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February 22, 2011

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

RE: Docket No. R-1404 (Regulation II, Debit Card Interchange Fees and Routing) and RIN No. 7100 AD63.

Dear Ms. Johnson,

As primary author of Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (commonly known as the "Durbin Amendment"), I respectfully submit the following comments in response to the December 28, 2010 notice of proposed rulemaking ("NPRM") published by the Board of Governors of the Federal Reserve System ("Board") in the Federal Register (75 Fed. Reg. 81722 et seq.) on Debit Card Interchange Fees and Routing. I will provide several general comments before commenting on specific sections of the NPRM.

General Comments

I would like to begin by commending the Board and its staff for their diligent work in preparing the NPRM. The regulatory effort they are undertaking is one of considerable significance. We are at a point in our nation's economic history where traditional forms of payment - government-issued currency and the Federal Reserve-regulated checking system – are being supplanted by debit and credit card transactions. Yet the debit and credit card systems have evolved in a way that has concentrated enormous market power in the hands of several giant card network companies as well as the nation's largest banks. The result is that a small number of companies now have a substantial amount of control over the way money is used in the United States.

It is important for Americans to step back and recognize the reality of the situation. Visa, MasterCard and their bank allies want debit and credit cards to completely replace cash and checks. We are already halfway there - today more than half of all retail sales are made with debit and credit cards, and that percentage is growing. Visa and MasterCard cards are used in 80 percent of those debit and credit card transactions, and Visa and MasterCard set the fees and rules that apply to every transaction that goes across their network wires.

Under the current system, every time a sale is made with a Visa or MasterCard debit or credit card the person who makes the sale only receives 97 or 98 cents on the dollar because the card networks take an unregulated cut out of the transaction amount and share it with their issuing banks. As the card networks continue to grow in market power, the cut they take keeps increasing and the ability of sellers to refuse these cards keeps diminishing. Everyone who accepts these cards as payment – small and large businesses, charities, universities, even government agencies – is subjected to these network-established fees, and the fees are ultimately passed on to consumers in the form of higher prices.

If we let the debit and credit card systems continue on their present course, Visa and MasterCard will continue to consolidate their power over the debit and credit card systems. This will give them increased control over the way money is used in this country, and increased opportunity to use this control to their advantage and to the advantage of their banking allies. The economic consequences to American consumers, businesses, government agencies and taxpayers will be staggering. And those economic consequences have already arrived, in the form of tens of billions of dollars in unregulated, non-negotiable interchange fees that Visa and MasterCard require U.S. merchants and their customers to pay to banks each year.

It has long been accepted that government should reasonably regulate markets to ensure that competition, transparency and choice are preserved. Last year Congress tasked the Board with carrying out reasonable regulation of the network-established interchange fees and rules which dominate the debit card system. The goal of this reform law is to enhance transparency, competition and choice in a debit card market in which millions of Americans participate and over which $1.45 trillion was transacted in 2009. It is important that this reform take place now, as debit cards are expected to supplant cash as the nation's primary payment method by 2012.[1]

The Board issued its NPRM last December after conducting an information-gathering process that was notable for its transparency and thoroughness. Board Governors and staff held meetings with a wide range of stakeholders, and the Board published summaries of these meetings on the Internet for public review. The Board also aired a live webcast of its December meeting to discuss and vote upon the NPRM - the first time the Board has ever webcast one of its meetings. In no way did the Board's information-gathering process give short shrift to the financial industry's perspectives; prior to issuance of the draft rules, Board Governors and staff met with financial and card industry representatives at least 23 times (compared to three meetings with merchant representatives and one meeting with consumer groups).[2] The Board also conducted extensive surveys of financial institutions and received voluminous written comments from financial companies and trade associations.

As a result of this extensive information-gathering process, the Board has been able to obtain and reveal important facts about the interchange fee system which the financial industry had never

[1] Andrew Martin, "How Visa, Using Card Fees, Dominates a Market," New York Times, January 4, 2010, under graphic for "Toward a Cashless Society" ("Debit cards are expected to supplant cash as the primary payment method by 2012, and Visa is positioned to be the prime beneficiary.")
[2] See http://www.federalreserve.gov/newsevents/reform_interchange.htm.

made available before, not even to the Government Accountability Office.[3] The Board staff has rightly focused on identifying accurate facts, and the NPRM did an admirable job of cutting through numerous fictions about the debit interchange system that have long been promoted by the financial industry.

Overall, I believe the Board attempted to craft the NPRM in a way that adheres to the facts the Board has learned and to the law that Congress passed. I commend the Board for this, and I urge the Board not to waver from this adherence to the facts and the law as the rules are finalized.

I also urge the Board to pay particular attention to the views of consumer advocates as they finalize their rules. The banks and card companies talk extensively about what they believe is in consumers' best interests when it comes to interchange reform, but consumer advocates have far more credibility on the subject - especially given that for years banks have been quietly raising consumer fees to record levels while interchange fees were also going up.[4] I would particularly direct the Board's attention to the testimony submitted by consumer groups at the February 17, 2011 House Subcommittee on Financial Institutions and Consumer Credit hearing on the Durbin Amendment. In that testimony, the consumer groups explain that:

> (1) The current swipe fee market is broken and all consumers pay more for less because of escalating swipe fee laws; (2) Sixteen countries and the European Union regulate swipe fees and their experience demonstrates that regulation benefits consumers in lower fees and lower costs of goods; (3) There is no evidence that swipe fee regulation will lead to an increase in consumer fees; and (4) Reductions in swipe fees should result in substantially lower prices for all consumers.[5]

Finally, I will comment on the fact that the card companies and the $13 trillion dollar banking industry have engaged in near-hysterical criticism of the interchange reform that Congress enacted. As we move toward the issuance of final rules, there is no doubt the Board will face a sustained advocacy barrage from financial industry lobbyists. The banks and card companies will continue to argue that this new interchange law will drive small issuers out of the card business, hurt consumers, and have unintended consequences that will harm the economy.

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[3] See GAO Report GAO-10-45, "Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges" November 2009 at p. 23 ("Information on the amount of revenues larger financial institutions collect from interchange fees and how those revenues compare with their costs of card operations and rewards programs is limited. We were not able to obtain data from the largest card issuers about their revenues, profits, or expenses to compare interchange fee revenues with expenses.")

[4] See Kathy Chu, "Rising Bank Fees Are Setting Records," USA TODAY, Oct. 27, 2008 (noting that "bounced-check fees, ATM fees, monthly service fees and balance requirements for interest checking accounts all hit highs in 2008" and quoting Greg McBride, senior analyst at Bankrate.com, saying "bank fees have been going up consistently for 10 years.") With respect to debit interchange increases, the Board noted that in recent years "both PIN and signature debit fees have increased" (75 Fed. Reg. 81724) and GAO found that "interchange rates for credit cards have been increasing and their structures have become more complex" (GAO-10-45, November 2009 at p. 14).

[5] Testimony of US PIRG, Public Citizen and the Hispanic Institute submitted to the House Subcommittee on Financial Institutions & Consumer Credit, Hearing on "Understanding the Federal Reserve's Proposed Rule on Interchange Fees: Implications and Consequences of the Durbin Amendment", February 17, 2011, at p. 1, available at http://www.uspirg.org/uploads/55/13/55136cb6850bd9b4eb20be4d12cd9a5b/Consumer-Testimony.HFSC.Interchange.Feb-17.pdf

I want the Board to know that while these arguments are meant to sound frightening, they are the exact same arguments the banks and card companies used in May 2009 to kill a modest amendment that Senator Bond and I filed to the Credit CARD Act - an amendment that simply aimed to provide more transparency for interchange fees and to allow discounts for debit cards versus credit cards.[6] In fact, these are the same financial industry talking points that have been used to oppose any effort to reform the interchange fee system, no matter what the specific proposed reforms are. Every member of the Senate heard these arguments from the financial industry during Senate deliberation over my amendment, and 64 Senators voted in favor of the amendment. Yet I noted with dismay the comments of Chairman Bernanke just last week under questioning in the Senate Banking Committee about interchange reform which seemed influenced by the financial industry's talking points. It is imperative that interchange reform be based on the facts and the law, not on the lobbying might and scare tactics of the financial industry. America's consumers and businesses are counting on the Board to implement regulations that will benefit Main Street and not just Wall Street.

Specific Comments on the NPRM

The interchange reform amendment that I drafted and that Congress enacted contains two main parts: Electronic Fund Transfer Act (EFTA) Section 920(a), which directs the Board to place reasonable constraints on the interchange fee-setting that card networks like Visa and MasterCard perform on behalf of their issuing banks, and EFTA Section 920(b), which prohibits several anti-competitive restrictions that card networks have imposed on other participants in the debit system.

While the amendment directs the Board to prescribe regulations on several issues, it is important to note that several other provisions of the amendment did not require implementing regulations. These include EFTA Section 920(b)(2), which prevents card networks from penalizing merchants who offer discounts for the use of cash, checks or debit cards as a method of payment, and 920(b)(3), which prevents card networks from penalizing anyone who sets a $10 or less minimum for credit card transactions and from penalizing government agencies or universities who set a credit card transaction maximum. These provisions of the amendment are now law, and I urge the Board to take care not to craft their rulemaking in ways that would negatively impact these provisions (for example by drafting definitions in proposed 12 CFR 235.2 that do not take into account the use of those defined terms in EFTA 920(b)(2) and (3)).

I will comment on the NPRM's proposals regarding reasonable and proportional interchange transaction fees (12 CFR 235.3); adjustment for fraud prevention costs (12 CFR 235.4); network exclusivity and merchant routing restrictions (12 CFR 235.7); definitions (12 CFR 235.2); prohibition on circumvention or evasion (12 CFR 235.6); and several additional issues.

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[6] See the May 11, 2009 letter to Members of the U.S. Senate from the American Bankers Association, Credit Union National Association, Independent Community Bankers of America and National Association of Federal Credit Unions re Durbin-Bond Interchange Amendment to H.R. 627, available at http://www.aba.com/NR/rdonlyres/76DCD307-2D7E-48A6-A10F-623175F0AEAD/60651/SenateJointMemoreInterchange051109.pdf. The text of the Durbin-Bond amendment is available in the May 13, 2009 Congressional Record at S5446.

1. Reasonable and Proportional Interchange Transaction Fees

Background and Legislative Intent

EFTA Section 920(a) provides that effective one year after enactment, any interchange transaction fee (defined as a fee that is "established, charged or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction") that is received or charged with respect to an electronic debit transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. EFTA 920(a)(3) directs the Board to prescribe regulations to establish standards for assessing whether the amount of any debit interchange transaction fee is reasonable and proportional to the cost incurred by the issue with respect to the transaction.

The legislative intent behind EFTA 920(a) was to place reasonable constraints on the debit interchange price-setting that card networks like Visa and MasterCard currently perform on behalf of all their issuing banks. As Visa made clear in a November 8, 2010, letter to the Board, "issuers do not in practice set interchange transaction fees; rather, these fees are set by networks".[7] Network setting of interchange fees has negative implications for the efficiency of issuers' card operations and also prevents fee rates from being tempered by competitive market forces. In network-established interchange fee systems, there is no competition between issuing banks over the fees they receive, and each bank that issues the network's cards receives exactly the same network-established fee no matter how efficiently or inefficiently that bank processes transactions or prevents fraud. Also, it has often been observed that competition between networks does not lead to downward pressure on interchange rates because networks compete to attract issuers and do so by raising interchange fees.[8]

It is obvious why the current interchange fee system was set up by the banks and the dominant debit card networks Visa and MasterCard. The system is lucrative for issuing banks, who receive tens of billions per year in high fees that are not tempered by competitive market forces and that are not linked to any particular bank's actual costs. It also benefits the card networks, because they are paid each time a card is swiped and high interchange fees mean banks will issue more cards. But the system is unfair to consumers, who pay tens of billions per year in hidden fees passed on to them in the form of higher retail prices. And it is unfair to merchants, who cannot negotiate interchange fees and who can no longer realistically refuse to accept the dominant card networks despite constant fee increases.

Many have argued that interchange fees should be prohibited in the debit system as they are in the checking system. Congress did not go quite that far, instead requiring that any interchange transaction fee (carefully defined to only include fees that are established, charged or received by a network for the purpose of compensating an issuer) must be reasonable and proportional to the

[7] Visa comment letter to Louise Roseman, November 8, 2010, at p. 17, available at http://www.federalreserve.gov/newsevents/files/visa_comment_letter_20101108.pdf

[8] See e.g., Andrew Martin, "How Visa, Using Card Fees, Dominates a Market," New York Times, January 4, 2010 ("What we witnessed was truly a perverse form of competition," said Ronald Congemi, the former chief executive of Star Systems, one of the regional PIN-based networks that has struggled to compete with Visa. "They competed on the basis of raising prices. What other industry do you know that gets away with that?")

cost incurred by the issuer with respect to the transaction. This means that if an issuing bank is going to let a card network set the rate for the fee that the issuing bank will receive for a debit transaction, Congress has decided that the network-established fee must be reasonable and proportional to the cost the issuer incurred with respect to the transaction.[9]

In determining the appropriate cost considerations for the Board to keep in mind when crafting its standards, Congress limited the Board's consideration to "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction" because Congress intended to create a closer equivalency between the debit card system and the checking system in which transactions are regulated to clear at par. In so limiting network-established debit interchange fees to those incremental authorization, clearance and settlement costs, the new law will incentivize issuers to manage all other costs of their debit card operations efficiently.[10] This stands in stark contrast to the current system of unregulated network-established fees, in which inefficient and efficient issuers receive the same high fees.

The issuers that are regulated by EFTA 920(a) are issuers with assets of at least $10 billion. These banks may claim that limiting network-established debit interchange fees to an amount that is reasonable and proportional to incremental authorization, clearance and settlement costs will make it unprofitable or impossible for them to continue to offer debit cards. However, the history of the U.S. debit card system (in which interchange rates were minimal before Visa entered the debit market and dramatically increased debit fee rates)[11] and the experience of other countries (many of which enjoy vibrant debit systems in which interchange fees are strictly regulated or altogether prohibited) [12] clearly disprove these claims.

Further, some card-issuing banks and credit unions that are not regulated by EFTA 920(a) have claimed that the new law will nonetheless make it impossible for them to continue to issue debit cards. EFTA 920(a) was not intended to drive small issuers out of the debit card market and, as I explained at length in my February 17 letter to Chairman Bernanke, it will not have that effect.

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[9] Some have criticized the amendment's linking of interchange fees to a measure of issuer cost. But it is important to consider how interchange fees were set prior to enactment of the amendment. Visa CEO Joseph Saunders told me and Senators Kohl, Snowe and Specter in a June 3, 2008, letter that "interchange was not designed to recoup costs but as a transfer of value generating a form of revenue to card-issuing financial institutions." Congress determined that linking network-established interchange fees to a measure of issuer cost is preferable to permitting Visa to set interchange fees according to Visa's abstract conception of a "transfer of value," especially given Visa's explicit goal of generating revenue on behalf of their issuing banks and the lack of competition between banks or networks that would drive interchange downward.

[10] Note that the amendment only regulates interchange transaction fees as defined by the amendment. Issuing banks can, do, and will continue to charge many other types of fees which are not regulated by the amendment, although unlike interchange fees those other fees are currently set in a competitive market environment.

[11] See Andrew Martin, "How Visa, Using Card Fees, Dominates a Market," New York Times, January 4, 2010.

[12] See, e.g., Dennis W. Carlton, "Externalities in Payment Card Networks: Theory and Evidence, Commentary," from "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, at 129-130.

Specific Comments

- Reasonable and proportional: The Board's use of commonly accepted legal definitions of reasonable and proportional and the Board's considerations described in III.A.1 (75 Fed. Reg. 81733) are appropriate and consistent with the legislative intent behind the amendment.

- Footnote 44: In footnote 44 (75 Fed. Reg. 81733), the Board applies sound analysis and correctly distinguishes interchange transaction fees as defined in EFTA Section 920 from public utility rates.

- Considerations for standards: The Board correctly reflects Congressional intent in the first paragraph of III.A.2 (75 Fed. Reg. 81733-4).

- Activity costs to be considered: The Board properly proposes to limit allowable costs to the costs of authorization, clearance and settlement. As discussed above, these are the costs Congress deemed appropriate for a debit card network to set on behalf of its issuers. Thus, the Board's proposed calculation of incremental cost as average variable cost in its "Cost Measurement" analysis (75 Fed. Reg. 81735) is consistent with the legislative intent, and the inclusion of other costs in this analysis would be inconsistent with the language and intent of EFTA Section 920. Accordingly, Board Commentary 235.3, Alternative 1, 3(c)(3) (75 Fed. Reg. 81760) is also consistent with the language and intent of the statute.

- Alternative 1 (Issuer-Specific up to a Cap, With a Safe Harbor) vs. Alternative 2 (Stand-Alone Cap): The structure of Alternative 1 is more consistent with the legislative intent of constraining network-established interchange fees to levels that reflect the incremental authorization, clearance and settlement costs incurred by a regulated issuer for a particular transaction. As the Board noted in 75 Fed. Reg. 81736-7, the amendment conceptualized an issuer-specific determination but gave the Board discretion to set standards reflecting what is "reasonable and proportional" to an issuer-specific determination. Alternative 1, which establishes standards that consider the average variable costs of authorization, clearance and settlement for debit transactions constrained by a maximum fee, can credibly be deemed reasonable and proportional to "the cost incurred by the issuer with respect to the transaction" as contemplated by the amendment. Alternative 1 is also more consistent with the legislative intent because it provides for individualized analysis of regulated issuers whose costs fall between the safe harbor and cap benchmarks.

  The Board's proposal to apply a fee cap appropriately ensures that fees do not reach a level that is not "reasonable and proportional," and provides incentives for issuers to manage their costs efficiently rather than artificially inflate their costs in order to receive higher interchange. The Board's proposal to apply a safe harbor enhances ease of administration while also incentivizing issuers to achieve efficiencies that bring per-transaction costs to below the safe harbor level. The Board also appropriately proposes to re-examine the safe harbor amount periodically.

  It is not yet clear to me if the specific safe harbor and cap amounts that the Board proposes (7 cents for the safe harbor and 12 cents for the cap) are the correct ones. I am told

by many stakeholders that actual per-transaction variable costs on debit transactions are far lower than 7 cents, though I am not privy to all the information that the Board has obtained. I look forward to reviewing the comments the Board receives on what numbers are appropriate, and reserve judgment on those numbers until that time.

- Other potential methods: The Board discusses two other potential methods for implementing the interchange fee standard (75 Fed. Reg. 81738-9). These methods would permit variation above and below a benchmark so long as the average fee remained below the benchmark. Both of these methods would enable issuers to charge network-established interchange fees that exceed the statutory limit for some transactions, which would be contrary to the plain language and legislative intent of EFTA Section 920 and would also be unfair to the participants in those transactions. Further, permitting such variation would enable networks to establish fees that significantly advantage some categories of card acceptors over others, and the networks could use this leverage to demand concessions from card acceptors in exchange for assigning sub-benchmark interchange fee rates for those merchant categories. This would provide no clear benefit for consumers or for the overall debit system.

- Costs of other activities excluded: As the Board notes in Board Commentary 235.3, Alternative 1, 3(c)(3)(iv), under the Board's proposal "fraud losses, the cost of fraud-prevention activities, and the cost of rewards programs" are not includable as allowable costs for purposes of network-established interchange fees (75 Fed. Reg. 81760). This is consistent with the language and intent of EFTA Section 920. First, allowing networks to set interchange fees that increase as issuers' fraud losses increase would give issuers no incentive to avoid fraud losses, but rather would incentivize them to steer customers to more fraud-prone authorization methods. Second, the cost of fraud-prevention activities is addressed later in EFTA Section 920(a)(5) as an issuer-specific adjustment to the base interchange rate. Finally, the intent of EFTA Section 920 is not to permit network-established interchange fees to be used to subsidize issuer debit rewards programs as this creates a regressive cross-subsidy. Instead, issuers should be incentivized to manage any debit rewards programs they choose to offer efficiently.

- Disclosures to payment card networks: As the Board noted, under Alternative 1 each regulated issuer would need to provide networks with sufficient information to ensure compliance if the issuer receives over the safe harbor amount.[13] The Board's proposed reporting requirements, including in Board Commentary 235.3, Alternative 1, 3(d), are appropriate.

2. Adjustment for fraud-prevention costs

Background and Legislative Intent

The legislative intent of EFTA Section 920(a)(5) was to incentivize card-issuing banks to take steps that will enhance security and reduce the incidence of fraud in the debit system. I am

[13] See 75 Fed. Reg. 81739 in which the Board notes that "[b]ecause payment card networks, not issuers, establish interchange fees, issuers must provide networks with information sufficient to ensure the issuers' compliance."

pleased that reports indicate that the debit card industry is already moving toward security improvements such as increased use of online PIN debit in response to this new law.[14]

The current system of network-established interchange fees creates precisely the wrong incentives for issuers when it comes to fraud prevention. Under the current system, all issuing banks in a network receive the same network-established interchange fee rates. This provides little incentive for issuers to minimize fraud, since they will receive the same interchange fee whether there is significant fraud or no fraud associated with their debit transactions.

Under the current system networks also give issuers higher interchange fees for fraud-prone authorization methods such as signature debit. Some in the financial industry claim that higher interchange for signature debit is needed to compensate issuers for the higher fraud losses associated with signature (as the Board noted in the NPRM, in 2009 $1.15 billion in fraud losses arose from signature debit compared to only $200 million in PIN fraud losses). But it is extremely inefficient to permit networks to reward issuers with higher interchange when those issuers encourage their cardholders to use less-secure methods of authorization. The current system gives issuers incentives to steer customers away from PIN debit,[15] and also incentivizes issuers and networks to block the adoption of more secure authorization technologies in the United States. The argument that issuers need higher interchange to pay for signature debit fraud losses is further undermined by the Board's finding that 45 percent of those fraud losses are actually charged back by issuers to merchants.

In contrast to the current inefficient system, EFTA Section 920(a)(5) will incentivize regulated issuing banks to reduce fraud by allowing banks that take successful fraud prevention steps to receive increased interchange fees. EFTA 920(a)(5) provides that the Board may allow for an adjustment of the interchange fee amount received by a particular regulated issuer if the issuer complies with standards established by the Board that demonstrate that the issuer is taking effective steps to reduce the occurrence and cost of debit fraud, and if the issuer demonstrates that the adjustment it seeks is limited to those reasonably necessary fraud prevention costs.

It should be noted that any fraud prevention adjustment to the fee amount would occur after the base calculation of the reasonable and proportional interchange fee amount takes place, and fraud prevention costs would not be considered as part of the incremental issuer costs upon which the reasonable and proportional fee amount is based. Further, any fraud prevention cost adjustment would be made on an issuer-specific basis, as each issuer must individually demonstrate that it complies with the standards established by the Board, and as the adjustment would be limited to what is reasonably necessary to make allowance for fraud prevention costs incurred by that particular issuer.

[14] See Will Hernandez, "Online Debit Use Could Get Lift from First Data Move," The American Banker, Feb. 15, 2011 (discussing First Data's decision to support an internet PIN debit system and noting that "Visa has said its issuers prefer that their customers use signature-debit or credit cards online because they generate more interchange income. That position could change if the Board finalizes its proposed 12-cent cap because PIN-debit transactions are more secure.")

[15] See Sara Lepro, "Counterintuitive Pitch for Higher-Fee Debit Category," The American Banker, April 21, 2010 (discussing JP Morgan Chase's efforts to urge all of its cardholders to stop using PIN).

EFTA 920(a)(5)(B) directs the Board to issue fraud prevention regulations within 9 months after enactment and directs the Board to consider a number of factors such as how much electronic debit fraud occurs in the system, which types of debit transactions are associated with fraud, the available and economical means by which fraud may be reduced, who bears the costs of fraud prevention and fraudulent transactions, and the extent to which interchange fees have in the past affected incentives to reduce fraud. This list of considerations is intended to ensure that the Board's fraud prevention regulations are based on a comprehensive set of facts about the ways that fraud occurs and is handled in the debit card system.

Specific Comments

- Information collected: I am pleased that the Board's information-gathering efforts have produced statistics that will greatly inform the final fraud prevention rulemaking. For example, the Board discovered that signature debit fraud losses are 3.75 times PIN debit fraud losses. The Board also revealed that issuers spend approximately 1.6 cents per debit transaction on fraud prevention activities and 0.2 cents per transaction on debit card data security activities. Finally, I am pleased that the Board has made clear that merchants in fact bear a significant percentage of fraud losses – 43 percent across all debit transactions - because of issuer chargebacks and that merchants also have significant fraud-prevention and data-security costs related to compliance with PCI-DSS security standards that are imposed on merchants by the major card networks. The information gathered by the Board has greatly clarified the reality of how fraud is handled in the debit system.

- Technology specific approach vs. non-prescriptive approach: The Board did not propose specific regulations in the NPRM to implement the adjustment for fraud-prevention costs. The Board instead set forth two broad approaches: a technology-specific approach and a non-prescriptive approach. The Board highlighted the advantages and disadvantage of these two approaches, and requested comment on these or other recommended approaches.

  In my view, the best approach for implementing the fraud prevention provision is a metrics-based approach. The Board should promulgate regulations establishing target metrics for issuers with respect to the occurrence of fraud and fraud losses. Issuers that meet those metrics through the use of cost-effective technologies should be able to receive a fee adjustment to make allowance for reasonably necessary fraud prevention costs that the issuer incurred. By prescribing ambitious but achievable target metrics rather than promoting specific technologies, the Board will incentivize the market to implement new and successful fraud prevention technologies.

  In crafting regulations to implement the metrics-based approach, I urge the Board to consider the thoughtful fraud-prevention comments submitted to the Board by the Merchants Payments Coalition on January 20, 2011.[16] These comments demonstrate that the Board can, with relative ease, implement and administer rules that will create the proper incentives for fraud prevention while also encouraging technological innovation.

[16] See http://www.federalreserve.gov/SECRS/2011/February/20110203/R-1404/R-1404_012011_61804_561400767649_1.pdf.

- Next steps: I strongly believe that the fraud prevention adjustment in EFTA 920(a)(5) provides a tremendous opportunity to enhance the security of the debit card system in America, and that it is imperative for the Board to promulgate final regulations that seize this opportunity. However, the Board must also follow the statutory requirement to prescribe final fraud-prevention regulations within 9 months after enactment. I urge the Board to work expeditiously through the comments it receives in order to finalize fraud-prevention regulations within the law's timeframe. If final regulations are not ready within 9 months after enactment, the Board should implement temporary fraud prevention rules which will bridge the gap until final regulations are completed. Such temporary rules should only be used as a last resort and should have a clearly established expiration date.

3. Network Exclusivity and Merchant Routing Restrictions

Background and Legislative Intent

EFTA Section 920(b)(1)(A) directs the Board to issue regulations providing that networks and their issuers cannot restrict the number of networks on which a debit transaction may be processed to one exclusive network (or to two networks which are affiliated with each other). The intent behind this provision was to inhibit the continued consolidation of the dominant debit networks' market power and to ensure competition and choice in the debit network market.

Up until recent years, banks routinely issued debit cards that bore the logos of and could be transacted upon multiple debit networks. However, in recent years "the largest national PIN debit networks have increasingly required issuers to sign exclusive agreements under which they become the sole PIN network whose logo appears on an issuer's cards."[17] The American Banker, citing a J.P Morgan Securities analyst, reports that currently "about 40% to 50% of the debit card market in the U.S. is under exclusive routing arrangements." [18] This trend toward exclusivity agreements, particularly when utilized by dominant four-party networks such as Visa, is troubling in three ways: it limits merchant and consumer choice; it diminishes competition by threatening to drive competing debit networks out of business; and it creates significant barriers to entry for new debit networks.

EFTA Section 920(b)(1)(A) preserves competition and enhances choice by directing the Board to issue regulations ensuring that a card network and/or issuer cannot directly or indirectly limit a debit card to only be allowed to run on one exclusive network. It is important to note that the amendment was drafted to prohibit a negative scenario – exclusivity arrangements – and was not drafted to affirmatively require what the non-exclusive world must look like. The amendment therefore confers a fair degree of discretion to the Board to lay out specific guidelines for a non-exclusive world that are consistent with the goals of preserving competition and choice.

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[17] "Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues", Robin A. Prager, Mark D. Manuszak, Elizabeth K. Kiser, Ron Borzekowski, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C. at p. 27. See also Frederick H. Lowe, "Exclusivity Seen as Trend for PIN-Debit Processing," American Banker, May 8, 2007.
[18] "Fed's Plan Raises Debit Issues Galore," Andrew Johnson, American Banker, December 20, 2010 (http://www.americanbanker.com/bulletins/debit-issues-galore-1030247-1.html)

EFTA Section 920(b)(1)(B) directs the Board to issue regulations providing that a network and/or issuer cannot inhibit the ability of a person who accepts debit cards to direct the routing of the transaction over any network that may process such transactions. This was not intended to be a "must carry" provision whereby issuers would be required to enable their cards with all networks, but rather a restriction on the ability of networks and issuers to inhibit a merchant's ability to direct the transaction over any of the networks that the issuer has enabled the card to use. (The Board has accurately explained this in Board Commentary 235.7-7(b)(1)). As a practical matter, the inclusion of EFTA 920(b)(1)(B) in the amendment was essential to ensure the effectiveness of the non-exclusivity provision in EFTA 920(b)(1)(A), because otherwise a network or issuer could functionally require exclusivity through merchant routing restrictions. Under the new law, once networks and issuers have determined which networks will be enabled on a card, the networks and issuers cannot then dictate how a merchant must route a transaction between those networks.

The amendment requires the Board to prescribe its non-exclusivity and routing regulations within one year after enactment but does not state that the regulations must be effective on that date, thereby giving the Board latitude to allow for a reasonable implementation period before its regulations take effect. The Board has recognized this and has appropriately proposed such implementation time periods for the options it is considering.

Specific Comments

- Alternative A vs. Alternative B: It is important to provide context when commenting on the two alternatives the Board has presented. The amendment did not write specific authorization methods (e.g., PIN and signature) into statute and then mandate how those authorization methods must be treated in a non-exclusive world. The concern was that doing so would lock acceptance of those authorization methods into federal law, which would run contrary to the overall amendment's goal of incentivizing the development and use of more efficient and more fraud-proof authorization methods than those currently in use in this country. For example, a key goal of the overall amendment is to incentivize the use of better authorization and authentication technologies than the current signature debit system. Thus, it would not be optimal for EFTA 920(b)(1) to specifically require an overhaul of the debit industry to ensure that every card can be transacted over two signature debit networks if the amendment succeeds in incentivizing new authorization methods that quickly supplant signature debit altogether. On the other hand, it would be even less optimal for the goals of ensuring competition and choice if signature debit managed to survive as a common authorization method and if exclusivity arrangements were allowed to continue to predominate in the signature debit space.

  Statutory language is limited in its ability to keep pace with potentially fast-moving technological developments in the debit card system. It is for that reason that EFTA 920(b)(1) confers rulemaking discretion upon the Board on how best to guide us through a non-exclusive world. What the statute makes clear is that network- or issuer-imposed network exclusivity agreements (as well as network- or issuer-imposed routing restrictions that achieve the same effect) are to be prohibited under the regulations that the Board

prescribes when those regulations take effect. This is essential to the goals of preserving and enhancing competition and choice in the debit system.

- Other federal laws: EFTA 920(b)(1) only directs the Board to issue regulations that limit networks and issuers from imposing network exclusivity. The statute does not prohibit exclusivity agreements to the extent they are required by other agencies of the federal government (as opposed to those agreements required by networks or issuers). This should not be viewed as a license for issuers to lobby their regulatory agencies to require exclusivity agreements for them, but rather should be viewed as an effort to ensure that the new non-exclusivity law does not require issuers or networks to run afoul of other independently-based federal laws.

4. Definitions

The Board's proposed definitions and related Board Commentary are generally consistent with the plain language and legislative intent behind EFTA Section 920, but below are comments regarding several specific definitions and commentary.

- Account: It would be inconsistent with the plain language and legislative intent of the amendment to exclude business-purpose debit cards from the ambit of EFTA 920, and the Board has rightly chosen not to adopt such an exclusion.

- Debit card: The Board's proposed definition is appropriate, and the associated Board Commentary under 235.2-2(f) is consistent with the legislative intent and appropriately reflects the Board's anti-circumvention authority granted under EFTA 920(a)(1).

- Designated ATM network: The Board's proposed definition is consistent with the legislative intent. However, Board Commentary 235.2-2(g)(1), which seeks to clarify the meaning of "reasonable and convenient access," is troubling in its use of a metropolitan statistical area (MSA) as a proxy for a reasonable distance from a person's location. MSAs can be quite large and using MSAs as a proxy for reasonable access may not align with the Board's goal of clarifying what constitutes an ATM network that an individual can access "with relative ease."

- Interchange transaction fee: The Board's proposed inclusion of the words "and paid by a merchant or acquirer" creates a possibility for circumvention in that acquirers could contract with an additional middleman who pays interchange transaction fees on the acquirer's behalf in order for the fee arrangement to fall outside of the definition. Allowance for this type of circumvention should be avoided.

- Payment card network: Several points are relevant here.
  - The Board's proposal to remove the reference to credit cards in proposed 12 CFR 235.2(m) is problematic because of the application of the definition of "payment card network" in EFTA 920(b)(2) and (3) [which limit payment card networks from placing restrictions on offering discounts for use of a form of payment and from setting certain credit card transaction maximums and minimums] as well as because of the possibility of hybrid credit-debit cards.
  - The Board's proposed clarification in 12 CFR 235.2(m)(2) that the term "payment card network" applies to an entity that establishes the rules, standard or guidelines that govern the rights and responsibilities of issuers and acquirers involved in processing debit transactions is consistent with the legislative intent of the amendment.
  - With respect to the Board's request for comment on whether certain non-traditional or emerging payment systems would be covered by the statutory definition of "payment card network," I stated in the Congressional Record on July 15, 2010 that: "it should be noted that the payment card networks as defined in the amendment are entities such as Visa, MasterCard, Discover, and American Express that directly, or through licensed members, processors or agents, provide the proprietary services, infrastructure and software that route information to conduct credit and debit card transaction authorization, clearance and settlement. The amendment does not intend, for example, to define ATM operators or acquiring banks as payment card networks unless those entities also operate card networks as do Visa, MasterCard, Discover and American Express." With respect to mobile phones, if a traditional payment card network is involved in the transaction in which the mobile phone is used as a debit device, then the transaction should be covered because the phone is serving as a "device" within the amendment's definition of "debit card".
  - Third party intermediaries which contract with a traditional card network are not intended to be covered except to the extent they have been contractually designated by the network to perform the functions traditionally performed by a network.

5. Prohibition on Circumvention or Evasion

In general, the Board's approach on this issue is consistent with the language and intent of EFTA Section 920. However, in proposed 12 CFR 235.6, the Board's statement that "Circumvention or evasion of the interchange fee restrictions under §§ 235.3 and 235.4 *occurs if* an issuer receives net compensation from a payment card network with respect to electronic debit transactions" appears to imply that this is the only scenario in which circumvention or evasion may occur. Because there are clearly many other scenarios in which circumvention and evasion of §§235.3 and 235.4 may occur (such as through deceptive accounting practices), the words "occurs if" should be stricken and replaced with "includes when". The Board need not provide an exhaustive list of scenarios that would be deemed to constitute circumvention or evasion, but should be able to respond to new scenarios as they may arise.

6. Additional Comments

- Coverage of ATM transactions and networks (75 Fed. Reg. 81727): The Board requested comment on whether ATM transactions and networks should be included in the scope of the rule.[19] As the Board correctly points out, the only type of fee regulated by EFTA Section 920(a) is the "interchange transaction fee" which is defined as a fee established "for the purpose of compensating an issuer". That term as defined in the amendment would not apply to current ATM interchange fees because such fees are paid by issuers and thus do not fall under the amendment's definition. So the main question is whether the non-exclusivity and routing provisions of EFTA Section 920(b) should be applied to ATM networks such that an ATM operator would have the ability to route ATM transactions over the operator's choice of at least two unaffiliated networks.

  The goal of EFTA Section 920(b)'s non-exclusivity and routing provisions is to preserve competition and choice between networks that conduct electronic debit transactions where an asset account is debited. The provisions give a fair degree of discretion to the Board to implement the provisions in a way that preserves competition and choice. In my view, the Board could reasonably construe an ATM withdrawal as an electronic debit transaction under the amendment and apply the non-exclusivity and routing provisions to situations where a network or issuer attempts to restrict the number of networks on which an ATM transaction may be conducted to one network or to two affiliated networks. Such a step would have the benefit of ensuring that competition and choice exist in the market for ATM network transactions so that consumers are not forced to pay higher ATM fees as a result of a lack of competition and choice. As noted earlier, EFTA Section 920(b) enables the Board to establish an effective date for implementation that will allow for any necessary transition.

- Coverage of three party systems (75 Fed Reg. 81727-8). The Board requested comment on the appropriate application of the interchange fee standards to electronic debit transactions carried over three party systems in which the network serves as both issuer and acquirer. As a practical matter, three-party systems are not currently in use for debit transactions- as the Board stated, "[t]he three-party model is used for some prepaid card transactions, but not for other debit card transactions." (75 Fed. Reg. 81723). Further, the core problem with the interchange transaction fee in the four-party system – the centralized fixing of fees by a network for the purpose of compensating many separate issuers – is not a concern in the three-party model where the network and issuer are the same. As a practical matter, the merchant discount rate charged in the three party system compensates the network for all elements of the transaction (including what would be considered the interchange fee, network switch fee, and acquirer fee), and it would be administratively infeasible to determine which part of a merchant discount rate in a three- party system is intended to compensate the

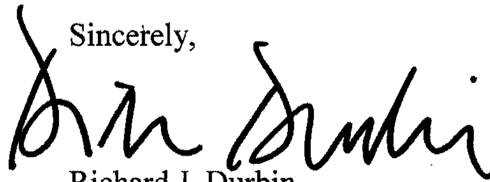
[19] I would note that ATM transactions and networks are different from ATM operators and would point out that I stated in the Congressional Record on July 15, 2010 that "[t]he amendment does not intend, for example, to define *ATM operators* or acquiring banks as payment card networks unless those entities also operate card networks as do Visa, MasterCard, Discover and American Express." (emphasis added). However, the Board's request for comment focuses on networks over which ATM transactions are conducted, not ATM operators, and so I will address the ATM network question here.

network for its role as issuer. Thus, there does not appear to be an appropriate application of the EFTA Section 920(a) interchange fee standards to the three-party systems in place today, though there may be a need to revisit this if four-party networks attempt to use three-party systems for circumvention purposes.

With respect to the non-exclusivity and routing provisions of EFTA Section 920(b)(1), the Board notes that "the statute does not provide any apparent basis for excluding three-party systems from the scope of the provisions of EFTA Section 920(b)." (75 Fed. Reg. 81728) Again, because three-party systems do not currently operate to a significant degree in the debit card space, they were not the intended focus of the non-exclusivity and routing provisions. If three-party systems begin to acquire more than de minimis market share in the debit card space, or if the typical four-party debit networks somehow transform themselves into three-party networks to circumvent the requirements of this law, the Board should pay careful attention. In such circumstances the Board should monitor whether exclusivity arrangements in the three party systems are having a detrimental effect on competition and choice in the debit card system and modify its prescribed rules accordingly.

Thank you for the opportunity to submit these comments. Should you need any clarification or further information please feel free to contact my office.

Sincerely,



Richard J. Durbin
United States Senator