American Bankers Association
Building Success. Together.

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By electronic delivery to regs.comments@federalreserve.gov

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
Debit card interchange fee and routing proposal
Regulation E, Electronic Fund Transfers Act
75 *Federal Register* 81722, December 28, 2010

Dear Governors and Staff:

ABA appreciates the opportunity to comment on this extremely difficult and payment system-altering proposal to implement the debit card interchange and routing provisions of Section 1075 (debit card amendment) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) provisions. Those provisions require the Board of Governors of the Federal Reserve System (Board) to "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." In addition, the Board must prescribe regulations prohibiting issuers and networks from restricting the number of networks over which a debit card transaction may be routed and from inhibiting the ability of a merchant to direct the routing of a debit card transaction as long as that payment network that may process those transactions.

ABA recognizes the Board's challenges in promulgating a regulation due to the severe shortcomings of the statutory language and the lack of evidence of Congressional intent, given lack of hearings on the amendment[1] or on debit card interchange fees, as well as the last minute attachment of the amendment to the Dodd-Frank Act. That bill otherwise has no connection to this issue. We appreciate the good faith and hard work reflected in the proposal, especially given the extreme time constraints of the statute, but believe that the proposal is seriously flawed and inconsistent with the statutory language. ABA has joined with other trade associations to set out in detail the arguments to support this position in a joint trade association letter dated February 22, 2011 (joint letter). In that letter, we stress that the Board should:

- Exclude from the regulation any debit card interchange fee cap as the statute does not authorize such a cap;

- Adopt a standard for assessing whether interchange fees are "reasonable and proportional to the cost" incurred by issuers that allows them to recover their actual costs (with limited exclusions as provided in the statute) plus a reasonable return on their costs as provided in the statute and provide an alternative safe harbor for those who wish to avoid the administrative burdens of such a calculation;

- Use its statutory authority to expand the list of "allowable costs" for assessing fees to include costs related to fraud losses and fraud prevention costs, customer service costs including customer inquiries, and payment network fees, as the statute anticipates and policy requires; and

- Adopt the proposed Alternative A's more flexible and workable network exclusivity provision which allows issuers to comply by having one payment card network available for signature transactions and one unaffiliated network available for PIN transactions initiated at point of sale.

We also echo the joint letter that a limit on fees would be "confiscatory," constituting a violation of the Takings and Due Process Clauses of the Fifth Amendment to the United States Constitution. Consistent judicial precedent provides that a limit on rates is confiscatory under the Constitution unless it provides for a recovery of costs *and* a reasonable return. In addition, we stress that the statute must be read as a whole. Accordingly, "excluded costs" must be limited so as to be as consistent as possible with the operative provisions of the debit card amendment, which provides for the issuer to receive *all* costs incurred *with respect* to the transaction *and* a rate of return. Finally, under Section 904 of the Electronic Fund Transfers Act (EFTA), the Proposed Rule must minimize harm to consumers, particularly low-income consumers, financial institutions, and the payments system.

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1 There were no hearings on the debit card amendment specifically nor on debit card interchange fees generally, though there were hearings on *credit card* interchange fees. In addition, neither the Board nor any other government agency was asked to testify regarding the impact of the debit card amendment.

This letter will highlight and amplify select topics.

POTENTIAL ADVERSE IMPACT OF PROPOSED RULE

Regardless of how the Board ultimately implements the interchange fee provision of the debit card amendment, the rule will have unintended consequences adverse to consumers, banks, merchants and businesses, and the payment system. These include a decrease in free and low-cost checking account services and disruption of a valued, safe, efficient, and reliable payment system. The rule may also lead to a gradual reduction in the quality level of fraud prevention and a shift of fraud losses back to merchants and businesses that causes a negative change in the customers' debit card use experience. We are also concerned that the rule will chill innovation and investment in payment system products. The Board should also recognize in finalizing the rule that small institutions will be significantly impacted notwithstanding a technical exemption for institutions with assets less than $10 billion.

Accordingly, in interpreting the rule the Board should use the authority the statute provides it to minimize these adverse unintended consequences by expanding costs card issuers may recover through the interchange fee. In addition, when determining what costs debit card issuers may recover, the Board should not overlook the fact that merchants and businesses may in effect avoid paying interchange altogether by offering discounts for non-card payment methods.

One of the most troubling aspects of the proposal is its impact on the availability of free and low-cost checking accounts that are supported by interchange fees and that are particularly important to low and moderate income individuals. The final rule should seek to minimize this impact.

Basic economic theory holds that for businesses to be successful long term, revenue has to exceed expenses. If the government eliminates or restricts a source of revenue, that lost revenue has to be made up either through higher prices or through fewer services. As the Board anticipates, financial institutions will make up the income lost from interchange fees through other means such as increased bank customer fees.[2] Thus, we can expect banks to recover some of the lost income through checking account-related fees, whether they are monthly maintenance fees, debit card and debit card transaction fees, or other fees. In addition, to reduce costs and uncompensated risk, debit card transactions may be restricted, e.g. , by amount or by number of transactions per month, because issuers will be unwilling to accept the risks associated with large transactions absent adequate compensation. Some accountholders may find themselves ineligible for a debit card.

2 "The Board notes that even the highest-cost issuers have sources of revenue in addition to interchange fees, such as cardholder fees, to help cover their costs." (75 Fed. Reg. 81737).
"[T}he Board also recognizes that issuers have other sources, besides interchange fees, from which they can receive revenue to help cover the costs of debit card operations." (75 Fed. Reg. 81736).

Most impacted will be low and moderate income account holders who are unwilling or unable to pay those fees or ineligible for a debit card under stricter eligibility rules, in effect, pushing them to non-traditional financial providers such as check-cashers and requiring them to carry and protect large amounts of cash. This result is contrary to the efforts and goals of policymakers and regulators to move people *into* the bank system, as recently evidenced by the FDIC's adoption of its "Templates for safe, low-cost transactional and basic savings accounts."[3]

In addition, in finalizing the rule, the Board should be sensitive to disrupting an efficient, reliable, and safe payment system that is valued by merchants and businesses and their customers. Debit cards promote commerce by facilitating a safe, quick, easy-to use payment mechanism usable in-person, online, and by phone from and to locations around the world. Consumers avoid the inconvenience and dangers associated with getting and carrying large amounts of cash and the inconvenience of carrying and using checks – where those checks are still accepted. Furthermore, the final rule should encourage, not discourage, fraud prevention, investment, and innovation by ensuring that issuers recover their costs and have the incentive of a return on their investment.

It is also critical that the Board take into account the impact the rule will have on smaller institutions, notwithstanding the technical exemption for institutions with assets under $10 billion. As discussed in our joint letter, Congress recognized that the statute would adversely impact small issuers and provided the exemption. However, as our community bank members advise us, they believe that any protection for such banks is highly speculative at best. To start, while one network has stated that it has the ability to provide a two-tiered pricing system, others have not yet indicated that they are able and willing to support a two-tiered pricing schedule. Even if they are able to support such a schedule, there is no reason to believe that current interchange rates will be maintained for exempt institutions or that any differential will be meaningful. Ultimately, economic forces tend to drive business to the lowest price, and there is little reason that interchange fees will be the exception. During his recent testimony before the Senate Banking Committee, Chairman Bernanke explicitly recognized these serious threats to the effectiveness of the exemption.[4]

Finally, when determining what costs debit card issuers may recover, the Board should not overlook the fact that merchants and businesses may, in effect, avoid paying interchange altogether by offering discounts for non-card payment methods, including cash and checks as

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3 See http://www.fdic.gov/consumers/template/background/.

4 Sen. Banking Tr. at 18 ("We are not certain -- and I think this is something we are trying to better understand through the comments and through our outreach -- we are not certain how effective that exemption will be. It is possible that because merchants will reject more expensive cards from smaller institutions or because networks will not be willing to differentiate the interchange fee for issuers of different sizes, it is possible that that exemption will not be effective in the marketplace. It is, after all, allowable and not a requirement. And so there is some risk that that exemption will not be effective and that the interchange fees available to the smaller institutions will be reduced to the same extent that we would see for larger banks.")

well as other emerging payment system competitors and online options. Some merchants, such as gas stations, have done exactly that by offering gas at discounted prices for cash transactions. Merchant discounts permit the customer to decide whether they want to pay for the convenience of debit cards. Merchants and businesses may also avoid interchange fees by choosing not to offer the card option to their customers. These merchant options put competitive pricing pressure on interchange fees to ensure a competitive market. Indeed, fast food restaurants and grocery stores, for example, have successfully negotiated lower interchange fees.

For these reasons, we strongly recommend that the Board use its authority to ensure that issuers are permitted to recover their costs and a reasonable return. In any case, the Board should expand its proposed list of allowable costs.

DISCUSSION OF THE BOARD'S FLAWED RATE-SETTING ANALYSIS

The par value analogy should expand, not narrow, the costs that should be reflected in the interchange fee.

As the Board notes, it must consider certain factors in establishing standards for assessing fees. One factor is "the functional similarity between (i) electronic debit transactions; and (ii) checking transactions that are required within the Federal Reserve bank system to clear at par." The Board relies primarily on the fact that checks cleared through the Federal Reserve System clear at par and, without further explanation, determines that allowable costs exclude any issuer's costs that a payor bank in a check transaction would not recover (except for recovery of authorization, clearance, and settlement costs as specifically allowed in the statute).

Given the statute's mandate to consider functional similarities between debit transactions and check transactions, the Board proposes that allowable costs be limited to those that the statute specifically allows to be considered, and not be expanded to include additional costs that a payor's bank in a check transaction would not recoup through fees from the payee's bank.[5]

In other words, the Board simply concludes that because banks paying checks through the Federal Reserve System pay at par,[6] issuing banks paying debit card transactions should also pay at par (except for authorization, settlement, and clearance). Some of the functional similarities and differences are discussed in the Supplemental Information, but do not appear to be considered. Moreover, in discussing functional similarities and differences, the Board adopts an overly narrow meaning of "functional" and dismisses or overlooks many of the key functional features that distinguish debit cards from checks. It also ignores other factors the statute permits it to consider.

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5 75 Fed. Reg. 81735.

6 The par value rule requires the entity presenting the check not the entity depositing it to be paid at par.

There are a number of reasons that the Board's reliance on its analogy to par value check clearing is misplaced and inappropriate. First, the history and reasons for the Federal Reserve System's par value rule do not apply to debit cards. Second, the par value rule is limited to checks processed through the Federal Reserve System. Third, there are important legal and structural distinctions between the two payment systems. Finally, the analysis fails to recognize key functional differences between the two payment methods.

The basis of par clearing within the Federal Reserve System was to create a subsidy for check clearing to facilitate check transactions. In effect, it was intended to speed check processing in order to facilitate commerce. Prior to the Federal Reserve System's entry into check processing, checks were being processed through circuitous routes in order to avoid check presentment fees. This delay in check processing and uncertainty about payment inhibited and slowed commerce. To speed up check collection and increase the number of check transactions – and therefore facilitate commerce -- the Federal Reserve System promoted par value.

Clearly, this is not the situation with debit cards. There are no complaints that the debit card system is too slow or is inhibiting commerce. To the contrary, all agree that the debit card system is enormously successful precisely because it is quick, efficient, and reliable, and it very much facilitates commerce, including international and online commerce. As noted, the par value promotion was intended to increase transactions, not inhibit or reduce them as the proposal will for debit card transactions.

Furthermore, the par value rule, established by the Federal Reserve System, only applies to checks processed through the Federal Reserve System. Checks processed outside the Federal Reserve System may or may not be subject to other par value laws or agreements. Thus, the Federal Reserve System and its par value rule for checks cleared through its own system is more akin to a debit card payment system network and its pricing rules. In both cases, participants choose to use the entity (that is, the Federal Reserve System or debit card payment network) and agree to the rules, including pricing rules. Accordingly, the par value model argues for allowing card payment networks to set their own rules and prices for participants who join the network voluntarily, just as the Federal Reserve System sets rules for banks and others who choose to use its system for check clearing.

In addition, any analogy between checks and debit cards must recognize important legal and structural differences between the two payment systems. For example, checks have a legal existence by themselves and legal rights and liabilities attach to each party in check transactions through the Uniform Commercial Code. In contrast, the debit card has no independent legal existence and does not function outside a private network. Unlike checks, debit card disputes between merchants and banks are resolved strictly through network rules rather than by payment laws. In addition, as the Board observes, to receive payments for checks, the merchant need only have an account at any bank that processes checks. In contrast, the merchant must choose to join the card network and agree to card network rules.

The proposal also fails to acknowledge major and minor differences between the debit card and check processing systems that demonstrate that the two systems are fundamentally different both, in function and services.

First, the Board seems to adopt an overly narrow meaning of "functional" and dismisses or overlooks key functional differences between checks and debit cards. It seems to limit the meaning of "functional" to the physical processing and movement of transactions within the very limited confines of banks and merchants, when neither the statute nor common meaning of the term do. We believe the Board should consider not only limited processing differences, but also how each payment channel functions, that is, performs.

Second, the Board limits its analysis of functional similarities to the bank and merchant perspective, when it should also consider the consumer perspective as to how each payment channel functions – or performs -- as this affects each channel's cost and its value to both business and consumers, and therefore its pricing structure. The inter-relation of costs and benefits to both consumers and merchants is axiomatic to the two-sided markets represented here. The chart below describes those differences.

Differences between checks and debit cards

Function	Checks	Debit Card
System characteristics	Merchant need only have account at any bank that processes checks.	Merchant must choose to join network.
Guarantee payment/Payment authorization	Check may be returned for any reason: account closed, nonexistent account, insufficient funds, stop payment by customer, counterfeit or altered check. If check is returned, merchant accepts any loss and potential collection costs. Merchants may purchase check verification or check guarantee services." Requires record of customer information, e.g., name, address, phone number, driver's license number. Guarantee services involve substantial fees, e.g. 25¢ plus 1% to 1.5%, are not available to all merchants, and may have check amount restrictions.	If authorization procedures are followed, merchant is generally guaranteed payment for in-person transactions even if fraudulent.

Function	Checks	Debit Card
Acceptance	Checks are not accepted at many merchant locations. Checks are generally not accepted outside the U.S. Non-U.S. checks are more difficult for U.S. merchants to accept. Foreign checks may be subject to lengthy collection process.	Debit cards are widely accepted at merchants and businesses, including those outside the U.S. Cards of non U.S. accounts are acceptable regardless of currency or country of issuer.
Internet use	Generally, checks not a payment option for online transactions.	Debit cards are widely accepted online, though merchant may not be guaranteed payment.
Merchant fee	Merchant directly or indirectly pays bank for handling and processing of checks. Merchant may also have to pay employees to count, bundle, transport, and protect from theft and loss. Merchant pays costs related to returned checks.	Merchant pays interchange fee, but may offer discounts for noncash transactions so customer may decide whether to pay for the convenience of paying with cash.
Processing and speed of processing at point of sale	Customer must carry checkbook and use single check for each transaction. Customer must manually fill out check. Check may have to be swiped. Customer must present identification and provide personal information such as address, phone number, date of birth which merchant may record, Requires employee involvement.	Customer swipes card and transaction is completed after approval. Customer usually must sign or enter PIN. Single card used for all transactions. Cards can be used without human intervention, e.g. gas pumps.

Function	Checks	Debit Card
Record keeping	More difficult to trace and sort checks because information is manually inserted: only automated information relates to the bank and account number but neither name of merchant nor customer is electronically available.	Customers, banks, and merchants may trace and sort transactions more easily including by merchant or merchant type.
Process method and availability of payments to merchant	Traditionally paper, but now may be electronic, through remote capture, but merchant pays for that service. Requirement to deposit checks delays merchants ability to use the money to pay bills etc..	Transactions are transmitted electronically, so merchant has quick access to money to pay bills etc.

Close examination of those differences do not support a conclusion that the debit card pricing system should parallel the Federal Reserve System's par value pricing system. Rather they argue for permitting issuers to recover costs and a return on investment.

Payment authorization and guaranteed payment. The Board notes that payment authorization is one of the principal functional differences between debit cards and checks. We agree. However, it is more than simply verifying that there are funds in the account as the Board indicates. If the authorization procedures are followed, for in-person transactions, the business and merchant are generally guaranteed payment even if there is no account or insufficient funds, or the card is counterfeit. In contrast, checks may be returned for any reason: the account is closed or nonexistent; there are insufficient funds in a valid account; the customer has stopped payment on the check; or the check is counterfeit or altered. In these cases, the business may suffer the loss and/or incur returned deposit fees and collection cost.

The Board dismisses this key difference by noting that merchants and businesses can purchase value-added check verification and guarantee services from third-party service providers. However, those guarantee services involve substantial fees. A random review of check guarantee services found that the discount rates range between 1 percent and 1.5 percent of the check amount, the transaction fee between 14¢ and 25¢, and the monthly fees between \$5 and \$15.[7] In addition, check guarantees are not available to all merchants and may be limited to checks under a certain amount. These substantial check guarantee fees and

7 http://www.instamerchant.com/check-guarantee.html
http://www.nobouncedchecks.com/check-guarantee.html
http://www.1nbcard.com/content/check_guarantee_merchant_services.html
http://www.merchantseek.com/checkg.htm

limitations on availability demonstrate that there are significant costs and risks that checks may not be collectible due to fraud and other reasons. Given that there is a clear value for which merchants pay for guaranteed check payments, any analysis of the functional similarities between debit cards and checks paid at par must incorporate the value and cost of guaranteed payment into the permissible interchange fee.[8]

Process method, settlement, and access to funds. The Board observes that settlement time frames are roughly similar for both payment types, with payments settling within one or two days of deposit. But settlement times are determined by the deposit time and while some merchants and businesses are "depositing" checks through electronic remote capture, many do not for a variety of reasons, including lack of eligibility, cost, and inconvenience. Instead, they must physically deposit the checks at a bank location, a necessity which may be delayed by distance, weather, traffic congestion, etc... In contrast, debit card transactions are almost always processed electronically, so that there is no necessity to physically transport the transactions. This means the merchants and businesses have faster use of their money.

Return times. The Board states that the return deadlines for checks are typically midnight of the banking day after presentment to the paying bank, but notes that the payor's bank may have legal remedies in the event of a dispute of financial loss." In fact, payor banks may make claims against checks for a variety of reasons such as warranty violations long after the midnight deadline. Indeed, Section 229.34 of Regulation CC, which implements the Expedited Funds Availability Act, specifically recognizes certain warranty claims, including those based on remotely created checks. In effect, a warranty claim functions as a payment return and the business or merchant may suffer the loss. That period to make a claim may be longer than the period during which debit card transactions may be reversed.

Acceptance. In addition to the differences noted in the Supplementary Information, there are other functional differences that the Board should consider, not only from the bank and merchant perspective but also the consumer perspective. For example, part of how a payment method "functions" is the level of its acceptance, that is, the number and geographic locations of businesses and merchants that will honor it. Checks, even local ones, but especially nonlocal and international ones, are not nearly as widely accepted by U.S. and non-U.S. merchants and businesses as debit cards. This means Americans traveling outside the country are not likely to be able to use checks, and American merchants and businesses are not likely to accept checks drawn on non-American accounts. And even if a business or merchant accepts a foreign check, there are complications associated with currency conversion. In contrast, consumers from around the world may use their debit cards with ease at locations that are local, national, and international, regardless of the location of the card issuer. Currency conversion is automatic

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8 While generally online and other debit card-not present transactions are not strictly guaranteed, they are nonetheless feasible payment options, whereas checks are not an option at all for online transactions.

and uncomplicated. Moreover, debit card transactions are widely accepted online to facilitate local, national, and international commerce. Checks, as a practical matter, are not accepted online.

Ease and speed of use. Related to the level of acceptance and the functional attributes of payment methods is the ease and speed of use of each method. A single check is required for each check transaction. Thus, to make a payment, customers must carry a checkbook and ensure they have a sufficient number of checks for their purchases. They often must manually complete the check information and provide for the merchant's and business's retention, personal information such as address, driver's license number, and telephone number. The customer also must usually provide some sort of identification that also contains additional personal information such as date of birth. The process generally requires significant employee participation. These procedures and processes are integral to how the check functions.

In contrast, for debit cards, customers need only carry a single card for all transactions. They swipe the card and provide a signature or PIN, and the transaction is complete within seconds. Human intervention is unnecessary, so debit cards are usable for automated delivery of merchandise and labor costs for debit card transactions are cheaper for the merchant and business.

Record keeping and retrieval. Other functional differences relate to how merchants, businesses, and customers may use each payment method to research and sort payment transactions, create a payment history, or otherwise collect payment transaction information for record keeping, tax, budget, and other purposes. Debit card transactions, including the name of the payee and date of the transaction, are identified in receipts and on periodic statements. This, along with the electronic nature of debit card transactions, means customers may easily verify, research, compile, and sort their debit card transactions by merchant and merchant type. In contrast, for checks, the name of the payee, for example, is usually not transmitted or recorded in an electronically-usable fashion. Customers may only search for checks transactions electronically by the check number and transaction amount, which limits the ability to sort transactions by payee.

In summary, the significant differences between debit cards and checks outlined above demonstrate how the two payment methods function very differently, from the merchants', customers', and banks' perspective. Many of those differences, which relate to the reliability, efficiency, and ease of use for merchants, businesses, and consumers, are the result of issuers' innovation, investment, and continuing costs. These differences and the issuers' related investment and costs argue against a reliance on the par value rule for checks processed through the Federal Reserve System as a justification to limit interchange fees to the costs of authorization, clearance, and settlement that are specifically recognized in the statute. Rather, these differences and the issuers' related costs illustrate that a price model different from the Federal Reserve System's par value check model, one that permits issuers to recover their costs and a return on investment, is appropriate.

The interchange fee should permit issuers to recover fraud losses and fraud prevention costs to ensure a reliable system and minimize fraud.

While we recognize the tight time constraints of the statute and the Board's obligation to adopt regulations within a short nine months, we strongly urge the Board to include in any interchange fee rule account fraud prevention costs and fraud losses in the calculation. ABA previously submitted a November 8, 2010 letter as well as a November 19, 2010 white paper authored by Edgar, Dunn & Company discussing the reasons for inclusion of these costs in the interchange fee. We also suggested approaches to incorporating these factors, so as to preserve as much as possible the incentive to prevent fraud and invest in new fraud prevention solutions. We encourage the Board to avoid locking in particular technologies or solutions and allow flexibility in fraud prevention solutions to maximize fraud prevention results. We would like to reiterate and expand on the importance and reasons for doing so.

Failure to compensate issuers' for fraud losses and their investment in fraud prevention will discourage investment in and use of fraud prevention solutions, leading to the gradual deterioration of their effectiveness, to the detriment of businesses and merchants and their customers, banks, and the payment system. It will also likely shift back to merchants and businesses responsibility for fraud losses through the elimination of the guaranteed payment and will halt development of guaranteed payment models for online transactions, which thus far have only met with limited success. The consequence is merchants and businesses suffer more losses, and consumers sacrifice some of the convenience and privacy that the anonymity of debit cards currently offers, as merchants and businesses demand and retain more personal information and require more customer actions to make a purchase or payment. Ultimately, commerce becomes more cumbersome and slows, rather than advances to a more efficient, consumer-friendly model.

Finally, it is clear from the legislation that Congress intended for fraud losses and fraud prevention costs to be a component of the interchange fee. The original amendment that passed the Senate contained no provisions related to issuers' recovery of fraud loss and fraud prevention costs. However, two provisions that specifically direct or allow the Board to incorporate into permissible fees recovery of fraud losses and fraud prevention were added in the final bill, a clear indication of Congress's intent that fraud losses and fraud prevention should be factors in the interchange fee rule.

Adjustment for fraud losses.

More specifically, the Board should include in issuers' authorization costs issuers' fraud losses. Under the statute, the Board must consider "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." [9] It is difficult to divorce fraud loss from a particular transaction from its authorization. For example, if a stolen or counterfeit card is used to obtain the issuers'

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[9] Section 920(a)(4)(B)(i).

authorization of the transaction, there is a clear connection and cost to the authorization of that particular transaction: the improper authorization, due to a flaw in the authorization process, caused the loss, and only changes to and investment in the authorization process will prevent the loss in the future.

If the Board disagrees that fraud losses are connected to authorization, it should rely on Section 920(a)(5)(B)(ii)(V) which requires that the Board consider "the costs of fraudulent transactions absorbed by each party involved in such transactions (including consumers, persons, who accept debit cards as a form of payment, financial institutions, retailers and payment card networks)." If the Board is going to depend on the analogy with the Federal Reserve System's par value rule for checks in promulgating the permissible interchange fee, then, at the very least debit card losses should be shifted to the merchant as they are with checks by including issuers' losses in the interchange calculation. As discussed earlier, checks may be returned for many reasons, unlike in-person debit card transactions which are paid so long as proper authorization was obtained. That a debit card transaction may be returned later than a check transaction is no more relevant than the fact that checks and debit cards are authorized, settled, and cleared differently. It is just one more difference between checks and debit cards. The fact is that merchants may suffer 100 percent of the loss for unpayable checks, but may suffer 0 percent, and in any case much less than 100% percent, of the loss for authorized in-person debit card transactions – in part in exchange for paying interchange fees. That some merchants (e.g. online merchants) may at times suffer losses from debit card fraud is irrelevant to the losses incurred by issuers for purposes of determining the permissible interchange fee. Those merchants' losses simply reduce the total of the issuers' fraud losses. The ABA urges the Board to incorporate such factors into the final rule before the rule takes effect, as to do otherwise would reflect an incomplete analysis of cost factors that is inconsistent with sound public policy and has serious repercussions.

Adjustment for fraud prevention costs.

The statute provides that the Board may allow for an adjustment to the interchange fee amount received or charged if:

1. Such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to debit card transactions involving that issuer; and

2. The issuer complies with fraud-prevention standards established by the Board.

The statute requires that the Board take into consideration various factors.

At this time, the Board is not proposing a specific provision to implement an adjustment for fraud-prevention costs. Instead, the proposal sets forth two approaches, a technology-specific approach and a non-prescriptive approach.

Technology-specific approach.

Under this approach, issuers would be permitted to recover costs for implementing major innovations that would likely result in substantial reductions in fraud losses. This approach would establish technology-specific standards than an issuer must meet to be eligible to receive the adjustment to the interchange fee. Under this approach, the Board would identify the paradigm-shifting technologies that would reduce debit card fraud in a cost-effective manner. The adjustment would be set to reimburse the issuer for some or all of the costs associated with implementing the new technology, perhaps up to a cap. Accordingly, issuers and the Board would have to estimate the costs of implementing the new technology in order to set the adjustment correctly. Such technologies could include, for example, end-to-end encryption, tokenization, chip and PIN, and the use of dynamic data.

Non-prescriptive approach.

The alternative approach is to establish a more general standard that an issuer must meet to be eligible to receive an adjustment for fraud-prevention costs. Such a standard could require issuers to take steps reasonably necessary to maintain an effective fraud-prevention program but not prescribe specific technologies that must be employed as part of the program. Under this approach, the adjustment would be set to reimburse the issuer for some or all of the costs of its current fraud-prevention and data-security activities and of research and development for new fraud-prevention techniques, perhaps up to a cap.

ABA strongly recommends the non-prescriptive approach and strongly opposes any cap on recovery of fraud prevention costs.

As outlined in our letter of November 8, 2010 to the Board, the key goals of the fraud adjustment should be:

1. to formulate as a simple a calculation as possible;

2. to preserve as much as possible the incentive to prevent fraud and invest in new fraud prevention solutions; and

3. to avoid locking in particular technologies or solutions and allow flexibility in fraud prevention solutions to maximize fraud prevention results.

It is in everyone's best interest – bank customers, merchants, banks, the payment networks, and policy makers – to minimize payment system fraud and employ effective fraud prevention solutions. It is axiomatic that fraud and fraud prevention solutions are ever-changing and quickly become obsolete as criminals learn to circumvent them. Accordingly, it is critical that the regulation ensure that issuers are compensated for fraud prevention costs to encourage the use and development of effective fraud prevention measures, not freeze prevention solutions, or handicap banks in responding to the latest fraud event or scam by locking in a particular technology or technique. Simply put, encouraging investment in and supporting fraud prevention through compensation means less fraud, which benefits all parties.

A general rule as envisioned by the "non-prescriptive approach" gives issuers flexibility in determining fraud prevention techniques without dictating particular techniques or technology that often quickly become obsolete. Under this approach, it would not be necessary to measure the general value of any particular fraud prevention technique across all institutions. Rather, it recognizes that a single technique or technology may not be the optimal solution for all issuers or circumstances, a critical aspect of effective fraud prevention. Moreover, it recognizes that to fight fraud, issuers have to be flexible, nimble, quick, and imaginative.

In contrast, a government prescribed solution would be more likely to be lagging and ineffective for many institutions. Indeed, the process for determining which solutions qualify for the fraud adjustment would alone compromise the government prescribed solution by giving criminals advance notice so they may more quickly learn how to circumvent them. It is not clear how the Board, which has no direct role in preventing debit card fraud, would be able to identify and judge better the effectiveness and appropriateness of a particular fraud prevention solution than institutions driven by their own self interest, which includes customer relations, reputation, and competition, to find the best solution for their institution and their customers.

We also agree that the general, non-prescriptive approach should allow capture of research and development costs even if a particular solution is not ultimately adopted. There will always be research, tests, and pilots for any new technology and theory that may ultimately not be applied for various reasons. However, the knowledge and insight gained from that research still inform and advance the goal of preventing fraud. Failure to compensate for research and development will chill innovation and experimentation and discourage development of effective fraud prevention solutions.

This general, non-prescriptive approach is similar to the approach found in other regulations such as those implementing the data protection provisions of Gramm Leach Bliley Act 501(b)[10] and the Fair Credit Reporting Act Identify Theft Red Flag provision.[11] The approach

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10 Section 501 of the Gramm Leach Bliley Act requires the banking agencies to establish appropriate standards for financial institutions relating to administrative, technical, and physical safeguards for customer records and information. In implementing this provision, the banking agencies adopted guidelines that provide general direction without mandating specific actions or solutions.

11 Section 615(e) of the Fair Credit Reporting Act requires federal agencies to develop identify theft prevention guidelines and regulations. The implementing regulation provides a requirement that covered institutions adopt an identity theft prevention program designed to identify, detect, and respond to relevant identify theft red flags, but does not include specific red flags or fraud prevention solutions. Rather, the

has worked effectively in encouraging data protection and fraud prevention in a manageable and effective manner.

In addition, as discussed in our November 8, 2010 letter, the fraud prevention adjustment factor should not be limited to solutions that are focused exclusively on debit card fraud prevention. Issuers should be permitted to allocate a portion of the cost fraud prevention solutions that reach more broadly than debit card fraud if those solutions also are designed to prevent debit card. Otherwise, the rule would encourage distortions in how fraud prevention resources are allocated and create silos within fraud prevention departments, which is not the most efficient or effective way to manage fraud. This allocation could be measured, for example, by comparing by channel actual losses and losses avoided.

We note that adjusting for fraud losses and fraud prevention costs will not encourage or tempt issuers to use or retain ineffective solutions or act without regard to whether a loss is incurred. They have strong incentives to prevent fraud in a cost efficient manner even if they receive a general allotment in the interchange fee for fraud prevention costs: (1) the fraud adjustment will not be based on individual issuers' fraud prevention expenses, so the cost-effectiveness (return on investment) of their individual fraud prevention solutions will continue to be measured against their bottom line, and (2) fraud adversely impacts their customer relationship, customers' trust and confidence in the bank, and the bank's reputation.

ABA also strongly objects to a cap on recovery of fraud prevention costs. An artificial cap will only discourage vital investment in fraud prevention to the detriment of all parties, including bank customers, as already discussed.

Dispute and inquiry costs.

The final rule should also incorporate into the permissible fee the cost of handling customer inquiries and disputes related to debit card transactions. Inquiries and disputes are linked to the authorization and clearance of a particular transaction, which as noted earlier, are costs the Board must consider.

Debit card inquiries and disputes related to a particular transaction contest whether the issuer should have authorized, settled, and cleared a particular transaction. Without the authorization, settlement, and clearance process that results in posting the transaction, there would be no inquiry. Inquiries about individual transactions are a natural consequence to the authorization, settlement, and clearance. In addition, an improperly authorized transaction, for example, reflects a shortcoming in the authorization system that should be addressed.

Moreover, the Board itself suggests the minimum standard should be whether the cost "would still be incurred in the absence of debit card transactions" in its discussion of whether

accompanying guidelines provide factors that institutions should "consider." The supplement to the guidelines lists examples of red flags.

fixed costs should be considered.[12] Clearly, there would no cost to a debit card transaction inquiry if there were no debit card transaction.

Network processing fees.

The Board has not included in "allowable costs" network processing fees that issuers pay for each transaction. The Board requests comment on whether those fees should be included.

It is difficult to justify the exclusion of network payment fees from the interchange calculation when the statute generally provides that all costs be included, as outlined in the joint letter and the statute specifically requires the Board to consider "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." [13] The Board itself acknowledges that "card issuers pay such fees to networks for each transaction processed over those networks" and "a particular transaction cannot be authorized, cleared, and settled through a network unless the issuer pays its network processing fees." [14] Network payment fees are clearly related to authorization, settlement, and clearance, as none are possible without their payment, and they are clearly related to a "particular electronic debit transaction."

The Board offers little rationale other than "allowing them to be recovered could put merchants and acquirers in the position of effectively paying all covered issuers' network processing fees,[15] and "because the Board recognizes that if network processing fees were included in allowable costs, acquirers (and by extension, merchants) might be in the position of effectively paying all network fees associated with debit card transactions."[16] However, payment network fees are arguably no different than fees banks pay to various banks in the check processing chain that the bank of first deposit (which sits in position of the acquirer) and, by extension, its customers ultimately may pay, directly or indirectly. Accordingly, they are precisely costs the statute anticipated and provided should be reflected in the interchange fee.

In other words, but for the debit card transaction, the cost would not exist. Moreover, the Board itself suggests the minimum standard should be whether the cost "would still be incurred in the absence of debit card transactions" in its discussion of whether fixed costs should be considered. [17] Clearly, there would be no transaction network processing fee, if there were no debit card transaction.

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12 75 Fed. Reg. 81735.

13 Section 920(a)(4)(B)(i).

14 75 Fed. Reg. 81735.

15 Federal Reserve Board's December 13, 2010 release of proposal (p.5).

16 75 Fed. Reg. 81735.

17 *Id.* at 81735.

PROPOSED NETWORK EXCLUSIVITY AND ROUTING REQUIREMENTS

The proposed rule creating a new EFTA Section 920 requires the Board to implement new requirements regarding the type of networks available on the card and how debit card transactions are routed at the point of sale (POS). Unlike the interchange fee provision, no asset threshold exemption applies to these exclusivity requirements. Accordingly, all banks will be forced to change their business processes and contractual arrangements, regardless of asset size.

The proposed requirements fall into two categories. First, the proposed network exclusivity rule prohibits issuers and payment card networks from restricting the number of networks on which a POS debit transaction may be processed. Second, the proposed network routing rule bars issuers and networks from preventing the ability of any person or merchant from directing the routing of debit cards over any network that can process those card transactions.

Currently, many debit card issuers limit the number of networks by which transactions (both signature and PIN) of their cards may be processed. Most cards limit processing of signature transactions to one network. Limiting the number of networks available for processing minimizes the need for the issuer to negotiate with multiple networks and comply with multiple and varying contracts. These negotiations and contract terms address significant matters including: network security and reliability standards; pricing (including volume discounts), settlement processes; dispute resolution procedures; marketing efforts; customer reward programs; and the size of the network. Negotiations may include consumer benefits such as rewards points, lottery chances, and liability limitations. In addition, a signature network that operates a PIN network may offer preferred pricing or services to issuers if they include that PIN network on their card or if they restrict PIN transactions to that affiliated network. Packaging signature and PIN networks reduces the issuer's costs.

The Board offers two alternative approaches to meeting the statutory requirement to prohibit network exclusivity arrangements on debit card transactions.

The Board should adopt Alternative A of its proposed provisions on network exclusivity arrangements.

Alternative A. The first alternative would require a debit card to have at least two unaffiliated payment card networks available for processing a debit card transaction. Under this alternative, an issuer could comply, for example, by having one payment card network available for signature transactions and one unaffiliated network available for PIN transactions initiated at a point of sale.

This option would require many issuers to add to their debit card a new unaffiliated PIN network to process PIN transactions. Such a transition will be costly and time-consuming because the issuer will be required to add a new relationship with new contract terms related to settlements and dispute resolutions and other points of contact. Card issuers will be required to maintain separate but parallel systems for the processing transactions received from two separate networks. The issuer will also lose any preferred pricing benefit it may have had when its contract was exclusive with one network. Many debit card issuers will incur significant costs associated with complying with Alternative A.

Nevertheless, this option avoids the disruption resulting from a requirement that issuers have two signature networks enabled on each card as Alternative B would require as discussed below.

Alternative B. The second alternative would require a debit card to have at least two unaffiliated payment card networks available for processing debit card transactions for each method of authorization available to the card holder. In other words, the card would have to be enabled for two signature networks and two PIN networks. The Board notes that 6.7 million merchant locations in the United States accept signature transactions and only 1.5 million were able to accept PIN transactions. A requirement that debit card transactions be processed through two unaffiliated signature networks would expand the choice of those merchants. These merchants would benefit from Alternative A by enabling their devices to accept PIN transactions.

If implemented, Alternative B would be extremely disruptive and cause a massive reorganization of the debit card system at the expense of the proposed rule's intended beneficiaries, merchants, as well as issuers. As noted earlier, the current infrastructure does not support two signature networks. Adding a second signature network would require extensive and complex technical changes involving software and hardware updates at the card networks and reprogramming costs for merchant point of sale devices. The process of adding a second signature process would require several years, and the costs would far outweigh any benefit to the consumers or merchants.

In addition, requiring at least two unaffiliated networks for each type of authorization would multiply contract negotiation and management costs. It would also increase costs associated with ongoing transactions with multiple, and ultimately duplicative settlement processes and dispute resolution schemes among the many issues that would now have to be managed against multiple sets of rules and contracts. The problems associated with multiple PIN networks outlined in the prior section will be multiplied if more than one unaffiliated network is required to be placed on each card.

The Board also raises concerns about merchant network choices for merchants that do not accept PIN transactions and in instances where the card only permits PIN transaction. We believe that any harm is minimal and does not justify the costs and disruptions associated with adding a second signature network.

Cards may be grouped into three categories with regard to processing: (1) signature and PIN; (2) signature only; and (3) PIN only. The Board in the Supplementary Information notes that 87% of debit cards fall into the dual use category (that is enabled for signature and PIN networks) while 4% work only on signature networks, and 9% only on PIN networks. Each of these three debit cards is a different product with different underlying costs and pricing. Some may reflect consumer preference, for example, for a PIN-only card, though a dual use card is available.

Many merchants and businesses that do not accept PIN transactions have the option to do so but choose not to. Online merchants also now have the option to accept PIN transactions using new products and receive the benefit of Alternative A.[18] They also have other online payment options to which they may steer customers and avoid "signature" card networks. Thus, because they have a choice of a second network, they presumably are satisfied with their selection of signature-only processing. They will continue to have the option to add PIN processing capability if it makes economic sense for them.

In addition, some consumers prefer and request PIN-only cards. It makes no sense to force consumers to accept the signature option. In addition, for security and underwriting reasons, banks may also limit some customers to PIN-only transactions.

Given customer preferences, the extraordinary disruption, confusion, and costs associated with adding a second signature network and the fact that merchants (including those who choose not to accept PIN network transactions) will continue to have choices, we do not believe that requiring two signature networks is justified as proposed in Alternative B. Accordingly, we strongly endorse Alternative A. ABA also recommends that Alternative A clarify that debit cards that offer only signature network access not be required to enable PIN transactions and that PIN-only cards not be required to be signature-enabled.

The Board acknowledges the massive change and costs that Alternative B would entail if enacted. Both issuers and merchants would absorb those costs. The expense of these technical changes would be borne against the backdrop of a new and uncertain debit card industry model that would distance debit card issuance from network routing, increasing the uncertainty of issuers' revenue and costs. Coupled with the drastic reduction in interchange fees in the proposal, Alternative B creates a very uncertain business environment for banks.

The Board should extend the deadline for compliance to October 1, 2013.

The statute requires the Board to issue the final rule affecting network exclusivity by April 21, 2011, and the Board proposes October 1, 2011 as a potential effective date for compliance with Alternative A. We believe that this date is too early and will increase risk to the debit card

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18 *See, e.g.*, Digital Transactions, February 14, 2011, http://www.digitaltransactions.net/news/story/2925/

payment system, banks, and their customers with little benefit. Adding a new PIN debit card network or replacing an existing PIN debit card network is an enormous and expensive task and doing so in haste will threaten the reliability of the network.

Adding a new PIN network to a debit card portfolio involves a lengthy process that includes:

- Identifying and conducting due diligence review of multiple potential PIN networks;
- Negotiating an agreement with the network regarding service levels, pricing, and other matters;
- Updating all internal bank debit card operations including settlement, dispute resolution, and customer service to allow for a second stream of information from a second network;
- Installing additional fraud detection systems which may not communicate effectively with existing ones;
- Installing new internal software;
- Training employees including customer service representatives; and
- Testing transactions on the new network.

This proposed provision would require approximately 15,000 financial institutions to complete the steps noted above in less than six months. Networks themselves could be overwhelmed by the demand and unable to ensure that all issuers will be able to complete the process by October 1, 2011. Such time pressure also put issuers at an unfair disadvantage with regard to contract negotiations, as networks will use the issuer's legal obligations and short deadline as effective leverage to force concessions from the issuers, increasing issuers' cost, potentially compromising reliability and security, and reducing their service.

Our members advise us that they usually need at least 12 months to complete any systems change of this size. However, given that all financial institutions will be required to make the change at the same time, 12 months is insufficient time to complete the transition and to ensure that PIN debit transactions continue uninterrupted, safe, and secure. The time constraint is amplified by the limited number of PIN networks in existence. Fewer than a dozen national and large regional networks exist to take on the business of 15,000 financial institutions. The burden on the networks will be even greater than the burden on the banks and credit unions.

For the reasons noted above, ABA recommends that the network exclusivity requirements become effective on October 1, 2013, if Alternative A is adopted. Were Alternative B adopted an even later effective date would be required but how much longer is uncertain until more specific information on the extent of the necessary system changes is available.

The rule should permit at least 12 months to add a network in the event of the merger of unaffiliated networks.

The Board seeks comment on a similar issue related to the potential merging of unaffiliated networks. It asks whether 90 days is enough time to negotiate new agreements and establish connectivity with an unaffiliated network to ensure compliance enough if an issuer is compliant under the new rule's Alternative A and subsequently the two unaffiliated networks become affiliated. ABA strongly objects to the 90 day proposal as it is inadequate. ABA recommends that the time period allowed for establishing new connectivity to another network under these circumstances be a minimum of 12 months.

No further clarification of the prohibition against exclusivity arrangements is necessary.

The Board requests comment on whether the proposal prohibiting debit card issuers from entering into exclusivity agreements with payment card networks needs further clarification in the regulation. The Board asks whether the terms of such agreements need to be addressed in the rule or whether the affirmation of the prohibition of network exclusivity enough. We do not believe that further clarification in the regulation is needed.

If adopted, the final rule should be flexible with regard to networks with limited geographic networks.

Under the proposed rule, an unaffiliated network that operates only in a limited geographic network would not comply. However, the Board notes that an issuer would comply if it has one national network and multiple regional networks that are unaffiliated with the national network. ABA recommends that card issuers be considered in compliance if they have established network connectivity with a regional POS network that, in turn, has access arrangements with other payments networks that grant them nationwide coverage.

Non-reloadable prepaid cards and reloadable prepaid cards that are not both PIN and signature enabled should be exempt from the network exclusivity requirements.

The effect of the network exclusivity requirements on prepaid cards requires careful review, given that most are only signature- enabled. The Board notes in the Supplementary Information significant differences between prepaid cards and debit cards. Its research indicates that while 87% of debit cards were enabled for signature and PIN transactions, 4% of debit cards were enabled for signature only, and 9% were enabled for PIN, 74% of prepaid cards were enabled for signature networks only and 1% were enabled for PIN use only. This means that only one quarter of the cards could be used for both types of transactions.

Network exclusivity requirements must be sensitive to prepaid debit card products that only offer one payment channel, either signature or PIN debit, so as not to make the product so prohibitively expensive that the product is eliminated. Earlier, we discussed the significant technical and financial challenges of adding a second signature network to a debit card that make it infeasible to do so.

Single channel cards define themselves as specific products. If a “signature only” prepaid debit card were required to add a new PIN network channel, it would be transformed into a different product with different underlying costs and prices. Similarly, if a “PIN only” prepaid debit card were required to add a new signature network, it would be transformed into a new product with a different infrastructure and different business model.

Another factor that makes application of the network exclusivity requirements to prepaid cards that are not reloadable impractical is that there are a limited number of transactions over which additional costs can be amortized. It does not make sense to spend the resources needed to add new network access to a card only worth $25, $50, or $100 before it is liquidated. The result of such a burden will be that these products will not be available at prices that consumers will be willing to pay. This does not benefit consumers, merchants, or debit card issuing banks.

Prepaid cards that are reloadable and only carry one payment channel option, either signature or PIN, should also be exempt from the requirements. Adding another signature network is impractical to any product as discussed earlier. It would also create a new product that would require an entirely different cost structure. Equally, adding a second PIN channel to a PIN only reloadable card would also add fixed costs that card issuers could not reasonably recover.

ABA recommends that the network exclusivity rules not be applied to any non-reloadable prepaid cards or to any one channel reloadable prepaid cards that offer either PIN transactions or signature authorization, but not both.

Further, these requirements should only apply to prepaid reloadable cards sold after October 1, 2013. This will ensure that debit card issuers who recently updated card stock and disclosure products to comply with the recent CARD Act provisions on gift cards are able to manage down their inventories to avoid more regulation-mandated waste and financial loss.

Healthcare cards should be exempt from the network exclusivity provisions.

In recent years, the use of debit card networks has fostered a much more efficient and secure method of reimbursing consumers than the lumbering process of sending paper checks through the mail. This is particularly true for cards associated with Flexible Spending Accounts (FSAs) and Health Reimbursement Accounts (HRAs). Using these cards, consumers are reimbursed quickly and program administrators have firmer control on the purchases being made. Only signature debit networks have the capability to process these transactions. Healthcare cards are generally signature network only cards.

In older, legacy healthcare reimbursement programs, consumers paid for eligible medical expenses and submitted receipts by fax or by mail for reimbursement. This is slow and puts the consumer at the disadvantage of having to pay for the eligible expenses in advance. A consumer purchasing an ineligible item by mistake will not be reimbursed.

Advancements in payments processing have allowed the industry to address the shortcomings of the old paper-based system. These healthcare cards fund payments for only certain categories of approved medical expenses. Payment is made directly from the healthcare card to the merchant for eligible items. The consumer does not have to advance the funds and wait to be reimbursed.

This improved process is made possible by the product screening capabilities of the Inventory Information Approval System (IIAS). With IIAS technology, the merchant and the card issuer exchange information about the specific items being purchased and the eligibility of each item is validated as part of the transaction authorization. The information exchanged during a healthcare card transaction can only be exchanged on signature networks. PIN networks do not have the functionality to process the data. For example, if a consumer at a drugstore attempts a $100 purchase for prescription medication, the merchant terminal transmits the product identification code to the card issuer and the transaction is approved. If a consumer at the same store tries to buy $100 worth of newspapers and cigarettes, then the transaction is rejected because those items are not identified as eligible healthcare products.

Healthcare card processing is more efficient for the consumer, the merchant, and the benefit provider. The cost of the claims process is much lower and consumers no longer have to pay out of pocket expenses while waiting to be reimbursed.

Healthcare cards provide a unique service that can only be achieved through the use of the signature card networks. PIN networks are not capable of exchanging information to identify products eligible for purchase. Requiring additional PIN networks to be enabled on these cards would add an unnecessary expense with little benefit to a card product that has a specific valued purpose that cannot function on a PIN network. For these reasons, they should be exempt from the network exclusivity rules.

Network Exclusivity Requirements Applicability: ABA Recommendations.

	Debit Card	**Reloadable Prepaid Card**	**Non Reloadable Prepaid Card**	**Healthcare Cards**
Signature and PIN	Covered	Covered	Exempt	N/A
Signature Only	Exempt	Exempt	Exempt	Exempt
PIN Only	Exempt	Exempt	Exempt	N/A

The proposed merchant routing restrictions should be adopted without change.

The statute also prohibits debit card issuers and payment card networks from restricting, by contract or penalty, the ability of merchants to "direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions."[19] The intent was to allow merchants to choose between available networks and not be locked into using a network designated by the issuer or payment card network.

The routing restriction provisions are closely linked with the network exclusivity provisions in this regulation. Increasing the number of networks enabled on a debit card will increase choices for merchants. It is critical that the merchants' choice is limited to networks approved by the issuer and enabled on the card, a fact the Board wisely has recognized.

Debit card issuers select networks to process their transactions for a number of reasons including reliability, security, fraud controls, risk management, and dispute resolution procedures. Cost is another factor considered, but it is taken into consideration with the other factors. A price for a transaction is worthless it if the network is unreliable or unsafe. Debit card issuers understand that security and reliability are important to their customers and will avoid exposing their customers to any unnecessary risk, regardless of the cost implications.

The proposed regulation limits merchant choice to the networks that are enabled on the card by the issuer. This is critical because it prevents merchants from using unknown networks that do not have an established relationship with the issuer from processing transactions. If issuers were compelled to accept transactions from unknown networks, the opportunity for fraud and losses would increase dramatically. Issuers limit transactions to known networks because those networks must meet established security standards and present transactions in an acceptable format that the issuers' systems will recognize. This minimizes transaction errors and allows the issuer to integrate the data into fraud management detection programs to further minimize risk to card holders.

The Board requests comment on whether ATM transactions and ATM networks should be included within the scope of the rule. In addition, if they are included, the Board requests comment on how it should implement the network exclusivity prohibition and routing requirements under the rule. Finally, the Board requests comment on the effect of including ATM transactions on small issuers and whether cardholders would benefit from such an approach.

As the Board noted in its comments, the statute does not include ATM transactions within its scope. However, the Board states that EFTA Section 920's definitions of "debit card," and "electronic debit transaction," could be read to bring ATM transactions within the coverage of the rule since most ATM cards can be used to debit an asset account. In addition, the Board

[19] 15 U.S. C 1693o-2(b)(1)(B).

suggests that since an ATM operator accepts the debit card as form of "payment" to carry out the transaction, the ATM network could be covered by the statutory definition of a "payment card network." Essentially, the Board suggests that the ATM operator should be viewed like a "merchant" in determining whether the rule should apply.

Including ATM transactions and networks within the scope of the rule would be contrary to the intent of Congress and would have severe negative consequences. Although the Board acknowledges that Congress couldn't have intended to include ATM within the interchange restrictions of the statute since the issuer is not the receiver, but rather the payer of interchange in the ATM context, the Board nonetheless suggests that other parts of the rule should still apply to ATM transactions. However, the overall intent of the debit card amendment was to limit interchange. By including ATM transactions, the Board would be doing the opposite of the intent of Congress. Instead of allowing the party paying the interchange to choose the network that would minimize interchange expense, it would allow the party receiving the interchange to route to the network that pays the highest rate.

This result would also be at odds with significant differences between POS merchants and ATM operators. Merchants accept card payments in return for goods and services. Proponents of the debit card amendment argued that allowing the merchant to choose the most cost effective routing system would allow the merchant to pass along the savings to customers or at least to encourage rather than discourage the use of payment cards to buy more goods and services from the merchant. This, in turn, would encourage the continued movement from cash and checks to safer forms of payment and would also promote continued innovation in the area of electronic payments. There is no similar justification in the ATM context.

Finally, ATM operators and merchants behave differently in the way they participate in ATM networks versus POS networks. For example, merchant acquirers generally accept all of the POS networks while ATM operators are more exclusive and participate in nationally accepted networks, like MasterCard, VISA, Amex and Discover, and one or more of the regional networks. Unlike merchants, ATM operators vary significantly with their participation in regional networks like NYCE, PULSE, and STAR. Under the proposed rule, adding an unaffiliated regional payment card network would not satisfy the requirement for an issuer to permit at least two unaffiliated national payment card networks to route their transactions. As a result, card issuers would be faced with the choice of adding three or more regional networks that might cover the nation, along with at least one national network or just opt for the two unaffiliated national networks. Most issuers would obviously find it easier to just participate in the two national networks. As a result, an unintended consequence of the inclusion of ATMs in the non-exclusivity provision would be to impair the ability of the regional networks to compete with the national networks and could very likely result in fewer rather than more choices in the market for ATM network processing.

ABA sees no benefits to small businesses or consumers if the ATM transactions and ATM networks are included in the scope of this regulation. Small issuers who have a large percentage of transactions occurring at foreign ATMs will be forced to pay higher interchange fees on a higher percentage of transactions. Small issuers will also be forced to absorb the expense of entering into new contracts with national ATM networks. Consumers will be negatively affected because there likely will be an increase in ATM fees making it more expensive for them to access their own cash. For these reasons, ABA strongly objects to expanding the scope of the regulation to include ATM transactions and networks.

CONCLUSION

ABA appreciates the Board's challenge, efforts, and hard work in implementing the debit card amendment. Nevertheless, as outlined in detail in the joint letter, ABA believes that the proposal is at odds with the statute. There is no statutory authority for the proposed interchange rate cap. Rather, the Board should, as the statute prescribes, adopt a standard which allows issuers to recover their actual costs (with the limited exclusion as provided in the statute) plus a return on their costs. In any case, the Board should use its statutory authority to expand the list of "allowable costs" for assessing fees to include important costs such as those related to fraud losses, fraud prevention, customer service, and payment network fees.

We are happy to provide any additional information.

Respectfully submitted,

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