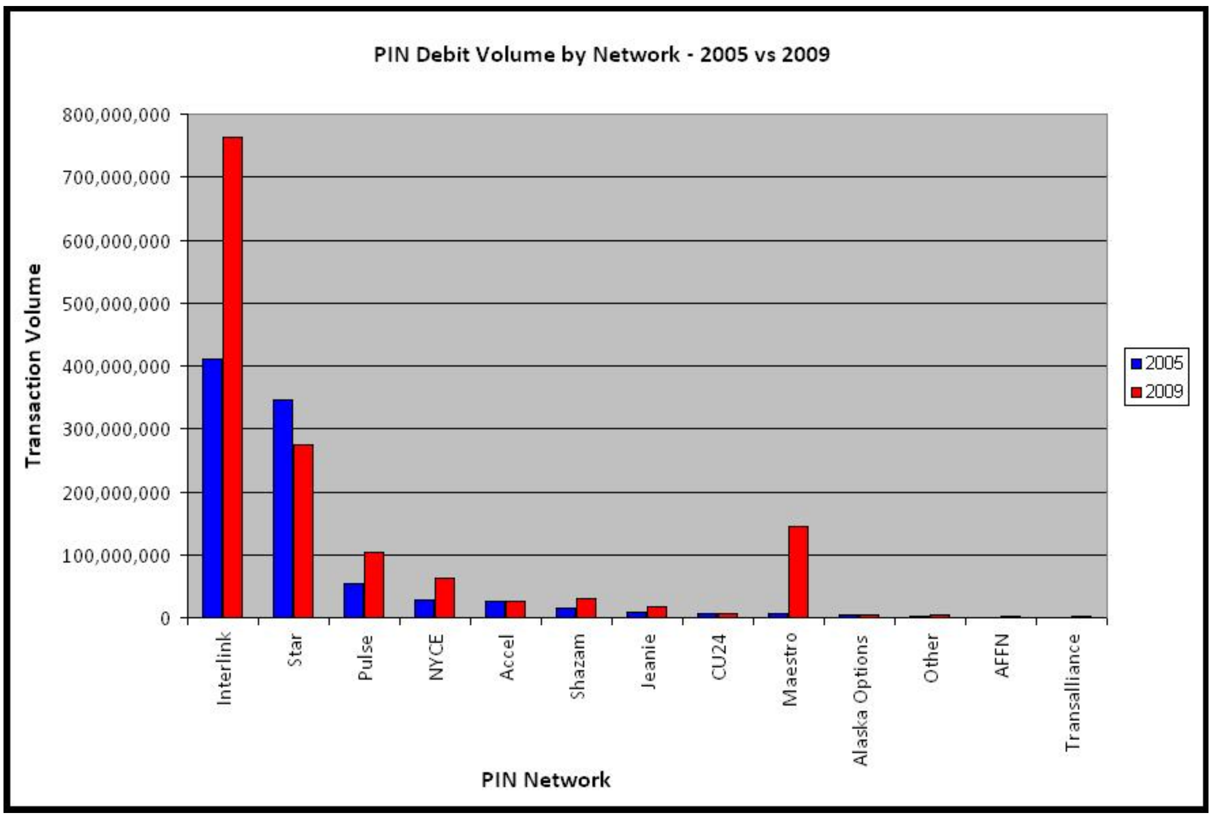
Source: The Nilson Report Issue 983

[11] 2010 Pulse Debit Issuer Study at pg. 17. [PIN debit card fraud losses in 2009, as measured in dollars per card per year, were $0.17, while signature debit cards fraud losses were $2.29. Signature point-of-sale fraud losses average 0.075 % while PIN point of sale losses average 0.01 % or 1 cent on every $100.]

[12] 2010 Pulse Debit Issuer Study Executive Summary. [Cardholder use of PIN versus signature varies considerably by merchant category. Many PIN POS transactions take place in supermarkets (39%) while supermarkets account for only 11% of signature POS transactions activity].

Visa owns a PIN debit network - Interlink - and MasterCard owns a PIN debit card network – Maestro. Recently, both networks have offered financial institutions the opportunity to issue cards exclusively with their networks. This consequently has led traditionally lower cost PIN debit networks to create premier pricing that gives the issuer higher interchange fee revenue if the card only carries their network (exclusivity), which has led to increased overall costs in the debit card system for retail grocers and other merchants. Below is a chart based on industry survey data that shows the dramatic increase in market share of both the Visa and MasterCard PIN networks over the past four to five years.

Without network competition on each transaction (PIN or Signature Debit), it is highly unlikely that we will see any downward pressure on interchange fees to move them below the cap over time. A perfect example is small ticket transactions. In August, Visa released rates that increased existing small ticket interchange rates by roughly 1 cent from a range of 4 to 6 cents. MasterCard shortly thereafter announced small ticket rates at the Federal Reserve's cap, and consequently Visa came back within that month and also moved their small ticket rate up to the cap resulting in roughly a 500% interchange fee increase on small ticket transaction that is nowhere near reasonable and proportional.



What is the impact of reforms on grocery shoppers?

Currently, the industry is still analyzing the impact of reforms. As noted, for some grocers, savings will be very limited or non-existent. Also, rates primarily changed only for regulated transactions so savings will depend on the penetration of regulated bank cards in a particular market. Additionally, the network routing provisions do not go into effect until April 2012 so it will take some time to see if increased competition in that space is effective.

We do know that supermarkets compete heavily on price, so if there are savings to be passed through to the consumer that is one area where they could be realized. In the Food Marketing Institute's 2010 consumer survey low prices were stated as a very important factor by 75 percent of respondents, up from 64 percent in 2007 and 37 percent of consumers cited having low prices as being the **top consideration** in deciding a primary grocery store, up from 31 percent in 2007.[13]

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Food Marketing Institute (FMI) conducts programs in public affairs, food safety, research, education and industry relations on behalf of its 1,500 member companies — food retailers and wholesalers — in the United States and around the world. FMI's U.S. members operate approximately 26,000 retail food stores and 14,000 pharmacies. Their combined annual sales volume of $680 billion represents three-quarters of all retail food store sales in the United States. FMI's retail membership is composed of large multi-store chains, regional firms and independent supermarkets. Its international membership includes 200 companies from more than 50 countries. FMI's associate members include the supplier partners of its retail and wholesale members. www.fmi.org

[13] Food Marketing Institute, 2010 U.S. Grocery Shopper Trends.