People's United Bank

February 11, 2011

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

Re: RIN 7100-AD63 Notice of Proposed Rulemaking: Regulation II - Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

On behalf of People's United Bank, I appreciate this opportunity to comment on the Board's notice of proposed rulemaking on new Regulation II (the "Proposal"). The Proposal would implement Section 920 of the Electronic Funds Transfer Act (the "EFTA"), relating to debit card interchange fees, fraud prevention and exclusivity and routing restrictions for credit and debit cards.

People's United is a $25 billion federal savings bank headquartered in Bridgeport, Connecticut and one of the largest independent banks in New England, with 350 branches in 6 states. People's United has issued approximately 650 thousand debit cards to its depositors, utilizing both signature and PIN debit features; the Proposal is, therefore, of tremendous significance to the Bank and to its customers.

Section 920(a) of the EFTA provides that the amount of any interchange transaction fee that may be charged by a debit card issuer shall be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." Section 920(a)(3) directs the Federal Reserve Board to establish standards for assessing whether the amount of an interchange transaction fee is "reasonable and proportional" to the issuer's cost for the transaction.

On December 16, 2010 the Board issued the Proposal, pursuant to which it set forth two alternative approaches to implementing the "reasonable and proportional cost" provisions of EFTA Section 920(a). Both of these alternatives contemplate the imposition of price controls on interchange services, based on a narrow definition of "allowable costs," without regard to the issuer's actual costs of providing those services. Under Alternative 1, an issuer would determine the amount of interchange fee that could be imposed by calculating its "allowable costs" for interchange fees and dividing these by the number of transactions, subject to a cap of 12 cents per transaction. The issuer would not have to

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perform a cost calculation if the amount of the fee was seven cents or less. Alternative 2 would establish a cap of 12 cents per transaction.

As proposed, only *variable* costs associated with the issuer's role in authorization, clearance and settlement of debit transactions can be included in interchange fees charged to merchants, and then only to the extent that these costs are equal to or lower than 7-12 cents. Fixed costs are not included, even if they are attributable only to debit card transactions. No provision is made for recovery of costs associated with debit card fraud or investment in new technology, much less a reasonable profit.

People's United believes that the Proposal is deficient in a number of very significant ways and we respectfully urge the Board to reconsider its entire approach, taking into consideration the extent to which its rulemaking would stifle innovation, harm banks and consumers, and create an administratively burdensome and expensive system of price controls.

EFTA Section 920 requires assessment standards, not price controls

As Governor Warsh noted during the Board's December 16th meeting, Section 920(a) directs the Board to establish *standards for assessing* whether the amount of any interchange fee is reasonable and proportional to the issuer's cost for the transaction. It does not authorize the Board to set prices. The plain language of the statute contemplates the issuance of a set of criteria against which the reasonableness of a fee can be assessed, based on the specific facts associated with the transaction, including the issuer's actual costs. The statute does not require the Board to evaluate whether the costs themselves are reasonable, but only to develop a framework to determine whether the fees charged bear a reasonable relationship to the actual costs.

By setting price controls, the Board has in effect determined that under all circumstances a transaction fee (or average transaction fee) of 7-12 cents is "reasonable," while a transaction fee of 13 cents presumably is not. Moreover, it bases this determination on admittedly incomplete and possibly inaccurate data provided by a very small number of issuers.

We respectfully suggest that the Board's final rule eliminate price controls and instead establish assessment standards to be used in determining a reasonable and proportional interchange fee.

Interchange fee assessment standards should reflect full consideration of the factors specified in EFTA Section 920(a)(4)

In developing its interchange fee regulations the Board is directed to:

- consider the functional similarity between electronic debit transactions and checking transactions;

- distinguish between incremental costs incurred by the issuer in the authorization, clearance and settlement of a transaction and other costs incurred by the issuer, which are not specific to a particular electronic transaction; and
- consult as appropriate with the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the Administrator of the Small Business Administration and the Director of the Bureau of Consumer Financial Protection

As discussed below, we believe the Proposal does not adequately reflect consideration of any of these factors.

The Functional Similarities between Checks and Debit Cards

EFTA Section 920 directs the Board to consider the *functional* similarities between check and debit card *transactions*, noting that checks clear at par. The provision doesn't direct the Board to consider only activities related to authorization, clearance and settlement. Rather, it explicitly obligates the Board to consider how a debit card transaction functions in its entirety and to compare this to a checking transaction.

The Proposal's analysis of the similarities and differences between checks and debit cards was focused almost exclusively on a single part of a checking transaction, the authorization, settlement and clearing process between the payor and payee bank. Checks clear at par between those two parties to the transaction. But this doesn't tell the whole story about how a debit card transaction functions in comparison to a checking transaction.

As was noted in the Board's Supplementary Information discussion, check clearance is not free to the merchant. Merchants incur both direct and indirect costs from checking transactions, including deposit and per check fees, costs associated with third party check verification, administrative expense related to handling checks and finally, the risk that the check will be returned unpaid.

Because the costs to a merchant of accepting checks, particularly costs associated with bad checks, can be significant, an increasing number of merchants, including supermarkets, convenience stores, restaurants, movie theatres and gas stations don't accept checks at all or accept checks only from known customers. Yet the voluntary acceptance of debit cards by merchants has grown exponentially, despite the existence of interchange fees. Why? It is because debit cards provide significant and measurable *functional* benefits to merchants that are not associated with checks, including the assurance of payment.

Debit (and credit) cards permit merchants to operate with fewer employees; they enable merchants to offer self-service checkout and they speed transaction time for other sales, when compared to paper checks. Finally, merchants receive prompt crediting of debit card payments and don't have to bear the costs associated with check fraud or pay third party check verification/guarantee fees. All of these are *functional* differences between checks and debit cards that should have been considered and assigned a value in the Proposal. We suggest that in order to be complete, the Board's analysis of the functional similarities between debit cards and checks must take into consideration the average cost to merchants to accept and process checks.

The Proposal's Definition of Incremental Costs

The Proposal defines incremental costs to include average variable costs associated with a transaction. This definition is unduly narrow, even when considered in connection with the restrictive language of Section 920, because it fails to take fixed costs, even fixed costs that are solely attributable to debit card transactions, into account. Moreover, the proposal does not include provision for additional costs to issuers to implement of the network availability and routing provisions of EFTA Section 920(b).

Section 920(a)(5) provides that the Board must establish standards for issuers to make adjustments to interchange fees for costs associated with debit card-related fraud prevention pursuant to standards to be adopted by the Board. However, the Board has indicated that it will not issue rulemaking related to recapture of fraud related costs at this time. Instead it solicited comment on issues related to fraud-prevention and indicated that it will issue proposed rules related to fraud-prevention costs at a later date. The Board's interchange rules should include provisions for issuers to recover fraud prevention costs, even if these costs must be estimated.

The proposed 7-12 cent per transaction price cap, combined with no provision for recovery of fraud related expense, would permit issuers to recover only a fraction of the costs associated with operating a debit card program. Unfortunately, these costs don't disappear. They will either be shifted to the issuers' customers- namely consumers – in the form of higher fees, or issuers will have to recoup the expense in other ways, such as by reducing staff, closing branches, and reducing or eliminating investment in branches, technology and products.

Consultation with other agencies

The supplementary section of the Proposal contains no mention that the Board consulted with any of the agencies listed in Section 920(a)(4)(C) prior to issuing the Proposal. A complete analysis of a matter of this significance would appear to us to require the Board to consult with agencies with oversight responsibility over those most likely to be harmed by this rulemaking, namely issuers and consumers.

The Proposal would set price controls based on limited and inadequate information

Even if Section 920 had authorized the Board to establish price controls based on average costs, the method used by the Board in determining average costs for purposes of the Proposal is seriously deficient. The 7-12 cent price cap was determined based on debit card processing cost estimates provided by 89 issuers of debit cards in response to a survey provided by the Federal Reserve. The responders represent approximately 75% of issuers with assets greater than $10 billion, but only a tiny fraction of the thousands of issuers who will be affected by the price controls, should they be implemented. As the Board acknowledged in the Supplementary Information that accompanies the Proposal, even among the small subset of issuers that responded to the survey, not all responders were able to provide detailed cost data concerning authorization, clearance and settlement costs associated with debit card transactions. In addition, there were inconsistencies in approach to reporting the data and a wide range of cost estimates were reported.

Moreover, by setting a fixed price cap, rather than establishing standards based on actual costs, the Board provides a disproportionate benefit to the largest debit card issuers, which can take advantage of economies of scale not available to smaller issuers. These very large debit card issuers are also issuers of credit cards and can mitigate to some extent the impact of debit card fee restrictions by providing incentives to customers to use credit cards rather than debit cards for purchases.

We recognize that Section 920 provides a very short time period for the Board to adopt regulations with respect to interchange fees. As a result, the Board may not have been allowed sufficient time to gather the information necessary for a complete and accurate understanding of the interchange cost structure. Given the impact of this rule-making on issuers and their customers and shareholders, however, we believe that the Board should not make any final determination with respect to interchange costs, much less establish formal interchange price controls, without further inquiry and analysis.

The Proposal will bring debit card innovation to a halt

The Board states that by creating "safe harbors" below which a transaction will be deemed to be reasonable and proportional, issuers will be incented to innovate and to become more efficient. This might be true if the Proposal offered issuers the opportunity to earn a reasonable return on their investment in new technology or systems. Unfortunately, the Proposal does nothing of the kind. It permits issuers to recoup only a small subset of debit card related costs; it certainly does not permit recovery of costs associated with creating and implementing new technology.

Under the pricing system contemplated by the Proposal, the costs associated with technological innovation will be borne by the issuer[1], while any cost savings that may result from such innovation will ultimately be enjoyed by merchants in the form of still lower interchange fees, as the amount of the interchange safe harbor is reset from time to time to reflect changes in cost structure. As noted in the Supplementary Information,

[1] Except, at some unspecified point in the future, some costs related to fraud prevention.

"[t]he Board recognizes that issuers' costs may change over time, and the Board proposes to...re-examine the cap amount periodically in light of changing issuer costs." Since the statute requires that costs always be "reasonable and proportional," the cap will be decreased over time to reflect cost savings resulting from technological innovation.

The Proposal does not allow issuers either to recoup the fixed costs associated with implementation of new technology or to benefit from any increased efficiency that might result. Thus innovation would serve only to further increase issuers' costs and make the debit card product even more unattractive from a business and competitive point of view. This result will be harmful to consumers, who have benefitted from debit card innovation and the safety and convenience associated with the use of debit cards compared to cash and checks.

Network availability and routing

Section 920(b)(1)(A) directs the Board to adopt regulations that would prohibit issuers from restricting the number of payment networks on which a debit card transaction can be processed to fewer than two unaffiliated payment card networks. The Board has proposed two approaches to implementing this mandate. Under Alternative A, issuers would have to make two unaffiliated networks available. Under Alternative B, issuers would have to make two unaffiliated networks available for each type of authorization method permitted by the debit card (i.e. PIN or signature debit). Implementation of Alternative B would require issuers to develop and adopt new technology, because multiple networks are not technologically feasible at this time, and would also impose significant other expense, such as costs associated with re-issuance of cards. *None* of these costs would be recoverable through interchange fees, even though the merchant would be the only party to the transaction to derive benefit from the additional choice of networks.

Alternative B would benefit merchants by allowing them more flexibility in determining the lowest cost alternative. As the Board observes, however, issuers often choose to limit debit card volume to one or two networks to "reduce core processing costs through economies of scale; to control fraud and enhance data security...and to eliminate or reduce the membership and compliance costs associated with connecting to multiple networks." Consumers may also be disadvantaged by a requirement that cards be processed over multiple networks, because benefits such as enhanced liability protection, charge-back rights and insurance protection may be available only through a specific network.

Thus, multiple networks (i) will not benefit (and may disadvantage) consumers; and (ii) will impose additional costs and risk on issuers that that they will be unable to recoup from merchants. Given this, we believe it is unreasonable to require issuers to assume the costs of making available more than the two networks required by law, as provided in Alternative A.

We concur with the Board's interpretation of the routing provisions in EFTA Section 920(b)(1)(B) as permitting routing only over networks that are already available.

Conclusion

Thank you for the opportunity to provide our perspective on the Proposal. We recognize that the language of EFTA Section 920 requires the Board to adopt and implement debit card rulemaking over a very short period of time and we appreciate the Board's willingness to receive and consider our comments.

Very truly yours,

John P. Barnes
President and Chief Executive Officer
People's United Bank