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Subject: Reg I I - Debit card Interchange

Comments:

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Comments:
I congratulate the staff of the Board for their excellent assimilation of the facts regarding the operations of debit card networks, and the basics of Interchange Reimbursement Fees. My comments are all intended to encourage the staff to widen their considerations to embrace additional elements of this complex business, so as to better reflect the realities of the market as well as the intent of the legislation which gave rise to their considerations.
Guidance regarding the setting of prices vs. setting prices I echo the concerns raised by Kevin M. Warsh, that the legislation did not call for the setting of prices, but for the establishment of guidelines regarding prices. Major networks for cards payments each establish interchange fees which are paid to issuers of card products. These interchange fees vary by card type (credit, debit with PIN, debit with signature) as well as by market segment (face-to-face, e-commerce, mail/phone order), the extent to which electronics are used
(terminal or key-entered, magnetic stripe read, chip read), and retail environment (low-value, travel and dining, very high value, supermarket). The costs to the issuer vary with each of these variables, making setting of a single, system-wide safe-harbor or cap as an average across all variables, into the creation of an average rate which will be inappropriate to some merchants as well as to some issuers. A reasonable alternative might be to let the networks set rates, with variable outcomes for each of these dynamics, according to guidelines as issued by the regulators. Guidelines might include: 1. whether rates include fixed as well as variable costs 2. the extent to which fraud losses and fraud management costs might be included 3. exclusions which would not be considered part of the costs (most notably marketing costs such as advertising and rewards programs) The actual mechanics of gathering cost data and computing rates would then be left to the applicable networks, with
auditing of methodologies and conformance left to the regulators, as is done

for so many other regulatory functions. I submit that such an approach would allow for reasonable management of the business of card payments by the participants in the system, rather than management by regulators, as well as allowing the networks to incorporate the dynamics of market realities based on card, technology, retail environment, and risk profiles of various card acceptance environments which change over time. Reasonable costs I am greatly concerned that reasonable costs are not deemed in the current proposal to include the relatively expensive areas of customer service, dispute resolution and fraud management, because they are apparently 'fixed costs' or too difficult to quantify. Without either customer service or fraud management, specific to cards programs, and beyond what is available for a deposit account without a debit card, a debit card is not a viable product. Although merchants understandably want the lowest possible costs included in interchange fees, excluding these two functions makes the issuance of a debit card infeasible in an electronic marketplace. In other words, these functions are essential to making the card useful for purchases at merchants, and therefore should be included in the costs of each transaction. Comparisons to Check systems If comparisons between card systems and check systems are to be considered, then one must certainly also take into consideration the differences between these two payment systems. No merchant can reasonably compute the cost of check acceptance without also including the cost of either 1) losses from fraudulent checks or 2) check guarantees. Examination of either of these costs will reveal that these costs are significant. Equivalent costs therefore must be included in the service of 'authorization' for debit cards, to include fraud management, customer service, and dispute resolution, just as the cost of check acceptance must include the cost of losses on fraudulent checks or check guarantees. What legislation exclusions tell us The legislation specifically excludes government benefit card programs, because the costs of running such programs need to be recovered through interchange, as explained in your own deliberations. Does not that statement alone imply that interchange components, as narrowly defined in the draft regulation, are not sufficient to cover the real costs of running a debit card program ? Encouraging a dynamic marketplace As Kevin Warsh pointed out, the regulation to be implemented must be seen to encourage a dynamic and competitive marketplace. Taking into consideration the competitors to debit card usage, you might reasonably include: credit cards, PayPal, and closed-loop systems (American Express, Discover, JCB, Diner's Club). Since each of these alternatives has fees which are comparable to today's interchange fees, and are many times te scale of the proposed
safe-harbor or cap, one must acknowledge that the proposed interchange puts debit card issuers at such a disadvantage that they are non-competitive for issuers, although consumers prefer to use debit cards because of the control they offer over personal finances. Transaction routing and competitive environments The requirement to allow merchants to determine transaction routing will have unintended consequences due to the networks being customized to deliver functionality aligned with the network's branded cards. A network does not simply route transactions, but rather applies various processing services which are proprietary to that brand. Many services invoked in debit card processing, most notably those dealing with security, authentication of the card and the cardholder, and authorization of the transaction amount, are performed by the card brand's network on the issuer's behalf at the issuer's option. Without these services, every card issuer must implement complex processes
which many do not undertake today, or alternatively, many transactions will become less secure due to missing security processes, presumably resulting in much higher fraud losses. If an issuer must now enable such services on more

than one network, the new alternate networks will gain exposure to proprietary security measures of the card's brand. As an example, if MasterCard's network must be available as an alternative to Visa's network for a Visa branded card, then all Visa services associated with authorization and settlement of a card item must now be implemented in MasterCard's network. Essentially, the two networks are completely homogenized by this requirement, and neither can implement any branded advantage over the other, since that capability must immediately be implemented on the other network. Different brands offer different services. The cardholder chooses the brand of card that he wants; if the merchant chooses to accept a given brand, should he not be required to deal with that brand's network ? While merchants would like to be able to route at their whim, this seems equivalent to requiring that a grocer be able to buy Coke items from the Pepsi distributor.