VISA

November 8, 2010

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Executive Vice President
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Via Electronic Delivery

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

Re: Regulations to Implement Dodd-Frank Debit Provisions

Dear Ms. Roseman:

Visa Inc. ("Visa") recognizes that the Board is confronted with a difficult task in developing rules to implement the recent Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") amendments to the Electronic Fund Transfer Act ("EFTA"). As you know, the Act directs the Board of Governors ("Board") to issue regulations implementing Section 920 of the EFTA relating to debit interchange fees, and the routing of debit transactions. Section 920 raises a number of unique and challenging issues that differ from the regulatory issues that the Board frequently addresses as Section 920 requires the Board to set standards for rates on commercial transactions. Visa has tried to view the task of writing rules to implement Section 920 from the Board's perspective and is providing this letter in an effort to assist the Board staff in its thinking about these issues and to aid the Board in arriving at a workable and balanced approach to implementing Section 920. Specifically, this letter addresses the following issues that are likely to confront the Board in developing its implementing regulations:

(1) important policy considerations in drafting regulations to implement the interchange and exclusivity and routing provisions of Section 920;

(2) clarifying the exclusivity and routing provisions, including encouraging consumer disclosure;

(3) developing a framework for debit interchange fees and related issues; and

(4) the scope and timing of the Board's regulations.

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I. IMPORTANT POLICY CONSIDERATIONS

In writing rules to implement the debit interchange and exclusivity and routing provisions of Section 920, we believe that the Board must make a choice between a detailed, prescriptive approach and a more flexible market-based approach, while adhering to the core policy objectives of Section 920 of setting standards for the interchange transaction fees applied to electronic debit transactions so that such fees are reasonable and proportional to the cost of providing such services. A prescriptive approach likely would require an ongoing level of detailed data collection and monitoring by the Board – including by product, by processing mode, by transaction size, by merchant and merchant segment, by issuer and by network – that would be inherently burdensome and unreliable and would involve an arbitrary level of "allocation" as costs are generally not neatly divided in this manner. A flexible, market-based approach in contrast would reduce the Board's need to manage multiple rates and the associated data collection and analysis, while better supporting the purposes of the Act, and would help to avoid detailed requirements that could distort market outcomes and lead to artificial constraints and inefficiencies. Consistent with this theme, in some cases the requirements of Section 920 could be implemented in a way that frustrates consumer control over their financial transactions or even raises unnecessary risks to the efficient completion of consumer transactions. Visa believes that the Board will wish to avoid choices that lead to such results. The specific comments in this letter reflect these general views.

In addition, the following comments are consistent not only with the regulatory mandate in Section 920, but also with the regulatory requirements for rulemaking that continue to apply to the Board under section 904 of the EFTA. For example, section 904(a) provides that the Board, in prescribing regulations to carry out the purposes of the EFTA, must, among other things: (1) "take into account, and allow for, the continuing evolution of electronic banking services and the technology utilized in such services"; (2) "prepare an analysis of economic impact which considers the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers . . . and the effects upon competition in the provision of electronic banking services among large and small financial institutions and the availability of such services to different classes of consumers, particularly low income consumers"; and (3) to the extent practicable, "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions."[1]

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[1] 15 U.S.C. §§ 1693b(a)(1)-(3).

II. EXCLUSIVITY AND ROUTING OF DEBIT TRANSACTIONS

Subsection (b) of Section 920 imposes limitations on payment card issuers and networks regarding the restrictions that may be imposed on merchants and other entities in connection with the usage of debit cards for payment. The first paragraph of subsection (b) directs the Board to prescribe regulations implementing restrictions on debit card issuers and payment networks with respect to the exclusivity and routing of debit card transactions.

A. Exclusivity

Section 920(b)(1)(A) provides that the Board must prescribe regulations that prohibit issuers and payment card networks from restricting, including by contract or penalty, the number of payment card networks on which an electronic debit transaction may be processed to: (1) one network; or (2) two or more networks that are owned, controlled or operated by affiliates or networks affiliated with the issuer.[2] By its plain terms, this provision requires that an issuer must enable at least two unaffiliated networks on its debit cards.

Some issuers currently enable only a single payment card network (or affiliated networks) on their debit cards and would therefore be required to add another network. For commercial and regulatory reasons, issuers today only enable networks with appropriate controls in place including contractual terms governing transaction processing options, liability, settlement procedures, and so forth. Requiring an issuer to contract with a payment card network that is not of its choice is an unusual statutory requirement in the area of financial services and raises significant issues relating to the costs and risks of those mandated additional network connections, and subsequent routing of debit transactions, that are not addressed in the statutory language. Moreover, it would be equally unusual for the Board to create regulations that choose among bona fide networks for issuers. Rather, network competition should continue to allow an issuer to choose which networks may carry its transactions and negotiate the terms under which those transactions are carried.

The statutory language does not specify on what terms such a transaction must take place, including whether the issuer can require risk controls or other terms so that the issuer does not increase its own credit, regulatory, data security, fraud exposure or other risks as a result of accepting transactions from a new network. Accordingly, an issuer may choose one network rather than others based on a number of network factors,

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[2] 15 U.S.C. §§ 1693o-2(b)(1)(A).

including settlement risk management, policies to insure other network participants are financially sound, prompt and accurate financial settlement and mechanisms for taking collateral or otherwise controlling counterparty financial risk. Certain networks may simply not provide the risk/fraud controls, or meet other standards that the issuer may require for any entity handling and accessing its cardholders' financial information. Where a network itself provides a settlement guarantee for transactions on its network, the financial condition of the network provider may also be an important consideration.

Visa believes that the most practical approach to implementing this requirement is for the Board to adhere strictly to the statutory language and to not require that an issuer contract with more than two unaffiliated payment card networks, and that the issuer be given discretion in choosing among networks that meet the statutory criteria of being unaffiliated and determining the terms and conditions governing its participation. Thus, following the plain language of Section 920(b)(1) a debit card issuer should be required to receive electronic debit transactions from no more than two unaffiliated networks of the issuer's choosing.

B. Routing

(i) Plain Language Reading of Provision

Section 920(b)(1)(B) also provides that the Board must prescribe regulations that prohibit issuers and payment card networks from restricting, including, for example, by contract or penalty, a merchant that accepts debit cards from "direct[ing] the routing of electronic debit transactions for processing over any payment card network that may process such transactions."[3] While the statute may be unclear, we believe that the routing provision must be read together with the exclusivity provision. That is, as a practical matter, the statute by its plain terms provides that issuers must include at least two unaffiliated networks on their debit cards. As a result, this will inherently limit a merchant's routing options to networks that the issuer has authorized by identification on the card or otherwise, in part as required by Section 920(b)(1)(A).

As noted, issuers select networks for a number of regulatory or commercial reasons, including the network's risk management, fraud controls and tools, transaction processing requirements, data security, network brand value with consumers and marketing or promotional support. Issuer choice of a particular network typically involves operational considerations as well, such as use of common data formats and information; robust processing functionality across diverse transaction types; stand-in

[3] 15 U.S.C. §§ 1693o-2(b)(1)(B).

processing; efficient dispute resolution handling, including arbitration; and seamless, secure and reliable network links. Issuers often focus on a network's ability to manage settlement risk and overall liabilities, as well as the integrity, reliability, and financial condition of the network itself. Networks vary in providing issuers with different degrees of assurances in managing liability allocations, financial exposure and compliance with operational and security standards. Further, issuers may choose a network based on that network's ability to provide redundancy to backstop other networks in processing a transaction.

If a merchant were able to route a transaction through a network that the issuer did not enable on the card, the issuer would be effectively forced to receive a transaction: (1) without knowing the financial strength, data processing quality or security or other functionality or controls associated with that network or source of the transaction; (2) that may be handled, used or stored by third parties that the issuer has no contractual or other connection to; or (3) that may not be legitimate, from the issuer's actual customer or presented in a manner consistent with issuer processing systems, or (4) that may not allow the issuer to apply its fraud, risk, credit or other controls. This compulsory transaction is likely to lead to financial and legal risks and could have a significant negative effect on consumers, including degradation in the consumer service levels due to more declined transactions or referrals, dispute items, inefficient exception handling, and potentially a reduction in the integrity and reliability of the transaction records. Therefore, we believe it is appropriate to read the exclusivity and routing provisions together and provide that in directing transactions under Section 920(b)(1)(B) a merchant may route only to the networks that the issuer has enabled.

(ii) Operational Challenges with Certain Products

Additionally, it is also worth noting that the exclusivity and routing provisions raise operational issues with regard to an identified subset of debit cards. Specifically, although Section 920 includes exemptions or exclusions to the debit interchange provisions for government programs and certain prepaid cards, these apply only with respect to subsection (a) and not also to subsection (b). However, certain debit card product types or payment technologies may inherently not support multiple routing options. For example, Flexible Spending Account ("FSA") and Health Reimbursement Arrangement ("HRA") cards require functionality that identifies qualifying health care expenses versus non-qualifying expenses in order to comply with federal tax laws governing use of these cards with tax-favored healthcare spending accounts. Visa, other payment networks, merchants and others were required by IRS Notice 2007-02 to develop Inventory Information Approval System ("IIAS") standards for facilitating such identification of transactions. We understand that PIN debit networks generally have not

developed systems that facilitate such transactions, nor have merchants incurred the additional expense of upgrading their terminals to support IIAS for PIN debit transactions. In addition, cash access is not permitted on such cards. Therefore, issuers issue FSA/HRA cards without PIN debit functionality (*i.e.*, signature only), inherently restricting the potential routing of transactions on such cards. Certain types of government social benefit program cards (like low-income housing assistance) may be expected to have similar restrictions, such as no cash access or limitations on usage to specific merchant category codes.

Similarly, gift cards and other non-reloadable prepaid cards, although not exempt from Section 920(a), typically do not have PIN functionality. This limitation on PIN functionality is due in part to anti-money laundering concerns with anonymous access to cash. In addition, there are practical reasons for this limitation, including operational challenges of delivering a secure PIN to an unidentified purchaser. Because prepaid card programs are typically higher cost and lower margin, issuers may simply reduce or discontinue rather than modify such programs to provide for another network, limiting the availability of products to consumers.

The Board may need to consider these and other limitations with regard to certain products in order to effectively implement the routing provisions. Senator Dodd indicated that a Congressional intent was to exempt reloadable prepaid products including FSAs, HRAs and Health Spending Accounts from the exclusivity provisions of Section 920. Such an exemption based on operational challenges and to preserve consumer choices may also need to be considered by the Board.

C. Consumer Disclosure

In developing its standards to implement the exclusivity and routing provisions, the Board should recognize the impact that the processing and routing of a debit card transaction can have on a debit cardholder. The Board should also consider whether its regulations should protect a debit cardholder's ability to select the payment method, when more than one option is available to access a single DDA account.

As the Board may be aware, Visa Operating Regulations require that merchants honor a debit cardholder's preferred method to access their debit account when the cardholder indicates at the point of sale a preference that the transaction be processed as a Visa transaction. Moreover, these Visa requirements prohibit merchants from misleading consumers about the payment system that is being used to handle the transaction. At the physical point of sale, for debit cards with multiple debit networks, a consumer decision is generally facilitated today by the distinction between the consumer entering her PIN

number for a PIN debit transaction, versus signing or conducting a "no signature required" (or automated acceptance device) transaction for Visa debit cards. In the e-commerce environment, merchants can provide detailed menus that offer the consumer specific network options, allowing the consumer to direct which network carries the transaction.

Debit cardholders have a number of reasons to have a preference for how their transactions are handled. In certain circumstances, a debit cardholder may only receive certain benefits or features associated with her card when a particular transaction is routed through the Visa network. As a result, if a merchant steers the cardholder to a non-Visa network, the consumer may lose access to certain features or functions associated with her Visa account. For example, Visa's Zero Liability policy does not apply if transactions are processed on non-Visa networks. While issuers may individually offer a similar level of protection for other transactions, they are typically not required to do so by PIN debit networks. Visa-processed debit transactions also offer chargeback processing for protections that go beyond Regulation E requirements and are generally offered to debit cardholders by Visa issuers on Visa transactions, such as "claims and defenses" chargebacks (*e.g.*, goods not as described). As another example, some optional consumer services, such as Visa Alerts that notify cardholders by email or text message when their card has been used according to parameters set by the cardholder, only operate where the authorization response message is processed through VisaNet. And, certain promotions only function where the transaction is processed through VisaNet both for Visa (*e.g.*, use your card and be eligible to win the "Super Bowl for Life" promotion) and the merchant (*e.g.*, use your card for 7 meals, and the 8th is free). In this regard, issuers typically provide disclosures to cardholders indicating the circumstances in which the cardholder will receive that feature (*i.e.*, only when processed by Visa). If the merchant routes such transactions through a different network, the consumer may not receive that benefit or feature. Finally, some cardholders simply prefer to enter a PIN, and some absolutely refuse – either way the decision should remain with the consumer.

For these reasons and for consistency with the requirements of Section 904, we believe that, at a minimum, the Board's regulations should require that merchants disclose to the consumer options for the routing of their debit card transactions. Such a requirement would be consistent with the Congressionally declared purpose of the EFTA itself, which is to protect consumers—"[t]he primary objective of this title . . . is the provision of individual consumer rights."[4] This requirement could be implemented in a number of ways, including clarifying that networks may continue to require: (1) the

[4] 15 U.S.C. § 1693(b).

physical point-of-sale merchants to allow the consumer to choose whether a PIN is entered; and (b) e-commerce merchants to include specific network disclosure and choice in the e-commerce environment. As technology advances and point-of-sale hardware allows the consumer to choose the network among the available choices (*e.g.*, among multiple PIN debit networks), merchant disclosures at the point of sale may ultimately be required to inform the debit cardholder that she has the right to direct the method to access any individual debit account the cardholder may have and by which her transaction will be processed.

III. DEBIT INTERCHANGE FRAMEWORK

Section 920 of the EFTA, as amended, begins by providing that "[t]he amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[5] In this regard, the Board is directed to prescribe rules that "establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[6] In so doing, the statute indicates that the Board must distinguish between "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" and "other costs incurred by an issuer which are not specific to a particular electronic debit transaction."[7] The statute specifies that the "other costs" that are not specific to a particular electronic debit transaction may not be considered a "cost incurred by the issuer with respect to the transactions."[8]

A. The Basic Interchange Fee Limitation

As a threshold matter, the Board must determine how to state the basic debit interchange fee elements of its regulation in a manner that implements the statute. As noted above, the statute limits a permissible interchange fee for any given debit transaction to an amount that is "reasonable and proportional" to the issuer's cost with respect to that transaction. In light of the very general language of the statute, the Board must interpret and provide meaning to the phrase "reasonable and proportional." Specifically, in order to implement the statute, the Board must determine what it means for a fee to be "reasonable and proportional" to an issuer's cost with respect to a

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[5] 15 U.S.C. § 1693o-2(a)(2).
[6] 15 U.S.C. § 1693o-2(a)(3)(A).
[7] 15 U.S.C. §§ 1693o-2(a)(4)(B)(i), (ii).
[8] 15 U.S.C. § 1693o-2(a)(4)(B)(i).

transaction. The Board's standards for determining whether an issuer's interchange fee is "reasonable and proportional," which are discussed below, will depend on the Board's interpretation of the phrase "reasonable and proportional," as well as the statutory language regarding incremental and other costs.

It is important to turn initially to the actual language of the statute. The statute's clear focus is that the permitted issuer costs are those that are related to debit card transactions. For example, the statute states that the amount of any interchange fee that an issuer may receive or charge with respect to a debit transaction must "be reasonable and proportional to the *cost incurred by the issuer with respect to the transaction.*" It is important to note that this language does not indicate that a debit interchange fee for a given transaction must be limited solely to the relevant costs associated with the transaction; instead, the language simply requires that there be a "reasonable and proportional" relationship between the two. Moreover, the statute calls for the Board to distinguish between "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*" and "other costs incurred by an issuer *which are not specific to a particular electronic debit transaction.*"

These two concepts ("incremental costs" and "other costs") are not all inclusive. A narrow reading of the term "incremental" may exclude costs that are nevertheless specific for a particular electronic debit card transaction. We believe that the statutory language does not require such a narrow reading. More specifically, we do not believe that the statute requires the Board to limit permissible issuer costs to those that are incremental in connection with the authorization, clearance and settlement of debit transactions. Instead, we believe that the only limitation actually imposed by the statute is that "other costs" that are not specific to debit card transactions may not be included. As a result, we believe that the Board has the discretion under the statute to consider issuer costs other than incremental costs for authorization, clearance and settlement, narrowly defined, so long as those costs are specific to debit card transactions, and we feel the Board's policy objectives would suggest this discretion be employed.

B. The Need for a Safe Harbor

As indicated above, the statute's interchange fee limitation is transaction specific. Specifically, the statute provides that the amount of any interchange transaction fee that an issuer may receive or charge with respect to a debit transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. In light of the tremendous volume of debit card transactions conducted in this country and differences in issuer costs for these transactions, however, it would be impossible for the

Board to examine an issuer's compliance with (and impossible for an issuer to demonstrate its compliance with) the Board's standards on a transaction-by-transaction basis. Moreover, the actual costs associated with a debit transaction are not actually known until the relevant time period has elapsed in which the consumer can dispute the transaction and any dispute can be resolved between all participants (including the merchant). In short, it is impossible to calculate an interchange fee for each and every transaction at the time of the transaction. This is the inherent difficulty associated with cost-based limitations in which the costs are not all fixed and can be dramatically different depending on the transaction.

In developing its standards, it will be important for the Board to consider how its standards can actually be implemented by issuers and networks and how the Board will enforce these standards. For example, the Board must be cognizant of how a debit card issuer will be able to demonstrate its compliance with the regulation's interchange fee limitation. In this regard, it makes little sense to require an issuer or a network to attempt to calculate and justify a separate interchange fee in connection with each individual debit card transaction. In fact, it likely would be impossible for the Board to examine a debit card issuer's operation for a specific year and evaluate each and every debit card transaction conducted on every card issued by that issuer. As a result, as a practical matter, it would appear that the Board's standards must be based upon average costs and provide some type of safe harbor "rate" standard, as discussed below.

This same issue was addressed by the Board in its credit card penalty fee rulemaking under the Truth in Lending Act. As in that scenario, Visa believes that the only way for the Board to provide a standard that practically can be implemented by issuers and payment card networks and also examined and enforced by the Board is to provide some form of safe harbor. The Board, however, will have to determine what an appropriate level is for the safe harbor, as discussed below.

C. Possible Debit Interchange Frameworks

In order to implement the debit interchange provisions of Section 920, the Board must determine how to incorporate permissible issuer costs into an interchange framework that will be used to determine compliance with the interchange limitation. In essence, the Board must engage in a ratemaking, similar to, for example, the FERC ratemaking in the energy industry. In this regard, the Board has a variety of options in order to implement the interchange provision. For example, the Board could:

(1) set a general interchange "cap" that provides one or more specific interchange rates that an issuer may receive or charge; or

(2) establish the specific interchange rates that an issuer may receive or charge for specific types of transactions; or

(3) define the types of issuer costs that may be included in a permissible interchange fee and then allow the payment card networks to establish the rates at a transaction level; or

(4) establish an average effective interchange rate that an issuer may receive or charge for all debit transactions and then permit a payment card network to establish various interchange rates so long as the effective average of the rates ultimately charged through the network adheres to the Board's effective interchange rate.

We believe that the final option described above is most appropriate and would have the effect of setting overall effective debit interchange rates to reflect issuer costs for various types of debit transactions plus a reasonable return on investment. This average effective interchange approach would not only likely reduce interchange costs to businesses accepting electronic debit transactions and provide a workable and flexible framework for the industry, but would also provide the Board with a framework that would be far simpler to monitor, update and enforce. Where appropriate, we describe how these options may work in an illustrative $50 transaction.

Unlike the effective interchange rate approach, each of the other options described above likely would present significantly more difficulties. For example, option 1 would be a cap-based approach where, for example, the Board would set a percentage cap of 1.00% and no interchange rate could be set above that cap, thus resulting in interchange of $.50 on a $50 transaction. Unless the Board set the cap or caps to compensate issuers for the types of transactions in which the issuers incur the greatest cost, issuers would receive interchange fees for some types of transactions that would be less than the permitted costs incurred by the issuers with respect to those transactions. This would discourage more costly transactions in which the interchange fee would not recover the costs associated with those transactions. Declining or unwinding these transactions would adversely affect merchants because electronic debit transactions might not be authorized for more costly merchant environments. In order to recover the costs associated with transactions where the costs are greater than the interchange fee, issuers may charge interchange fees up to the "cap" for those transactions where the costs are less than the cap. Even with this cross-subsidization, higher cost transactions would be discouraged because this approach would not recognize the significant differences in cost to serve specific merchant segments. Nonetheless, merchants operating in lower-cost environments likely would subsidize those merchants operating in higher-cost

environments. The types of nonalignment between interchange received and costs incurred, and cross-subsidization among issuers, merchants, merchant categories and transaction types, would occur regardless of whether the Board sets a cap on a percentage basis (*e.g.*, 1% of transaction amount) or a fixed basis (*e.g.*, $.50 per each transaction).

In order to address the difficulties of option 1, the Board could instead choose to establish specific interchange rates that an issuer may receive or charge for specific types of transactions. Under this option, for example, the Board could set a rate of 1.20% for one type of transaction, a rate of 0.80% for a second type of transaction, and so on, and all payment networks would have to apply those specific interchange rates for the specified transaction types. Thus, a sample $50 transaction could have an interchange fee of $.60 or $0.40 depending on the type of transaction. Inevitably, this process would lead to similar problems as the "cap" approach. The Board also may need far more detailed data than it has collected in its issuer and network surveys in order to implement this approach, as ratemaking would need to account for differences in cost that occur at a transaction level. The Board would also have to devote substantial resources to track and set rates for individual transaction types based on costs, which vary by issuer. As mentioned above, this would raise the issue of accounting for differences in cost at the transaction level, when many of the ultimate costs are not fully known until the full lifecycle of a transaction (including resolution of any disputes) is complete. As with option 1, setting such interchange rates on a fixed, rather than percentage, basis would not reduce or eliminate these inherent problems.

The Board also could define the types of issuer costs that may be included in a permissible interchange fee and then allow the payment card networks to establish the rates (option 3). Although this approach would avoid the difficulties associated with setting specific rates or caps, this approach would be far more cumbersome for the Board to enforce and for issuers and networks to comply with. While the Board would specify the relevant cost categories, these cost categories likely would vary from issuer to issuer. As a result, in order to determine whether interchange fees were appropriate, the Board would have to examine the issuer's cost structure for some relevant period preceding the period in which the fees were charged, as opposed to the other approaches in which the Board could enforce by, for example, confirming the average or maximum rates of interchange fees that an issuer received. It is also worth noting that adopting an approach in which interchange may vary by issuer would also present challenges for acquirers because their existing billing systems do not take into account the identity of the issuer when forecasting interchange, setting merchant discount rates or even billing merchants.

Unlike the other approaches, we believe option 4 (the average effective interchange rate approach) would be the most effective and flexible for issuers and

payment card networks, would permit the use of interchange fees to encourage efficient processing and would likely be easier for the Board to implement and enforce. Under this option, for example, the Board would set an average effective interchange of 1.00%, and each payment network would establish its own interchange rate structure (whether one rate, multiple rates, fixed, variable or a combination), such that their overall effective interchange rate over time is equal to or less than the 1.00% rate.[9] In this regard, the Board would establish an "average effective" interchange rate that an issuer may receive or charge for all debit transactions and then permit the payment card network to establish various rates based on different factors, such as merchant type and authorization mechanism, so long as the overall average effective rate charged by the network is no greater than the Board's average effective interchange rate over a defined period.

Option 4 would not only provide payment card networks with the flexibility to set interchange rates to control for risk (*e.g.*, fraud), but also to provide incentives to merchants to adopt more efficient processing solutions or safer technologies. These incentives include encouraging merchants to improve data quality at the point of sale, comply with emerging data security initiatives and engage in best practices for fraud prevention. Moreover, within the permitted average effective rate, the payment card networks and issuers would have the flexibility to adopt varying rates in order to address the complex cost alignment and cross-subsidization issues discussed above.

As noted above, implementing the average effective rate model at the network level, as opposed to the issuer level, would be most practical and efficient. We believe that this approach is the most practical and efficient for a number of reasons, including the fact that the payment card networks currently set the interchange rates for debit transactions over those networks, and would be the least disruptive to the industry and preserve the most flexibility for future innovation.

Under any approach, the Board likely would be confronted with the issue of reconciling its debit interchange rate setting framework with its regulations related to network exclusivity and routing. Looking at either of these tasks in isolation has the potential to impact the outcome in either area, and potentially to impact the extent to which the policy objectives are achieved. As compared to frameworks in which the Board itself establishes debit interchange rates or rate caps, a framework in which

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[9] For example, one payment network could establish a single 1.00% interchange rate for all of their transactions, while a second payment network may choose to set a $0.50 rate for one merchant segment that has an average ticket size of $50 (equivalent to a rate of 1.00%) and represents 50% of their network volume, and an 0.80% rate for a second type of merchant segment which represents 25% of network volume, and a 1.20% rate for a third type of merchant segment with the remaining 25% of their network volume—in total the effective interchange rate would still be equal to the 1.00% average.

networks can set individual rates enables them to do so in such a way to effectively compete for the routing decisions being made by merchants and acquirers. Under the average effective rate approach, because networks must maintain an average effective interchange rate over time, consistent with the level determined by the Board, the Board would be provided with confidence that the overall level of debit interchange in the system is consistent with its standards.

D. Relevant Issuer Costs

Under whatever rate framework the Board ultimately adopts, the Board must determine the types of issuer costs that may be included within that framework and that will comprise permissible debit interchange fees. In this regard, debit card issuers incur a wide variety of costs in connection with their debit card operations. For example, an issuer's "total" costs for its debit card program include: (1) costs that vary with the volume of debit card transactions (variable or incremental transaction costs), such as certain activation costs; and (2) costs that are related to debit card transactions, but that do not vary significantly with card transaction volume (fixed transaction costs), such as capital investment costs and the costs of printing cards and mailing statements. Nonetheless, any cost incurred by an issuer with respect to its debit card program facilitates its debit card transactions in some manner. Said differently, if an issuer did not incur its various costs, some or all aspects of its various debit card transactions could not be processed. At the same time, there are other costs associated with transaction amount payments, such as check and ACH transactions, that are not related to a particular debit card transaction. In many cases, costs will be related both to particular electronic debit card transactions and to other transactions, and it may be necessary to allocate some costs to electronic debit card transactions and some to other transactions. For example, a "but for" cost of debit card transactions includes providing the cardholder with a statement with respect to the transactions; however, statement costs will also relate to other transactions, and, therefore, the total statement costs must be allocated among transactions on some reasonable basis.

We believe that the Board will want to include "nonvariable" costs in its calculation of reasonable and proportional interchange transaction fees under Section 920 for several reasons. First, failure to include all costs of electronic debit card transactions in interchange transaction fees may lead debit card issuers to cross-subsidize these transactions from other deposit account revenues. Whether or not such cross-subsidies would take place may vary among institutions, but some larger institutions may be more able to do so. Alternatively, if this cross-subsidization did not occur, some electronic debit card transactions may not be offered by some institutions. A reduction in the availability of electronic debit transactions would seem to be inconsistent with the

perceived need to regulate the interchange applied to these transactions. That is, regulation of electronic debit transactions carries with it the inherent judgment that these transactions are important transactions to the businesses accepting the transactions or the business should refuse to accept them in the first place. Accordingly, any regulation of electronic debit transactions should retain the economic viability of these transactions.

Second, if cross-subsidization of electronic debit transactions did not take place and the full costs of these transactions were explicitly charged, or re-directed, to debit cardholders (a structure that would differ markedly from price structures for check, ACH, ATM and cash transactions), the costs to consumer cardholders for these transactions could increase in a way that is inconsistent with the statutory admonitions to the Board in section 904(a)(2)(d)(3) of the EFTA concerning preserving competition in the provision of electronic banking services (*e.g.*, ACH vs. debit card transactions) and compliance costs and consumer protection. This interchange structure also would have the effect of discouraging electronic debit transactions, as opposed to check and cash transactions, which would be inconsistent with the policy of encouraging electronic commerce.

Third, even if the Board felt that it should interpret Section 920 narrowly to limit its consideration to "incremental costs," we believe that the Board will want to recognize that, for several reasons, "incremental costs" cannot practically be viewed as the computer and telecommunications processing cost of the next electronic debit card transaction handled by an issuer enjoying significant economies of scale. For example, the costs to authorize, clear and settle a transaction necessarily include the costs incurred in reaching final settlement of these transactions. These costs include not only the data processing costs of processing and posting a transaction that settles without incident or dispute, but also the costs of resolving disputes raised by cardholders who may question whether a particular transaction is authorized. In other words, the incremental costs of a transaction necessarily depend on which "incremental" transaction is considered.

Fourth, in its most literal sense, incremental costs will differ transaction by transaction, depending on the network, the issuer, the type of transaction, the routing of the transaction and so on. Accordingly, any incremental cost identified by the Board for regulatory purposes under Section 920 necessarily will be an average of some number of transactions. Not only will this average include disputed, as well undisputed transactions, and transactions involving different networks and issuers, but it will also inherently include different transactions over time. For example, different transactions at different times will use different portions of fixed resources, depending on the other transactions competing for those resources during the measurement period. Similarly, different transactions at different times will be subject to different costs because of changes in the costs of the services required to authorize, clear and settle the transactions. Accordingly,

any "incremental" cost must, as a practical matter, reflect an average of the costs of different transactions. Any reasonable average should be designed to capture cost differences over time, as well as cost differences across transactions. While we recognize that the Board has already focused on calendar year 2009 costs and has collected data on that basis, we believe that the costs of different institutions may yield a reasonable proxy for costs over a longer period (pending collection of such actual data over time). Further, the effect of the exclusivity and routing provisions in subsection (b) would be likely to impose additional costs to support multiple networks, a cost which will need to be reevaluated over time.

Fifth, as discussed below, the costs of providing electronic debit card transactions should include a reasonable rate of return on the issuer's investment in its debit card operations. Debit card issuers must make significant investments in their debit card operations. In order for these business lines to receive continued investment within their respective institutions, these investments must yield a market rate of return or the funds will simply not be available for investment.

For all these reasons, we encourage the Board to include in its evaluation of issuer costs not only "incremental" costs, but also those "nonvariable" costs described above that are integral to the provision of a debit transaction. These costs, coupled with a reasonable rate of return on investment, are necessary to support an innovative and flexible debit market. In the absence of sufficient recovery of costs, the policies of continued growth of electronic commerce and competition in electronic banking services may both be inhibited.

E. "Reasonable and Proportional" and Return on Investment

The requirement that interchange rates must be "reasonable and proportional" should include a component for return on investment, regardless of whether or not that return is viewed as a "cost." The concept of reasonable and proportional is substantially similar to the requirement in traditional federal ratemaking that regulated rates be "just and reasonable." Federal ratemaking typically allows for a reasonable rate of return on investment. For example, the Federal Power Act provides FERC with the authority to establish rates that may be charged for wholesale power and transmission of power in interstate commerce.[10] Similarly, the Natural Gas Act provides FERC with the authority to establish rates for pipelines that transport natural gas in interstate commerce.[11] In

[10] 16 U.S.C. § 791 *et seq.*
[11] 15 U.S.C. § 717 *et seq.*

addition, the currently effective remnants of the Interstate Commerce Act grant FERC the authority to regulate pipelines that transport oil in interstate commerce.[12]

The traditional form of price regulation used in most or all of these industries is cost-based regulation, or "cost of service" regulation. Under this type of regulation, a utility is allowed to set rates based on the cost of providing service to its customers, including the right to earn a limited profit or return on investment. Each of the acts above charges FERC with assuring that the regulated prices are "just and reasonable" for customers, a term of art around which a considerable body of law has developed. The Supreme Court has described just and reasonable rates as being rates that allow a utility the opportunity to recover its costs and earn a return "commensurate with returns on investments in other enterprises having corresponding risks."[13]

In its most simplistic form, this means that a utility is entitled to establish a rate that will allow it to recover its actually incurred operating and maintenance costs, an annual return of a reasonable amount of its capital investment in the utility assets in the form of depreciation and a reasonable return on its capital investment as calculated by a prescribed methodology. FERC's normal method of calculating that return is to use the Discounted Cash Flow method for a number of similar companies (*Hope*'s "enterprises having corresponding risks") to calculate a range of returns on equity, and then taking a number, often the mid-point, in that range for calculating the rate of return in question by combining it with the regulated company's actual debt-to-equity ratio and cost of debt figures. Normally, the costs and return data are obtained for a recent time period (the "test period") along with a projection of the throughput or consumption of the service or commodity in question, and then a forward-looking rate is derived by dividing the total costs (including the return, or profit) by the throughput or consumption projection.

Accordingly, while Section 920 addresses interchange fees in terms of "electronic debit transactions," this term must be viewed as an average of some number, or grouping, of different types of debit transactions. We do not believe that Section 920 requires this grouping to be issuer specific. That is, cost recovery need not be, and in practice cannot be, measured efficiently on an issuer-by-issuer basis. We believe that groupings at the network level are most appropriate and would be most efficient because issuers do not in practice set interchange transaction fees; rather, these fees are set by networks and issuers accept transactions from different networks.

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[12] 49 U.S.C. § app. 1 *et seq.* (1988).
[13] *See Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

F. How to Set the "Effective" Interchange Rate

The first step in implementing an average effective debit interchange rate framework would be for the Board, as described above, to identify allowable issuer costs that can be included in a permissible debit interchange fee. Using cost data and transaction volumes from the issuer and network surveys, the Board would then calculate an average effective debit interchange rate for the debit card industry generally that is based on these "allowable" costs, including, as discussed above, a reasonable return on investment, (the "Average Effective Debit Interchange Rate"). This Average Effective Debit Interchange Rate would not be specific to any given payment card network, and could be expressed, for example, in terms of basis points of transaction amount.

This Average Effective Debit Interchange Rate would then function as a safe harbor for an issuer operating on or as any payment card network. That is, a debit card issuer operating on or as a payment card network would be deemed in compliance with the statute's interchange limitation if the average, systemwide effective debit interchange across all domestic debit transactions on that network is maintained at the Average Effective Debit Interchange Rate over a to-be-defined time period (*e.g.*, four calendar quarters). Under this approach, a network could set different rates based on merchant size, merchant segment, acceptance channel (*e.g.*, card present vs. card not present), processing requirements or other factors, so long as the network's overall effective debit interchange rate is maintained at the Average Effective Debit Interchange Rate. Similarly, this approach would allow a payment card network to establish individual debit interchange rates using fixed amounts, variable amounts or a combination of the two. The Board would need to periodically update the Average Effective Debit Interchange Rate as the underlying aggregate issuer cost profiles change over time.

This approach, in addition to implementing the requirements of Section 920, places the burden of determining and managing individual rates on the networks (rather than the Board), while preserving the ability of networks to use interchange to provide stakeholder incentives to grow participation in, and strengthen the quality of transactions being processed over, a given network.

G. Fraud Adjustments

Section 920 also provides that the Board may permit issuers to receive a fraud-related adjustment (*i.e.*, increase) to the debit interchange fees that they receive. Specifically, the Board may allow a fraud adjustment if: (1) the adjustment is "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer"; and (2) the issuer

complies with the Board's fraud standards.[14] Although there are a variety of approaches to implementing a fraud-adjustment factor, we believe that a simple, flexible approach would be more effective and readily administered and enforced. For example, the Board could treat issuer fraud prevention costs and fraud losses the same as the other issuer costs discussed above. That is, the Board could incorporate these fraud costs into the Average Effective Debit Interchange Rate. Under this approach, all issuers would receive the fraud "adjustment."

In turn, the Board would issue general, risk-based fraud prevention standards that each covered issuer would be required to comply with. For example, the Board's fraud prevention standards could be modeled on the information security standards issued by the Board and the other federal banking agencies to implement Section 501(b) of the Gramm-Leach-Bliley Act ("GLBA"). Under the GLBA information security standards, a bank must implement a risk-based information security program that includes, where appropriate, various information security measures identified by the agencies that are designed to protect customer information. A GLBA-like approach would provide a number of important benefits. First, it would allow each covered issuer to tailor its fraud prevention program based upon the nature and scope of its actual debit card practices. Moreover, this approach would provide both the Board and covered issuers with the flexibility to adapt with changes in technology, as well as changes in fraud activities and techniques. As the "fraud adjustment" provision of Section 920 itself inherently implies, issuers are already incented to control fraud and have regulatory obligations to do so. Among other reasons, they may bear the liability for certain fraudulent transactions in riskier merchant environments or where basic processing and authentication standards are not met; processing or other systems to prevent fraud can be costly and require substantial resources to manage; they incur greater costs for handling chargebacks or other exception processes for fraudulent transactions; there may be customer disruption from re-issuance or other fraud control measures; and, networks they participate in may devote substantial resources to support their ability to manage fraud risks and appropriate handling of transactions by merchants, third party processors or others. A more detailed approach that prescribed specific controls that all issuers must adopt would provide issuers with far less flexibility in order to adapt to changing technologies and fraud patterns, and the Board would need to continually monitor and update the standards as appropriate.

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[14] 15 U.S.C. §§ 1693o-2(a)(5)(A)(i), (ii).

H. Monitoring and Enforcement of the Average Effective Interchange Rate Approach

In order to adopt the "blended effective rate" approach, the Board would need procedural mechanisms to assist the Board in monitoring, updating and enforcing the Average Effective Debit Interchange Rate. We believe that the following procedures could easily be enforced by the Board, and would assure that covered issuers would receive or charge debit interchange fees that are based on the Average Effective Debit Interchange Rate over time.

On an annual basis, each payment card network would file with the Board its current debit interchange rate structure, report on the amount of debit interchange and volume processed over its network during the previous year, and indicate whether its average, system-wide effective debit interchange across all domestic debit transactions was at or below the Average Effective Debit Interchange Rate for that year. A network would report both from the perspective of what acquirers or merchants paid, and what issuers received, so that the Board could confirm compliance from both sides.

If a network's actual effective debit interchange rate exceeded the Average Effective Debit Interchange Rate during the measurement period, the network could be obligated to promptly take steps to bring the actual effective debit interchange rate into line with the Average Effective Debit Interchange Rate. These steps could include rate changes or other adjustments, at the Board's discretion. In the event further corrective action was warranted, the Board could instruct the network to reduce some or all of its debit interchange rates so as to lower the network's effective debit interchange rate, and, potentially, other measures that the Board deems appropriate. These steps could be coupled with quarterly reporting to track the relationship between the network's actual effective debit interchange rate and the Average Effective Debit Interchange Rate. Any enforcement mechanism should recognize that a change in the mix of transactions can change not only the actual effective debit interchange rate, but also the issuers' costs over the measurement period, however those costs may not be fully known until the next cost survey. Remedial actions should be reserved for cases where it is clear that any excess in the actual effective debit interchange rate above the Average Effective Debit Interchange Rate does not also reflect an increase in issuer costs.

I. Comparison to Checks

Section 920(a)(4)(A) requires the Board to consider the functional similarity between electronic debit transactions and checking transactions that are required within the Federal Reserve bank system to clear at par. Simply put, Visa believes that this

consideration should have no practical influence on the Board's decisions as to the implementation of Section 920. As Visa will be happy to discuss in greater detail the history of par clearance within the Federal Reserve bank system is based on the circuitous routing of check transactions at a time almost a century ago when those transactions were a key means of payment in commercial transactions. Par clearance was designed to facilitate commercial transactions by helping to facilitate prompt payment. Today when large commercial transactions are often settled by wire transfer and checks occupy a different role in payments, there are marked differences in the processes, risks and legal requirements for check and electronic debit transactions. Indeed, while par clearance was designed to make check transactions more efficient, and therefore more attractive as a means of payment, par clearance of electronic debit transactions would almost surely drastically reduce the availability of these transactions, a result that would seem entirely inconsistent with the purpose of the requirement for par clearance of checks.

IV. OTHER ISSUES

A. Geographic Scope of Covered Debit Transactions

Neither Section 920 specifically nor the EFTA generally specify the jurisdictional scope of their provisions. Nonetheless, we believe that it is important that the Board specify that its regulations, including both the interchange limitations and the exclusivity and routing provisions, apply only with respect to debit transactions involving U.S. issuers and U.S. merchants accepting electronic debit transactions. It should not be assumed that Congress intended to regulate foreign commerce unless a statute explicitly does so; moreover, the complications of regulating cross-border transactions and the potential foreign retaliation far outweigh any small benefit to U.S. merchants from regulating debit interchange for foreign issuers.[15] There may be a number of additional complications, including, for example, the absence of an enforcement mechanism against foreign issuers, significant costs/technology issues and potential conflict of law to the extent that foreign issuers are subject to separate regulation. It is also not clear what data source the industry would use to determine which issuers are exempt or non-exempt from the regulation – a factor which would also add to the Board's burden in monitoring compliance. Moreover, the Board would not have cost data from foreign issuers on which to base interchange transaction fees. The complication of applying the exclusivity and routing provisions of Section 920 to transactions involving non-U.S. issuers are even more pronounced. In addition to the considerations above, such issuers may not even be

[15] *See, e.g.*, *F. Hoffmann-La Roche Ltd v. Empagran SA*, 542 US 155, 164 (2004) ("This Court ordinarily construes ambiguous statutes to avoid unreasonable interference with the sovereign authority of other nations.") (collecting cases).

aware of the provision related to a second unaffiliated debit network; an additional domestic debit network from a foreign country may not even function in the United States in which case the issuer (anywhere in the world) may conclude it needs to contract with a U.S.-based network; and the Board has no industry information upon which to make considered regulatory decisions with respect to applying the regulations to such non-U.S. issuers or transactions involving them. Finally, there is no apparent policy basis for applying the requirements of Section 920 to transactions originating from foreign issuers or at foreign merchants.

B. Business Debit

The EFTA is a consumer protection law, and the amendments to the EFTA adding Section 920 are in the consumer title of the Act. Applying Section 920 to business debit transactions likely would be inconsistent with what many legislators thought was the focus of the provision. In addition, the structure and costs of business debit transactions, the spending patterns (business-oriented purchases, and higher spend), and the accounts that are used differ from consumer transactions and accounts. We believe that the Board may want to consider excluding business debit transactions from its implementing rules.

C. Timing and Implementation

It is also worth noting that the interchange and exclusivity and routing provisions may require significant changes to some existing issuer and payment card network practices and systems. In this regard, the Board will want to consider the timing of when issuers and payment card networks will be required to come into compliance with the Board's regulation. The statute directs that the Board issue its debit interchange regulations in final form within 9 months following enactment, and the statutory limitation on interchange fees goes into effect 12 months following enactment.[16] In addition, the statute directs that the Board issue its exclusivity and routing regulations within 12 months following enactment.[17] We believe that issuers and payment card networks, and other entities which support the industry such as processors, will be confronted with significant business and operational constraints in revising relevant systems in order to come into compliance within 12 months after enactment, which likely would be at most three months following final Board regulations. We believe that the concept of reasonable fees can also include a temporal component. That is, that reasonable fees include a reasonable phased transition to any new fee structure. For example, the Board could phase in any new fee structure

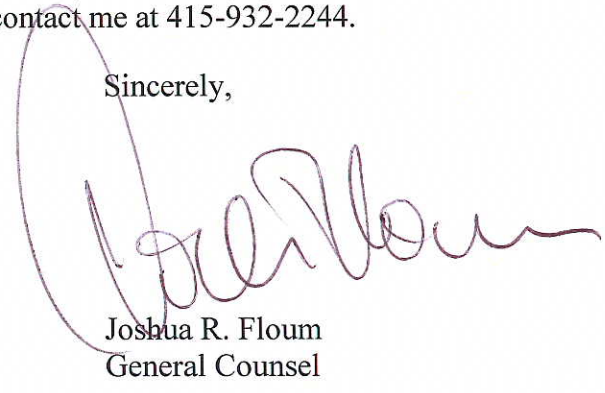
[16] 15 U.S.C. §§ 1693o-2(a)(3)(A), (a)(9).
[17] 15 U.S.C. § 1693o-2(b)(1).

in increments over a period of a number of years. Such a phase-in would avoid radical dislocations due to a large and abrupt change in interchange fees and the systems changes necessary to support such changes.

* * * *

We would be happy to follow up with you on any aspects of this letter, with further supporting information or submissions. If you have any questions concerning the issues raised in this letter do not hesitate to contact me at 415-932-2244.

Sincerely,



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