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Financing America's Economy

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February 18, 2011

Jennifer J. Johnson
Secretary,
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Notice of Proposed Rulemaking on Debit Interchange Fees and Routing, Docket No. R-1404

Dear Ms. Johnson:

The Financial Services Roundtable (the "Roundtable"[1]) appreciates the opportunity to provide the Federal Reserve Board (the "Board") with its comments on the proposed rule (the "Proposed Rule") to implement Section 1075 (the "Durbin Amendment") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), as set forth in the Notice of Proposed Rulemaking published in the Federal Register on December 28, 2010 (the "Comment Request"[2]). The Roundtable strongly believes that the Proposed Rule is fundamentally flawed and that the Board should withdraw and revise it.

In unprecedented fashion, every major financial services trade association is united in their opposition to the Proposed Rule. The Roundtable has joined with the other trade associations in signing a letter to the Board outlining our specific

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[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

[2] (December 28, 2010).

concerns with the Board's Proposed Rule.[3] The discussion below echoes many of the points stressed in the joint trade letter. For a more in depth discussion of sections I – VI, please reference the joint trade letter, attached.[4] In the Roundtable's view, the themes in the joint trade letter are extremely important. It is critical that the Board understand the seriousness of this issue and the unprecedented negative effects the Proposed Rule will have on consumers and the financial services industry, while equally harming most merchants due to the consequential negative effect on consumer payment options. Additionally, the Roundtable would like to take this opportunity to also respond to the Board's proposals regarding routing and exclusivity. We believe the Proposed Rule raises significant issues that must be addressed before the Board can make any progress towards implementing a comprehensive final rule.

I. Description of the Durbin Amendment

The Durbin Amendment in its current form was introduced on May 13, 2010 as a last-minute addition to the Dodd-Frank Act. There was no serious Senate debate of the Durbin Amendment before it was voted on by the Senate.[5] Further, there were no hearings conducted in the House of Representatives or Senate on the Durbin Amendment before it was signed into law.[6] Additionally,

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[3] Joint Trade Comment Letter Signed by (Roundtable, TCH, ABA, ICBA, CUNA, NAFCU, CBA, and Mid Size Bank Coalition).

[4] *Id*.

[5] Senators Dodd and Durbin were the only Senators to speak on the Durbin Amendment on the floor of the Senate. *See* S3588-90 (May 12, 2010); S3704 (May 13, 2010); S5925-27 (July 15, 2010). Representatives Frank, Kanjorski, Larson, and Brown were the only Representatives to speak on the Durbin Amendment on the floor of the House, and did so only for purposes of emphasizing the exemptions within the amendment for smaller issuers and health care costs. *See* H5235-6 (June 30, 2010); H5254 (June 30, 2010); H5256-7 (June 30, 2010).

[6] Although a few Congressional hearings were held on a variety of matters tangential to the payment of debit interchange fees (*e.g.*, federal government payment of interchange fees), there was not a single

there was no analysis presented to either Chamber of Congress regarding the impact on consumers, the overall economy, or the banking system. In brief, the Durbin Amendment was never reviewed or debated publicly during the House-Senate Conference for Dodd-Frank. Thus, because the Durbin Amendment was part of the Senate bill, there was no stand-alone vote on it in the House of Representatives. Former United States Representative Paul Kanjorski (D-PA) summed up the lack of substantive debate when he stated: "Additionally, I continue to have apprehensions about the interchange provisions inserted into this legislation by the Senate. This issue, without question, would have benefitted from additional time and study."[7]

II. The Statutory Mandate

The two operative provisions of the Durbin Amendment, Paragraphs (a)(2) and (a)(3), establish a simple formula. Debit card issuers are permitted to receive a fee for debit interchange transactions that is not greater than the sum of: (1) their costs with respect to the transactions plus; (2) an additional amount that satisfies the Federal Reserve's "standards for assessing" whether that amount is "reasonable and proportional" to those costs. The process for the Federal Reserve to establish standards for assessing "reasonable and proportional" fees consists of three actions: (1) The Federal Reserve must determine the total costs incurred by the issuer with respect to the electronic debit transaction ("Total Costs");[8] (2) the Federal Reserve must determine certain non-specific costs incurred by the issuer that cannot be considered ("Excluded Costs") and deduct Excluded Costs from

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hearing specifically devoted to the Durbin Amendment, nor was the Federal Reserve or any other government agency called to testify regarding the impact of the amendment.

[7] H5238 (June 20, 2010).

[8] §§ 920(a)(2), (3)(A).

Total Costs;[9] and (3) the Federal Reserve must establish standards for assessing whether the fee charged by the issuer is reasonable and proportional to the allowable cost.[10]

In applying this three-pronged approach, there are two key issues for the Federal Reserve to determine. *First*, what costs are Excluded Costs? *Second*, what is the framework for "reasonable and proportional"? We submit that both determinations must be made by the Federal Reserve on the basis of four considerations. First, a limit on fees that would be "confiscatory" constitutes a violation of the Takings and Due Process Clauses of the Fifth Amendment to the United States Constitution. As discussed below, consistent judicial precedent provides that a limit on rates is confiscatory under the Constitution unless it provides for a recovery of costs *and* a reasonable return. Second, the statute must be read as a whole. Accordingly, Excluded Costs must be limited so as to be as consistent as possible with the operative provisions of the Durbin Amendment. Third, words must be interpreted in accordance with their plain meaning as well as prior statutory and regulatory usage. Fourth, under Section 904 of the Electronic Funds Transfer Act ("EFTA"), the regulation must minimize harm to consumers (particularly low income consumers), financial institutions, and the payment system. The Roundtable submits that the application of these considerations to the rate formula proposed by the Federal Reserve would result in permissible fees substantially higher than those provided for in the Proposed Rule. Conversely, the rates provided for in the Proposed Rule would violate the Fifth Amendment of the Constitution, as described further herein.

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[9] § 920(a)(4)(B)(ii).

[10] §§ 920(a)(2), (3)(A).

III. Description of the Proposed Rule

The Proposed Rule was released on December 16, 2010. As an initial matter, the Board's proposal appears to assume, without analysis, that the Durbin Amendment requires the issuance of hard price controls on debit interchange fees, rather than "standards for assessing." The Proposed Rule assumes that the Durbin Amendment's instruction to establish a standard for assessing fees that were "reasonable and proportional" to "the costs of the issuer" means that the fees should be no greater than a certain narrow set of the costs of the issuer.[11] The Proposed Rule then explicitly rejects the Durbin Amendment's mandate to consider the "incremental" cost of each debit card transaction when determining standards for assessing whether the fees at issue were reasonable and proportional to the costs of the issuer.[12] Rather, it proposes to use "average variable cost" to calculate the issuer's cost per transaction.[13] In doing so, the Board acknowledged that the Proposed Rule was not considering "costs that are common to all debit card transactions and could never be attributed to *any* particular transaction, (i.e., fixed costs), even if those costs are specific to debit card transactions as a whole."[14] Finally, the Proposed Rule's determination of cost also does not consider an adjustment for fraud loss and fraud prevention costs even though those are explicitly allowed by the Durbin Amendment.[15]

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[11] 75 Fed. Reg. 81,733.

[12] 75 Fed. Reg. at 81,735.

[13] *Id.*

[14] *Id.* at 81,736 (emphasis added).

[15] *Id.* at 81,740.

IV. The Proposed Rule is Legally Defective

The Roundtable believes that the Proposed Rule is legally defective based on four separate and distinct legal grounds. First, the language of the Durbin Amendment requires the Board to set "standards for assessing," but does *not* authorize the government price controls set forth in the Proposed Rule. Second, the Proposed Rule misinterprets the phrase "reasonable and proportional" to mean no greater than a limited set of *costs*, whereas the statute clearly provides for interchange fees that allow for a reasonable return on those costs. Third, the proposal fails to follow the statutory definition of "costs" as "incremental costs." Finally, placing an arbitrary cap on debit interchange fees at 7-12 cents is significantly below what it actually costs issuers to provide debit card services to consumers. Moreover, it does not allow the issuers to make any return on their investment. In fact, the Proposed Rule is confiscatory, so as to violate the Takings and Due Process Clauses of the Fifth Amendment to the Constitution. The Federal Reserve is legally bound to issue rules that avoid such a result.

VII. Exclusivity and Routing of Debit Card Transactions

Section 920(b) of the EFTA imposes restrictions on the ability of debit card issuers and payment card networks to agree on the network through which, and the rules under which, debit card transactions will be processed. Specifically, Section 920(b) directs the Board to prescribe regulations concerning the ability of a debit issuer and a payment card network to (1) restrict the number of payment card networks on which an electronic debit transaction may be processed (exclusivity restriction) or (2) inhibit the ability of a merchant that accepts debit cards for payments to direct the routing of those electronic debit transactions over any payment card network that can process those transactions (routing restriction).

a. Exclusivity of Debit Card Transactions

Section 920(b)(1)(A) of the EFTA directs the Board to "prescribe regulations providing that an issuer or payment card network shall not . . . 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 . . . affiliated persons or . . . networks affiliated with such issuer." Therefore, this subsection requires a debit card issuer to enable those cards so that transactions may be processed over two unaffiliated payment card networks.

In addressing the exclusivity restrictions of Section 920(b)(1)(A), however, the Board has proposed two alternative approaches. Under the first alternative ("Alternative A"), the Board proposes that "[a]n issuer or payment card network shall not . . . restrict the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks."[16] Although Alternative A would have substantial unintended consequences, particularly for consumers, community banks and credit unions, this alternative at least is consistent with the plain meaning of Section 920(b)(1)(A).

Nevertheless, the Board has offered a second alternative ("Alternative B") under which "[a]n issuer or payment card network shall not . . . restrict the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks for each method of authorization that may be used by the cardholder."[17] Based on Alternative B's requirement for at least two payment card networks per method of authorization, an issuer that

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[16] 75 Fed. Reg. at 81,757.

[17] 75 Fed. Reg. at 81,757.

enables both signature and PIN authorization for its debit cards would be required to enable four (or more) unaffiliated payment card networks on those debit cards—at least two unaffiliated networks for signature transactions and two unaffiliated networks for PIN transactions. Such a result is not consistent with the clear and unambiguous meaning of Section 920(b)(1)(A); that is, no part of Section 920(b)(1)(A) either requires or suggests that the Board should adopt a rule that obligates the enabling of redundant unaffiliated payment networks based on authorization methods.

In addition to its inconsistency with the clear Congressional intent to require a debit card issuer to enable no more than two unaffiliated payment card networks, Alternative B also would impose substantial new cost burdens on debit card issuers, discourage issuers from implementing important innovations, including innovations relating to security and fraud prevention and, ultimately, increase consumer costs and consumer confusion.

Moreover, proposed Alternative B is built upon the outdated premise that signature and PIN are the only two authentication methods currently in use and that these two methods will remain the focus for debit transactions in the future. While the terms "signature" and "PIN" are widely used by the payments industry today, these terms actually encompass a wide variety of authentication methods that have been created to address various specific merchant segments or payment channels, such as internet transactions and the use of key fobs, mobile phones and other devices equipped with Near Field Communication technology, which do not utilize either signature or PIN technology. By locking issuers into an outdated "signature" and "PIN" authorization framework, the Board ignores the rapid innovation that has resulted in industry-wide adoption of alternative authentication methods beyond "signature" and "PIN". Not only would the proposal create

disincentives to the development of alternative authorization methods, it could preclude entirely the future introduction of alternative authentication methods.

In addition, the Board's adoption of Alternative B would stifle other forms of debit card innovation and competition among debit card industry participants. Because Alternative B would require at least two unaffiliated payment card networks for each authorization method, any new proprietary authorization method, and related fraud prevention technology, that is only available through one payment network, would be prohibited under Alternative B. Therefore, the bizarre outcome under proposed Alternative B is that such a payment card network would be forced to license or give away its proprietary technology in order to employ that same technology for its own payment network without violating proposed Alternative B. The likely result, of course, is that without the ability to drive consumer preference based on proprietary technology and capture market share, the incentive to invest in such new technology would be greatly diminished, if not eliminated altogether.

Instead, consumers, debit card issuers, payment networks and merchants all would be better served by a regulatory framework that encourages and facilitates innovation and competition, rather than undermining innovation and competition. In fact, the current debit card systems, which provide fast, secure and reliable transactions for both consumers and merchants, were created in exactly such an innovative and competitive environment.

In addition, the adoption of Alternative B would impose even more substantial operational and compliance costs on debit card issuers and payment networks than Alternative A, at the very time that the Board is proposing to restrict the ability of card issuers to recover most of their current costs. The most

obvious of these costs, of course, would be the cost to debit card issuers and networks of creating, entering into and maintaining multiple processing network and related contractual relationships and network rules for each authorization method. Not only would these regulatorily-imposed contractual relationships, which likely would never be profitable, create substantial operational inefficiencies with no increased issuer or consumer benefits, the operational costs of implementing systems capable of supporting such operational redundancies could be overwhelming.

While a debit card issuer may currently have the capability of enabling two PIN debit networks on a single debit card, most merchants do not currently have the ability to accept any PIN transactions. Moreover, the functionality to enable multiple signature debit networks does not even currently exist. In order to enable signature debit network redundancy on a single card, millions of merchant terminals either would have to be reprogrammed or be replaced. In addition, in order to implement and maintain multiple signature debit networks on the same debit card, issuers, acquirers, processors and networks would be forced to incur substantial costs to upgrade, replace or even create the technologies necessary to support transaction processing among multiple signature networks.

These substantial cost increases, when combined with the Board's proposed restrictions on the ability of debit card issuers to recoup most of their existing costs of providing debit card services, and their inability to realize any return, let alone a reasonable rate of return on their investment, would require substantial restructuring of debit card programs. As a result, many consumer benefits, as well as consumer protections such as advanced security and fraud prevention measures, would need to be reduced, if not eliminated entirely. Similarly, debit issuers and

payment networks would have no incentive whatsoever to invest in new technologies aimed at improving consumer services and consumer protections.

For all of these reasons, if any exclusivity requirements are to be imposed on debit card issuers and payment networks, the only rational approach for implementing Section 920(b)(1)(A) is for the Board to strictly follow the statutory language by adopting proposed Alternative A, rather than requiring debit card issuers to contract with multiple unaffiliated payment card networks for each authorization method, as would be required under Alternative B.

b. Routing of Debit Card Transactions

Under Section 920(b)(1)(B) of the EFTA, the Board is directed to "prescribe regulations providing that an issuer or payment card network shall not . . . inhibit the ability of any person who accepts debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions." In response to Section 920(b)(1)(B), the Board has proposed that "[a]n issuer or payment card network shall not . . . inhibit the ability of any person that accepts or honors debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions."[18]

In addition, proposed Commentary section 7(b)(1) states that "an issuer or payment card network is prohibited from inhibiting a merchant's ability to route or direct the transaction over any of the payment card networks that the issuer has enabled to process an electronic debit transaction for that particular debit card."[19]

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[18] 75 Fed. Reg. at 81,756.

[19] 75 Fed. Reg. at 81,763.

And, proposed Commentary section 7(b)(2) states in subsection (i) that a merchant may not be prohibited "from encouraging or discouraging a cardholder's use of a particular method of debit card authorization, such as rules prohibiting merchants from favoring a cardholder's use of PIN debit over signature debit, or from discouraging the cardholder's use of signature debit."[20] The Supplementary Information accompanying the Proposed Rule also states that under these proposed comments, for example, a merchant could block the use of signature debit altogether.[21] Therefore, unlike current practices where a merchant can steer an electronic debit transaction to an available payment network, but cannot exclude specific functionality associated with a debit card (*i.e.*, PIN or signature debit functionality), the Proposed Rule would permit a merchant to do exactly that. In doing so, the Proposed Rule would permit a merchant to inaccurately represent to consumers, in its media ads or through its store signage, that the merchant accepts debit cards displaying the brands of popular debit card networks when, in fact, the merchant has no intention of processing debit transactions over those networks. Moreover, such conduct would be inconsistent with Section 920(b)(2), which states that "in the case of a discount or in-kind incentive for payment by the use of debit cards, the discount or in-kind incentive [should] not differentiate on the basis of the issuer or the payment card network."

Even more troubling is the fact that the Board's proposal would permit merchants to override consumer choice as to how a particular debit transaction will be handled. There is no requirement, or even suggestion, in the statute that Congress intended such an anti-consumer result. To the contrary, regardless of what approach the Board determines to take on routing, the primary rule for how a

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[20] 75 Fed. Reg. at 81,763

[21] 75 Fed. Reg. at 81,752.

transaction is routed should be consumer choice, and a merchant choice should only apply in the absence of consumer choice. In this regard, there are many reasons why a consumer might choose a signature debit transaction over a PIN debit transaction, for example, or might choose a particular payment network over another network, including security concerns. Consumers may base their choice on the benefits or features offered by a particular form of debit transaction or a particular payment network, including enhanced cardholder protections that exceed current legal requirements. For example, a consumer would lose the zero liability protection provided by her selected card network (that is, the network whose brand appears on her debit card) when the merchant routes the transaction to a cheaper network that does not offer such fraud protection. Essentially, the merchant would permit a consumer to initiate a debit transaction and then transform that transaction into an entirely different transaction governed by an entirely different set of rules. Accordingly, by permitting merchants to override a consumer's choice of payment network, or her choice of authorization method, the merchant would not only deny the consumer the benefits associated with her card, but would also make it virtually impossible for the debit card issuer to accurately disclose to the consumer the terms and conditions applicable to her debit card account.

For all of these reasons, when implementing the routing restrictions of Section 920(b)(1)(B), at a minimum, the Board should require merchants to honor the choice made by the consumer for the routing of her debit transactions; namely, the network whose brand is reflected on her debit card. Not only would this approach be consistent with the purpose of the EFTA, to protect consumers, but to do otherwise would substantially decrease debit card benefits currently available to consumers, decrease competition among debit card issuers and payment

networks and, ultimately, cede control of the debit payments system to merchants, rather than to consumers, card issuers or payment networks.

c. Effective Dates for Exclusivity and Routing Rules.

The Board has proposed effective dates for both Alternative A and Alternative B. Specifically, under the Board's proposal Alternative A would be effective October 1, 2011 and Alternative B would be effective January 1, 2013.[22] Although Alternative A is more consistent with statutory language and far less disruptive than Alternative B, Alternative A still would require far more implementation time than the proposed October 1, 2011 effective date, given the significant operational changes that would be required throughout the payment industry. For example, debit card issuers would need to negotiate new contracts with additional unaffiliated payment networks and connectivity would need to be established with such payment card networks. In addition, other debit card industry participants, such as acquirers and processors, would need enough time to update their systems in order to handle the new payment card networks, and all payment card networks would need additional time to address the operational complexities of the new requirements. The proposed changes also would require extensive consumer education and changes to all debit card consumer agreements. Therefore, the effective date for Alternative A should be no earlier than January 1, 2013.

V. The Proposed Rule Harms Consumers

The Roundtable believes the Proposed Rule raises significant public policy concerns as a result of its negative effects on consumers. First, the Proposed Rule

[22] 75 Fed. Reg. at 81,753.

will force issuers to suffer a loss on every debit interchange transaction, which, in turn, would likely compel debit card issuers to limit the issuance of debit cards and possibly eliminate certain debit card products and services altogether. In addition, issuers would be forced to seek out other sources of revenue, including fees on checking accounts. The Roundtable believes that the upcoming changes to the law imposed by the Durbin Amendment will clearly and directly shift all of the merchants' costs to consumers, threaten the health of small businesses, and undermine the stability of the payment card network by substantially reducing vital fee revenue earned by financial institutions of all sizes and structures. The sole beneficiaries of this unprecedented cost shift in the payment card industry will be large retail chains. According to industry analysis, the largest 1.5% of merchants account for over 80% of debit transaction volume.[23] The Durbin Amendment carries no requirement that those merchants benefitting from lower interchange fees must pass on those savings to their customers and there is no reason absent congressional action to believe that the merchants will do so voluntarily. Indeed, evidence from similar government price caps on interchange fees in Australia makes clear that merchants will not pass cost savings to consumers.

VI. The Proposed Rule Threatens the Safety and Soundness of the Financial System

The Proposed Rule poses numerous threats to the financial system. The Proposed Rule threatens to dramatically lower revenue for card issuers during a period of financial uncertainty. The Proposed Rule will force some banks to restrict consumers' use of debit cards and debit card transactions. Any significant

[23] The Consequences of Debit Interchange Price Fixing.

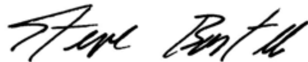
reduction in interchange fees will greatly increase the cost of checking accounts and lower their availability and, eventually, their desirability. The Proposed Rule sets a dangerous precedent that financial institutions may be subject to future, unknowable price controls on other financial products and services. This, in turn, could also undermine investor confidence in financial institutions. As well, the Proposed Rule contradicts important free market principles. Financial institutions are now in jeopardy that their investments of billions of dollars into improvements of existing products and services and the creation of new ones could be rendered valueless by government price controls. This will be a strong disincentive for innovation and investment by financial institutions in payment systems and other financial products and services.

VIII. CONCLUSION

In closing, the Roundtable reiterates our opposition to the Proposed Rule. We strongly urge the Federal Reserve to revise its proposal to remove price controls.

The Roundtable expresses its sincere thanks to the Board for the opportunity to comment. If you have any questions, please feel free to contact me or Brian Tate at (202) 289-4322.

Sincerely,



Steve Bartlett
President and CEO
Financial Services Roundtable