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To: Jennifer J Johnson June 26, 2011
Secretary, Board of governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551

Subject: Regulation II – Debit Card Interchange Fees and Routing - Docket No. R-1404

Dear Ms. Johnson,

Although I responded in the original period for comments, I feel compelled to submit added corroborating information received since the "Comment" period because it may be relevant. If this is out-of-order, my apologies and you may return my communication. Two of the matters that may be relevant are:

1) There appears to be an incorrect assumption underlying one of the instructions in the Amendment, and reflected in the Proposed Rule on debit card interchange fees and routing.

2) It is not clear how smaller retailers, who could be the biggest beneficiaries can to actually realize the potential savings.

An unexpected Result.

3) There is reason to believe that some large retailers are already paying a net Interchange close to cost, and recent remarks by the CFO of Home Depot seem to indicate that the proposed rules would result in proportionately small savings to them.

1 – There is an apparent incorrect assumption underlying instructions.

Please see section 920 (a) **REASONABLE INTERCHANGE TRANSACTION FEES FOR ELECTRONIC DEBIT TRANSACTIONS** sub-paragraph (4) CONSIDERATIONS; CONSULTATION. – **In prescribing regulations under paragraph (3) (A), the Board shall -**

"(A) consider the functional similarity between-

"(i) electronic debit transactions; and
"(ii) checking transactions that are required within the Federal Reserve bank system to clear at par;

This may have been intended to infer that "electronic debit transactions" do not clear at PAR while checks do. Interchange, which is charged to the Acquirer is then marked up and charged to the Merchant.

Both checks and Debit card transactions do clear at PAR or face value, they have to or no one could reconcile them. This inference appears to overlook the fact that when checks were prevalent at the Point-of-Sale and before debit cards were introduced, retailers bore the entire cost of handling, authorizing, balancing and delivering checks to a bank (which normally charged a fee for accepting and processing the deposit). Retailers also bore the full cost of collecting or writing-off returned checks (unless covered by the insurance they purchased).

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The unexpected consequence of this mis-direction and the resultant Recommendations may perhaps give a small group, the major Debit issuers, a competitive advantage over smaller Financial Institutions who have in recent months made it clear that the Proposed Rule is not in their interest.

Looking back at how debit got started, it appears that issuers assumed most of the cost of the debit card system , including fraud. This relieved Merchants of the substantial costs of Check Acceptance and the very high cost of preventing, then recovering the value of returned checks. The losses are believed to have been much higher than the fraud losses from debit cards today.

Considering that debit card transactions are settled at PAR (face value) and the infrequent chargebacks are also settled at PAR, the inference that they don't settle at PAR may be categorically incorrect. Furthermore, the dual mode, PIN and Signature Debit cards can permit higher rates of overdraft, which result in disproportionate fees by issuers from the card holder when an Overdraft occurs even if the bank has authorized the transaction.

Issuers arguably may deserve to receive an Interchange fee to cover the cost of the system and the fraud losses plus some margin of profit. This would suggest that, instead of being compensated for operational costs as the Proposed Rule appears to state, perhaps issuers should also receive a rate of return comparable to what merchants normally realize on merchandise – a rate well-defined in retailing as the "Keystone" markup, normally 100% of cost. It could also be noted that the retailer is probably in a better position to absorb some of the fraud cost because their loss is only cost of merchandise and processing, not the face (or PAR) value. The financial institutions on the other hand must absorb the entire loss at PAR (or face) value.

This approach might be more acceptable to the smaller Financial Institutions and the smaller retailers who are more likely to be their customers, possibly eliminating the need for a two tier system. This is pertinent when considering that no more than a dozen banks issue an overwhelming majority of Debit cards and it is those Big banks who may have found ways to significantly lower the net cost of debit cards to selected large retailers.

The Amendment further stated:

The amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be <u>reasonable and proportional to the cost</u> incurred by the issuer with respect to the transaction. This could be interpreted that the transaction fee should be proportional to the cost, but can be higher as long as it is reasonable (e.g. a Keystone markup).

It could be argued that the Board's proposed rule was based on a reasonable estimation of cost, but it also does not appear to exclude an Interchange that is reasonable and proportional to, but higher than cost. After all, there is a need for banks to be profitable too.

This does not excuse the apparent overcharging, but two wrongs do not make a right.

Attachment (a) is an article discussing this issue, <u>written by a banker</u> and published after the Comment period by Digital Transactions, who have a reputation for thorough and objective reporting.

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2 - It may be difficult for smaller retailers to actually realize the potential savings.

The Amendment and the board's proposed rules correctly focussed on the network monopolization as creating an excessive cost to retailers, with no clear added cost to the networks. But it may be difficult technically for smaller retailers, who may be paying a disproportionate share of the debit transaction costs, to select which network is to handle their transactions because they have no direct ability to do so. What may have been overlooked is the extra layer of so-called ISO's, a fourth or fifth-party who do the actually billing and support of most small retailers. This very large and profitable sub-industry does not appear to have been considered in the proposed rules and as described in Attachment (b), may reluctantly pass any savings along to the small merchants.

3 – An unexpected result

The CFO of Home Depot stated they expect to realize savings of about $35million per year from Durbin. This is a significant amount. But a review of their financial statement appears to indicate US sales in the range of $70-90billon. If all bank cards were only 50% of their sales revenue, and Debit was 60% of that, the savings appear to be a very small percentage of the transaction values which would tend to indicate that their net Interchange expense may be close to cost already. This may not be the expected situation.

The biggest reductions would then appear be in Debit costs of smaller retailers, who may be more likely to be customers of smaller financial institutions, some of whom may be considering dropping issuance of debit cards.

Yours sincerely,

Paul Close

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Attachment (a)

A Response to the NRF, published by Digital Transactions, Mar. 1, 2011

The National Retail Federation misstates par value, understates banks' costs to process debit cards, and conveniently forgets how merchants have benefited from replacing checks with electronic transactions, says Rule Loving.

Merchants should be careful of what they seek. Unintended consequences from misinformation may tarnish anticipated benefits.

Rule Loving is assistant vice president for retail services at Stoneham Bank, Stoneham, Mass. Reach him at rloving@stonehambank.com

In December, Digital Transactions published an article by Mallory Duncan, senior vice president and general counsel of the National Retail Federation, called "Reasonable and Proportional" Should Mean Close to Par," which was a defense of the Durbin Amendment and an argument for very deep reductions in debit card interchange.

The article was very slick, arguing that merchants should collect full ("par") value on debit card transactions just as they do on checks. Just one big problem: The article completely ignores the fundamental legal differences between checks and electronic transactions, invalidating all price comparisons between the two payment types. Beyond that, Duncan offers no evidence to support other, even more outrageous claims.

Start with the article's title:'Reasonable And Proportional' Should Mean Close to Par." This statement simply implies that card transactions do not settle at par value like checks. Anyone who has written a check to a merchant for one transaction, and has used a debit card for another, has seen the check post to his statement for the amount of the purchase and the debit item also post for the amount of the purchase. This fact means the debit transaction has settled at par value.

When a merchant deposits checks, it receives full value for the checks. It is then subject to fees from the bank of first deposit to deposit those checks. The bank of first deposit will then submit the checks for collection, and pay fees if the items are submitted to the Federal Reserve Bank. The merchant is paying fees for the settlement of the items and any encoding of the amounts on the checks. The merchant is responsible for the items through the collection process, and if a check is returned for any reason, such as closed account or insufficient funds, the merchant bears the risk.

Thus, there are processing fees associated with the movement of the check through the banking system. The paying bank for the check has 24 hours to return the item to the merchant. After 24 hours, the paying bank has risk ownership.

With debit transactions, merchants can get authorization and approval at the point of sale. Card information is submitted to the issuing bank through the card network, and the issuing bank approves or denies the amount submitted. Once the transaction is approved under the card network's regulations, the issuing bank is responsible for the collection of the item from the customer. The total amount of the transaction is credited to the merchant and settled at the issuing bank.