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Ms. Louise L. Roseman
Director
Division of Reserve Bank Operations and Payment Systems
Board of Governors of the Federal Reserve System
Washington, DC 20551

Re: October 13, 2010 Meeting Follow-up

Dear Louise,

Thank you for taking the opportunity to meet with the consumer group representatives concerning the interchange fee provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act on October 13.[1] This letter is a follow up to respond to questions posed by the Staff. Below we address three main points:

- An at-par interchange system will act to correct the broken debit card market and lead to greater consumer welfare, increase issuer competition, and increase incentives for PIN debit use.

- PIN debit use is a safer method of payment than signature debit; and at-par interchange will lower issuers' incentives to issue signature-based debit over PIN debit.

- Network routing should provide for merchant choice which will best reflect the interests of consumers.

Interchange at Par

As we have stated in our earlier filings, the debit card market is broken and consumers have been harmed by the exercise of market power by Visa and MasterCard. The two firms collectively represent over 80% of all U.S. debit card transactions. Because most debit cards issued in the U.S. bear either the Visa or MasterCard logos, merchants have no choice but to accept these cards. Because acceptance of Visa and MasterCard is essential for almost all

[1] The groups you met with included US PIRG, Consumers Union, Consumers Action, Public Citizen, and the National Consumers League.

merchants, Visa and MasterCard have the incentive and ability to increase interchange fees which have harmed merchants and consumers (through higher merchandise prices).

Consumers have significant concerns about the problem of escalating debit card interchange fees. Interchange fees have increased from $16 billion in 2001 to over $50 billion in 2009.[2] Although there may be suggestions that consumers may indirectly benefit from interchange fees, we hope the Board recognizes that a large portion of the population receives no benefits from interchange -- the 25% of the population that is unbanked and other consumers that pay by cash and checks. In fact, a recent Federal Reserve Bank of Boston study demonstrates that interchange fees are a regressive penalty on the unbanked; each cash-using household pays, on average, $149 to credit card-using households, and each credit-card using household received $1,133 from cash users every year.[3] While this study is demonstrative of credit cards, a similar dynamic exists for debit cards.

Interchange fees currently inflate the costs for all consumers. As the Hispanic Institute has observed in a study, interchange fees raise retailers' costs resulting in higher prices for consumers: "in competitive industries, interchange fees are passed through to the consumer resulting in higher nominal prices, so when interchange fees are lower, prices are lower."[4] Further, the Federal Reserve Bank of Australia has observed, reducing the increased interchange will result in savings in this area being passed on to the consumer in the form of lower priced goods. After an exhaustive study post-interchange regulation, the Reserve Bank reported that reduced interchange fees resulting in lower prices and the notion of merchants passing savings from lower interchange fees on to consumer "is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge. A similar conclusion was reached by the House of Representatives Standing Committee on Economics, Finance and Public Administration when it considered the Bank's payments system reforms in 2006."[5]

The most effective solution to this problem and clearly the solution envisioned by Congress is to set interchange at par. An at-par interchange system will benefit consumers as a whole by reducing overall retail prices, increasing issuer competition and incentivizing PIN debit use.

<u>Increased issuer competition</u>

Increased incentives for issuers to compete for card issuance is likely in an at-par interchange system. Debit is a form of access to the consumer's demand deposit account and a convenient way for bank customers to access accounts. Issuing banks have incentives to

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[2] See National Retail Federation, Credit Card Swipe Fees, available at http://www.nrf.com/modules.php?name=Pages&sp_id=838.
[3] Scott Schuh, Oz Shy, and Joanna Stavins, *Who Gains and Who Loses From Credit Card Payments? Theory and Collaborations*, Federal Reserve Bank of Boston Public Policy Discussion Paper No. 10-3 (August 2010).
[4] The Hispanic Institute, *Trickle-Up Wealth Transfer: Cross-Subsidization of Consumers in the Payment Card Market,* November 2009 at 25.
[5] Reform of Australia's Payments System Preliminary Conclusions of the 2007/08 Review (April 2008).

continue providing debit cards and promoting the use of debit cards instead of cash and checks because the incremental transactional costs for debit transactions are lower than the banks' cost for cash and checks. Banks reduce their overall transactional costs by issuing debit cards and by having their customers use debit instead of the cash and check alternatives. Moreover, by issuing debit cards, banks attract more customers and those customers may carry higher average balances.[6]

The experience of other countries demonstrates that debit at par will enhance the use of online debit which is the most efficient and safest form of payment. In seven of the eight countries with the highest debit card usage per capita there are no interchange fees. Those countries are Canada, New Zealand, Iceland, Norway, Finland, Denmark, and the Netherlands.[7]

Canada has one of the highest debit card uses in the world, and it has zero debit interchange. In many respects PIN debit in Canada is far superior than debit in the U.S. Fraud rates are far lower. At-par interchange system has fostered much innovation in Canada and this innovation surpasses the degree of innovation in the U.S. For example, the Interac system additionally offers an Internet payment service enabling over 500 merchants to offer their customers a secure internet payment option using PIN debit cards.[8] Moreover, issuers are creating stronger fraud controls through Chip & PIN systems, which will be complete by 2015.[9]

Increased PIN debit use

Creating an at-par interchange system will lead to an increase in PIN debit card usage and increased merchant acceptance. At-par interchange will lower networks' incentives to encourage issuers to promote signature debit because the higher interchange fees that now reward the issuance of signature cards will not be available. In turn, banks will issue more PIN-based debit cards as demanded by consumers; PIN debit acceptance is a benefit to consumers, as fraud rates with PIN debit are much lower compared to signature debit. As seen in Canada, at-par interchange systems incentivize issuers to issue higher numbers of PIN debit cards because of the security and efficiency of PIN versus signature.

As we discussed in our earlier filings, because of Visa's market power and exclusivity arrangements the interchange rates of signature and PIN debit have converged. Perversely, the forced increase in PIN debit interchange has deterred the deployment of PIN terminals and PIN acceptance by merchants.

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[6] It should be noted that the Reserve Bank of Australia found that the reduction in credit interchange led to increased competition among issuers to provide lower interest rates. *See* Payments System Board Annual Report, *Reserve Bank of Australia*, 2005 at 14. Regulating debit interchange to at-par could allow a similar dynamic to occur with increased issuer competition for new demand deposit account holders.

[7] Dennis w. Carlton, "Externalities in Payment Card Networks: Theories and Evidence, Commentary," The Changing Retail Payments Landscape: What Role for Central Banks, proceedings of a conference held at the Federal Reserve Bank of Kansas City, November 9-10, 2009, pp. 129-130.

[8] *See* http://www.interac.ca/consumers/productsandservices_ol_search.php#letter=A.

[9] Interac has set a deadline for complete migration to chip debit cards of December 31, 2012 for ATMs, and December 31, 2015 for point-of-sale. *See* http://www.interac.ca/merchants/chip.php.

PIN Debit is a Safer Payment Method than Signature Debit and At-Par Interchange Will Lower Issuers' Incentives to Issue Signature-Based Debit over PIN Debit

The debit interchange system that exists now is one built on an anticompetitive market with perverse fraud prevention incentives. The networks provide much greater incentives for financial institutions to issue more fraud-prone signature debit cards over the safer and more efficient PIN debit. Signature based cards are far less safe from fraud since they do not require the use of a personal identification number and the debit from the account is not instantaneous. Yet because the networks and issuers of signature-based debit cards are able to exercise their market power, merchants are required to pay higher interchange fees when their customers use less secure signature-based debit cards and this leads to higher prices for consumers. An at-par interchange system without the higher interchange fees flowing to issuers will shift the incentives for issuers to promote the safer and more efficient PIN debit product leading to savings for everyone.

The evidence is uncontroverted that signature debit is far less safe than PIN debit. A recent study found that in 2009, 95% of issuers suffered from a signature debit data breach, with 31% of their cards potentially compromised.[10] The result was an increase in issuers' net debit fraud losses. The study documents that fraud was far more significant for signature debit than PIN debit, and was increasing more rapidly for signature debit. Signature fraud losses increased by 43%, to 7.5 basis points from 5.2 basis points, while PIN fraud losses rose by only 24%, to 1.0 basis points from 0.8 basis points.[11] In addition, of the 64 financial institutions that collectively represent more than 78 million debit cards that participated in this study, 46% expect signature debit fraud loss rates to increase over the next two years.[12]

Under the current system, issuing banks either provide debit-card rewards, or assess surcharges on PIN debit transactions to encourage signature debit usage. According to a recent bankrate.com study, 65% of debit rewards programs offer rewards only on signature debit purchases; the range for rewards on PIN purchases is significantly lower, between 0.1 and 0.5 percent.[13] A system that promotes the less secure and more costly product for consumers makes no economic sense and is a sign of a broken market. Banks should not be rewarded through higher interchange fees because of the inefficiency that flows from signature debit.

At-par interchange will shift issuers' incentives to provide consumers with more PIN-debit over signature-based cards. The fraud prevention costs to issuers are actually cheaper for PIN than for signature. This is because banks have to spend much more money to try to prevent signature debit fraud then they do to prevent PIN debit fraud. If interchange fees are decreased, issuers will begin to promote the less-costly and more efficient product.

Some networks and issuers may suggest that signature is still preferred over PIN debit by some consumers. One of the arguments made is that generally card-not-present merchants,

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[10] *See* Pulse, 2010 Debit Issuer Study (June 2010).
[11] Id.
[12] Id. at 18.
[13] http://investor.bankrate.com/releasedetail.cfm?RelaseID=489440.

particularly Internet merchants, do not house the infrastructure to accept PIN debit transactions; and further, PIN debit consumers are reluctant to input a PIN over the internet because of the risk of fraud. Any suggestion that the use of PIN deters debit card acceptance on the Internet is belied by the experience in other countries where PIN is used on the Internet.

Moreover, consumers are no more reluctant to insert PINs for internet transactions than they are to input other personal information such as credit card numbers, addresses, passwords, or credit card verification codes which verify individual credit cards authenticity, the same way a PIN does. This was demonstrated in a 2009 PULSE study which reported that a survey of consumers found that 79% of respondents "would feel more comfortable using debit cards online with a PIN than without it."[14] Further, PULSE found that 54% of cardholders paying for online purchases preferred to enter a PIN, when given a choice between PIN or signature options.[15]

PIN debit over the Internet is still in development and its lack of development is due to anticompetitive conduct, rather than a lack of market interest. Visa has in fact, in the past, attempted to discourage PIN debit transactions over the Internet through anticompetitive conduct. In 2008 the DOJ, jointly with the attorneys general of New York, Ohio and Washington, D.C., investigated a Visa operating rule that discriminated against non-Visa debit networks by requiring merchants to treat Visa-branded debit cards differently when used as a PIN debit card (and processed over non-Visa networks) from the same cards when used as signature debit cards and processed on the Visa network.[16] More specifically, the Visa rule prohibited banks from allowing merchants to waive entry of a PIN for most non-Visa debit transactions initiated from Visa-branded debit cards, which included almost all internet transactions. The DOJ's investigation considered that the rule adversely impacted competition in the debit card market by restricting small-value and internet PIN debit transactions, and by potentially interfering with the innovation of new types of PIN debit services. As a result of the investigation, Visa rescinded its rule.

Network Routing Should Provide for Merchant Choice

Consumers benefit when merchants are able to bargain for the best products at the lowest price. Consumer sovereignty is based on merchant choice and where merchants are victimized by limited choice, consumers can suffer. Congress clearly envisioned the need to protect consumers by giving merchants the ability to route transactions through the lowest cost, safest and most efficient network and consumers agree that merchant routing will benefit consumers.

Giving merchants the ability to route is critical to spurring network competition, which in turn will lead to lower consumer prices. Visa and MasterCard often form exclusivity arrangements with issuing banks, in which either Visa or MasterCard becomes the sole network for transactions made with those cards. Moreover, and additionally crippling to competition, MasterCard imposes a fee to merchants if a transaction could have been routed over the

[14] "Pulse Introduces PIN Debit for E-Commerce Transactions," News Release (July 14, 2010).
[15] Id.
[16] DOJ Press Release, *Visa, Inc. Rescinds Debit Card Rule as a Result of Department of Justice Antitrust Investigation*, July 1, 2008.

MasterCard network but was cleared on another network; and Visa rules require that MasterCard's signature debit network not be offered on the same card as Visa's signature debit network.[17]

Merchant routing is pro-consumer. As we suggested, the Board should mandate at least two unaffiliated networks for signature and PIN to provide choice for merchants on each transaction. Multiple signature and PIN debit card network choices on each card allowing merchants to control the routing will reduce networks' exercise of market power over merchants and incentivize them to compete by offering lower fees and better quality and services, which in turn benefits consumers.

Opponents to merchant-directed routing may argue that such merchant choice may undermine the consumer ability to obtain rewards or other benefits currently available on some debit cards. They may also suggest merchant routing may deter efforts at combating fraud. Both of these arguments are overstated. Any reward programs on debit cards are very modest and are enjoyed by very few consumers. Efforts to control fraud are typically directed by the card-issuer and not the network, and those efforts will not be deterred by the network that is selected. The issuers will receive the same information and be able to detect fraud no matter which network handles the transaction.

Moreover, the opposition to merchant routing is an effort to circumvent the clear intent of the Dodd-Frank Act which says

> an issuer or payment card network shall not, directly or through any agent, processor, or licensed member of the network, by contract, requirement, condition, penalty, or otherwise, 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.[18]

Through merchant-directed routing, networks and issuers will have the incentive to compete on lower fees and better services, which directly benefits consumers.

Overall, providing greater network routing through merchant choice will facilitate greater use of the PIN debit networks as well as entry and expansion of other signature debit networks, which can reduce the market power of Visa and MasterCard. Greater competition will lead to significant consumer benefits.[19]

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[17] See Visa International Operative Regulations, April 1, 2010, ID#: 0140410-010410-0006300.

[18] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 1075 (a)(2).

[19] Such consumer welfare is certainly the focus of the Dodd-Frank Act amendments to the Electronic Fund Transfer Act, under which Section 904 it states "[t]he primary objective of this title…is the provision of individual consumer rights."

We again thank you for the opportunity to meet. Please contact us should you have any remaining questions or any issues you would like to further discuss.

Sincerely,

David A. Balto

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