Massachusetts Bankers Association

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
RIN No. 7100 AD63

Dear Ms. Johnson:

On behalf of the Massachusetts Bankers Association's (MBA) more than 190 commercial, savings, cooperative banks and savings and loan associations in Massachusetts and New England, we appreciate the opportunity to comment on the Federal Reserve's proposed rule regarding Debit Card Interchange Fees and Routing. This proposed rule implements Section 1075 of the Dodd-Frank Act (DFA), which adds a new Section 920 to the Electronic Funds Transfer Act (EFTA). MBA is extremely concerned with the affect the proposed rule will have on depository institutions of all sizes, and believes the Fed should withdraw the rule for further study of its unintended consequences.

General Comments

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." The law 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.

MBA believes that the Fed's proposed rule represents an unprecedented form of price controls between two industries that will have long-lasting unintended consequences for consumers, small businesses and local banks in Massachusetts. While the proponents of the provision claim that banks under $10 billion in assets are exempt from the Fed's regulation, we do not believe that this provides any protection to smaller institutions. Market forces will compel banks to adopt the same price level or risk losing market share to the largest institutions. The Fed's proposed cap on fees and the price differential between large and small institutions will provide merchants with strong incentives to steer customers to cards that are subject to the price controls in the regulations – driving customers away from smaller banks to larger ones. This will lead to artificially lower interchange rates for all institutions – not just those directly subject to the regulation.

Unfortunately, these price controls ignore the fact that bank customers have come to expect debit card access to their checking accounts, and banks both large and small must respond to this demand. However, by issuing debit cards and using and maintaining the electronic payment network, institutions incur significant costs. Interchange revenue helps offset some of these costs, particularly for smaller institutions, and allows banks to offer these products at the lowest possible price

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Price Controls on Debit Transactions

The Fed's proposed rule of December 16, 2010 suggests two alternative approaches to implementing the "reasonable and proportional cost" provisions of the law. Unfortunately, both of these alternatives go far beyond the statute and impose federally mandated price controls on interchange services based on the Fed's extremely narrow definition of "allowable costs."

The first alternative would allow debit card issuers to determine the interchange fee by calculating its "allowable costs" for interchange fees and dividing these by the number of transactions. However, all issuers under this scenario would be subject to a cap of 12 cents per transaction – regardless of the actual cost of providing these services. Issuers could avoid performing the cost calculations if they agreed to a cap of seven cents or less per transaction.

Under Alternative 2, networks may set fees that vary with the value of the transaction, as long as no interchange fee exceeds 12 cents. Payment networks could also establish different interchange fees for different types of transactions or different types of merchants, however all transactions would still be subject to the 12 cent cap. Banks would not be required to calculate costs under this alternative.

Neither proposed alternative differentiates between different types of transactions, such as PIN, signature, or prepaid cards, regardless of the costs associated with those transactions. In addition, only variable costs associated with the issuer's role in authorization, clearance and settlement of debit transactions can be included in interchange fees -- fixed costs are not included, even if they are attributable only to debit card transactions.

The Fed's proposal for implementing Section 920 goes far beyond the language in the statute, which 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. The law does not explicitly authorize the Board to set interchange prices and it does not require the Fed to evaluate whether the costs themselves are reasonable, only to develop a system to determine whether the fees charged bear a reasonable relationship to the actual costs.

The Rule Should Reflect all the Factors in the EFTA

The statute includes several factors that the Fed must consider when developing the interchange fee regulations. These include:

1) The functional similarity between electronic debit transactions and checking transactions;
2) Distinguishing 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
3) Consulting with the banking regulatory agencies, as appropriate.

Similarities between Debit and Check Transactions

MBA believes that the Fed's proposal falls short in all of these areas. Specifically, the law directs the Fed to consider the functional similarities between check and debit card transactions, which we believe requires the Fed to consider how a debit card transaction functions in its entirety and to compare this to a check transaction.

However, the proposal is focused almost entirely on the authorization, settlement and clearing process of the check transaction. While checks clear at "par" between the two parties to the transaction, 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 refuse to accept checks at all. Many of these same businesses, however, have encouraged consumers to use debit cards, even with current uncapped interchange fees. This is because debit cards provide significant and measurable benefits to merchants that are not associated with checks, including guaranteed, prompt crediting of payments, and the lack of liability and costs associated with check fraud. In addition, card payments allow merchants to serve customers more quickly, increase sales volumes, reduce labor costs through self-service options, provide Internet commerce, and offer merchants the option of cash discounts. None of these benefits of accepting debit cards was analyzed by the proposed rule.

Fraud Prevention Adjustment and Definition of Incremental Costs

The proposal also defines incremental costs in such a narrow manner that it fails to consider fixed costs, even costs that are solely attributable to debit card transactions. In particular, the statute provides that the Fed may allow for an adjustment to the interchange fee amount received or charged if the issuer complies with fraud-prevention standards established by the Federal Reserve.

We are disappointed that the proposal does not contain provisions to implement the fraud prevention adjustment. Instead, the proposal asks for comment on technology-specific and non-prescriptive approaches to fraud prevention. After reviewing the comments, the Fed will propose regulations regarding the fraud adjustment; however, these regulations will likely not be adopted by the July 22, 2011 mandatory effective date of the interchange rule.

The Association strongly believes that the final rule must contain provisions for issuers to recover fraud prevention costs. Here in Massachusetts, a number of large retailers, including BJ's Warehouse, TJX, and Hannaford Supermarkets, have lost customer payment information in data breaches. Many times these breaches are due to lax security standards and procedures at the retailer. Unfortunately, it is the bank, not the merchant that is responsible for making consumers whole and absorbing the cost of issuing new cards, offsetting fraud losses, and providing customer service assistance to affected customers.

The proposed 7-12 cent per transaction price cap, combined with the lack of a fraud adjustment provision, would permit issuers to recover only a fraction of the costs associated with operating a debit card program. Instead, banks may be forced to impose additional fees on their own customers to cover the costs of data breaches at merchants.

Consultation with Federal Banking Agencies

The proposal does not indicate that the Fed consulted with any of the agencies listed in Section 920(a)(4)(C). Particularly given the limited implementation timeframe required under the statute, a more thorough analysis that included the expertise of the banking agencies seems warranted.

Network Availability and Routing

The statute also requires the Fed to write regulations to prohibit an issuer or payment card network from restricting the payment card networks on which a debit transaction may be processed to one network or to one network and affiliated networks. It also prohibits an issuer or payment card network from directly or indirectly inhibiting any person that accepts debit cards for payment from directing the routing of a debit transaction through any network that may process that transaction (merchant routing restrictions).

In order to implement this provision, the Fed is seeking comment on two alternative approaches regarding the prohibition on network exclusivity:

A. **Unaffiliated networks include different networks for PIN and signature transactions**. An issuer or payment card network may not restrict the number of payment card networks on which a debit transaction may be processed to less than two unaffiliated networks. An issuer could comply, for example, by having one payment card network available for signature transactions and a second, unaffiliated payment card network available for PIN transactions.

B. **Unaffiliated networks include two networks each for PIN and signature transactions.** An issuer or payment card network must have at least two unaffiliated payment networks available for processing a debit transaction for each method of authorization available to the cardholder, that is, two unaffiliated payment card networks for PIN transactions and two unaffiliated payment card networks for signature transactions.

MBA believes the Fed should adopt alternative A in implementing the routing requirement. Alternative A limits the expense of managing unneeded relationships with additional networks and increases the number of PIN network routes available for merchants. Alternative B would require our member institutions to manage multiple PIN network relationships, creating costs with little benefit for consumers.

Alternative B would require multiple signature networks be deployed on one card. This is impractical as currently the signature card payment systems do not support such a choice. This could mean that banks would be forced to re-issue cards in many cases, an unnecessary expense and an inconvenience to customers.

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 impose significant expenses, such as costs associated with re-issuance of cards.

Alternative B would benefit only merchants while disadvantaging consumers, since many benefits such as enhanced liability protection, charge-back rights and insurance protection may be available only through a specific network. Finally, we would note that the proposal does not allow banks to recover any of the costs of managing multiple networks through an increase in interchange fees, even though the merchant would be the only party to the transaction to derive benefit from this requirement.

Conclusion

The average checking account costs a bank approximately $250 a year to operate. Debit card interchange revenues offset a portion of these expenses. If the Fed finalizes the proposed rule without substantial changes, banks of all sizes will be faced with difficult choices, including abolishing free checking, increasing current checking account fees, imposing an annual fee on debit cards, or limiting other services that customers have come to expect. Separately, since the big box retailers that benefit most from this rule are not required to pass along any of the cost savings to consumers, their increased profitability will only serve to make local small businesses less competitive.

Thank you again for the opportunity to comment on the proposal. If you have any questions or need additional information, please contact me at (617) 523-7595 or via email: jskarin@massbankers.org.

Sincerely,

Jon K. Skarin
Director, Legislative & Regulatory Policy