

Legal Department

November 12, 2010

Ms. Louise Roseman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Re: Rulemaking pursuant to Section 920 of the Electronic Fund Transfer Act

Dear Ms. Roseman:

Bank of America (or “Bank”) respectfully offers the Board of Governors of the Federal Reserve System (“Board”) and its staff thoughts and legal analysis of the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act in connection with the Board’s promulgation of regulations related to debit card interchange, card routing and merchant discounts under Section 920 of the Electronic Fund Transfer Act (“EFTA”).

The Bank is the leading debit card issuer in the country and has a deep understanding of the economic underpinnings of the debit card product, its functionality, and its appeal to consumers and merchants alike. In 2009, Bank of America’s customers conducted more than 5.7 billion debit transactions on approximately 24 million debit cards representing approximately \$240 billion of purchases. On an average day the Bank processed more than 15 million transactions (approximately 180 transactions a second), representing \$658 million of consumer and small business spending.

I. Key Issues

- *Consumer interests are paramount.* The Board has the flexibility and legal mandate to set debit interchange standards to ensure that consumers continue to enjoy the benefits and security of debit card usage.
- *Consumers will be harmed if the Board sets debit interchange standards inappropriately.* If merchants do not pay their fair share for the benefits they receive through debit card acceptance, consumers will be forced to pick up the merchants’ share of the tab. If the Board’s interchange standards under Section 920 are too low:
 - c Banks will be forced either to recover the revenue elsewhere or to limit the services they provide; and

- c Merchants will shift costs to consumers while still reaping the benefits of debit card acceptance. Experience in other jurisdictions shows that merchants will not pass interchange savings to consumers in the form of lower prices.¹
- *Debit interchange reductions may have a disproportionate impact on low- and moderate-income consumers.* Though debit has broad appeal across all customer segments, there is a high concentration of debit card usage among low- and moderate-income consumers. Low- and moderate-income consumers may suffer disproportionate harm if debit interchange is greatly reduced.
 - c For many lower-income or under-banked consumers, higher debit card fees—a likely result of lower debit interchange rates—will present new barriers to establishing long-term financial security through a banking relationship.
 - c For those consumers who will not pay the increased debit card fees and are credit constrained, they may lose the benefits of electronic payments and be forced back to less appealing forms of payment, such as cash and checks.
- *Specific considerations for the Board when setting interchange standards.* To avoid these unintended consequences, and others discussed in greater detail below, the Board should act within its statutory mandate to:
 - c Include appropriate debit program costs and a reasonable profit margin when setting debit interchange standards; and
 - c Establish a single safe harbor debit interchange rate.²
- *The Board should approach fraud adjustments to allow issuers to recapture costs while ensuring fraud responsibilities are allocated appropriately.* With respect to the permissible fraud adjustments under Section 920, the Board should carefully consider how it approaches the fraud mitigation standards.
 - c Fraud is fluid, and will generally flow to the “weak link” in the payments chain, which includes issuers, merchants, acquirers, various payments networks and processors. Accordingly, overemphasizing the fraud prevention capacity of issuers to the exclusion of the other participants in the payment process, including merchants, will impose extra cost on issuers without necessarily effectively or efficiently reducing fraud.
 - c As federally regulated banks, issuers already are subject to significant fraud control standards under existing federal requirements (*e.g.*, Regulation E, FACT Act/Fair Credit

¹ See, *e.g.*, U.S. Gov't Accountability Office, *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges*, November 2009 at 45. See, also, Robert Stillman and others. “Regulatory Intervention in the Payment Card Industry by the Reserve Bank of Australia: Analysis of the Evidence,” CRA International (Apr. 28, 2008).

² We agree with the letter Oliver Ireland of Morrison & Foerster recently sent the Board regarding a safe harbor interchange rate that can be managed by the networks at the network level. Such an approach would also be appropriate in the context of any fraud adjustment.

Reporting Act, Gramm-Leach-Bliley Act), as well as network fraud control standards, which are consistent with “fraud-related standards” called for under Section 920.

- c A more inclusive definition of allowable fraud prevention costs—combined with these minimum fraud control standards—would encourage innovation in the development and implementation of cost-effective fraud prevention standards by all participants in the payment chain as described in detail below.
- *The Board should take a straightforward approach to exclusivity and routing.* With respect to Section 920(b) of the EFTA and the network exclusivity provisions, the statute requires issuers to enable at least two unaffiliated networks on a debit card. With minor clarifications, we believe the Board’s regulations should generally mirror the statutory language.

II. In General

A. Consumers (and Merchants) Like Debit Cards

As the Board and its staff are well aware, consumers have adopted debit cards as a preferred form of payment. The adoption of debit cards by consumers is a direct result of the tremendous benefits they provide to consumers. These consumer benefits include:

- *Convenience.* Debit cards are more convenient than cash or checks. Consumers can make purchases over the Internet, and consumers do not like having to carry a check book or large amounts of cash to make purchases in a store.
- *Security.* Debit cards are more secure than cash or checks. With the debit card protections Bank of America provides, in addition to those included in Regulation E, consumers face very little danger of suffering a loss from unauthorized use of a lost or stolen card.
- *Control.* Consumers feel that debit cards give them more control over their financial situation since consumers generally cannot use debit cards to spend more than their checking account balance. (As the Board is aware, Bank of America has taken an industry-leading position in not allowing customers to overdraw their account through point-of-sale debit card transactions.)
- *Benefit Programs.* Consumers also receive other benefits through use of a debit card, such as enhanced financial management tools and innovative savings products like the Bank’s “Keep the Change®” program.

The industry and the Bank have invested heavily over the years in improving the debit card experience for consumers. Significant investments by the industry and the Bank in the security and reliability of the debit networks also have provided consumer benefits such as:

- *Online Banking.* Enhancing the online banking experience for debit card users by, for example, providing real-time display of debit card authorizations and updating the available balance to reflect those authorizations;

- *Alerts.* Real time alerts via text messages for debit card transactions, for specific settings chosen by the customer;
- *Photo Security.* Providing a photo security option on the debit card; and
- *Innovation.* Developing innovative savings products associated with debit card usage like Keep the Change®.

For consumers to continue to benefit from their debit products, the Bank must be able to invest in innovation. Interchange is a key component that allows us to do that. If the Bank and the industry are forced to operate debit programs without a sufficient return, there will be little incentive to continue to invest in the debit card product and provide continued consumer innovation.

Like consumers, merchants have rapidly adopted the debit card as a preferred form of payment because of the many benefits merchants receive in connection with debit card acceptance. This rapid adoption occurred without the regulation of interchange rates, suggesting that merchants believed the costs of debit acceptance were outweighed by the benefits. As we describe in more detail below when discussing the difference between checks and debit card transactions, merchants receive significant and important benefits from debit card acceptance today. Merchants should pay a fair price for those benefits.

B. The EFTA Is a Consumer Protection Statute

The primary purpose of the EFTA is to protect individual consumers, not to provide a wealth transfer from consumers to merchants.³ The regulation of interchange rates creates material risk that consumers will be asked to pay for the benefits that merchants receive when they accept debit cards for payment. If merchants do not pay their fair share of the cost of a debit transaction, consumers will have to pick up the merchants' tab. This is not the purpose of the EFTA, and we ask the Board to approach its implementation of the Durbin Amendment with that in mind.

III. Debit Interchange Standards

Congress has directed the Board to issue regulations to provide standards for assessing whether interchange fees on debit card transactions are: (i) reasonable; and (ii) proportional to the cost incurred by the issuer. Furthermore, Congress requires the Board to consider, as part of its rulemaking process: (i) the similarities of the clearing of check and the processing of debit card transactions; (ii) the incremental costs incurred by an issuer in its role as an issuer in the authorization, clearance or settlement of debit card transactions; and (iii) the role fraud plays in the system.

A. Reasonableness Means Costs Plus Reasonable Profit Margin

In directing the Board to promulgate regulations that ensure interchange fees are "reasonable," Congress is deemed to understand current judicial interpretations of law and presumably intended for the Board to

³ See 15 U.S.C. § 1693(b). ("The primary objective of this title... is the provision of individual consumer rights.")

consider relevant judicial interpretations.⁴ The courts have experience in interpreting “reasonable” or “just and reasonable” in the context of rate regulation.⁵ The Supreme Court has determined that a reasonable rate of return on investment is constitutionally required pursuant to the takings clause of the Fifth Amendment.⁶ In Verizon Communications, the Supreme Court described the history of the constitutionality of rate setting and concluded:

The traditional regulatory notion of the ‘just and **reasonable**’ rate was aimed at navigating the straits between gouging **utility** customers and confiscating **utility** property. More than a century ago, reviewing courts charged with determining whether **utility rates** were sufficiently **reasonable to avoid unconstitutional confiscation took as their touchstone the revenue that would be a ‘fair return’** on certain **utility** property known as a ‘rate base.’

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What is remarkable about this evolution of just and reasonable rate setting, however, is what did not change. The enduring feature of rate setting from *Smyth v. Ames* to the institution of price caps was the idea that calculating a rate base and then allowing a **fair rate of return** on it was a sensible way to identify a range of rates that **would be just and reasonable to investors and ratepayers.**⁷

In fact, in the rate-setting context, the courts have distinguished between business-to-business relationships and business-to-consumer relationships. In business-to-business relationships, like those at issue here, the federal regulators and courts have determined that the “just and reasonable” standard to create a presumption that a contractual rate established in the market-place is “just and reasonable” unless the rate “seriously harmed the public interest.”

When commercial parties did avail themselves of rate agreements, the principal regulatory responsibility was not to relieve a contracting party of an unreasonable rate (“its improvident

⁴ See Int’l Union, United Auto., Aerospace & Agric. Implement Workers of Am., Local 737 v. Auto Glass Employees Fed. Credit Union, 72 F.3d 1243, 1248 (6th Cir. 1996) (“It is a settled principle of statutory construction that when Congress drafts a statute, courts presume that it does so with full knowledge of the existing law.”).

⁵ It is worth noting in the United States, government rate regulation has generally only been used in situations where a “natural monopoly” exists, such as utilities. “A natural monopoly exists in an industry where a single firm can produce output such as to supply the market at a lower per unit-cost than can two or more firms.” Depoorter, Ben W.F., Regulation of a Natural Monopoly. Center for Advanced Studies of Law and Economics, University of Ghent. Given the thousands of debit card issuers in the United States, there is no reason to think that debit card issuing is a natural monopoly that warrants rate regulation.

⁶ See, e.g., Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989). (“One of the elements always relevant to setting the rate under *Hope* is the return investors expect given the risk of the enterprise.”). Cf., Tenoco Oil v. Dept. of Consumer Affairs, 876 F.2d 1013 (1st Cir. 1989) (finding rate setting that fails to consider a reasonable rate of return should be analyzed under the takings clause rather than the due process clause). Cf. Phillip Morris v. Reilly, 312 F.3d 24 (1st Cir. 2002) (under general regulatory takings analysis, two significant factors are “reasonable investment backed expectations” and “economic impact.”).

⁷ Verizon Commc’n., Inc. v. FCC, 535 U.S. 467 (2002) (internal cites omitted). (Emphasis added.) The decision goes on to note that the approach that Congress and the FCC has taken in the Telecommunications Act of 1996 segregated the analysis of costs from reasonable profit, and thus, deviated from the historical approach.

bargain”), but to protect against potential discrimination by favorable contract rates between allied businesses to the detriment of other wholesale customers.⁸

Because the relationship between merchants, acquirers, networks and issuers is a purely business-to-business relationship, the interchange rate that results from their contractual interactions should be entitled to the presumption that it is just and reasonable.

Thus, by using the word “reasonable” in its mandate to the Board, Congress acknowledged that, in order to pass constitutional muster, the Board should – indeed, must – include a fair profit margin to the issuers.

In addition to the constitutional mandate, the Board can look to the requirements that Congress placed upon the Board itself for establishing its own fees should be consistent with the concept of “reasonableness.” Indeed, a scheme or description of fee-setting for the Board would be a good starting place for determining what might be considered “reasonable.” In the Monetary Control Act, Congress requires the Board to adhere to the following standards in its own fee setting:

Over the long run, fees shall be established on the basis of all direct and indirect costs actually incurred in providing the Federal Reserve services priced, including interest on items credited prior to actual collection, overhead, and an allocation of imputed costs which takes into account the taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm, except that the pricing principles shall give due regard to competitive factors and the provision of an adequate level of such services nationwide.⁹

If “overhead and allocation of imputed costs... and the return on capital” are considerations for the Federal Reserve, a governmental entity that has a primary purpose other than profitability, then they are certainly factors that can and should be considered under a “reasonable” approach to determining what is appropriate for a private, for-profit entity to receive for its services.

Thus, there appears to be general recognition that, when charged with establishing “reasonable” rates or otherwise having a governmental entity dictate pricing, a regulator should think broadly to ensure all costs are considered, and the regulated entity must be allowed to earn a reasonable rate of return.

B. Proportionality Means Interchange May Exceed Costs

Section 920 of the EFTA does not require debit interchange to *equal* actual costs. Instead, Congress has mandated that, in addition to debit interchange being reasonable, debit interchange must also be “proportional to the costs.” A dictionary definition of proportional is “having the same or constant ratio,” which may include a multiple of costs.¹⁰

⁸ *Id* (internal cite omitted). See also, *NRG Power Mktg., LLC v. Me. PUC*, 130 S. Ct. 693 (2010) (citing *Morgan Stanley Capital Group Inc. v. Pub. Util. Dist. No. 1*, 128 S. Ct. 2733 (2008)).

⁹ The Monetary Control Act, 12 USC 248a ; see also http://federalreserve.gov/paymentsystems/pfs_principles.htm.

¹⁰ *Webster’s Ninth New Collegiate Dictionary*, Merriam Webster Inc., 1991.

In a variety of contexts, both Congress and the courts have concluded the term “proportional” means a multiple of costs. For example, in assessing the question of the proportionality of attorney’s fees to a damage award, courts have not hesitated to approve fees that are a multiple of the damages awards.¹¹ Congress has also required attorneys fees be proportional to awards in certain claims. For example, pursuant to 42 U.S.C. § 1997e(d)(1)(B)(i), Congress mandated that awards of attorneys fees in inmate suits must be “proportional” to the award of damages the inmate is awarded; and in so doing, Congress expressly and explicitly acknowledges that a multiple of the damage award is “proportional.” In the case of the statute, the multiple is 150%.¹² “Proportional” has also been interpreted by courts in the context of awarding punitive damages to mean something greater than one-to-one. For example, the Supreme Court has determined that in order to survive constitutional review, absent statutory authority to the contrary, the relationship between compensatory and punitive damages must be proportional, and a ratio of four to one, or even up to ten to one may be appropriate and proportional.¹³

Consistent with the plain meaning of the term, and prior congressional interpretations of the term “proportional,” interchange rates should be established at a multiple of the costs. The Board’s challenge in interpreting the “proportional” language is determining what multiple of costs is appropriate in the interchange context.

In sum, the references to “reasonable” and “proportional” costs within the overall statutory scheme make sense. The “reasonable” requirement recognizes issuers must be allowed a profit margin; while the “proportional to costs” requirement establishes the relationship between that allowable profit margin and the underlying costs, by allowing interchange to be set at a multiple of costs. Finally, the statute addresses those costs that constitute the basis of this calculation, as discussed in the section that follows.

C. Allowable Costs Should be Broad

Pursuant to Section 920(a), there are three distinct sets of costs for the Board to define: costs the Board **must** consider, costs the Board is **prohibited** from considering, and costs the Board **may**, but is not required to, consider (*i.e.* those costs that are described in neither of the above clauses).

Under Section 920(a)(4)(B)(i), the Board must consider the incremental costs “incurred by the issuer for the role of the issuer” associated with the authorization, clearance or settlement of debit card transactions. This establishes some fairly straightforward cost considerations that the Board must consider, including:

- Processing (authorization, interbank clearing and settlement, cardholder posting);
- Network fees (switch and processing, assessments, charge-backs);
- Service (card production and delivery, inquiries and claims);

¹¹ See, e.g., *Johnson v. Kakvand*, 192 F.3d 656 (7th Cir. 1999).

¹² See, e.g., *Riley v. Kurtz*, 361 F.3d 906 (6th Cir 2004).

¹³ *Pacifica Mutual Life Ins. Co. v. Haslip*, 499 U.S. 1, 23-24 (1990) (affirming a ratio of 4 to 1 as appropriate); *TXO Product Corp. v. Alliance Res. Corp.*, 509 U.S. 443, 460 (1993) (affirming a ratio of 10 to 1, though emphasizing that the acceptability of the 10 to 1 ratio did not rely primarily on the consideration of the proportionality of punitive to actual damages). See also, *Action Marine, Inc. v. Cont'l Carbon, Inc.*, 481 F.3d 1302 (11th Cir 2007) (“The question we must ask then is whether a punitive damages award of \$ 17.5 million is **proportionally** related to the compensatory damage award of approximately \$ 3.2 million. Under the circumstances of this case, we think it is.”) (Emphasis added.); *Dowling v. Litton Loan Servicing Inc.*, 2009 U.S. App. LEXIS 8347 (6th Cir. 2009) (affirming a \$49,560 attorney fee award in light of a \$26,000 damages award).

- Rewards and incentives;
- Data and systems security; and
- Fraud costs related to particular electronic debit transactions.¹⁴

Importantly, Congress could have written Section 920(a)(4)(B)(i) without using the words “incremental...for the role of the issuer” and achieved the list of expenses above. Since rules of statutory construction require courts and regulators to give meaning to each word in the statute, the phrase “for the role of the issuer” must mean something more than these types of direct expenses listed above.¹⁵ A reasonable interpretation of the distinction between incremental costs incurred only “in the authorization, clearance or settlement” of a transaction and incremental costs incurred more broadly “**for the role of the issuer** in the authorization, clearance or settlement,” are the inclusion of all incremental costs that an issuer incurs so that it may perform the role of an issuer. That is, calculate the costs a bank has before it becomes a debit card issuer and compare that to the incremental costs associated with becoming a debit card issuer. Such costs include:

- Product development costs;
- Maintaining the infrastructure to meet all of the regulatory requirements associated with being an issuer (*e.g.*, providing periodic statements, maintaining appropriate customer service staff, etc.); and
- Costs associated with selling and distributing debit cards.

Thus, pursuant to Section 920(a)(4), the Board must consider all costs directly associated with the authorization, clearance or settlement of specific debit card transaction including all incremental costs associated with the issuer acting in the role of the issuer to effectuate those transactions.

The Board is prohibited from considering “other costs by an issuer which are not specific to a particular debit card transaction.” This prohibition is consistent with the so-called “prudent investor” rule. Under the prudent investor rule, when rate-setting based on cost, the rate setter shall abide by the principle “that a utility can only recover prudently invested capital that is being ‘used and useful’ in providing the public a good or service.”¹⁶ Costs that clearly fall into the “other” category include costs not associated with the bank’s “role of an issuer” – that is, costs unrelated to the debit card business.

The Board is allowed, but not required, to consider costs that are related to a particular debit card transaction, but are independent of the authorization, clearance or settlement of a transaction. Examples include expenses associated with call center personnel that respond to customer inquiries or costs related to periodic statements or other customer notices that include information about particular debit card transactions. This third category of allowable costs is quite broad, and gives the Board ample flexibility

¹⁴ While Congress addresses fraud-related costs in two separate sections of Section 920, we believe Congress clearly intended that the transaction-specific fraud costs be included in the basic interchange rate. There is simply no way to reconcile the requirement to consider costs related to the “authorization, clearance or settlement of a particular electronic debit transaction” with an exclusion of fraud prevention costs imbedded in the authorization, clearance and settlement process. Furthermore, the language in Section 920(a)(5)(A) clearly indicates that the fraud costs are part of the underlying interchange transaction fee—otherwise issuers would be free to establish their own fraud-related adjustments outside of the requirements of Section 920(a) (*i.e.*, because they are not regulated interchange fees).

¹⁵ See *Walker v. Bain*, 257 F.3d 660, 667 (6th Cir. 2001), cert. denied, 535 U.S. 1095, 122 S. Ct 2291, 152 L. Ed. 2d 1050 (2002) (“Every word in the statute is presumed to have meaning, and we must give effect to all the words to avoid an interpretation which would render words superfluous or redundant.”).

¹⁶ *Verizon*, 535 U.S. at 484.

to consider costs necessary to support the infrastructure and investment necessary to maintain and grow the debit card business, on which consumers and merchants have come to rely.

D. Debit Transactions Are Significantly Different Than Check Transactions

Section 920 directs the Board to consider the similarities between the processing of debit card transactions and the processing of check transactions. Inherent in this requirement is the need to consider the differences between the two forms of payment.

There are some obvious similarities between checks and debit cards (*e.g.*, they draw from a consumer's transaction account). However, despite any high level similarities, the differences between the two types of transactions are profound. Key examples of such differences (and benefits to merchants) include:

- *Guaranteed Payment.* If a merchant receives an authorization approval at the point of sale in connection with a debit card transaction, today the merchant is guaranteed payment regardless of whether there are funds in the consumer's account when the transaction settles. A merchant receives no automatic payment guarantee in connection with the acceptance of a check, and the merchant risks the check being returned. There are obvious costs associated with the payment risk inherent in a check, including returned item fees and the loss of merchandise without payment. This benefit alone in connection with a check payment apparently has a value of 92 basis points.¹⁷
- *Funds Availability.* Generally, merchants have access to their debit card transaction funds in a more timely manner than they do with checks.
- *Merchant Convenience.* Debit card functionality allows greater opportunity for merchants to make payment acceptance more efficient, including through the automation of payments. Pay-at-the-pump terminals and self-checkout at the grocery store, for example, cannot accept checks as a form of payment. Internet sales would be a small fraction of what they are today if merchants were limited to checks or similar payments for Internet transactions. Even traditional checkout terminals are more efficient (*e.g.*, less labor costs, less customer waiting time) with debit card acceptance than with check acceptance.
- *Consumer Satisfaction.* Merchants can decide which payments they are willing to accept, but consumers have always had the ability to choose from among those payment types. Merchants accept debit cards for the same reason merchants build parking lots, provide air conditioning, and hire sufficient staff—because these types of things satisfy their customers. If a merchant accepts debit cards, customers who want to pay with funds from a deposit account no longer have to carry a checkbook and go through the tedious process of writing a check with every purchase. Even consumers who do not pay by debit card benefit from quicker checkout times—virtually everyone has had the experience of standing behind the person who slowly writes a check at the cash register.

¹⁷ See Check Authorization – 2009, The Nilson Report, July 2010, 1 at 7.

- *Fundamentally Different Settlement Functionality.* Unlike debit cards, and as we mention in a footnote below, checks are negotiable instruments with historical reasons behind the “clear at par” requirement. Checks are settled between counterparties with the associated risks. Debit cards are not.

In short, consumer behavior tells us millions of times a day that the differences between checks and debit cards are profound. It would be unwise to rely on superficial similarities to conclude as a matter of regulatory policy that the clearing and settling of debit card transactions should be priced like check transactions.¹⁸

E. Achieving Efficiency in the Marketplace Requires the Board to Consider More than Costs

Economic theory suggests that maximizing efficiency is the same as maximizing social utility, and the proper role of regulation is to correct market inefficiencies (not to create or exacerbate inefficiencies). In other words, the public policy mandate to the Board under Section 920(a) of the EFTA is to maximize efficiency in the debit card arena – not to reallocate costs in a manner that picks winners and losers, especially since consumers stand to be on the losing end of such reallocation.

If the Board’s interchange standards are to maximize efficiency, and therefore social utility, it is critical that the Board considers the appropriate costs associated with a debit transaction. To that end, the conclusion by some of the Board’s own experts on this issue suggests that the most efficient interchange regime considers something more than “costs associated with producing a card-based transaction.”¹⁹ Today, interchange fees consider more than only those costs and, as the Board staff have repeatedly concluded, interchange fees already play a very important part in improving the efficiency of the payments world.²⁰

In any market, price is a key factor in optimizing efficiency. Absent externalities, in a standard, efficient market the law of supply and demand drives price to an optimal level. However, in a “two-sided” market, such as the debit card market, it is generally accepted that a “transfer payment” is usually necessary to facilitate efficiency. In the debit card arena, interchange functions is that transfer payment facilitating efficiency.²¹ There are consequences if the transfer payment is not set in a manner that

¹⁸ Furthermore, clearing checks at par was not mandated due to any concern that the payee was being harmed by interbank costs. Rather, clearing at par was a governmentally developed tool to encourage efficiency in check processing—not to regulate the consumer payments market. See, e.g., Ed Stevens, *Non-Par Banking: Competition and Monopoly in Markets for Payment Services*, Federal Reserve Bank of Cleveland Working Paper 9817 (November 1998).

¹⁹ See, e.g., Robin A. Prager, et al., Division of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., *Interchange Fees and Payment card Networks: Economic Industry Developments and Policy Issues*, Finance and Economic Discussion Series 3 (2009) (hereinafter “Prager”) at 3. Prager discussed primarily credit card interchange, but the discussion is directly relevant to debit card interchange.

²⁰ See, e.g., Prager.

²¹ As Prager describes it, interchange can be useful to internalize externalities:

More formally, the two-sided nature of the market for payment cards introduces the possibility of *externalities*. An externality arises when one agent’s action affects the welfare of another agent, without any compensation for the effect. Because an agent’s private incentives in the presence of an externality do not reflect the true social cost or benefit of his or her actions, socially inefficient outcomes can result. The economics literature has emphasized the importance of two potential externalities in the context of payment cards (Rochet 2003). The first, described in the numerical example above, has been termed the usage externality and arises because each party in a given transaction

maximizes efficiency. For example, if interchange is established at too low a level, issuers will not have sufficient incentive to enhance and promote debit card usage to an efficient level; if interchange is too high, then merchants will not have sufficient incentive to accept debit cards and hence will do so at a sub-optimal level.²²

Prager lays out the basic framework of a “two sided” market and the role interchange plays.

Payment card markets are often described by economists as being *two-sided*. A two-sided market is a market for the provision of a product whose value is realized only if a member of each of two distinct and complementary sets of users simultaneously agrees to its use (Rochet and Tirole 2006a). A payment card has value only if a merchant and the merchant’s customer agree on its use to carry out a transaction. The two-sided nature of demand for payment cards has important implications for pricing that are absent in standard markets. In particular, the prices faced by the two sides of the market must be set at levels that “balance demand,” because a payment card that appeals to one side of the market will not be used if it does not also attract the other side of the market

In order to maximize efficiency, interchange should be established in a manner “not solely dependent on the cost of producing a card-based transaction.”²³ Given the public policy mandate from Congress and the clear economic mandate, the Board should seek the efficiency-maximizing level of interchange within the parameters established in the statute.

F. The Board Must Establish Interchange in a Manner to Avoid Violating the Constitution

The Board is facing a lawsuit filed by TCF National Bank, Case No. 4:10-cv-04149-LLP (S.D. South Dakota), challenging the constitutionality of the Durbin amendment. The Bank believes that the Board has been granted sufficient discretion within the Durbin amendment to allow the Board to avoid

evaluates his or her own costs and benefits associated with a particular payment method, but does not consider the costs and benefits of the other party. A second type of externality, referred to as a network (or adoption) externality, reflects the fact that the value of a payment card network increases for both merchants and consumers as the card becomes more ubiquitous. In other words, a larger cardholder base makes card acceptance more valuable for merchants, while broader merchant acceptance makes cardholding more attractive for consumers. When deciding whether to accept cards, the merchant may not account for the increased network value associated with his or her acceptance. Similarly, a consumer’s decision about whether or not to hold a card may not account for the effect of his or her decision on the value of the overall network

A standard economic prescription to deal with externalities involves adjusting prices (through taxes, subsidies, or transfers) so that agents’ private incentives reflect the true social costs and benefits of their decisions. In the context of payment cards, this involves appropriate pricing of card services for all of the parties involved in a card transaction. How this could be accomplished depends on the organizational form of the card system. In the three-party card system (in which the network itself is both issuer and acquirer), the network could, theoretically, set transaction prices for consumers and merchants that would align private and social costs and benefits. In a four-party card system, the network cannot directly set transaction fees for merchants and consumers. It can, however, establish an interchange fee – a transfer payment between the merchant’s bank (acquirer) and the consumer’s bank (issuer) – that influences the costs of card transactions for those banks and the transaction fees that they subsequently charge merchants and consumers (i.e., merchant discounts and card use fees or rewards). As a result, an interchange fee can, at least theoretically, improve efficiency by internalizing externalities.

²² See generally, Prager.

²³ Prager at p. 3.

violating the Constitution – but only if the Board utilizes its discretion to set interchange at a multiple of allowable costs so that issuers may make a reasonable profit margin over and above all costs.

IV. Fraud Allowances

The obligation to prevent fraud in a debit card network falls on many parties, including card issuers and merchants. Debit card issuers are already subject to a variety of data protection requirements, and generally have a very strong record of protecting debit cardholder data. Merchants, on the other hand, create significant security risks within a debit card network. For example, more than 80% of debit fraud risks are associated with data compromises, which are almost exclusively associated with merchants or their service providers.

The Board rules should allow issuers that maintain strong fraud prevention standards to recapture fraud prevention costs and fraud losses. Standards articulated by the Board that are applicable uniformly to all issuers will help ensure issuers do their part to anticipate and help prevent fraud. Allowing those issuers to recoup their costs of prevention, as well as the fraud losses they incur (despite their preventative efforts), by means of a uniform fraud adjustment to interchange, provides appropriate incentives for issuers to do more to prevent fraud and helps ensure fraud responsibilities are allocated appropriately, as described in the paragraphs that follow.

A. Fraud Prevention Standards Should Take Into Account Existing Requirements

Under the current statute, to qualify for an adjustment to interchange for fraud costs permitted in Section 920(a)(5) (“Fraud Adjustment”), an issuer must comply with fraud standards issued by the Board. Issuers are already subject to a variety of data security and related requirements, such as those under the Gramm-Leach-Bliley Act, the red flags requirements under the Fair Credit Reporting Act, customer identification requirements, and suspicious activity reporting requirements. In addition to these robust federal requirements, card issuers also comply with the Payment Card Industry Data Security Standard and offer a variety of fraud prevention tools in connection with debit card activity, such as card security features, real-time transaction authorization, transaction monitoring, and cardholder identity verification tools (*e.g.*, AVS, CVV2/CVC2). In promulgating its fraud prevention standards, the Board should consider whether these existing requirements, to which issuers are already subject, are sufficient for purposes of Section 920.

We believe the most appropriate approach is for the Board to adopt a requirement similar to the information security safeguards under the Gramm-Leach-Bliley Act or the red flags program under the Fair Credit Reporting Act. Such an approach would require issuers to conduct a risk assessment and develop a written fraud program that is reasonably designed to address those risks in a cost-effective manner. This would avoid overly prescriptive requirements, while ensuring that issuers appropriately address debit card fraud.

B. The Board Should Provide an Allowance for All Debit- Related Fraud Costs

Issuers who meet the fraud prevention standards prescribed by the Board, should be allowed to recoup, through a Fraud Adjustment, their costs, which include fraud losses. Section 920(a)(5)(A)(i) provides the Fraud Adjustment must make allowance “for costs incurred by the issuer in preventing [debit card]

fraud.” We note that Congress did not direct the Board to exclude any fraud costs from the Fraud Adjustment.²⁴

When giving debit issuers the ability to recover fraud costs, Congress clearly intended issuers to be able to recover fraud *losses*, which are a significant fraud-related cost to issuers. In Section 920(a)(5)(A)(ii)(I), Congress directs the Board to exclude any “fraud-related reimbursements (including amounts from charge-backs)” that have been received by debit issuers from consumers, merchants or payment card networks. Such reimbursements generally would be for fraud losses incurred by the issuer; therefore, this exclusion makes sense only if allowable fraud costs include fraud losses (*i.e.*, losses the issuer absorbed).

The statutory scheme establishes appropriate incentives for all parties to seek to avoid fraud losses. Allowing an issuer to recover fraud losses through a Fraud Adjustment, for example, will not lead to a lessening of fraud prevention measures, because the issuer must meet the Board’s minimum fraud standards in order to qualify for the Fraud Adjustment in the first place. Moreover, including within the Fraud Adjustment fraud losses, which are frequently caused by merchants rather than issuers, will serve as an incentive to merchants generally to improve their data security efforts. Put another way, an inclusive definition of allowable fraud prevention costs—combined with minimum fraud control standards—would encourage innovation in the development and implementation of cost-effective fraud prevention standards by all participants in the payment chain.

Finally, we believe the Board’s staff survey was thorough in its attempts to quantify fraud costs (including losses). It is difficult to quantify, however, the amount that any debit card issuer may need year to year to thwart debit card fraud. Fraud costs depend heavily on the activities of the criminals and of the participants in the payment chain. We ask the Board to craft the Fraud Adjustment with this in mind.

C. Fraud Standards and Adjustments Should be Uniform

We believe that fraud standards should apply uniformly to all issuers subject to the Board regulations and the Fraud Adjustment amount need not be specific to each issuer. The statute clearly supports such a result. The requirement in Section 920(a)(5) provides that the adjustment must be “reasonably necessary to make allowance for [fraud] costs incurred by the issuer.” In other words, the Fraud Adjustment is not required to *equal* such fraud costs, but only be a reasonably necessary allowance for such costs. Had Congress intended the Fraud Allowance to match each issuer’s actual fraud-related costs, Congress could have clearly chosen more direct and unambiguous language.

²⁴ Section 920(a)(5)(B)(ii) directs the Board to take certain factors into consideration when “issuing the [fraud prevention] standards and prescribing regulations” under Section 920(a)(5), and that such factors require the Board to consider relative fraud related costs incurred by various participants in a debit transaction. The Board may, in fact, consider those costs in a manner that is compliant with both the requirement to make for a reasonable allowance for all of an issuer’s fraud costs and to consider the relative costs when issuing fraud prevention standards and establishing the Fraud Adjustment. For example, the Board could consider the costs a breached merchant or processor pays to an acquirer which are provided to the issuer through network fraud reimbursement rules and net out such funds from the Fraud Adjustment.

There are practical implications of an issuer-specific Fraud Adjustment. We believe that such an outcome would be overly complex and not provide any level of certainty to debit card issuers or payment card networks.

More problematic, however, is the lack of certainty issuers would have if the Board did not provide a Fraud Adjustment safe harbor or similar mechanism by which issuers could determine their Fraud Adjustment. As the Board has likely experienced in connection with its interchange data survey, issuers can come to different conclusions as to how to make various calculations, even if the Board provides instructions as to how those calculations are to be made. Furthermore, issuer-specific Fraud Adjustments invite those issuers willing to take a more aggressive read of the Fraud Adjustment calculation requirements to gain additional benefits relative to their more conservative competitors.

V. Network Routing

The statute directs the Board to issue regulations requiring a debit card to access more than one unaffiliated debit network. The definitions in the statute provide that a debit card network is one that allows for the processing of electronic debit transactions, regardless of whether the authorization is based on signature, PIN, or other means.²⁵ In short, Congress has directed the Board to ensure that more than one nonaffiliated network is enabled on a debit card, regardless of its authentication methodology.

For several reasons, the Board's rulemaking should require issuers to enable more than one unaffiliated debit network, without adding requirements not contemplated by the statute as to authentication.

- *First*, such an approach is consistent with the plain language of the statute and express congressional intent. Congress did not direct the Board to require any given type of debit authentication method to be included on debit cards. Two compelling justifications for Congress' approach are described below.
- *Second*, if the Board were to require at least two unaffiliated signature debit networks, as opposed to simply requiring two unaffiliated debit networks, the Board risks "hard wiring" specific technology and authentication methodologies associated with debit cards. Not only might this approach result in requiring networks, issuers, and merchants to support outdated technology,²⁶ but it may also inadvertently thwart development of new authentication measures that could benefit consumers, merchants, and issuers.
- *Third*, competitive considerations would not justify such an extraordinary interpretation of the statute, as competitive forces post-Durbin will continue to protect all parties, including merchants, and are strengthened through the overall statutory scheme. Merchants will continue to have choice as to which types of cards they will accept. Moreover, the Durbin Amendment gives merchants added choice (and likely increases competition among payment networks): For those cards the merchant accepts, merchants will now be able to direct routing to one of at least

²⁵ See 15 U.S.C. § 1693o-2(c)(11) and (c)(2)(A).

²⁶ Although the Board would have the flexibility to amend the exclusivity regulations in the future to address such concerns, the regulatory revision process will necessarily lag technological advances.

two competing networks enabled on a particular card.²⁷ And merchants have enhanced ability to steer customers to use particular cards. The overall statutory scheme, therefore, enhances competition among payment networks, and merchants are likely to benefit from overall declines in interchange rates, regardless of authentication type.

For all these reasons, the Board's rulemaking in this area should closely follow the statutory language.

VI. Miscellaneous Provisions

Limited Clarifications to Exclusivity Restrictions are Necessary

To ensure that consumers continue to receive certain benefits associated with a small number of specialized debit products, the Bank believes that the Board should provide for very limited clarifications to the rules it issues under the network routing exclusivity provisions of Section 920(b)(1). For example,

- Bank of America has consumers who prefer to carry "ATM only" access devices, that could be deemed "debit cards" under the statute. We do not believe Congress intended that the Board's rules should require such cards to be enabled on more than one ATM network.
- The Bank also issues debit cards in connection with health care benefit programs. Pursuant to IRS requirements, these cards are permitted for use only on eligible purchases (*e.g.*, prescription medication, doctor visit co-pays). The Bank generally enables only one debit network, which has signature debit functionality because the PIN-based networks generally do not offer the controls to ensure that the health care cards are used only for specific types of purchases. To require the Bank to enable another unaffiliated network on such cards would likely destroy the viability of the product, at least in the near term, to the detriment of consumers, employers, and the merchants who want to accept them.
- We also offer a prepaid product to our commercial clients who, in turn, offer the product to their employees or consumers (*e.g.*, as an incentive). This product would appear to meet the definition of a debit card in Section 920(c)(2)(B). We do not offer PIN debit functionality on these cards, as they are not approved for cash (or cash back) transactions. Again, to require that the Bank enable two unaffiliated signature debit networks on these types of cards may eliminate the commercial viability of the product with no real benefit to merchants.

Effective Date

Once the Board issues regulations requiring issuers to enable their debit cards with at least two unaffiliated debit networks, debit card issuers will have significant compliance obligations. The majority of debit cards issued by Bank of America would likely not comply with the new requirements, and we would need to make significant changes to our debit card functionality to come into compliance.

²⁷ If a debit card is enabled to access an offline and an online routing option, the merchant is generally free to enable either authentication method. We recognize that this is not necessarily true in a "card not present" situation; however, we do not believe an exception should be made in this narrow circumstance, for all the foregoing reasons. We also urge the Board to avoid any requirement mandating that online authentication methodology be made available in the card not present environment, as there are significant fraud control issues associated with enabling a PIN authentication process that accesses a transaction (as opposed to credit) account.

We suspect many—if not most—debit card issuers will be in a similar situation. Issuers should be given at least 12 months to comply.²⁸

VII. Conclusion

The Board will seek to implement Section 920 in a manner that protects consumers, while remaining faithful to the statute and the congressional intent. In doing so, the Board need consider the statutory mandate of the EFTA to prioritize consumer protections over the interest of merchants.


The Board also need avoid violating the Takings clause of the United States Constitution; the Board can avoid the Taking problem by utilizing a multiple of the allowable costs to establish a final interchange rate that provides a reasonable rate of return to issuers.

With regard to fraud, the Board must include the fraud costs associated with “authorizing, clearing and settling” debit card transactions in the base interchange rate. The Board then should allow an adjustment to the base interchange considering all other fraud-related costs, including non-reimbursed fraud losses.

²⁸ This compliance timeframe assumes that the final rules do not mandate a particular authentication technology, or that issuers must enable two signature debit networks on a debit card. If the final rules require more than enabling two unaffiliated debit networks, the time needed to comply could extend to 18 or 24 months.

The Bank appreciates the opportunity to provide its thoughts on Section 920 of the EFTA to the Board and its staff. Please do not hesitate to contact me at (980) 386-7886 or Gavin Dowell, Associate General Counsel, at (980) 386-9645, if we can be of further assistance.

Sincerely,



Stacie E. McGinn
Deputy General Counsel
Consumer and Small Business Banking
Bank of America