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Financing America's Economy

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February 22, 2011

Jennifer J. Johnson
Secretary,
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Notice of Proposed Rulemaking on Debit Interchange Fees and Routing, Docket No. R-1404

Dear Ms. Johnson:

The Financial Services Roundtable (the "Roundtable"[1]) appreciates the opportunity to provide the Federal Reserve Board (the "Board") with its comments on the proposed rule (the "Proposed Rule") to implement Section 1075 (the "Durbin Amendment") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), as set forth in the Notice of Proposed Rulemaking published in the Federal Register on December 28, 2010 (the "Comment Request"[2]). The Roundtable strongly believes that the Proposed Rule is fundamentally flawed and that the Board should withdraw and revise it.

In unprecedented fashion, every major financial services trade association is united in their opposition to the Proposed Rule. The Roundtable has joined with the other trade associations in signing a letter to the Board outlining our specific

1 The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

2 (December 28, 2010).

concerns with the Board's Proposed Rule.[3] The discussion below echoes many of the points stressed in the joint trade letter. For a more in depth discussion of sections I – IV, please reference the joint trade letter.[4] In the Roundtable's view, the themes in the joint trade letter are extremely important. It is critical that the Board understand the seriousness of this issue and the unprecedented negative effects the Proposed Rule will have on consumers and the financial services industry, while equally harming most merchants due to the consequential negative effect on consumer payment options. Additionally, the Roundtable would like to take this opportunity to also respond to the Board's proposals regarding routing and exclusivity. We believe the Proposed Rule raises significant issues that must be addressed before the Board can make any progress towards implementing a comprehensive final rule.

I. Description of the Durbin Amendment

The Durbin Amendment in its current form was introduced on May 13, 2010 as a last-minute addition to the Dodd-Frank Act. There was no serious Senate debate of the Durbin Amendment before it was voted on by the Senate.[5] Further, there were no hearings conducted in the House of Representatives or Senate on the Durbin Amendment before it was signed into law.[6] Additionally,

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3 Joint Trade Comment Letter Signed by (Roundtable, TCH, ABA, ICBA, CUNA, NAFCU, CBA, and Mid Size Bank Coalition).

4 *Id.*

5 Senators Dodd and Durbin were the only Senators to speak on the Durbin Amendment on the floor of the Senate. *See* S3588-90 (May 12, 2010); S3704 (May 13, 2010); S5925-27 (July 15, 2010). Representatives Frank, Kanjorski, Larson, and Brown were the only Representatives to speak on the Durbin Amendment on the floor of the House, and did so only for purposes of emphasizing the exemptions within the amendment for smaller issuers and health care costs. *See* H5235-6 (June 30, 2010); H5254 (June 30, 2010); H5256-7 (June 30, 2010).

6 Although a few Congressional hearings were held on a variety of matters tangential to the payment of debit interchange fees (*e.g.*, federal government payment of interchange fees), there was not a single

there was no analysis presented to either Chamber of Congress regarding the impact on consumers, the overall economy, or the banking system. In brief, the Durbin Amendment was never reviewed or debated publicly during the House-Senate Conference for Dodd-Frank. Thus, because the Durbin Amendment was part of the Senate bill, there was no stand-alone vote on it in the House of Representatives. Former United States Representative Paul Kanjorski (D-PA) summed up the lack of substantive debate when he stated: "Additionally, I continue to have apprehensions about the interchange provisions inserted into this legislation by the Senate. This issue, without question, would have benefitted from additional time and study."[7]

II. The Statutory Mandate

The two operative provisions of the Durbin Amendment, Paragraphs (a)(2) and (a)(3), establish a simple formula. Debit card issuers are permitted to receive a fee for debit interchange transactions that is not greater than the sum of: (1) their costs with respect to the transactions plus; (2) an additional amount that satisfies the Federal Reserve's "standards for assessing" whether that amount is "reasonable and proportional" to those costs. The process for the Federal Reserve to establish standards for assessing "reasonable and proportional" fees consists of three actions: (1) The Federal Reserve must determine the total costs incurred by the issuer with respect to the electronic debit transaction ("Total Costs");[8] (2) the Federal Reserve must determine certain non-specific costs incurred by the issuer that cannot be considered ("Excluded Costs") and deduct Excluded Costs from

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hearing specifically devoted to the Durbin Amendment, nor was the Federal Reserve or any other government agency called to testify regarding the impact of the amendment.

[7] H5238 (June 20, 2010).

[8] §§ 920(a)(2), (3)(A).

Total Costs;[9] and (3) the Federal Reserve must establish standards for assessing whether the fee charged by the issuer is reasonable and proportional to the allowable cost.[10]

In applying this three-pronged approach, there are two key issues for the Federal Reserve to determine. *First*, what costs are Excluded Costs? *Second*, what is the framework for "reasonable and proportional"? We submit that both determinations must be made by the Federal Reserve on the basis of four considerations. First, a limit on fees that would be "confiscatory" constitutes a violation of the Takings and Due Process Clauses of the Fifth Amendment to the United States Constitution. As discussed below, 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. Second, 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 Durbin Amendment. Third, words must be interpreted in accordance with their plain meaning as well as prior statutory and regulatory usage. Fourth, under Section 904 of the Electronic Funds Transfer Act ("EFTA"), the regulation must minimize harm to consumers (particularly low income consumers), financial institutions, and the payment system. The Roundtable submits that the application of these considerations to the rate formula proposed by the Federal Reserve would result in permissible fees substantially higher than those provided for in the Proposed Rule. Conversely, the rates provided for in the Proposed Rule would violate the Fifth Amendment of the Constitution, as described further herein.

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9 § 920(a)(4)(B)(ii).

10 §§ 920(a)(2), (3)(A).

III. Description of the Proposed Rule

The Proposed Rule was released on December 16, 2010. As an initial matter, the Board's proposal appears to assume, without analysis, that the Durbin Amendment requires the issuance of hard price controls on debit interchange fees, rather than "standards for assessing." The Proposed Rule assumes that the Durbin Amendment's instruction to establish a standard for assessing fees that were "reasonable and proportional" to "the costs of the issuer" means that the fees should be no greater than a certain narrow set of the costs of the issuer.[11] The Proposed Rule then explicitly rejects the Durbin Amendment's mandate to consider the "incremental" cost of each debit card transaction when determining standards for assessing whether the fees at issue were reasonable and proportional to the costs of the issuer.[12] Rather, it proposes to use "average variable cost" to calculate the issuer's cost per transaction.[13] In doing so, the Board acknowledged that the Proposed Rule was not considering "costs that are common to all debit card transactions and could never be attributed to *any* particular transaction, (i.e., fixed costs), even if those costs are specific to debit card transactions as a whole."[14] Finally, the Proposed Rule's determination of cost also does not consider an adjustment for fraud loss and fraud prevention costs even though those are explicitly allowed by the Durbin Amendment.[15]

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[11] 75 Fed. Reg. 81,733.

[12] 75 Fed. Reg. at 81,735.

[13] *Id.*

[14] *Id.* at 81,736 (emphasis added).

[15] *Id.* at 81,740.

IV. The Proposed Rule is Legally Defective

The Roundtable believes that the Proposed Rule is legally defective based on four separate and distinct legal grounds. First, the language of the Durbin Amendment requires the Board to set "standards for assessing," but does *not* authorize the government price controls set forth in the Proposed Rule. Second, the Proposed Rule misinterprets the phrase "reasonable and proportional" to mean no greater than a limited set of *costs*, whereas the statute clearly provides for interchange fees that allow for a reasonable return on those costs. Third, the proposal fails to follow the statutory definition of "costs" as "incremental costs." Finally, placing an arbitrary cap on debit interchange fees at 7-12 cents is significantly below what it actually costs issuers to provide debit card services to consumers. Moreover, it does not allow the issuers to make any return on their investment. In fact, the Proposed Rule is confiscatory, so as to violate the Takings and Due Process Clauses of the Fifth Amendment to the Constitution. The Federal Reserve is legally bound to issue rules that avoid such a result.

V. Exclusivity and Routing of Debit Card Transactions

Section 920(b) of the EFTA imposes restrictions on the ability of debit card issuers and payment card networks to agree on the network through which, and the rules under which, debit card transactions will be processed. Specifically, Section 920(b) directs the Board to prescribe regulations concerning the ability of a debit issuer and a payment card network to (1) restrict the number of payment card networks on which an electronic debit transaction may be processed (exclusivity restriction) or (2) inhibit the ability of a merchant that accepts debit cards for payments to direct the routing of those electronic debit transactions over any payment card network that can process those transactions (routing restriction).

a. Exclusivity of Debit Card Transactions

Section 920(b)(1)(A) of the EFTA directs the Board to “prescribe regulations providing that an issuer or payment card network shall not . . . restrict the number of payment card networks on which an electronic debit transaction may be processed to: (i) 1 such network; or (ii) 2 or more such networks which are owned, controlled, or otherwise operated by . . . affiliated persons or . . . networks affiliated with such issuer.” Therefore, this subsection requires a debit card issuer to enable those cards so that transactions may be processed over two unaffiliated payment card networks.

In addressing the exclusivity restrictions of Section 920(b)(1)(A), however, the Board has proposed two alternative approaches. Under the first alternative (“Alternative A”), the Board proposes that “[a]n issuer or payment card network shall not . . . restrict the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks.”[16] Although Alternative A would have substantial unintended consequences, particularly for consumers, community banks and credit unions, this alternative at least is consistent with the plain meaning of Section 920(b)(1)(A).

Nevertheless, the Board has offered a second alternative (“Alternative B”) under which “[a]n issuer or payment card network shall not . . . restrict the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks for each method of authorization that may be used by the cardholder.”[17] Based on Alternative B’s requirement for at least two payment card networks per method of authorization, an issuer that

[16] 75 Fed. Reg. at 81,757.

[17] 75 Fed. Reg. at 81,757.

enables both signature and PIN authorization for its debit cards would be required to enable four (or more) unaffiliated payment card networks on those debit cards—at least two unaffiliated networks for signature transactions and two unaffiliated networks for PIN transactions. Such a result is not consistent with the clear and unambiguous meaning of Section 920(b)(1)(A); that is, no part of Section 920(b)(1)(A) either requires or suggests that the Board should adopt a rule that obligates the enabling of redundant unaffiliated payment networks based on authorization methods.

In addition to its inconsistency with the clear Congressional intent to require a debit card issuer to enable no more than two unaffiliated payment card networks, Alternative B also would impose substantial new cost burdens on debit card issuers, discourage issuers from implementing important innovations, including innovations relating to security and fraud prevention and, ultimately, increase consumer costs and consumer confusion.

Moreover, proposed Alternative B is built upon the outdated premise that signature and PIN are the only two authentication methods currently in use and that these two methods will remain the focus for debit transactions in the future. While the terms "signature" and "PIN" are widely used by the payments industry today, these terms actually encompass a wide variety of authentication methods that have been created to address various specific merchant segments or payment channels, such as internet transactions and the use of key fobs, mobile phones and other devices equipped with Near Field Communication technology, which do not utilize either signature or PIN technology. By locking issuers into an outdated "signature" and "PIN" authorization framework, the Board ignores the rapid innovation that has resulted in industry-wide adoption of alternative authentication methods beyond "signature" and "PIN". Not only would the proposal create disincentives to the development of alternative authorization methods, it could preclude entirely the future introduction of alternative authentication methods.

In addition, the Board's adoption of Alternative B would stifle other forms of debit card innovation and competition among debit card industry participants. Because Alternative B would require at least two unaffiliated payment card networks for each authorization method, any new proprietary authorization method, and related fraud prevention technology, that is only available through one payment network, would be prohibited under Alternative B. Therefore, the bizarre outcome under proposed Alternative B is that such a payment card network would be forced to license or give away its proprietary technology in order to employ that same technology for its own payment network without violating proposed Alternative B. The likely result, of course, is that without the ability to drive consumer preference based on proprietary technology and capture market share, the incentive to invest in such new technology would be greatly diminished, if not eliminated altogether.

Instead, consumers, debit card issuers, payment networks and merchants all would be better served by a regulatory framework that encourages and facilitates innovation and competition, rather than undermining innovation and competition. In fact, the current debit card systems, which provide fast, secure and reliable transactions for both consumers and merchants, were created in exactly such an innovative and competitive environment.

In addition, the adoption of Alternative B would impose even more substantial operational and compliance costs on debit card issuers and payment networks than Alternative A, at the very time that the Board is proposing to restrict the ability of card issuers to recover most of their current costs. The most obvious of these costs, of course, would be the cost to debit card issuers and networks of creating, entering into and maintaining multiple processing network and related contractual relationships and network rules for each authorization method. Not only would these regulatorily-imposed contractual relationships, which likely would never be profitable, create substantial operational inefficiencies with no increased issuer or consumer benefits, the operational costs of implementing systems capable of supporting such operational redundancies could be overwhelming.

While a debit card issuer may currently have the capability of enabling two PIN debit networks on a single debit card, most merchants do not currently have the ability to accept any PIN transactions. Moreover, the functionality to enable multiple signature debit networks does not even currently exist. In order to enable signature debit network redundancy on a single card, millions of merchant terminals either would have to be reprogrammed or be replaced. In addition, in order to implement and maintain multiple signature debit networks on the same debit card, issuers, acquirers, processors and networks would be forced to incur substantial costs to upgrade, replace or even create the technologies necessary to support transaction processing among multiple signature networks.

These substantial cost increases, when combined with the Board’s proposed restrictions on the ability of debit card issuers to recoup most of their existing costs of providing debit card services, and their inability to realize any return, let alone a reasonable rate of return on their investment, would require substantial restructuring of debit card programs. As a result, many consumer benefits, as well as consumer protections such as advanced security and fraud prevention measures, would need to be reduced, if not eliminated entirely. Similarly, debit issuers and payment networks would have no incentive whatsoever to invest in new technologies aimed at improving consumer services and consumer protections.

For all of these reasons, if any exclusivity requirements are to be imposed on debit card issuers and payment networks, the only rational approach for implementing Section 920(b)(1)(A) is for the Board to strictly follow the statutory language by adopting proposed Alternative A, rather than requiring debit card issuers to contract with multiple unaffiliated payment card networks for each authorization method, as would be required under Alternative B.

b. Routing of Debit Card Transactions

Under Section 920(b)(1)(B) of the EFTA, the Board is directed to "prescribe regulations providing that an issuer or payment card network shall not . . . inhibit the ability of any person who accepts debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions." In response to Section 920(b)(1)(B), the Board has proposed that "[a]n issuer or payment card network shall not . . . inhibit the ability of any person that accepts or honors debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions."[18]

In addition, proposed Commentary section 7(b)(1) states that "an issuer or payment card network is prohibited from inhibiting a merchant's ability to route or direct the transaction over any of the payment card networks that the issuer has enabled to process an electronic debit transaction for that particular debit card."[19]

[18] 75 Fed. Reg. at 81,756.

[19] 75 Fed. Reg. at 81,763.

And, proposed Commentary section 7(b)(2) states in subsection (i) that a merchant may not be prohibited "from encouraging or discouraging a cardholder's use of a particular method of debit card authorization, such as rules prohibiting merchants from favoring a cardholder's use of PIN debit over signature debit, or from discouraging the cardholder's use of signature debit."[20] The Supplementary Information accompanying the Proposed Rule also states that under these proposed comments, for example, a merchant could block the use of signature debit altogether.[21] Therefore, unlike current practices where a merchant can steer an electronic debit transaction to an available payment network, but cannot exclude specific functionality associated with a debit card (*i.e.*, PIN or signature debit functionality), the Proposed Rule would permit a merchant to do exactly that. In doing so, the Proposed Rule would permit a merchant to inaccurately represent to consumers, in its media ads or through its store signage, that the merchant accepts debit cards displaying the brands of popular debit card networks when, in fact, the merchant has no intention of processing debit transactions over those networks. Moreover, such conduct would be inconsistent with Section 920(b)(2), which states that "in the case of a discount or in-kind incentive for payment by the use of debit cards, the discount or in-kind incentive [should] not differentiate on the basis of the issuer or the payment card network."

Even more troubling is the fact that the Board's proposal would permit merchants to override consumer choice as to how a particular debit transaction will be handled. There is no requirement, or even suggestion, in the statute that Congress intended such an anti-consumer result. To the contrary, regardless of what approach the Board determines to take on routing, the primary rule for how a

[20] 75 Fed. Reg. at 81,763

[21] 75 Fed. Reg. at 81,752.

transaction is routed should be consumer choice, and a merchant choice should only apply in the absence of consumer choice. In this regard, there are many reasons why a consumer might choose a signature debit transaction over a PIN debit transaction, for example, or might choose a particular payment network over another network, including security concerns. Consumers may base their choice on the benefits or features offered by a particular form of debit transaction or a particular payment network, including enhanced cardholder protections that exceed current legal requirements. For example, a consumer would lose the zero liability protection provided by her selected card network (that is, the network whose brand appears on her debit card) when the merchant routes the transaction to a cheaper network that does not offer such fraud protection. Essentially, the merchant would permit a consumer to initiate a debit transaction and then transform that transaction into an entirely different transaction governed by an entirely different set of rules. Accordingly, by permitting merchants to override a consumer's choice of payment network, or her choice of authorization method, the merchant would not only deny the consumer the benefits associated with her card, but would also make it virtually impossible for the debit card issuer to accurately disclose to the consumer the terms and conditions applicable to her debit card account.

For all of these reasons, when implementing the routing restrictions of Section 920(b)(1)(B), at a minimum, the Board should require merchants to honor the choice made by the consumer for the routing of her debit transactions; namely, the network whose brand is reflected on her debit card. Not only would this approach be consistent with the purpose of the EFTA, to protect consumers, but to do otherwise would substantially decrease debit card benefits currently available to consumers, decrease competition among debit card issuers and payment networks and, ultimately, cede control of the debit payments system to merchants, rather than to consumers, card issuers or payment networks.

c. Effective Dates for Exclusivity and Routing Rules.

The Board has proposed effective dates for both Alternative A and Alternative B. Specifically, under the Board's proposal Alternative A would be effective October 1, 2011 and Alternative B would be effective January 1, 2013.[22] Although Alternative A is more consistent with statutory language and far less disruptive than Alternative B, Alternative A still would require far more implementation time than the proposed October 1, 2011 effective date, given the significant operational changes that would be required throughout the payment industry. For example, debit card issuers would need to negotiate new contracts with additional unaffiliated payment networks and connectivity would need to be established with such payment card networks. In addition, other debit card industry participants, such as acquirers and processors, would need enough time to update their systems in order to handle the new payment card networks, and all payment card networks would need additional time to address the operational complexities of the new requirements. The proposed changes also would require extensive consumer education and changes to all debit card consumer agreements. Therefore, the effective date for Alternative A should be no earlier than January 1, 2013.

VI. The Proposed Rule Harms Consumers

The Roundtable believes the Proposed Rule raises significant public policy concerns as a result of its negative effects on consumers. First, the Proposed Rule

[22] 75 Fed. Reg. at 81,753.

will force issuers to suffer a loss on every debit interchange transaction, which, in turn, would likely compel debit card issuers to limit the issuance of debit cards and possibly eliminate certain debit card products and services altogether. In addition, issuers would be forced to seek out other sources of revenue, including fees on checking accounts. The Roundtable believes that the upcoming changes to the law imposed by the Durbin Amendment will clearly and directly shift all of the merchants' costs to consumers, threaten the health of small businesses, and undermine the stability of the payment card network by substantially reducing vital fee revenue earned by financial institutions of all sizes and structures. The sole beneficiaries of this unprecedented cost shift in the payment card industry will be large retail chains. According to industry analysis, the largest 1.5% of merchants account for over 80% of debit transaction volume.[23] The Durbin Amendment carries no requirement that those merchants benefitting from lower interchange fees must pass on those savings to their customers and there is no reason absent congressional action to believe that the merchants will do so voluntarily. Indeed, evidence from similar government price caps on interchange fees in Australia makes clear that merchants will not pass cost savings to consumers.

VII. The Proposed Rule Threatens the Safety and Soundness of the Financial System

The Proposed Rule poses numerous threats to the financial system. The Proposed Rule threatens to dramatically lower revenue for card issuers during a period of financial uncertainty. The Proposed Rule will force some banks to restrict consumers' use of debit cards and debit card transactions. Any significant

[23] The Consequences of Debit Interchange Price Fixing.

reduction in interchange fees will greatly increase the cost of checking accounts and lower their availability and, eventually, their desirability. The Proposed Rule sets a dangerous precedent that financial institutions may be subject to future, unknowable price controls on other financial products and services. This, in turn, could also undermine investor confidence in financial institutions. As well, the Proposed Rule contradicts important free market principles. Financial institutions are now in jeopardy that their investments of billions of dollars into improvements of existing products and services and the creation of new ones could be rendered valueless by government price controls. This will be a strong disincentive for innovation and investment by financial institutions in payment systems and other financial products and services.

VIII. CONCLUSION

In closing, the Roundtable reiterates our opposition to the Proposed Rule. We strongly urge the Federal Reserve to revise its proposal to remove price controls.

The Roundtable expresses its sincere thanks to the Board for the opportunity to comment. If you have any questions, please feel free to contact me or Brian Tate at (202) 289-4322.

Sincerely,

Steve Bartlett
President and CEO
Financial Services Roundtable

American Bankers Association
Building Success. Together.

The Clearing House

CBA Consumer Bankers Association

CUNA Credit Union National Association
www.cuna.org

The Financial Services Roundtable

ICBA Independent Community Bankers of America

MBCA Mid-Size Bank Coalition of America

NAFCU National Association of Federal Credit Unions

National Bankers Association
The Voice of Minority Banking Since 1927

February 22, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Proposed Rule on Debit Card Interchange Fees, Docket No. R-1404

Dear Ms. Johnson:

With virtually unprecedented unanimity, every major bank and credit union trade association[1] is writing to express opposition to the rule proposed by the Board of Governors of the Federal Reserve System (the "Federal Reserve") (the "Proposed Rule") to implement the debit card interchange provisions of Section 1075[2] (the "Durbin Amendment") of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[3] We recognize the hard work and difficult decisions that went into drafting the Proposed Rule, but we firmly believe that the government price controls it imposes are legally defective, because they are neither authorized by nor consistent with the Durbin Amendment. Moreover, the Proposed Rule would have profound adverse consequences on consumers (particularly low-income Americans), the banking system (particularly the nation's smaller banks and credit unions), and the United States payments system and economy as a whole. The Proposed Rule must be fundamentally revised to avoid this outcome.[4]

[1] A description of the associations joining this letter is attached as Appendix A.

[2] Codified as Section 920 of the Electronic Fund Transfers Act ("EFTA"), 15 U.S.C. 1693o–2.

[3] Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (proposed Dec. 28, 2010) (to be codified at 12 C.F.R. pt. 235).

[4] A table of contents for this letter is attached as Appendix B.

EXECUTIVE SUMMARY

Overview of Debit Cards

Debit card transactions have become the most popular non-cash means of purchasing goods and services in the United States. During 2009 alone, debit cards constituted 35% of all non-cash transactions, compared to 20% for credit cards and 22% for checks.[5] Indeed, debit cards have become the primary payment methodology of choice for millions of Americans and thousands of merchants, and the infrastructure that has been developed at a great cost by banks and credit unions functions effectively and efficiently. The extraordinary popularity of debit cards is illustrated by their proliferation, growing from 60 million cards in 1983 to 491 million cards in 2008, with projections of 585 million cards in 2011. The percentage of U.S. households using debit cards likewise has exploded, growing from 20% in 1995 to 71% by 2007.[6]

The volume of transactions and the total dollar amount of purchases made using debit cards has grown along with the number of Americans choosing to use debit cards. As explained in the supplementary information to the Proposed Rule (the "Supplementary Information"), "there were approximately 37.7 billion debit and prepaid debit card transactions in 2009, valued at over $1.45 trillion, with an average value of $38.58 per transaction".[7]

The remarkable growth of the use of debit cards is due to the simple fact that this payment mechanism represents one of the most effective and innovative consumer banking products of recent decades, bringing to merchants, consumers, and financial institutions very substantial benefits beyond cash or checks. The value of debit cards to both participants in transactions and the broad economy resides in:

- providing an inexpensive and effective payment mechanism for consumers who do not qualify for credit cards, especially to low and moderate income consumers;
- making banking more available;

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5 *See* Stan Sienkiewicz, *The Evolution of EFT Networks from ATMs to New On-Line Debit Payment Products*, Paper Cards Center of the Federal Reserve Bank of Philadelphia 14 (April 2002); The 2011 Statistical Abstract, U.S. Census Bureau, http://www.census.gov/compendia/statab/cats/banking_finance_insurance/payment_systems_consumer_credit_mortgage_debt.html.

6 Stan Sienkiewicz, *The Evolution of EFT Networks from ATMs to New On-Line Debit Payment Products*, Paper Cards Center of the Federal Reserve Bank of Philadelphia 4 (April 2002); The 2011 Statistical Abstract, U.S. Census Bureau, http://www.census.gov/compendia/statab/cats/banking_finance_insurance/payment_systems_consumer_credit_mortgage_debt.html.

7 75 Fed. Reg. 81,722.

- allowing customers to purchase goods and services beyond the amount of cash they are carrying, thereby freeing consumers from the risks and inconvenience of carrying cash;

- affording customers the convenience of widespread acceptance at retailers across the United States;

- enabling customer access to deposit accounts (including their account records) easily and electronically;

- facilitating customer service in connection with payments and account inquiries;

- facilitating internet and telephone transactions and quicker transactions at a physical check-out;

- serving as a global currency conversion payment vehicle to support trade and commerce worldwide;

- providing fraud protection to both consumers and merchants;

- providing merchants with assured, immediate payments (in contrast to checks);

- lowering merchants' security costs by making them less of a target for theft, and avoiding "shrinkage" at the till when customers pay in cash;

- reducing costs for merchants by eliminating checks deposited daily, as well as cash services necessary to conduct hard currency purchases; and

- reducing merchant costs by reducing the need for employee hours spent handling cash and check payments for certain goods and services (*e.g.*, pay at the pump).

Every participant in the debit card interchange system—every issuer, network, merchant, and consumer—has entered into the system voluntarily. More and more join every day. Any merchant that dislikes the debit card system for any reason has the option of never joining it in the first place (as many have chosen to do), leaving the debit card system entirely after joining, or remaining in the system but discouraging customers from using debit cards by offering discounts for using other methods of payment.[8] Because the merchants that have joined the debit card system understand

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[8] *See*, *e.g.*, *Visa International Operating Regulations*, at 354, *available at* http://usa.visa.com/download/merchants/visa-international-operating-regulations-main.pdf (noting that, under Visa's terms of agreements with merchants, "Visa merchants may not refuse to accept a Visa (footnote continued . . .)

the tremendous benefits it provides to them, few merchants choose to leave the system or even to discourage their customers from using debit cards to make purchases.

Yet, rather than encouraging the use of debit cards and the continuing development of the interchange system, the Proposed Rule would disrupt a fully functioning market by imposing a hard price cap on all debit card interchange fees of no more than 7-12 cents. This is an amount that the Federal Reserve concedes is approximately *80% below* the current fees.[9] It is based solely on what the Proposed Rule describes as the "average variable cost" of "authorization, clearance, and settlement" of debit card transactions. This cap effectively would apply to each and every debit card transaction by each and every issuer, regardless of the actual total cost incurred by the debit card issuer for that particular transaction. The Supplementary Information explicitly concedes that the cap (i) does not allow for any reasonable rate of return for debit card issuers on the investments they have made into the debit card system, and (ii) does not even allow issuers to recoup all their costs associated with debit card transactions.[10]

<u>The Statutory Mandate</u>

The two operative provisions of the Durbin Amendment, Paragraphs (a)(2) and (a)(3), establish a simple formulation. Issuers are permitted to receive a fee for debit card interchange transactions that is not greater than the sum of (i) their costs with respect to the transactions plus (ii) an additional amount that satisfies the Federal Reserve's "standards for assessing" whether that amount is "reasonable and proportional" to those costs. The only other direct element of this calculation is that certain costs, specified in clause (ii) of Paragraph (a)(4)(B), cannot be included.

Accordingly, the process for the Federal Reserve to establish standards for assessing "reasonable and proportional" fees should consist of three actions:

- *First*, the Federal Reserve must determine the total costs incurred by the issuer with respect to the electronic debit transaction ("Total Costs").[11]

(. . . footnote continued)

product that is properly presented for payment, for example, on the basis that the card is foreign-issued, or co-branded with a competitor's mark. *Merchants may steer customers to an alternative method of payment, such as providing discounts for cash, but may not do so in a confusing manner that denies consumer choice.*") (emphasis added).

9 75 Fed. Reg. at 81,736-37.

10 *Id.* at 81,733-37.

11 §§ 920(a)(2), (a)(3)(A).

- *Second*, the Federal Reserve must determine certain non-specific costs incurred by the issuer that cannot be "considered" ("Excluded Costs") and deduct Excluded Costs from Total Costs.[12] The result is "Allowable Costs".

- *Third*, the Federal Reserve must establish standards for assessing whether the fee ("Fee") charged by the issuer is reasonable and proportional to the Allowable Costs.[13]

This process can be delineated by the following formula (the "Rate Formula"):

Fees $\ngtr$ (Reasonable and Proportional) x (Total Costs – Excluded Costs).

We submit that the Federal Reserve must apply this three-pronged approach on the basis of the following considerations:

- The calculation of a *fee* that is reasonable and proportional to costs must appropriately take into account two considerations specified in the Durbin Amendment: (i) the incremental cost of authorizing, clearing, and settling a debit transaction,[14] and (ii) the functional similarity of debit cards to checks.[15] As discussed below, both of these considerations support the Rate Formula.

- Under Section 904 of the EFTA, the Proposed Rule must minimize harm to consumers, particularly low-income consumers, financial institutions, and the payments system.

- A limit on fees that would be "confiscatory" constitutes a violation of the Takings and Due Process Clauses of the Fifth Amendment to the United States Constitution. As discussed below, 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.

- 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 Durbin Amendment, which provide for the issuer to receive *all* costs incurred *with respect* to the transaction *and* a rate of return.

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12 § 920(a)(4)(B)(ii).

13 §§ 920(a)(2), (a)(3)(A).

14 § 920(a)(4)(B)(i).

15 § 920(a)(4)(A).

- Words must be interpreted in accordance with their plain meaning and prior statutory and regulatory usage.

The Rate Formula, calculated in light of these considerations, would result in fees substantially higher than those provided for in the Proposed Rule. Conversely, the rates provided for in the Proposed Rule would raise a serious constitutional issue under the Fifth Amendment and are inconsistent with the statutory mandate.

<u>The Proposed Rule is Legally Defective.</u>

We believe that the proposed rule is legally defective on five separate bases:

i. The statutory requirement to establish "standards for assessing" does *not* authorize the government price caps set forth in the Proposed Rule; it instead requires a framework (or guidelines) by which fees should be evaluated. Any argument that the Federal Reserve is required to establish caps has now presumably been eliminated by the brief (the "Federal Reserve's TCF Brief") filed by the U.S. Department of Justice, on behalf of the Federal Reserve, in the TCF case.[16] The Federal Reserve's TCF Brief states, at the virtual outset, that "the statute . . . does not obligate the [Federal Reserve] to set a specific rate for debit interchange fees".[17]

ii. The Proposed Rule erroneously interprets the statutory command to establish standards for assessing whether interchange fees are "reasonable and proportional" as meaning that interchange fees should *be no greater than* allowable costs, whereas the statute clearly provides for interchange fees that allow for a reasonable return on those costs. The conflation of costs and fees was evident throughout the Federal Reserve's recent testimony before the House Financial Services Committee.[18]

iii. The Proposed Rule fails to include numerous allowable costs that should be included under the statute. This improper limitation is due both to an incorrect reading of what constitutes an allowable cost and to an erroneous

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16 Defendants' Mem. of Law in Support of Defendants' Motion to Dismiss Plaintiff's Claims for Failure to State a Claim Upon Which Relief Can Be Granted and for Lack of Subject Matter Jurisdiction and Defendants' Response in Opposition to Plaintiff's Motion for a Preliminary Injunction ("Federal Reserve's TCF Brief"), *TCF National Bank* v. *Bernanke, et al*., No. 10 civ. 04149 (LLP) (D.S.D. February 18, 2011) (dkt. No. 64).

17 *Id.* at 2. *See also*, *id.* at 31 ("the statute does not mandate a fixed rate").

18 *See* Implications and Consequences of the Durbin Amendment: Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the H. Fin. Serv. Comm., 112th Cong. (2011) (statements of Sarah Raskin, Governor, Federal Reserve Board) (hereinafter, HFSC Transcript).

understanding of the Durbin Amendment's reference to consideration of the "functional similarity" between electronic debit transactions and checking transactions fees. As the Federal Reserve's TCF Brief forthrightly acknowledges, the Federal Reserve "can consider factors other than the authorization, clearance, or settlement costs that are specific to a particular electronic debit transaction".[19] In addition, the Proposed Rule fundamentally misapplies the check comparison and does not consider basic functional dissimilarities, as well as numerous other differences, between one system (debit cards) that generally provides almost immediate, guaranteed, and low cost payment and a second system (checks) that provides for delayed payment, no guarantee, and a high cost of processing, all of which help explain why debit cards are rapidly replacing checks.

iv. Because the cap on debit card interchange fees at 7-12 cents is far below what it actually costs issuers to provide customers with debit card services—and certainly does not allow the issuers to make any return on their investment—it is so confiscatory as to raise serious concerns that the Proposed Rule violates the Takings and Due Process Clauses of the Fifth Amendment to the Constitution. An administrative agency is legally compelled to issue rules that avoid such concerns, especially when a statute does not *compel* the outcome that raises those concerns.

v. The Proposed Rule fails to follow the statutory mandate under Section 904 of the EFTA to consider its effect on consumers, financial institutions, and the payments system. Had the Proposed Rule done so, we believe it would have allowed for the higher debit card interchange fees necessary to avoid harm to these constituencies.

It is, of course, indisputable that a Government agency is bound by statutory mandates. We respectfully submit that the Proposed Rule is not required by the Durbin Amendment, but rather violates its terms.

<u>The Proposed Rule Harms Consumers and Provides an Unjustifiable Windfall to Merchants.</u>

The Proposed Rule's legal defects are compounded by several significant public policy concerns—many of which the Federal Reserve must consider under Section 904

[19] Federal Reserve's TCF Brief at 2.

of the EFTA—raised by the potential harm to consumers and the unjustified windfall for merchants.[20]

First, banks and credit unions will be forced to seek to recover their costs from the consumer unless they are prepared to suffer massive and continuous losses (which no for-profit institution, or even a not-for-profit credit union, should be forced to accept and which would be contrary to sound regulatory policy). The sheer size of the lost revenues is likely to result in a number of additional charges and reduced services. For example, banks and credit unions could charge for various debit card-related products and services that are now offered free of charge, such as free debit cards and free debit card transactions. Issuers could also be forced to discourage the use of debit cards for certain transactions (such as for higher value purchases or online purchases, both of which carry greater fraud and operational risk). There could also be a reduction or termination of various products and services associated with debit card programs. The burden of this forced response would fall disproportionately on low-income Americans who lack non-cash alternatives and heavily depend on debit cards. Moreover, innovations (such as new payment methods) and benefits will be stifled.

These results should not be surprising. The Federal Reserve itself has recognized these likely consequences when it has opposed the adoption of government price control statutes by Congress in the past.[21]

Second, although the Durbin Amendment was presumably intended to help the consuming public, the price controls in the Proposed Rule are uniquely applied to reduce the charges paid by *merchants*, and neither the Durbin Amendment nor the Proposed Rule carries any requirement for the merchants that will benefit from lower interchange fees to pass on those savings to their customers. When similar caps on interchange fees were imposed in Australia, there was no discernible benefit for

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20 The Federal Reserve must consider Section 904 in promulgating rules to enact the Durbin Amendment. *See* Dodd-Frank, Section 1084 (specifically authorizing the Federal Reserve under Section 904 "to carry out the purposes of [the Durbin Amendment]").

21 For example, when analyzing earlier proposals to impose a nationwide cap on credit card fees, the Federal Reserve's Division of Research and Statistics concluded that "the low average profitability of bank and retail credit card plans suggests that card issuers would likely reduce costs and seek more revenue from alternative sources under the proposed nationwide interest rate ceilings. These adjustments by issuers would erode some of the benefits to borrowers and impose costs on other consumers." 73 Fed. Reserve Bull. No. 1, p. 10 (Jan. 1987). The Division further concluded that "these findings suggest that tight ceilings on credit card interest rates are more likely to result in reduced availability of bank credit card accounts for lower- and lower-middle income families than for higher-income families." *Id.* at 16. We submit that this result is even more likely to occur in respect of debit cards.

Australian consumers.[22] Accordingly, the actual effect of the Proposed Rule is to create harsh government price caps that, as Chairman Bernanke recently stated in his testimony before the Senate Banking Committee, provide no guarantee of any benefit to consumers.[23] In contrast, merchants will receive all benefits they obtain from the debit card interchange system, while paying interchange fees that are significantly below the issuers' costs of providing those benefits. We estimate that the Proposed Rule would provide the nation's largest merchants with billions of dollars in annual savings on interchange fees, and that this will occur at the expense of issuers, with no benefit and likely harm to consumers. This is just one of the many unintended and undesirable consequences of the Proposed Rule.

<u>The Proposed Rule Harms the Well-Being of U.S. Financial Institutions and the U.S. Payments System.</u>

The Proposed Rule poses numerous threats to the financial system.

- The Proposed Rule threatens to dramatically lower the revenue of banks and credit unions during a period of financial uncertainty, especially during a period when regulators are urging issuers to increase significantly their capital bases.[24] Issuers will need to look to various forms of cost savings, including the possibility of layoffs in an industry that already has seen recent and severe declines in its workforce.[25]

- The Proposed Rule will impact small banks and credit unions particularly harshly, notwithstanding attempts in the statute to exempt them from its

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22 Government Accountability Office, Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, But Options for Reducing Fees Pose Challenges , GAO-10-45, at 45 (Nov. 2009), *available at* http://www.gao.gov/new.items/d1045.pdf.

23 Transcript of Feb. 17, 2011 Hearing before the Senate Banking Committee (hereinafter, Sen. Banking Tr.), at 33-34 ("JOHANNS: But there's the problem with price-fixing. We can't guarantee that, can we? We can't guarantee that a single consumer will get any benefit from that legislation. I mean, we hope we do. You might even be able to make an economic argument that they will. But the reality is, we don't know, do we? BERNANKE: No, Senator. There's no guarantee, certainly.").

24 Based on issuers' annual receipt of debit card interchange fees of $16.2 billion (75 Fed. Reg. at 81,725) and the Proposed Rule's contemplated reduction of such fees from an average of 44 cents per transaction to 12 cents per transaction, issuers would lose approximately $11.8 billion in annual revenues assuming that the debit card market remains at current levels.

25 *See Survey: Fed Debit Card Rule Will Harm Community Bank Customers*, ICBA News (Feb. 14, 2011) (noting that 20% of the ICBA's nearly 5,000 members say they will have to "*eliminate jobs* or *halt plans to open new bank branches*" (emphasis in original)).

restrictions.[26] Debit card interchange revenues account for a large portion of their revenue, and small financial institutions have a more difficult time creating the economies of scale needed to reduce the costs of each transaction to levels approaching the proposed caps.

- As mentioned, the Proposed Rule could lead issuers to discourage consumers' use of debit cards and certain debit card transactions. This would almost certainly result in an increased use of cash for retail purchases, presenting heightened opportunities for money laundering, theft, and tax evasion.

- As Chairman Bernanke warned at the December 16 Federal Reserve Board meeting, it is crucial that the Proposed Rule "preserve[s] the dynamism, competition and innovation in payments, which has obviously been an important feature of that area for quite a long time".[27] The Proposed Rule, however, will discourage issuers from investing in the improvement, maintenance, and security of the debit card interchange payments system, because those issuers are unlikely to recoup the costs of such investments, let alone make any return on capital. Accordingly, the natural result of the Proposed Rule will be the degradation of the safety and soundness of the payments system (including system failures and security breaches) over time.

- The Proposed Rule sets a dangerous precedent, suggesting that financial institutions may be subject to future, unknowable price caps on other financial products and services, undermining important free-market principles. Financial institutions are now in jeopardy that their investments of billions of dollars into improvements of existing products and services and the creation of new ones could be rendered valueless by government price caps. This will be a strong disincentive for innovation and investment by financial institutions in other payments systems and other financial products and services.

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[26] During her recent testimony before the Senate Finance Committee, FDIC Chairperson Sheila Bair expressed serious concerns about the impact of the Proposed Rule on community banks, stating, "The interchange fee issue, I think, is a very real one. We are very concerned. We will be writing a comment letter. I think the -- the likelihood of this hurting community banks and requiring them to increase the fees they charge for accounts is much greater than any tiny benefit retail customers maybe get for that -- any, you know, savings to be passed along. I think that's just -- just obvious to me." Sen. Banking Tr. at 42.

[27] Transcript of Fed. Res. Bd. Open Meeting at 27 (Dec. 16, 2010) (hereinafter, Open Meeting Transcript) , *available at* http://www.cq.com/doc/financialtranscripts3782728.

In summary, we submit that the Federal Reserve should not impose price caps unless compelled to do so by clear statutory language, and certainly should not set any such caps below costs. As acknowledged in the Federal Reserve's TCF Brief, there is no such mandatory language in this case. Indeed, the Federal Reserve's Proposed Rule extends far beyond what Congress authorized.

Instead, the Federal Reserve should revise the Proposed Rule to (i) take account of an issuer's total allowable costs, *i.e.*, all costs that Congress has not explicitly excluded, and then (ii) set forth standards for assessing whether debit card interchange fees are reasonable and proportional to these costs, *i.e.*, a fee equal to the total allowable costs plus a reasonable profit. The Proposed Rule should also include a realistic safe harbor provision that would enable issuers, and the Federal Reserve, to avoid undue administrative burden and uncertainty. It is essential, however, that such a provision be a non-exclusive safe harbor, and not an effective cap.

Properly enacting a revised rule will require the Federal Reserve to provide a reasonable delay in its enactment of any rule beyond the April 21, 2011 statutory deadline. Such a delay is needed to allow the Federal Reserve to (i) study the allowable costs of smaller issuers, whom the Proposed Rule incorrectly assumes will not be affected by the proposed price controls, and (ii) complete the fraud prevention guidelines required by the Durbin Amendment. Moreover, the three-month period between the proposed enactment of the Proposed Rule and its effective date is insufficient to allow issuers and networks to make the adjustments required thereby.

<u>The Proposed Rule's Provisions on Evasion and Circumvention and on Network Exclusivity Restrictions Should be Substantially Revised.</u>

We also would like to take this opportunity to express some significant reservations about the Proposed Rule's sections on evasion and circumvention and on network exclusivity restrictions. Those concerns are specified in Sections VIII and IX below.

With respect to the portions of the Proposed Rule designed to prevent evasion and circumvention of the interchange fee restrictions, the Federal Reserve exceeds the authority granted to it by the Durbin Amendment. In addition to regulating compensation "with respect to electronic debit transactions", which is permitted under the Durbin Amendment, the Federal Reserve arbitrarily and unjustifiably regulates any compensation from a network to an issuer "*for debit card related activities*", a much broader and unauthorized standard. This application of the Durbin Amendment's mandate to prevent the circumvention and evasion of the interchange fee restrictions is overbroad and would prohibit legitimate and necessary network payments, likely undermining the ability of networks to enhance the efficiency of the payments system and diminishing competition among networks.

Likewise, with respect to the network exclusivity and routing restrictions, the Federal Reserve's interpretation of the Durbin Amendment is unjustifiably expansive and legally defective. Specifically, the Proposed Rule impermissibly:

i. distinguishes between transactions by method of authorization in proposed Alternative B (whereas proposed Alternative A fully meets the letter and intent of the Durbin Amendment); and

ii. prohibits all arrangements between networks and issuers that in *any way* restrict the networks made available on a debit card for processing a transaction.

Neither of these provisions is required or authorized by the Durbin Amendment. In addition to not being required or authorized, the Federal Reserve's adoption of Alternative B, which prohibits limiting the number of networks available for processing a transaction to fewer than two unaffiliated networks *for each method by which a transaction may be authorized*, would cause significant and unnecessary harm to the debit marketplace and to consumers without any offsetting benefits. In contrast, Alternative A is true to the Durbin Amendment's statutory requirements and, together with the routing restrictions, provides merchant choice in all but the most limited circumstances.

Ultimately, we urge the Federal Reserve to revise those sections of the Proposed Rule on evasion and circumvention and on network exclusivity restrictions to bring them into compliance with the Durbin Amendment, including, without limitation, the adoption of proposed Alternative A regarding network exclusivity. In doing so, the Federal Reserve should take notice of and make adjustments to avoid the unintended consequences of its rulemaking, many of which are described below.

DETAILED COMMENTARY

I. <u>Description of the Durbin Amendment</u>

The Durbin Amendment was introduced on May 3, 2010—a last-minute addition to the Dodd-Frank Act. That there was little serious Congressional consideration of the Durbin Amendment cannot be in dispute:

- There were no Congressional hearings on the Durbin Amendment.[28]

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[28] Although a few Congressional hearings were held on *credit card interchange fees* and *federal government payment of interchange fees*, there were no hearings devoted to either debit card interchange fees in general or the Durbin Amendment in particular, nor was the Federal Reserve or any other government agency called to testify regarding the impact of the Amendment.

- There was no meaningful debate in the House or Senate.[29]

- There was no analysis presented to Congress of the impact on consumers, the overall economy, or the banking system.

- There was no Congressional analysis of whether the $10 billion asset-size "safe harbor" would prevent harm to community banks and credit unions.

- Because the Durbin Amendment was part of the Senate bill, there was no stand-alone vote on it in the House of Representatives.

- As Rep. Kanjorski stated: "Additionally, I continue to have apprehensions about the interchange provisions inserted into this legislation by the Senate. This issue, without question, would have benefitted from additional time and study".[30]

The absence of meaningful legislative history requires that the statute be interpreted based on the normal meaning of the words on which Congress voted. After-the-fact explanation of what Congress, or any individual Senator or Representative, may have intended is entitled to little weight.[31]

Despite the lack of Congressional analysis and consideration before passage, the Durbin Amendment sets forth a few clear points of law in relation to debit card interchange fees that the Federal Reserve must follow.

First, the Durbin Amendment instructs the Federal Reserve to "prescribe regulations . . . to establish *standards for assessing* whether the amount of any interchange transaction fee . . . is *reasonable and proportional* to the *cost* incurred by

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29 Senators Dodd and Durbin were the only Senators to speak on the Durbin Amendment on the floor of the Senate. *See* 156 Cong. Rec. S3588-90 (daily ed. May 12, 2010) (statement of Sen. Durbin); 156 Cong. Rec. S3704 (daily ed. May 13, 2010) (statement of Sen. Durbin); 156 Cong. Rec. S5925-27 (daily ed. July 15, 2010) (statements of Sen. Durbin and Sen. Dodd). Representatives Frank, Kanjorski, Larson, and Brown were the only Representatives to speak on the Durbin Amendment on the floor of the House, and they did so only for purposes of emphasizing the exemptions within the Amendment for smaller issuers and health care costs. *See* 156 Cong. Rec. H5225-6 (daily ed. June 30, 2010) (statements of Rep. Larson and Rep. Frank); 156 Cong. Rec. H5254 (daily ed. June 30, 2010) (statement of Rep. Frank); 156 Cong. Rec. H5256-7 (daily ed. June 30, 2010) (statement of Rep. Brown); 156 Cong. Rec. H5238 (daily ed. June 30, 2010) (statement of Rep. Kanjorski).

30 156 Cong. Rec. H5238 (daily ed. June 30, 2010) (statement of Rep. Kanjorski).

31 *See Barber* v. *Thomas*, 130 S. Ct. 2499, 2507 (2010) ("[W]hatever interpretive force one attaches to legislative history, the Court normally gives little weight to statements, such as those of the individual legislators, made *after* the bill in question has become law.").

the issuer with respect to the transaction".[32] The italicized language requires two basic conclusions in developing the Rate Formula. *First*, in using the phrase "standards for assessing"—rather than other familiar legislative terms such as "rates" or "caps"[33]—Congress clearly intended for the Federal Reserve to issue *guidelines*, and not caps, through which it could assess current debit card interchange fees. *Second*, by using the phrase "reasonable and proportional to the cost incurred"—which is similar to the familiar legislative and judicial terms of art "reasonable" and "just and reasonable"—Congress clearly expressed its intent that such standards should be based on the proposition that issuers are entitled to receive fees that both cover their costs and provide a reasonable rate of return on their investment.

Second, the Durbin Amendment instructs that, in issuing the guidelines, the Federal Reserve should use the "*cost* incurred by the issuer *with respect to* the transaction" as the baseline on which to determine standards for a reasonable fee.[34] The italicized language requires a broad reading of the costs that are allowable under the Rate Formula, both because (i) the term "costs" is unmodified and unlimited, and (ii) the phrase "with respect to", as opposed to "for", requires that costs related to a transaction be included.

Third, the costs included in the Rate Formula are limited only by those costs specifically excluded by clause (ii) of Paragraph (a)(4)(B) of Section 920. No other provision purports to limit allowable costs. Specifically, the non-exclusive listing of allowable costs in clause (i) does not somehow serve as a limitation on the broad operative provisions of Paragraphs (a)(2) and (a)(3).

Fourth, clause (i) of Paragraph (a)(4)(B) helps guide this determination in two respects. This clause specifies that the Federal Reserve must consider "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, and settlement of a particular electronic debit transaction". In using the term "incremental" cost, rather than just cost, clause (i) reinforces the concept of the two operative paragraphs that "cost" means more than costs "directly attributable" to a particular transaction. Whether one defines "incremental" in normal parlance or by reference to the economic literature, it means more than just the direct, actual cost. Moreover, in

32 § 920(a)(3)(A) (emphasis added). The Durbin Amendment also instructs the Federal Reserve to issue final fee and fraud prevention guidelines within the same time period. § 920(a)(3)(A); § 920(a)(5)(B). Based on the Dodd-Frank Act's passage on July 21, 2010, the Federal Reserve should issue the guidelines by April 21, 2011. 75 Fed. Reg. at 81,723.

33 *See*, *e.g.*, 12 U.S.C. § 1821 (concerns establishing a single uniform interest "rate" for claims against an insolvent depository institution), 12 U.S.C. § 85 (addressing "rates" of interest on loans, discounts, and purchases), and 12 U.S.C. § 3806 (dealing with adjustable rate mortgage "caps").

34 §§ 920(a)(2), (a)(3)(A).

referring explicitly to "authorization, clearance or settlement" ("ACS") costs, clause (i) effectively restricts the limitation in clause (ii) to those "non-specific" costs that are "*other*" than ACS non-specific costs. Stated differently, read in conjunction with clause (i), clause (ii) does not exclude non-specific costs relating to ACS. As the Federal Reserve's TCF Brief concedes, "the [Federal Reserve] can consider factors *other than* the authorization, clearance, or settlement ('ACS') costs that are specific to a particular electronic debit transaction".[35]

Fifth, the Durbin Amendment also instructs the Federal Reserve to consider the "functional similarity" between electronic debit transactions and checking transactions when determining what constitutes a reasonable and proportional fee on debit card transactions.[36] To the extent that the functional similarity is limited (indeed, the relevant differences are far greater than the relevant similarities), the relevance of checking transactions is also limited.

Sixth, in recognition of the significant "costs incurred by the issuer in preventing fraud in relation to the electronic debit transactions involving that issuer", the Durbin Amendment gives the Federal Reserve clear direction to include such costs in the creation of the guidelines if the issuer also followed certain fraud prevention guidelines that were to be issued at the same time as the guidelines on fees.[37]

II. Description of the Proposed Rule

The Proposed Rule was issued on December 16, 2010. As an initial matter, the Proposed Rule appears to assume, without analysis, that the Durbin Amendment ties the Federal Reserve's hands and requires the issuance of hard price caps on debit card interchange fees, rather than "standards for assessing" whether debit card interchange fees are reasonable and proportional to the issuers' costs. Federal Reserve Governor Warsh raised this issue directly by asking, at the December 16 Federal Reserve Board meeting, why the Proposed Rule sought to impose hard price caps, rather than standards for assessing the reasonability and proportionality of debit card interchange fees.[38] No direct response to his question was given.[39]

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[35] Federal Reserve's TCF Brief at 2 (emphasis added).

[36] § 920(a)(4)(A).

[37] § 920(a)(5).

[38] Open Meeting Transcript at 12.

[39] Indeed, while we do not believe that extra-legislative statements by Congressman are entitled to any weight when analyzing the Durbin Amendment, it is interesting to note that Senator Durbin himself has stated that the Durbin Amendment does not authorize the Federal Reserve to impose price controls on interchange fees. *See* May 13, 2010 Statement of Senator Durbin,

(footnote continued . . .)

Next, the Proposed Rule assumes that the Durbin Amendment's instruction to establish a standard for assessing fees that are "reasonable and proportional" to "the costs of the issuer" means that the fees should be no greater than the allowable costs of the issuer.[40] In doing so, the Proposed Rule ignores Congress' prior use of similar terms of art such as "just and reasonable" in the public utility context, in which regulatory ratemakers allow utilities to recoup a reasonable return on their investments. In a footnote, the Proposed Rule attempts to reject this legislative and regulatory precedent on the grounds that (i) public utilities, unlike debit card issuers, are often required by law to provide their services, and (ii) debit card issuers have "other sources, besides interchange fees, from which they can receive revenue to cover their costs of operations and earn a profit".[41]

The argument made in this footnote cannot withstand scrutiny on multiple grounds. *First*, the Proposed Rule does not attempt to reconcile its position with the judicial precedent to the contrary or attempt to explain why these purported differences between public utilities and debit card issuers mean that the Durbin Amendment's use of the phrase "reasonable and proportional" precludes debit card issuers from being entitled to a reasonable rate of return on their costs and investments associated with the debit card interchange system. *Second*, in attempting to reject the precedent as limited to public utility ratemaking, the Proposed Rule ignores that courts have used the phrase "just and reasonable" to mean recovery of cost plus profit in other contexts.[42] *Third*, in attempting to distinguish issuers from public utilities on the basis of the latter's obligation to serve their communities, the Proposed Rule overlooks numerous statutory and regulatory requirements imposing such an obligation on issuers, including the Community Reinvestment Act, the process for approval of bank

(. . . footnote continued)

available at http://durbin.senate.gov/issues/leg_wallstreet_swipe.cfm ("[The] Durbin[] Amendment would not have the Federal Reserve set interchange prices. Under [the] Durbin[] amendment, the Fed would not set debit card interchange prices. Instead, the Fed would oversee the debit interchange fees set by card networks to ensure that they are 'reasonable and proportional' to cost.").

40 75 Fed. Reg. 81,736-33.

41 *Id.* at 81,733 n.44.

42 *See Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508, 509-515 (9th Cir. 1990) (holding that a statute reducing automobile insurance rates for one year to 15 percent below those in place the prior year failed to "guarantee the constitutionally required 'fair and reasonable return'") (quoting *Hope Natural Gas*, 320 U.S. at 603); *Calfarm Ins. Co.* v. *Deukmejian*, 48 Cal. 3d 805, 813, 820-21 (1989) (holding that a measure reducing automobile insurance rates to 20 percent below those in place the prior year on its face imposed rates that were likely to be confiscatory, and the avenues to obtain administrative relief from the rates were inadequate to provide a reasonable return for the underwriting of automobile insurance).

acquisitions, and the requirement for FDIC insurance.[43] *Fourth*, in attempting to justify the distinction based on issuers' supposed ability to recover their costs from consumers, the Proposed Rule ignores clear Supreme Court precedent to the contrary.[44]

The Proposed Rule also does not analyze whether the operative provisions of the Durbin Amendment, Paragraphs (a)(2) and (a)(3), establish a broad test for costs. It compounded this omission by effectively reading both clauses (i) and (ii) of Paragraph (a)(4)(B) as limiting allowable costs and adopting an expansive interpretation of those limitations. Specifically, the Proposed Rule limits costs to "average variable cost" (a term not used in the statute) for ACS.

In doing so, the Proposed Rule excludes a wide variety of costs that it is not required, or even permitted, to exclude, and thereby rejects the Durbin Amendment's basic mandate to use the "cost incurred by the issuer with respect to the transaction" when determining standards for assessing whether the fees at issue were reasonable and proportional to the costs of the issuer.[45] For example, the Proposed Rule's determination of allowable cost does not consider an adjustment for fraud losses or fraud prevention costs even though those are explicitly allowed by the Durbin Amendment.[46] Despite acknowledging that the specific and tangible costs of every debit transaction include fraud losses, the Proposed Rule gives no justification for not including fraud losses in the allowable costs. And the Proposed Rule's only rationale for disallowing fraud prevention costs is not that these costs are unreasonable or inappropriate, but that the Federal Reserve has not yet had time to adopt the fraud prevention standards described in the Durbin Amendment,[47] and such standards are not likely to be in place by the time the Proposed Rule becomes final (if it does so).[48]

After considering these factors, the Proposed Rule offers two alternatives. Under Alternative 1, "an issuer could comply with the standard for interchange fees by calculating its allowable costs and ensuring that, unless it accepts the safe harbor as described [in the Proposed Rule], it did not receive any interchange fee in excess of its

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43 *See*, *e.g.*, Community Reinvestment Act, 12 U.S.C. § 2901, *et seq.*; 12 C.F.R. §§ 345.21, 345.25; Bank Holding Company Act, 12 U.S.C. § 1842(c)(2); Federal Deposit Insurance Act, 12 U.S.C. § 1816.

44 *Brooks-Scanlon Co.* v. *Railroad Commission*, 251 U.S. 396 (1920); *Michigan Bell Tel. Co.* v. *Engler*, 257 F.3d 587 (6th Cir. 2001).

45 § 920(a)(2).

46 75 Fed. Reg. at 81,740.

47 *Id.*

48 Open Meeting Transcript at 20.

allowable costs through any network".[49] The Proposed Rule would set a cap on this fee of 12 cents per transaction, with a "safe harbor" of 7 cents per transaction, meaning any issuer could impose a fee of 7 cents per transaction without needing to demonstrate that its allowable costs on that transaction were equal to or greater than 7 cents.[50] Under Alternative 2, an issuer could receive a fee of up to 12 cents per transaction, regardless of the issuer's allowable costs.[51] As discussed above, even a 12 cent fee would represent an almost 75% reduction in fees.

III. __The Proposed Rule's Approach to Implementing the Durbin Amendment Is Legally Defective.__

There are five fundamental legal errors invalidating the Proposed Rule. The Proposed Rule would: (i) create a hard and fast cap, whereas the Durbin Amendment only authorizes the Federal Reserve to develop "standards for assessing"; (ii) interpret a "reasonable and proportional" fee to mean a fee that is limited to an unduly limited set of costs; (iii) interpret "costs incurred by the issuer with respect to the transaction" to be limited to "average variable cost" for ACS; (iv) raise serious concerns that it violates the Takings and Due Process Clauses under the Fifth Amendment to the United States Constitution; and (v) avoid the Federal Reserve's mandate to consider the Proposed Rule's effect on consumers, financial institutions, and the payments system. The Proposed Rule contradicts the "unambiguously expressed intent of Congress" in all these areas, and therefore is not entitled to deference under *Chevron U.S.A.* v. *NRDC*.[52]

A. __"Standards for Assessing": The Durbin Amendment Does Not Authorize the Imposition of a Price Cap on Debit Card Interchange Fees.__

Section 920(a)(3)(A) of the Durbin Amendment requires that the Federal Reserve "prescribe regulations . . . 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".[53] The Proposed Rule interprets this

49 75 Fed. Reg. at 81,726.

50 *Id.*

51 *Id.*

52 467 U.S. 837, 842-43 (1984). The Proposed Rule is also not entitled to *Chevron* deference because, as described below, its confiscatory nature raises serious Constitutional concerns. *See University of Great Falls* v. *NLRB*, 278 F.3d 1335, 1340-1341 (D.C. Cir. 2002) ("[T]he constitutional avoidance canon of statutory interpretation trumps *Chevron* deference").

53 § 920(a)(3)(A) (emphasis added).

language as requiring the imposition of hard-and-fast price caps, a position that the Federal Reserve has now disavowed in the Federal Reserve's TCF Brief.[54]

As the Supreme Court has consistently confirmed, statutory language must be construed in accordance with its normally accepted meaning.[55] This basic rule of statutory construction invalidates the Proposed Rule, because caps are virtually the antonym of "assessing". In common parlance, "assessing" is well understood to mean "evaluat[ing] or estimat[ing] the nature, ability, or quality of" something.[56] Accordingly, the phrase "standards for assessing" signifies guidelines by which to evaluate or estimate whether debit card interchange fees received by issuers are "reasonable and proportional" to their costs. It cannot mean predetermined, regulator-imposed caps.

A second basic rule of statutory construction is that each word of the statute must be given meaning.[57] Congress instructed the Federal Reserve to establish "standards for assessing" what constitutes "reasonable and proportional" debit card interchange fees when compared to the costs incurred by issuers.[58] Accordingly, even if "standards" (considered alone) enabled the Federal Reserve to impose caps, which, as discussed below, it does not, caps could not be established unless they were also consistent with "assessing". Indeed, Congress knows very well how to instruct agencies to issue hard caps when it wants to.[59]

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54 *See supra* at p. 6.

55 *See*, *e.g.*, *Leocal* v. *Ashcroft*, 543 U.S. 1, 9 (2004) quoting *Smith* v. *United States*, 508 U.S. 223, 228 (1993) ("When interpreting a statute, we must give words their 'ordinary or natural' meaning").

56 Oxford English Dictionary; *see also* Macmillan Dictionary ("to carefully consider a situation, person, or problem in order to make a judgment"); Collins English Dictionary – Complete and Unabridged ("to judge the worth, importance, etc., of; evaluate"); Encarta Dictionary ("judge something; to examine something in order to judge or evaluate it"); Webster's Online Dictionary ("evaluate or estimate the nature, quality, ability, extent, or significance of"); Cambridge Advanced Learner's Dictionary ("to judge or decide the amount, value, quality, or importance of something"); Wordnet Dictionary ("place a value on; judge the worth of something").

57 *See*, *e.g.*, *Alaska Dept. of Envt'l Conservation* v. *EPA*, 540 U.S. 461, 489 n.13 (2004) quoting *TRW Inc.* v. *Andrews*, 534 U.S. 19, 31 (2001) ("It is, moreover, a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant") (internal quotation marks omitted).

58 § 920(a)(3)(A).

59 *See, e.g.*, 7 U.S.C. § 211(a) (authorizing Secretary of Agriculture to "determine and prescribe what will be the rate or charge" that is "just and reasonable" for stockyards, including setting the "maximum or minimum [price] to be charged"); 15 U.S.C. § 717d(a) (authorizing FERC to determine "the just and reasonable" rate for wholesale natural gas and to "fix the same by order"); 16 U.S.C. § 824e(a) (authorizing FERC to "determine the just and reasonable rate" for

(footnote continued . . .)

In contrast, in the past, when Congress mandated that the Federal Reserve institute "standards for assessing", the Federal Reserve typically did so by creating a flexible framework of guidelines, as opposed to hard-and-fast rules. For example, in 2009, by amending Section 149 of the Truth in Lending Act, Congress instructed the Federal Reserve to "issue final rules . . . to establish *standards for assessing* whether the amount of any penalty fee or charge . . . is reasonable and proportional to the omission or violation to which the fee or charge relates".[60] The standards that the Federal Reserve generally created in response were not caps or absolute limits, but rather allowed for a level of flexibility in the affected institutions' compliance actions. For instance, 12 C.F.R. 226.52 prescribes "standards for assessing" fees on customers for violation of credit card agreements, and permits such an assessment so long as the institution determines that the amount is a "reasonable proportion of the total costs" it has incurred.[61] The standards established in 12 C.F.R. 226.59, dealing with an institution's evaluation of annual percentage rate increases for credit card accounts, are similarly flexible. They allow an institution to weigh the various "factors that [it] considers when determining" what rates are applicable.[62]

Moreover, even if the word "standards" alone were considered, precedent demonstrates that it is inconsistent with hard caps. For example, when Congress tasked the Federal Reserve with "prescrib[ing] standards" relating to safety and soundness practices,[63] the Federal Reserve did not seek to impose hard and fast rules, but permitted the affected institutions to create their own internal controls and monitoring systems, subject only to certain enumerated factors and in consideration of "the nature, scope, and risk of its activities".[64]

As another example, in Section 501 of the Gramm-Leach-Bliley Act, Congress instructed the Federal Reserve to establish "appropriate *standards* . . . relating to

(. . . footnote continued)

wholesale electricity and to "fix the same by order"); *id.* § 831k (authorizing Tennessee Valley Authority Board to set price for resale of electric power "at prices that shall not exceed a schedule fixed by the Board from time to time as reasonable, just, and fair").

60 15 U.S.C. § 1665d (emphasis added).

61 12 C.F.R. § 226.52(b)(1)(i). Other absolute amounts listed are merely safe harbors and do not require compliance. *Id.* at § 226.52(b)(1)(ii).

62 12 C.F.R. § 226.59(d)(ii). Factors that an institution may consider include, among others, the credit risk of a consumer and the prevailing market conditions. *Id*. at § 226.59(a).

63 12 U.S.C. § 1831p-1 (requiring each Federal banking agency to establish standards relating to, among other things, internal controls, credit underwriting, asset quality, and compensation).

64 *See* 12 C.F.R. Part 208 Appendix D-1.

administrative, technical, and physical safeguards" to ensure the protection of nonpublic personal information by financial institutions.[65] In the rulemaking process, the Federal Reserve granted each institution the ability to make its own assessment of whether measures were suitable, given "the size and complexity of the [institution] and the nature and scope of its activities".[66]

Along a similar vein, Section 23 of the Federal Reserve Act states that "[t]he Board shall . . . prescribe *standards* that have the effect of limiting the risks" posed by an insured depository institution's exposure to correspondent banks.[67] In doing so, the Federal Reserve permits institutions to create their own policies and procedures, allowing them to set internal limits on exposure that can be "fixed as to amount or flexible".[68]

Another fundamental rule of statutory construction is that Congress is deemed to know how specific words it has used in prior statutes have been interpreted in the past.[69] That rule compels the conclusion that these past Federal Reserve conclusions must guide its interpretation here.

Finally, Section 920(a)(1) of the Durbin Act's statement that the Federal Reserve "may prescribe regulations . . . regarding any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction, to implement this subsection" does not authorize—let alone mandate—the hard government price caps in the Proposed Rule. Rather, Section 920(a)(1) is simply a broad statement of regulatory purview, and does not override Section 920(a)(3)(A)'s specific instruction to institute "standards for assessing" debit card interchange fees.[70] In any event, the Federal

65 15 U.S.C. § 6801(b) (emphasis added).

66 *See* 12 C.F.R. Part 208 Appendix D-2.

67 12 U.S.C. § 371b-2(b) (emphasis added).

68 12 C.F.R. § 206.3(a), (c). Although an institution's credit exposure can be hard capped at 25% of a bank's total capital, this cap is only applicable if the institution cannot prove that a correspondent bank is adequately capitalized. *See* 12 C.F.R. § 206.4.

69 *See*, *e.g.*, *Republic of Argentina* v. *Weltover, Inc.*, 504 U.S. 607, 613 (1992) ("'[W]e assume that when a statute uses [a term of art], Congress intended it to have its established meaning'") (alteration in original; quoting *McDermott Int'l, Inc.* v. *Wilander*, 498 U.S. 337, 342 (1991); *see also Buckhannon Bd. and Care Home, Inc.* v. *West Virginia Dept. of Health and Human Resources*, 532 U.S. 598, 615 (2001) (Scalia, J. concurring) ("Words that have acquired a specialized meaning in the legal context must be accorded their legal meaning.").

70 "[I]t is a commonplace of statutory construction that the specific governs the general". *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 384-385 (1992); *see also Varity Corp.* v. *Howe*, 516 U.S. 489, 511 (1996) ("This Court has understood the present canon ('the specific governs the
(footnote continued . . .)

Reserve is prohibited from implementing Section 920 in a way that raises significant constitutional issues.

The Proposed Rule does not address the question of why it replaces the statutory command to create guidelines with hard-and-fast government price caps. Governor Warsh made this exact point during the December 16, 2010 meeting of the Federal Reserve: "So the statute -- the first reading of the statute says that [T]he [B]oard shall establish standards for interchange fees. It doesn't say we should establish prices".[71]

Although not articulated in the Supplementary Information, we understand that the Federal Reserve may believe that the authority to establish caps is implied in the word "reasonable". Such an argument is presumably that, because this term means there can also be "unreasonable" fees, caps are necessary to separate reasonable from unreasonable fees.

Any such argument has two flaws that render it invalid. First, such an inference cannot overcome the clear statutory mandate that the Federal Reserve could only establish "standards for assessing", which is inconsistent with pre-determined caps. Second, and perhaps more fundamentally, one cannot determine what is reasonable and what is unreasonable except in the context of first determining costs, which can vary, and such other factors as are captured by the term "reasonable", including profit margin, risk, etc.[72] This again precludes pre-determination of caps.

* * *

We respectfully submit that, by using the phrase "standards for assessing", Congress clearly intended the Federal Reserve to create a system whereby the Federal Reserve could assess whether debit card interchange fees were reasonable and proportional to issuers' costs, and not make a *pre*-determination of what those fees must be. We further submit that the appropriate way for the Proposed Rule to implement the Durbin Amendment would be to establish guidelines for interchange fees that are reasonable and proportional to each issuer's allowable costs, and also allowing a safe harbor such that the issuers, and the Federal Reserve, may avoid what the Proposed Rule acknowledges is, for many issuers, the significant "administrative

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(. . . footnote continued)

general') as a warning against applying a general provision when doing so would undermine limitations created by a more specific provision.").

71 Open Meeting Transcript at 12.

72 *FPC* v. *Hope Natural Gas Co*., 320 U.S. 591, 603 (1944).

burden" of calculating allowable cost.[73] That safe harbor should equal a decile of the various issuers' total per transaction costs plus a reasonable rate of return. This decile must be high enough to make it economically feasible for a substantial majority of issuers to invoke it, thus avoiding undue administrative costs. Moreover, the safe harbor should be based on the costs of *all* issuers, because many of the supposedly exempt issuers will be forced to interchange fee levels equal to the safe harbor, and it would be unreasonable to force smaller issuers to a safe harbor based only on the lower cost structure of larger issuers.[74] Including the costs of the supposedly exempt issuers will require the Federal Reserve to conduct a study of those costs.

B. <u>"Reasonable and Proportional": The Durbin Amendment Allows For a *Fee* On Each Transaction that Is Reasonable and Proportional to the Costs Incurred by the Issuers.</u>

The statutory language relating to the "reasonable and proportional" test is quite clear. There are two components of the test:

i. First, there must be a determination of the total cost with respect to a transaction actually incurred by the issuers.

ii. Second, there then must be a determination as to whether the debit card interchange fee is "reasonable and proportional" to that cost, as that term has always been understood.

Without explanation, the Proposed Rule erroneously concludes that "reasonable and proportional" fees must simply *be no greater than* allowable costs.[75] The Proposed Rule's approach is wrong on several levels.

First, a determination must be made whether the fee received by the issuer is "reasonable and proportional" to the issuer's costs, a phrase that clearly means something other than the fee must be "no greater than" the costs. If Congress had intended standards under which the fees would simply be no greater than the costs

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73 75 Fed. Reg. at 81,738. Although clearly disallowing the hard and fast caps in the Proposed Rule, there is nothing in the Durbin Amendment that prohibits the Proposed Rule from enacting legitimate safe harbors for issuers that are trying in good faith to follow the standards set forth in a proposed rule.

74 Although setting the safe harbor at a high decile would allow some issuers to receive debit card interchange fees above their allowable costs, the safe harbor amount would still be below their total costs (due to § 920(a)(4)(b)(ii)) plus a reasonable rate of return, and so would not be unreasonable.

75 75 Fed. Reg. at 81,733.

(and no more), *i.e.*, that issuers could only recover costs, then it could easily have said so.

Second, the actual language used by Congress demonstrates that Congress intended for there to be some margin between the debit card interchange fee and the cost. The phrases "reasonable" and "just and reasonable" have a long history in ratemaking, which is presumed to have guided Congress in using the phrase "reasonable and proportional" here. As the U.S. Supreme Court has explained, it is "assume[d] that when a statute uses [a term of art], Congress intended it to have its established meaning".[76]

Looking to the consistent legislative, regulatory, and judicial history of the phrases "reasonable", and "just and reasonable", it must be assumed that the Durbin Amendment provides for both an issuer's ability to recoup its investment in the debit card system as a whole (except as otherwise specifically excluded by statute), and its ability to make a profit on the transaction. An alternate reading of the phrase "reasonable and proportional" test—one that bifurcates the phrase into two tests, requiring fees to be both (i) reasonable, and, separately, (ii) proportional to the allowable costs—is erroneous for three reasons. First, it would untether "reasonableness" from any objective criteria, such as allowable costs, and would give the Federal Reserve no guidance as to the proportion of the allowable costs (*e.g.*, 150% of costs, 100% of costs, 50% of costs, etc.) that the fee should equal. Second, how can a fee be reasonable if it would require an issuer to provide a service at a loss? Third, this reading would ignore that "reasonable and proportional" is a well-understood term of art. Moreover, even if the term of art "reasonable and proportional" were a two-part test, that would not change the conclusion that the fee should be equal to the allowable costs plus a reasonable rate of return, because (i) it is unreasonable, as a matter of both law and economics, to force issuers to lose money on each transaction, and, therefore, (ii) the proportion of the fee must be greater than the allowable costs.

That "reasonable and proportional" is a well-known term of art in the context of regulatory ratemaking cannot reasonably be disputed. For example, Congress empowered the Federal Energy Regulatory Commission to regulate rates in various contexts, including rates that may be charged for wholesale power and transmissions of power in interstate commerce,[77] for pipelines that transport natural gas in interstate commerce,[78] and for pipelines that transport oil in interstate commerce.[79] Under these

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[76] *Republic of Argentina*, 504 U.S. at 613 (alteration in original; quoting *McDermott*, 498 U.S. at 342).

[77] *See* The Federal Power Act, 16 U.S.C. § 791 *et seq*.

[78] *See* The Natural Gas Act 15 U.S.C. § 717 *et seq*.

[79] *See* The Interstate Commerce Act, 49 U.S.C. § app. 1 *et seq*. (1988).

acts, the regulated prices must be "just and reasonable".[80] In a seminal decision relating to Congress' rate-making authority, the United States Supreme Court has held that setting a "just and reasonable" rate "involves a balancing of the investor and consumer interests".[81] The Court further stated that

> [f]rom the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[82]

Thus, traditional ratemaking regulations allow a utility or other regulated entity to establish rates that allow it to recover its operating and maintenance costs, a reasonable amount for depreciation and a reasonable return on its capital investment. Under this analysis, Congress' statement that fees be "reasonable and proportional" allows for interchange fees that enable an issuer to recoup its cost as well as obtain an appropriate return on investment. The Federal Reserve must assume that Congress was well aware of these precedents interpreting this and similar phrases when it enacted the Durbin Amendment.[83]

In a footnote, the Proposed Rule attempts to reject this clear and direct precedent on four grounds, none of which is sustainable. *First*, the footnote argues that the debit card interchange system is different from the utility ratemaking provisions at issue in *Hope Natural Gas*.[84] But the Proposed Rule never explains why Congress would have used similar language to express different meanings or why the purported functional difference between the Durbin Amendment and the other precedents means that the similar language used in the Durbin Amendment—"reasonable and proportional"—should have a radically different meaning from that previously used by Congress and the Supreme Court. Moreover, the Proposed Rule ignores that courts have used the phrase "just and reasonable" to mean recovery of costs plus profits in

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80 *See* 16 U.S.C. § 824d(a); 49 U.S.C. § app. 1(5)(a); 15 U.S.C. § 717c.

81 *Hope Natural Gas*, 320 U.S. at 603.

82 *Hope Natural Gas*, 320 U.S. at 591 (citation omitted).

83 *Republic of Argentina*, 504 U.S. at 613.

84 75 Fed. Reg. at 81,733.

contexts *outside* of utility ratemaking.[85] If the 15% and 20% reductions in rates in two of the non-utility cases, *Guaranty Nat'l Ins.* and *Calfarm Ins.*, respectively, were determined to be unreasonable, one can only imagine a court's reaction to a 75%-80% mandated reduction.

Second, the footnote also attempts to support its rejection of this precedent on the basis that issuers might be able to recover their loss by adding additional charges to their customers for other services. Even ignoring the staggering policy considerations of forcing $12 billion of additional costs on consumers and its conflict with Section 904 of the EFTA, this argument is wrong as a matter of law. As discussed below, the Supreme Court has rejected this line of argument, as has a leading Court of Appeals decision.[86]

Third, as explained below, the Proposed Rule's interpretation of "reasonable and proportional" denies issuers the ability to recover even their costs, let alone make any profit on their investment in the debit card interchange system, and thus raises serious constitutional issues.

Fourth, the footnote surprisingly suggests that issuers can be distinguished from public utilities in that only the latter have an obligation to serve their communities. Issuers, however, have a pervasive obligation to serve their communities. As cited above, specific examples of the obligation on issuers to serve their communities are found in the Community Reinvestment Act, the Bank Holding Company Act (criteria for approval), and the Federal Depository Insurance Act (requirement for insurance).[87]

Because the Proposed Rule incorrectly equates "reasonable and proportional" with no more than allowable costs rather than fees, it fails to include any analysis of the appropriate margin. Based on the guiding precedent, the margin between allowable costs and fees should include a profit margin and a recovery over time of the investments in the systems that are used for debit cards.[88] The profit margin should be sufficient "to maintain [the issuer's] credit and to attract capital", and should be "commensurate with . . . corresponding risks".[89] We submit that the Federal Reserve must conduct the same thorough analysis of the appropriate profit as it has with respect to costs.

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85 *See supra* at n. 42.

86 *Brooks-Scanlon*, 251 U.S. at 396; *Michigan Bell Tel.*, 257 F.3d at 587. *See infra* at Section III.D.

87 *See supra* at p. 16 & n. 43.

88 *Hope Natural Gas*, 320 U.S. at 603.

89 *Id.* at 591 (citation omitted).

C. <u>"Cost": The Proposed Rule Contravenes the Statutory Language In Calculating An Issuer's Cost With Respect to Transactions.</u>

1. The Proposed Rule Improperly Limits the Allowable Costs.

The Proposed Rule does not properly calculate "cost" as prescribed under §§ 920(a)(2), 920(a)(3), and 920(a)(4), because it contains multiple misinterpretations of the statutory language concerning allowable costs.

a. The Operative Provisions of the Durbin Amendments Describe "Costs" In Broad Terms.

The Durbin Amendment, in its operative provisions (Paragraphs (a)(2) and (a)(3)), twice instructs the Federal Reserve to create standards for assessing whether an interchange fee is reasonable and proportional to "costs incurred by the issuer with respect to the transaction". This statement of allowable costs is very broad in two respects, neither of which appears to have been considered in the Proposed Rule.

First, there is no limitation in these Paragraphs on the "costs" that should be allowed. Accordingly, absent an explicit limitation elsewhere in the statute, "costs" include all costs–whether direct or indirect, fixed or variable, or specific or non-specific.

Second, the costs are "with respect to", rather than "of", the transaction. This clearly covers not only costs that are direct, but also those costs (both fixed and variable) that are related to or associated with the transaction.

Accordingly, the permissible interchange fee is to be based on all costs, as broadly described, subject only to any specific exclusions. In view of this clear statutory objective, any exclusions should be equally clearly stated and strictly construed.

b. The Exclusion from Allowable Costs Is Narrowly Circumscribed; the Only Exclusion is Found in Clause (ii) of Paragraph (a)(4)(B).

The only statutory words of limitation on cost, *i.e.*, the only costs excluded from the Paragraphs (a)(2) and (a)(3) total costs, are found in clause (ii) of Paragraph (a)(4)(B). Nonetheless, the Proposed Rule misconstrues the entirety of Paragraph (a)(4)(B) (*i.e.*, clause (i) as well as clause (ii)) as words of exclusion. Under the Proposed Rule, only those costs explicitly referenced in clause (i) (as narrowly defined), *i.e.*, ACS costs, are deemed part of the cost base for purposes of Paragraphs (a)(2) and (a)(3), and all other costs are excluded. This approach is deeply flawed in multiple respects.

First, that is not the way the statute is constructed. As mentioned, the statutory formulation of fees begins with a calculation of *all* costs *with respect to a* transaction, and there is then a specific deduction pursuant to clause (ii) of Paragraph (a)(4)(B). In contrast to this statutory mandate, the Proposed Rule treats the entirety of Paragraph (a)(4)(B) as definitional, with Paragraph (a)(4)(A) serving as an additional limitation. The Proposed Rule thereby reverses the actual statutory structure by starting the analysis of allowable costs with Paragraph (a)(4) rather than with Paragraphs (a)(2) and (a)(3).

Second, because the only words of exclusion are in clause (ii), this clause is the appropriate starting—and ending—point for determining the extent to which the broad cost language of Paragraphs (a)(2) and (a)(3) is otherwise limited. When Congress explicitly provided that certain costs were to be excluded (*i.e.*, those listed in clause (ii)), there is no reason to believe that any other language somehow contains an implicit exclusion. Moreover, here there is no other language that even suggests an implicit exclusion.

Third, in attempting to read clause (i), as well as clause (ii), as words of exclusion, through a negative implication, and treating as allowable only those costs specifically referred to in clause (i), the Proposed Rule is completely at odds with the words of the statute. Clause (i) is written as a guide as to what can be considered without any suggestion whatsoever of exclusivity.[90]

Fourth, the Federal Reserve's TCF Brief could not be clearer in rejecting this "cramped" interpretation of the statute. The Government's position was directly stated: "[T]he Board can consider factors other than the authorization, clearance, or settlement ("ACS") costs that are *specific* to a particular electronic debit transaction."[91]

c. The Clause (ii) Exclusions Are Carefully Limited.

In providing exclusions from costs allowed by Paragraphs (a)(2) and (a)(3), Clause (ii) precludes only "*other* costs . . . which are not specific to a particular electronic debit transaction".[92] In seeking to determine what costs are "other" costs and what costs are "not specific" to a particular transaction, the Proposed Rule's analysis must be guided by the words of the statute itself, basic concerns of statutory construction, and underlying policy principles that are directed by statute.

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90 The question may then be raised as to what is the purpose of clause (i). As this letter has explained, Congress deferred in the main to the Federal Reserve's expertise, delegating to it the task to study the subject of interchange and electronic debit, and to then identify those costs that issuers incur with respect to electronic debit transactions; Congress required that the Federal Reserve "consider" one type of cost—incremental costs of ACS—when undertaking this study and identification exercise. It did not explicitly require the Federal Reserve to "consider" any other type of cost, and it certainly did not disallow other costs (explicitly or implicitly). In addition, as described below, clause (i) is used to explain the limitations on the clause (ii) exclusion.

91 Federal Reserve's TCF Br. at 2.

92 § 920(a)(4)(B)(ii) (emphasis supplied).

At the outset, clause (ii)'s exclusion applies only to those non-specific costs that are "other" than ACS. No other reading of clause (ii) is reasonable because, in context, its references to "other" costs can only be to costs other than those described in clause (i). Consequently, the non-specific cost exclusion in clause (ii) can apply only to costs that are not ACS, and ACS-related costs must therefore be included in the cost referred to in Paragraphs (a)(2) and (a)(3) regardless of whether they are specific to a particular transaction.

Turning to the question of which non-ACS costs are non-specific and therefore excluded by clause (ii), the Proposed Rule adopts an interpretation of "specific" that extends well beyond the plain meaning of that term. Although there are various definitions of "specific", the most normal is something that is related to or of the same class or category as something else.[93] Under this plain meaning reading, there is a wide variety of costs that are specific to particular debit card transactions because they relate directly and principally to a particular debit card transaction. These include fraud losses, fraud prevention, customer service—including handling customer inquiries and complaints about specific transactions, network connection fees, billing and collection, data processing, protection of consumer data, costs of issuing new and replacement cards, and costs associated with cardholder benefits. All these costs are part of the "costs incurred by the issuer with respect to the transaction" and not excluded from consideration under clause (b)(ii).[94]

There are costs that should probably be deemed not specific because they relate only tangentially to debit card transactions. These include, for example, checking accounts and the maintenance of the branches at which these checking accounts are housed.

The Proposed Rule also appears to assume, incorrectly, that fixed costs can never be specific. It would have been a simple matter for Congress to have excluded fixed costs, but that phrase was obviously not used. The absence of any reference to fixed costs is preclusive of an interpretation that fixed costs were automatically excluded.

This plain meaning analysis of clause (ii) is supported by the following factors, which argue strongly against an expansive reading of clause (ii).

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93 *E.g.*, Merriam-Webster's Online Dictionary ("constituting or falling into a specifiable category"); ("sharing or being those properties of something that allow it to be referred to a particular category").

94 Certain of these costs are also not subject to the clause (ii) exclusion because they are ACS-related.

First, a basic canon of statutory interpretation is that each provision of a statute should be read as consistently as possible to give effect to each other.[95] This canon would be violated if clause (ii) were to be read so broadly as largely to swallow the broad concept of allowable costs in Paragraphs (a)(2) and (a)(3).

Second, another interpretation canon is that statutes must be interpreted to avoid constitutional issues.[96] As discussed below, if issuers' ability to recover their costs were significantly limited, this could result in a confiscation in violation of the Takings and Due Process clauses of the Fifth Amendment.

Third, with respect to public policy considerations, as discussed below, Section 904 of the EFTA mandates that the Federal Reserve's regulations be formulated to protect consumers (particularly low-income consumers), financial institutions, and the payments system. An expansive reading of clause (ii) harms all three and would thereby violate Section 904.

d. There Is No Basis for Excluding Costs Not Covered by Either Clause (i) or Clause (ii).

As discussed below, the Proposed Rule interprets the incremental costs of ACS narrowly, which would create a category of costs that are not covered by clause (i) or clause (ii). Although we believe that this interpretation is incorrect, it should not make any difference in determining what costs are excluded from the fee formula in Paragraphs (a)(2) and (a)(3). This is because all costs are included unless they are specifically excluded.

As previously explained, the statute excludes only those costs covered by clause (ii) of Paragraph (a)(4)(B). There is no statutory basis for excluding any other costs, as recognized in the Federal Reserve's TCF Brief, and exclusion as a matter of purported

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95 *See Gustafson* v. *Alloyd Co., Inc.*, 513 U.S. 561, 575 (1995) (a statute must be interpreted to "avoid ascribing to one word a meaning so broad that it is inconsistent with its accompanying words, thus giving 'unintended breadth to the Acts of Congress'"); *Richards* v. *United States*, 369 U.S. 1, 11 (1962) ("a section of a statute should not be read in isolation from the context of the whole Act and . . . in interpreting legislation, we must not be guided by a single sentence or member of a sentence, but (should) look to the provisions of the whole law, and to its object and policy") (internal quotation marks omitted).

96 *See*, *e.g.*, *St. Martin Evangelical Lutheran Church* v. *South Dakota*, 451 U.S. 772, 780 (1981) ("A statute, of course, is to be construed, if such a construction is fairly possible, to avoid raising doubts of its constitutionality."); *Hernandez-Carrera* v. *Carlson*, 547 F.3d 1237, 1250 (10th Cir. 2008) ("It is well established that the canon of constitutional avoidance does constrain an agency's discretion to interpret statutory ambiguities"); *see also McBryde* v. *Committee to Review Circuit Council Conduct & Disability Orders of Judicial Conference of U.S.*, 264 F.3d 52, 63 (D.C. Cir. 2001) (noting "the norm requiring 'agencies' to avoid unconstitutional applications not mandated by Congress").

administrative discretion would violate both Section 904 of the EFTA and the judicial canon prohibiting interpretations that create Constitutional issues.

e. Even If the Proposed Rule Were Somehow Correct in Limiting Allowable Costs to Those Referred to in Clause (i), It Still Improperly Excludes Multiple Categories of Such Costs.

Even assuming that the Proposed Rule were somehow correct in concluding that allowable costs are limited to "incremental costs of authorization, clearance or settlement" of a particular transaction, the Proposed Rule fails to apply even this standard appropriately.

First, the Proposed Rule's definition of "incremental cost" is plainly erroneous. In normal parlance, the word "incremental" means "in addition to" or "greater than". In other words, it encompasses costs beyond the direct costs of the transaction. If, instead, one considers the phrase as a term of art in economics, it has a generally accepted meaning, as the Supplementary Information acknowledged. Nevertheless, after reciting several economic definitions of "incremental cost" in the Supplementary Information, the Proposed Rule disregards all of them, and, instead, invokes its own economic judgment to substitute "average variable cost per transaction at the current level of production" in lieu of "incremental cost". The Proposed Rule does so despite caselaw specifically distinguishing between incremental costs and average variable costs.[97] In substituting "average variable cost" for the standard established by Congress, the Proposed Rule limits incremental cost to the separately calculable per-transaction costs specifically associated with the issuer's "authorizing, clearing, and settlement" of individual electronic debit transactions. In contrast, commonly used economic definitions of "incremental cost" would have resulted in a broader range of allowable costs.

As an example, the use of average variable costs fails to account for the fact that issuers must make investments in debit card interchange systems such that those systems can handle peak shopping days, *e.g.*, the day after Thanksgiving. Issuers cannot simply create and maintain interchange systems that are able to handle only an average day's volume, and then watch as the systems become overwhelmed and shut down on

[97] *See MCI Communications Corp.* v *AT&T*, 708 F.2d 1081, 1115 (7th Cir. 1983) ("At trial long-run incremental cost was incorrectly equated with average variable cost while fully distributed cost was incorrectly equated with average total cost . . . . [L]ong-run incremental cost differs from average variable cost in that it is a long-run rather than a short-run cost measure. Because variable costs, by definition, are associated with the limited time period in which a firm cannot replace or increase its plant or equipment, the cost of plant and equipment is regarded as fixed and is not included in the calculation of a product's short-run marginal, or average variable, cost.").

peak days. By limiting the issuers' costs to average variable costs, the Proposed Rule erroneously treats issuers as though they only need to create and maintain interchange systems for average volume days, and does not credit the issuers with the incremental costs attributable to maintaining the interchange system for peak shopping days.

Second, even using the Federal Reserve's own definition of allowable costs as synonymous with "average variable costs", the Federal Reserve failed to include certain "average variable costs" reasonably related to the issuer's authorizing, clearance, and settlement of individual transactions, such as fraud losses, network processing fees and cardholder inquiries.[98] The Proposed Rule's refusal to consider fraud costs when determining a reasonable and proportional fee is particularly difficult to understand. The Proposed Rule specifically acknowledges $1.36 billion in fraud losses in 2009 alone, and that each loss due to a fraud is specific to a particular debit transaction.[99] Yet the Proposed Rule fails to explain why none of those costs is considered when determining a reasonable and proportional interchange fee. Likewise, at a time when bank regulatory agencies are focusing on bank responsiveness to customers, a regulatory-prescribed prohibition on recovering an issuer's costs of customer inquiry and dispute is counterproductive.

Third, the Proposed Rule appears to assume that the costs covered by clause (i) must be both specific and not fixed. The statutory language, however, is preclusive of any such restriction. Having *explicitly* included non-specific costs in clause (ii), it would be anomalous for Congress to have *implicitly* excluded them in clause (i). As discussed above with respect to clause (ii), the absence of any specific reference to "fixed costs" means that Congress chose not to distinguish between fixed and variable costs.

As a result of these deficiencies, the Proposed Rule has vastly understated the costs that they are instructed to consider under clause (i). Based only on the collection of data from some of the larger and mid-sized debit card issuers (who tend to have lower per transaction costs than smaller issuers), it appears that the Proposed Rule ignores all the following incremental ACS costs:

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[98] Although the Proposed Rule specifically acknowledges that "a particular transaction cannot be authorized, cleared, and settled through a network unless the issuer pays its network processing fees", the Proposed Rule would exclude network processing fees solely because, if network 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". 75 Fed. Reg. at 81,735. The fact that certain ACS costs are paid to third parties, however, should not preclude them from being included in allowable costs. If the Federal Reserve is concerned about circumvention or evasion in this area, it can address this concern on a case-by-case basis.

[99] 75 Fed. Reg. at 81,740-41.

Fraud losses:	$0.03
Fraud prevention:	$0.03
Network fees:	$0.04
Production and delivery:	$0.01
Attributable processing:	$0.01
Customer service (primarily cardholder inquiry):	$0.08
Total:	**$0.20**

When these costs are added to the 7 cents that the Federal Reserve recognizes, clause (i) encompasses 27 cents of cost rather than just 7 cents.[100] If the costs of smaller issuers were included in this data, it is likely that average incremental ACS costs would be even higher.

2. The Proposed Rule Unfairly Penalizes Issuers By Not Allowing for Issuers to Recoup Costs for Fraud Prevention.

An additional serious error in the Proposed Rule's definition of allowable costs is that the Proposed Rule does not factor fraud prevention costs (which are separate and distinct from actual fraud losses) into the definition of allowable "cost", although, as assumed in the Durbin Amendment, and as acknowledged in the Supplementary Information, there is a significant cost to the issuers for fraud prevention.[101] Moreover, although Congress authorized the Federal Reserve to make an adjustment in the guidelines for fraud prevention costs for issuers that adopted the Federal Reserve's fraud prevention standards—which Congress required to be issued at the same time as the final rule—the Federal Reserve has stated it will not have such standards ready by then.[102] The consequence of this timing should not be that fraud prevention costs are not considered in the guidelines until some undetermined time when the Federal Reserve decides to issue fraud-related standards. Rather, the Proposed Rule should estimate such costs now and include them in the formula.

100 *See* February 22, 2011 Comment Letter on Debit Interchange Fees and Routing submitted by Oliver Ireland (explaining the collection and analysis of data establishing a likely amount of at least 27 cents of incremental ACS cost per debit card transaction).

101 *See* § 920(a)(5)(A); 75 Fed. Reg. at 81,740-41.

102 Open Meeting Transcript at 20.

3. The Proposed Rule Fails to Take Into Account the Cost Structure for the Vast Majority of U.S. Depository Institutions.

Because of the Durbin Amendment's $10 billion asset "exemption", the Federal Reserve cost survey was limited to financial institutions with assets in excess of $10 billion. As is demonstrated by the signatories to this letter, however, the Durbin Amendment will affect all the approximately 15,000 U.S. depository organizations. Accordingly, the cost estimates must be revised, and we believe they are likely to be substantially higher when calculated across the affected universe of organizations.

D. The Proposed Rule Does Not Correctly Analyze the Similarities and Differences between Electronic Debit Transactions and Checking Transactions.

Another fundamental error in the Proposed Rule relates to its application of the statutory requirement that "[i]n prescribing regulations under Paragraph (a)(3)(A), the Board shall (A) consider 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".[103] This error is particularly significant because Governor Raskin relied heavily on §§ 920(a)(4)(A)(i)-(ii) in her recent testimony before the House Financial Services Committee.[104]

At the outset, the Proposed Rule repeats the fundamental error of conflating the statutory reference to fees with the statutory reference to costs. The Proposed Rule uses the check comparison as a "useful measure for which costs should and should not be included in 'the cost incurred . . . with respect to the transaction'".[105]

That is not, however, what the statute requires. The check comparison is to be used for "prescribing regulations under paragraph (3)(A)".[106] Those regulations relate to the reasonableness and proportionality of fees and not costs. The distinction is

103 §§ 920(a)(4)(A)(i)-(ii). The Federal Reserve's establishment of a rule to not process checks that do not clear at par was not the result of a statutory mandate to align fees with check processing costs; rather, the Federal Reserve developed the rule to avoid increasing systemic inefficiencies associated with efforts by banks to avoid check exchange fees (such as routing checks through multiple correspondent banks that did not assess exchange fees). *See* Bruce J. Summers and R. Alton Gilbert, *Clearing and Settlement of U.S. Dollar Payments: Back to the Future?*, Federal Reserve Bank of St. Louis Review, September/October 1996; Regulation J 12 C.F.R. § 210.4(c). Such inefficiencies are not present in the electronic debit transaction system.

104 *See* HFSC Transcript.

105 75 Fed. Reg. at 81,734.

106 §§ 920(a)(4).

confirmed by the specific references in Paragraph (4)(B) to "costs". Accordingly, to the extent that any comparison between debit cards and checks is valid, it should be to profitability (*i.e.*, margin over costs), rather than costs.

Of perhaps even more importance is the Proposed Rule's assumption that the comparison provides any reliable guidance.[107] Electronic debit transactions and checking transactions are fundamentally different systems for making payments, as shown by the following chart. Indeed, there is more similarity between electronic debit transactions and cash as a payment mechanism than between electronic debit and checks.

Comparison of Electronic Debit Transactions and Check Transactions

	Electronic Debit	**Check**
Payment	Yes	Yes
Immediate Availability of Funds to Payee	Yes	No
Fraud Risk Borne by the Payee	No	Yes
Merchant Processing Costs	Low	High
Online/Telephone Payment	Yes	No
Network Required	Yes	No
Legal Regime	Contractual	Uniform Commercial Code and Regulation J
Competition with Respect to the Product	Substantial	Limited

107 75 Fed. Reg. at 81,734.

Physical Property	Plastic	Paper
Need for Separate Identification	No	Yes
Universality[108]	Increasing	Decreasing

The predominance of dissimilarities between debit cards and checks argues for total rejection of checks as a relevant consideration. Even if, however, the comparison is made, it would argue for higher debit interchange fees, and if incorrectly applied just to costs, much higher allowable costs than recognized by the Proposed Rule.

The Proposed Rule concedes at least some of the significant functional dissimilarities between electronic debit transactions and checks, such as the certainty of payment, but it incorrectly reasons that the Durbin Amendment only allows the Proposed Rule to consider the functional similarity between electronic debit transactions and checking transactions for the purpose of *limiting* allowable costs.[109] There is, however, no indication in the Durbin Amendment that the functional and other dissimilarities between electronic debit transactions and checking transactions should be ignored for purposes of determining the amount of fees, let alone the scope of allowable costs.

As a result of its incorrect application of this portion of the Durbin Amendment, the Proposed Rule fails to account for many of the key dissimilarities between checks and debit cards. Had the Proposed Rule considered these key differences, we believe it would have allowed for much higher allowable costs to be recovered.

Merchants benefit significantly from a consumer's use of a debit card over a check, because of two key and fundamental differences. *First*, and crucially, debits card

108 Many establishments will not accept checks but will accept debit cards, including airlines (onboard), parking garages, quick service restaurants, gas stations, etc.

109 75 Fed. Reg. at 81,735; *see also* Statement by Sarah Bloom Raskin before the Subcommittee on Financial Institution and Consumer Credit of the Committee on Financial Services of the U.S. House of Representatives, Feb. 17, 2011 ("We also considered including other costs that are associated with a particular transaction but that are not directly associated with authorizing, clearing, and settling the transaction. Such costs might include, for example, the cost of providing cardholder rewards and the cost of responding to cardholder inquiries regarding specific transactions. However, given the statute's mandate to consider the functional similarities between debit card and check transactions, and the fact that these costs are not charged to merchants in check transactions, our proposal limits allowable costs to those costs that the statute explicitly directs the Board to consider. We specifically requested comment on whether other costs of a particular transaction should be included as allowable costs and what criteria should be used to determine the costs to be included.").

are generally a form of guaranteed payment; checks are not. The costs associated with the guarantee to merchants of settlement of electronic debit card transactions are generally borne by debit card issuers, which are currently able to recover those costs through the collection of debit card interchange fees. If a retailer seeks to replicate the debit card guarantee through guarantee services for check transactions, they are available only at an additional cost of an average of 92 basis points per transaction paid for *by the retailers*.[110] This guarantee feature alone represents a substantial portion of the debit card interchange fee. Indeed, given the fact that there were approximately $103 billion in returned checks in 2009,[111] and given that, as the Federal Reserve acknowledges, check guarantees are only available at an additional cost to merchants, this enormous value of the debit card guarantee *must* be included in the consideration of reasonable and proportional fees.

Second, debit cards represent a low cost form of payment for merchants, whereas checks represent a high cost form of payment. The cost differences include the elimination of the costs of handling, transporting, and depositing physical checks, as well as lower payroll costs from reduced checkout times. One economist has estimated that when these cost savings are combined with the benefits that merchants receive from the debit card guarantee of payment, merchants spend an average of approximately 45 cents per $49.38 debit card transaction, as opposed to 78 cents per $49.38 check transaction.[112]

Third, debit transactions generally provide for virtually immediate payment. Unlike checks, there is minimal risk in the availability of funds.

If, in fact, debit cards and checks were functionally similar, the rapid increase in debit card payments in relation to checks would be inexplicable. The overall comparative value and advantages of electronic debit transactions over checking transactions to merchants is clearly evident in the fact that merchants continue in increasing numbers to accept debit cards—even at current marketplace-set interchange fees—while increasingly refusing or aggressively discouraging the use of traditional checks. As one would expect merchants to act in their own economic interest, this indisputable trend suggests that merchants well recognize that the value of debit cards greatly outweighs the associated interchange fees, especially in comparison to checks.

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110 *See Check Authorization — 2009*, THE NILSON REPORT, Issue 953, July 2010, at 7.

111 Federal Reserve System, The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006-2009, at 9 (Dec. 8, 2010), available at http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf.

112 *See* Anne Layne-Farrar, Assessing Retailers' Costs and Benefits from Accepting Debit Cards, LECG, Feb. 15, 2011, at 16.

Indeed, many merchants deem debit cards (even with their allegedly high interchange fees) to be so superior to checks that they have stopped accepting checks altogether.[113]

The Proposed Rule also falls short in its consideration of the many and significant benefits to *consumers* associated with using debit cards over checks, including wide acceptance by merchants, safety, ease of use, speed of transaction, and the fact that consumers using debit cards do not leave a physical copy of their names and addresses behind like they do when they use a check.[114] According to a 2008 survey conducted by the Federal Reserve Bank of Boston, 47.9% of consumers reported that debit cards are almost always accepted for payment compared to 19.3% for checks; 48.4% of consumers reported that debit cards are very easy to use compared to 14.5% for checks; and 34.6% of consumers reported that debit cards are very fast to use compared to 6.7% for checks.[115] That consumers view debit cards as far more widely accepted by merchants and easier to use than checks is hardly surprising; many merchants no longer accept checks, merchants that do accept checks often require significant proof of identity and are reluctant to accept checks from out-of-town customers, and merchants generally do not accept checks for internet-based purchases.

These benefits to merchants and consumers associated with electronic debit transactions that are not available with standard checking transactions have a positive impact on the payments system and the economy as a whole, leading to increased sales, lower labor costs (resulting from a reduction in tender time at check out and the elimination of time required to handle and process deposits of physical instruments) and reduction or elimination of bad check losses.[116] The significance of the advantages of electronic debit transactions over checking transactions is clearly evident in payment trends over the last few years: a study conducted by the Federal Reserve System found

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113 *See*, *e.g.*, Jason Cochran, *Et tu latte? Starbucks no longer accepts traveler's checks*, Wallet Pop, May 18, 2009, *available at* http://www.walletpop.com/2009/05/18/et-tu-latte-starbucks-no-longer-accepts-travelers-checks.

114 *See The 2008 Survey of Consumer Payment Choice*. Federal Reserve Bank of Boston, April 2010, 38-39; Mercator Advisory Group, *Special Report: The Durbin Amendment: Impact Analysis*, June 2010.

115 *The 2008 Survey of Consumer Payment Choice*. Federal Reserve Bank of Boston, April 2010, 38-39.

116 *See* Government Accountability Office , Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges, GAO-10-45 (Nov. 2009), *available at* http://www.gao.gov/new.items/d1045.pdf; Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, Int'l Center for L. & Econ. Fin. Reg. Program White Paper Series 31 (Jun. 2, 2010).

that, between 2006 and 2009, the use of checks *decreased* by an average of 7.2% annually and the use of debit cards *increased* by an average of 14.8% annually.[117]

The advantages of debit cards over checks are the result of debit card issuers' ongoing and extensive investments in authorization, clearance and settlement infrastructure that have no direct corollary in the checking transaction system. These costs are necessary for the effectuation of electronic debit transactions with the efficiency, security and convenience currently expected by both consumers and merchants, but were unreasonably excluded from allowable costs under the Proposed Rule.

E. The Proposed Rule Raises Serious Constitutional Concerns.

Administrative agencies have an obligation to avoid, rather than create, constitutional issues when interpreting statutes and promulgating regulations thereunder,[118] and administrative interpretations of statutes that raise constitutional concerns are not entitled to *Chevron* deference.[119] Here, by forcing an 80% reduction in debit card interchange fees, the Proposed Rule not only fails to account for a reasonable rate of return on debit card services; it caps interchange fees at an amount that, as the Federal Reserve acknowledges, is far below an issuer's cost per transaction. This potentially confiscatory effect raises serious concerns under the Due Process and Takings Clauses of the Fifth Amendment.

As described above and as acknowledged in the Supplementary Information, the allowable costs under the Proposed Rule accounts for only a fraction of issuers' total costs of debit card services: allowable costs are limited to the average variable costs that an issuer incurs for authorizing, clearing, and settling an electronic debit transaction.[120] The Proposed Rule thus excludes from allowable costs, for example, many costs that are specific to particular debit transactions but which are not for

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117 Federal Reserve System, The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006-2009, at 4 (Dec. 8, 2010), available at http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf.

118 *See supra* at n. 96.

119 *See*, *e.g.*, *Edward J. DeBartolo Corp.* v. *Florida Gulf Coast Bldg. & Constr. Trades Council*, 485 U.S. 568, 574-577 (1988) (declining to defer to agency interpretation of ambiguous statute which raised "serious questions of the validity of [the statute] under the First Amendment"); *University of Great Falls* v. *NLRB*, 278 F.3d 1335, 1340-1341 (D.C. Cir. 2002) ("[T]he constitutional avoidance canon of statutory interpretation trumps Chevron deference."); *Bell Atl. Tel. Co.* v. *FCC*, 24 F.3d 1441, 1445-1446 (D.C. Cir. 1994) (rejecting *Chevron* deference for agency's interpretation of § 201 of the Federal Communications Act, which raised Takings Clause concern).

120 75 Fed. Reg. at 81,735-36.

authorization, clearance, or settlement. It also excludes costs (like certain fixed costs) that would be common to all debit card transactions on the basis that they could not be attributed to a particular transaction.[121] Finally, apart from depriving issuers of recovery of their total costs of debit card services, the Proposed Rule fails to account for a reasonable rate of return. The Proposed Rule's interpretations will, in the aggregate, cost issuers billions of dollars in annual interchange revenues used to support popular debit card-related products and services.

For this reason, the Proposed Rule, which would force a 75%-80% reduction in current fees, raises serious constitutional concerns under the Due Process and Takings Clauses of the Fifth Amendment. Courts throughout the country have held—as to both public utilities and other companies—that price-control regimes are unconstitutional where, as here, they do not permit regulated companies to recover their costs and obtain a reasonable rate of return.[122] At a minimum, the Federal Reserve should exercise its interpretive authority to avoid, rather than raise, these serious constitutional concerns.

The Proposed Rule cannot deflect these serious constitutional questions by raising the theoretical possibility that debit card issuers could turn to "other sources, besides interchange fees, from which they can receive revenue to cover their costs of operations and earn a profit".[123] This is so for two reasons.

First, as a matter of law, it is no answer to say that Government-induced losses are constitutionally acceptable if a regulated firm may be able to offset them in whole or in part in a different line or part of business. This has been clear since at least as early as 1920. In *Brooks-Scanlon*, the Supreme Court held that a Railroad Commission order requiring the Brooks-Scanlon Company to operate its railroad between two particular towns was unconstitutional.[124] Although the company could have offset the losses incurred from compliance with the order with proceeds from other aspects of its business, the Court held that the company "cannot be compelled to carry on even a

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121 *Id.* at 81,736.

122 *See, e.g.*, *Bluefield Waterworks & Improvement Co.* v. *Public Service Commission of West Virginia*, 262 U.S. 679, 683, 690 (1923) (stating that prescribed rates "which are not sufficient to yield a reasonable return on the value of the property . . . are unjust, unreasonable and confiscatory"); *Guaranty Nat'l Ins.*, 916 F.2d at 509-515 (government-imposed cap on fees was unconstitutional taking because it was so low as to prevent company from receiving reasonable rate of return on its investment); *Calfarm Ins.*, 48 Cal. 3d at 813-821 (same); *Michigan Bell Tel. Co.*, 257 F.3d at 594-596 (same).

123 75 Fed. Reg. at 81,736.

124 251 U.S. 396.

branch of business at a loss, much less the whole business of carriage".[125] The courts of appeals continue to apply this precedent. In *Michigan Bell Telephone*, for example, the Sixth Circuit held that a Michigan statute abolishing a fee charged to consumers by two telephone companies and freezing the overall rates charged by those companies was facially unconstitutional notwithstanding the purported ability to recover their losses by increasing other fees.[126] The Michigan statute did not permit the companies to recover a constitutionally reasonable rate of return, the court explained, and a firm is "not required to subsidize their regulated services . . . with revenues generated from unregulated services".[127]

This judicial approach reflects business reality. It cannot be known with any degree of certainty, and, at a minimum, not for some time, whether a company can recoup all or substantially all the revenues the Government has taken from a company. It is not possible to evaluate the long-term customer goodwill that will be lost if a company seeks to impose new charges on its customers, or over time, how susceptible its customers will be to future competition as a result of the new charges. Nor can it be predicted whether the new charges will result in immediate loss of customers.

Second, even if the case law were different and permitted the Proposed Rule to survive on a theory that issuers retain the technical ability to recoup their lost fees from "other sources"[128] within the debit card line of business, the two-sided market nature of the debit card industry[129] would mean that any "other sources" within the debit card line of business itself are uncertain to be sufficient to allow issuers to recoup their actual costs and the reasonable rate of return that the Constitution guarantees. The key feature of a two-sided market "is that it facilitates transactions among two . . . distinct groups . . . that would otherwise not take place, or not take place as efficiently, absent the intermediating platform bringing the parties together".[130] Thus, in a two-sided

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125 *Id.* at 399.

126 *See* 257 F.3d at 590-91.

127 *Id.* at 594-95 (citing *Brooks-Scanlon*).

128 75 Fed. Reg. at 81,733 n.44, 81,736.

129 *See* Government Accounting Office, Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges, GAO-10-45, at 18 (Nov. 2009), *available at* http://www.gao.gov/new.items/d1045.pdf.

130 Prager et al., *Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues* 14-15 (2009), *available at* http://www.federalreserve.gov/pubs/feds/2009/200923/200923pap.pdf (The debit-card market is a two-sided market—*i.e.*, "a market for the provision of a product whose value is realized only if a member of each of two distinct and complementary sets of users simultaneously agrees to its use") (citing Rochet & Tirole, Two-Sided Markets: A Progress Report, 37 RAND J. of Econ. 645 (2006)).

market, there are significant practical limits on the theoretical ability to increase charges on the more price-sensitive side of the market in response to confiscatory price caps on the less price-sensitive side of the market. As a result, in such a market, the constitutional problem is not cured or excused. It is not proper simply to posit as a matter of theory that issuers can charge debit card users higher prices equivalent to the lost interchange fee revenue needed to cover their costs and a reasonable rate of return. The significant negative effects on the debit-card issuing business and customer relations more broadly act as significant governors in recovery from other sources.

Accordingly, it is no answer to say that the Proposed Rule places no legal restrictions on issuers' authority to charge or receive fees from "other sources" if that option may be, in economic reality, no option at all, only a limited option, or an option with adverse or incalculable consequences. The Proposed Rule, and the stated grounds on which it is based, ignore these considerations, fail to investigate and make findings about the extent to which debit card issuance business would be harmed, and fail to recognize such a harm as an unconstitutional confiscation.

F. The Proposed Rule Harms Consumers, Financial Institutions, and the Payments System.

Section 904 of the Electronic Funds Transfer Act ("EFTA") requires the Federal Reserve to engage in the following analysis when proposing any regulation pursuant to EFTA—including the Durbin Amendment (which amends and is part of the EFTA):

i. consider the "costs and benefits to financial institutions, consumers, and other users of electronic fund transfers", of the regulation prior to issuing that regulation;

ii. consider the ways that the proposed regulation affects "competition in the provision of electronic banking services among large and small financial institutions and the availability of such services to different classes of consumers, particularly low income consumers"; and

iii. to the extent practicable, "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions".[131]

The requirement that the Federal Reserve consider these factors when issuing the Proposed Rule is bolstered by the Durbin Amendment's instruction to create guidelines for "*reasonable*" fees, a term that suggests considering the impact that such fees would have on all participants in the debit card interchange system. The Proposed

[131] 15 U.S.C. § 1693b(a)(2)-(3).

Rule, however, nowhere makes reference to any of the Section 904 requirements, and there is no indication that the Proposed Rule took any of them into account. The failure to follow the Congressional mandate to consider these factors invalidates the Proposed Rule, and is one of the many reasons that the Proposed Rule is contrary to the statutory mandate. Had these factors been considered, we believe that the Federal Reserve would have determined that the Proposed Rule, in its current form, would have a harmful effect on both consumers and debit card issuers.

1. The Proposed Rule Will Significantly Harm Consumers.

The collection of debit card interchange fees supports the ability of banks and credit unions to provide millions of consumers with a variety of free debit card products and services, including free debit cards, free debit card transactions, and fraud protection on debit card transactions, as well as free checking (bank accounts are estimated to cost banks $250-$300 annually per customer).[132] The Proposed Rule will sharply reduce the collection of debit card interchange fees, and thus lead to several unintended, undesirable, and unreasonable consequences for consumers.

First, as the Federal Reserve acknowledges, it is probable that the result of forcing banks and credit unions to accept suppressed, below-cost debit card interchange fees will be the loss of free debit card services and products and free or low-cost checking accounts for millions of Americans. Loss of these services and products will be particularly devastating for low-income Americans who would no longer qualify for free checking and will need either to start paying higher fees or be forced out of the mainstream banking system to check cashers and non-bank sources of lending[133]—business areas into which big box retailers unsurprisingly are aggressively expanding without (or with very limited) regulatory oversight.[134] Some have estimated that up to

132 *See The Cost of a Checking Account*, ABA, June 2010, http://www.aba.com/aba/documents/press/CostofCheckingAccountsJune2010.pdf.

133 Federal Deposit Insurance Corporation, FDIC National Survey of Unbanked and Underbanked Households 18 (December 2009), available at http://fdic.gov/householdsurvey/full_report.pdf ("Nearly 20 percent of lower-income U.S. households—almost 7 million households earning below $30,000 per year—do not currently have a bank account. As household income increases, the unbanked rate declines considerably."); *id.* at 25 ("Similar to households that have never had an account, previously banked households had financial reasons, more than any other type of reason, for closing their account. Slightly more than one-third (34.1 percent) of households that were previously banked closed their account because they did not have enough money to need an account . . . . Notably, nearly one-third (31.4 percent) of previously banked households closed their account because of the costs of maintaining it (*i.e.*, minimum balance requirement, service charges, overdrafts)."); *see also*, Todd Zywicki, *Dodd-Frank and the Return of the Loan Shark*, Wall St. J., Jan. 4, 2011, at A17; Ylan Q. Mui, *Bank of America to Change Fee Structure for Checking Accounts*, Wash. Post, Jan. 6, 2011, at A15.

134 *See, e.g., Ylan Q. Mui, Retailers Offer Financial Services to 'Unbanked', Wash. Post, January 31, 2011,* http://washingtonpost.com/wp-dyn/content/article/2011/01/31/AR2011013106177.html

(footnote continued . . .)

5% of Americans who currently have checking accounts could be driven from the banking system.[135] The traditional demand deposit account has long served as a gateway product for entry into the financial services mainstream. Customers without a traditional deposit account have a more difficult time building the credit history necessary to receive a bank loan or to access other banking services and products. Prior Federal Reserve statements have acknowledged this harm to consumers as the result of price fixing rates that issuers may receive in the parallel context of credit cards.[136]

Second, the Proposed Rule will make debit cards less desirable for those customers who remain able to obtain them. For example, interchange fees are often higher for larger purchases to compensate for the risk of higher fraud losses on such purchases. By imposing a price cap that fails to let issuers recover their costs, and especially their costs for larger purchases, the Proposed Rule may force issuers to limit a customer's use of a debit card to purchases below a certain dollar amount in order to avoid higher fraud losses. Issuers may also discourage debit card users from engaging in other higher fraud risk transactions, such as those where the cardholder is not present (*e.g.*, online payments). On top of that, because the Proposed Rule drastically lowers interchange fees, debit card issuers will also have fewer resources to invest in services and products that consumers demand, such as customer service, anti-hacking and other technologies to protect the security of their systems, and the development of new programs and methods of payment.

Third, the Proposed Rule will stifle the innovation that benefits consumers. Over the past few years, issuers have invested billions of dollars in specific online and mobile features that are specifically tailored to bolstering the ease and availability of online payments, including debit cards. Online and mobile banking systems for many issuers now provide customers with the benefit of immediately showing debit card activity. Several issuers also provide their customers with mobile, email, and Short Message

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(describing the efforts of large retailers to aggressively enter the non-traditional financial services market, including check cashing services).

135 *See* JPMorgan Chase 2011 Investor Day Presentation, available at http://files.shareholder.com/downloads/ONE/1170663794x0x441294/8b284551-067d-4b27-852f-8611af5749d1/2-15-11-Investor-Day-Retail-Fin.pdf, at 45.

136 *See*, *e.g.*, Kathryn L. Combs & Stacy L. Schreft, DO CONSUMERS REALLY WANT CREDIT CARD REFORM?, FED. RESERVE BANK OF KANSAS CITY 40 (1999), *available at* www.kc.frb.org (noting, in the context of proposed price controls for credit card rates, "[w]hen issuers adjust the unrestricted components of effective price to circumvent [a price] cap, from the perspective of the issuers the effective price remains unchanged. The same is not true for consumers; in general, some of them are worse off from the cap."); *id.* at 43 ("a cap on [] fees is likely to hurt, rather than benefit consumers. At a minimum, [consumers] are worse off because of adjustments to price terms and product features or because of credit rationing.").

Service ("SMS") alerts. And some issuers have introduced personal financial management ("PFM") features that auto-categorize a customer's spending by categories based upon debit card usage. If issuers are unable to recover even their basic costs associated with operating the current debit payments system, they will have no incentive to develop other debit payment programs and services that, while benefiting consumers, will also lead to additional costs that issuers cannot recoup under the Proposed Rule.

It is no answer to say, as the Proposed Rule attempts, that issuers will attempt to innovate in order to bring their per-transaction costs below the price caps set forth in the Proposed Rule.[137] As an initial matter, such an incentive to innovate would not encourage issuers to make new investments in the system or offer new services and products that customers would enjoy. Moreover, even if issuers could somehow bring their total cost per transaction below the caps in the Proposed Rule—caps that are concededly based on only a fraction of the total cost per transaction—the Proposed Rule sets forth a plan under which the Federal Reserve would constantly reevaluate whether the caps are "reasonable and proportional" to the allowable per-transaction cost.[138] That is to say, as soon as the issuers reduced their allowable costs, the Federal Reserve would lower the cap, thus eliminating any reward for issuers to lower their allowable costs. Indeed, the entire argument appears to be based on the faulty premise that a limit on fees will cause issuers to reduce their costs and their losses, whereas the profit objective has not in the past.

Finally, as Chairman Bernanke recognized in his testimony before the Senate Finance Committee,[139] the Proposed Rule fails to guarantee any benefit to consumers. Neither the Durbin Amendment nor the Proposed Rule requires merchants to pass their billions of dollars in savings from lower debit card interchange fees to consumers. The problematic nature of any consumer benefit is demonstrated by the United States Government Accountability Office's ("GAO") 2009 study of Australia's capping of merchant interchange fees. The GAO study found that Australian officials acknowledged there was no "conclusive evidence" that the merchants' 1.1 billion Australian dollars in savings resulted in lower merchant prices for consumers.[140]

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137 75 Fed. Reg. at 81,737.

138 *See* 75 Fed. Reg. at 81,738 ("The Board recognizes that issuers' costs may change over time, and the Board proposes to conduct periodic surveys of covered issuers and reexamine the cap amount periodically in light of changing issuer costs.").

139 *See supra* at n. 23.

140 Government Accounting Office, Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, But Options for Reducing Fees Pose Challenges, GAO-10-45, at 45 (Nov. 2009), *available at* http://www.gao.gov/new.items/dl045.pdf. Some merchant representatives interviewed for this study stated that merchants would take different steps to improve customer

(footnote continued . . .)

Chairperson Bair's testimony also expressed skepticism that merchants would pass on any significant portion of their savings to their customers.[141]

2. The Proposed Rule Will Harm Banks and Credit Unions.

Debit card issuers currently receive a substantial portion of their net revenue from debit card interchange fees. As discussed above, this revenue allows the banks and credit unions to provide their customers with free or otherwise attractively priced debit card products and services. If the issuers are no longer able to provide these products on these terms, they will lose customers.

The loss of the fees and customers will have a particularly severe effect on roughly 16,000 small banks and credit unions, which obtain a considerably higher percentage of their total revenues from debit card interchange fees than do larger issuers. Congress recognized that smaller issuers would have a more difficult time and attempted to remedy this problem by providing an exemption to the guidelines for issuers with assets of less than $10 billion.[142] Notwithstanding the intent, however, the major trade associations for smaller banks and credit unions strongly endorse this letter and oppose the Proposed Rule because they believe that any protection for small banks and credit unions, at best, is highly speculative. The Proposed Rule will require two separate pricing systems that every major trade association representing small banks and credit unions believes is unlikely to work as intended.[143] As an initial matter, several networks have not yet disclosed whether they are able or willing to create two separate pricings schedules. But even assuming that such two separate systems will be created, merchants will have a strong economic incentive to drive transactions to the lowest fee payment vehicles—*i.e.*, those offered by the large banks.[144] During his recent testimony

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service if interchange fees were lowered, such as hiring more employees, but there is again neither a requirement nor verifiable commitment to do so.

141 *See supra* at n. 26.

142 § 920(a)(6).

143 *See*, *e.g.*, January 3, 2011 Letter from Bill Cheney, President & CEO of the Credit Union National Association to Reps. Bachus and Frank; January 11, 2011 "ABA Statement on Visa's Plan For Two-Tier Debit card interchange System"; January 10, 2011 "ICBA Statement on Two-Tier Debit Card Interchange Plan"; January 21, 2010 Letter from B. Dan Berger, Executive Vice President, Government Affairs of the National Association of Federal Credit Unions to Reps. Bachus and Frank.

144 The Federal Reserve has conceded that it does not know whether smaller issuers will actually be exempt from the price controls under the Proposed Rule. *See* Open Meeting Transcript at 14 ("So with regard to the small issuers, we really don't know what the net effect of the rules will be, because it depends on actions to be taken by the networks and the merchants, and we can't predict those actions. Both the statute and our proposed rule permit, but do not require, the

(footnote continued . . .)

before the Senate Banking Committee, Chairman Bernanke explicitly recognized these very serious threats to the effectiveness of the exemption.[145]

Income attributed to debit card interchange for community banks represents approximately 8%-12% of total fee income. This estimate, however, was made before recent regulatory changes reducing bank overdraft program income went into effect in August 2010, and, therefore, the current number is likely even higher. In addition, interest earned from investing deposits, the primary revenue source used to support the cost of providing checking accounts, is at historic lows.[146] Moreover, the Proposed Rule threatens to lower the amount of interest even more, because its likely effect will be to cause issuers to start charging fees on basic banking services, thus driving customers and their deposits away. Accordingly, the importance of debit card interchange income has been greatly increased in the current environment, and multiplies the negative effect of reductions in that revenue.

3. The Proposed Rule Will Threaten the Effective Functioning of the Payments System.

One of the many likely consequences of the Proposed Rule is the exposure of the United States payments system to additional risk, which is antithetical to one of Dodd-Frank's overarching objectives of mitigating systemic risk.

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networks to establish higher interchange fees for the exempt issuers than for the covered issuers.").

145 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.")

146 The Money Blue Book, http://www.moneybluebook.com/best-online-bank-savings-and-checking-accounts/ (last visited Feb. 16, 2011); *see also* Consumerism Commentary, http://www.consumerismcommentary.com/rates/ (last visited Feb. 16, 2011); DepositAccounts.com, *Five Best Reward Checking Accounts Available Nationwide*, July 21, 2010, http://www.depositaccounts.com/blog/2010/07/five-best-reward-checking-accounts-available-nationwide.html.

As Chairman Bernanke explained in voting to issue the Proposed Rule for comment:

> I, too, can support issuance of this proposal for comment. Again, this is a very complex area. Within the parameters set by Congress it's very important that we, as Governor Warsh said, do all we can to preserve the dynamism, competition and innovation in payments, which has obviously been an important feature of that area for quite a long time, and, at the same time, as Governor Raskin was indicating, we should do all we can to minimize the administrative and regulatory burden implied by these rules. But with those injunctions, I think we can now take a vote to formally approve the issuance of this rule for public comment.[147]

Contrary to the injunctions, however, the Proposed Rule will decrease the dynamism, competition and innovation of the U.S. payments system in several crucial ways.

As described above, the Proposed Rule could lead to an increase in the unbanked population. Such an increase would mean higher use of non-electronic payment methods, such as cash and checks, and higher use of check cashers and similar high-cost non-bank service providers. Higher use of cash and checks will result in increased risk, increased costs, and less efficiency in the payments system. Whether through interchange fees on card transactions or bank fees on cash and check services, merchants pay for banking services they receive, but cash and checks are expensive payment methods relative to electronic debit transactions because of increased costs relating to handling and risk of loss. In addition, higher use of non-electronic payment methods reduces the ability of financial institutions to control fraud and monitor transactions and accounts for suspicious or illicit activity (like money laundering, terrorist financing or other unlawful activities), and increases the risk of theft from merchants and customers. Many of the alternative, non-bank payment solutions used by unbanked consumers, such as check cashers and similar service providers, are subject to less robust regulation, less regulatory oversight than debit card issuers, and less transparency. Driving consumers out of the bank and credit union-driven electronic payments system and into non-electronic payment alternatives not only harms these consumers, but increases systemic and regulatory risks and decreases the efficiency of the U.S. payments systems.

The Proposed Rule also threatens the effective functioning and improvement of the debit card interchange payments system by creating a strong disincentive for banks and credit unions to invest in maintaining and improving the system. American businesses have always proceeded on the assumption that their investments in new

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147 Open Meeting Transcript at 27.

products, if successful, will lead to a reasonable profit. Relying on this assumption, financial institutions have invested billions of dollars in creating and improving the modern debit card system.[148] Had these institutions anticipated that the federal government would make an *ex post facto* decision to deny them the ability to make a reasonable profit on their investment—indeed, to prevent the institutions from even recouping their costs of investment—it is doubtful that they would have even created the debit card system in the first place, let alone developed and improved it as they have.

The debit card interchange system will likely require billions of dollars in investments over the next few years to maintain, let alone improve and advance, the system. By capping interchange fees at below cost, the Proposed Rule provides a strong disincentive for issuers to make these investments, and thus leads to systems breakdowns and security breaches.

IV. The Proposed Rule Provides a Windfall to Merchants.

Merchants today receive numerous benefits from the global debit card interchange network. For an average cost of only about 44 cents or 1.14% per transaction,[149] merchants are able to attract customers to their stores, sell additional merchandise, and process payments quickly and safely, with little or no risk to themselves. For example, when fast food restaurants began accepting payment cards in the late 1990s and early 2000s, many of them reported significant "ticket lift", some on the order of 20% to 30% higher spends as compared to cash tickets, as well as higher throughput during peak hours.[150] The convenience of debit cards has particularly benefited certain categories of merchants, such as online merchants (whose business models depend on card payments over the internet) and self-serve gas stations (who save employee costs by allowing customers to pay at the pump themselves). Moreover, under the debit transaction system, merchants are guaranteed payment for in-person transactions even in the event the customer has insufficient funds. In contrast, checks

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148 As discussed below, this is illustrated, in part, by the extraordinary proliferation and availability of debit cards, which grew from 60 million in 1983 to 491 million in 2008, and are projected to reach 585 million in 2011. The percentage of households using debit cards grew, in tandem, from 20% in 1995 to 71% by 2007. The level of investment necessary to accommodate such numbers has been significant. *See* Stan Sienkiewicz, *The Evolution of EFT Networks from ATMs to New On-Line Debit Payment Products*, PAPER CARDS CENTER OF THE FEDERAL RESERVE BANK OF PHILADELPHIA 4 (April 2002); THE 2011 STATISTICAL ABSTRACT, U.S. CENSUS BUREAU, http://www.census.gov/compendia/statab/cats/banking_finance_insurance/payment_systems_consumer_credit_mortgage_debt.html.

149 75 Fed. Reg. at 81,725.

150 *Visa Efforts Demonstrate that Payment Card Acceptance Increases Ticket Size, Increases Speed, and Improves Customer Satisfaction*, BUSINESS WIRE, Nov. 12, 2002.

are not guaranteed and can be returned to merchants ($103 billion in returned checks in 2009).[151] Both the very substantial losses from returned check and the significant processing costs are avoided by debit card usage. Other benefits to merchants from debit card use include faster service for customers, lower payroll costs (because merchants need to spend fewer employee hours processing payments), faster use of money from sales through virtually immediate availability, the ability to offer multiple payment methods as part of their online commerce, and the elimination of the costs associated with processing cash and check payments.

Of course, merchants are not required to accept debit card payments and many do not. Moreover, any merchant currently accepting such payments has the right to stop accepting them. This must mean that the merchants that currently accept debit card payments—and the number of merchants accepting debit card payments is growing rapidly—find the current debit card interchange rates to be economically desirable. In the alternative, they can accept debit cards but avoid fees altogether by offering discounts for non-card transactions and allowing customers to make the choice of whether they want to pay for the card's convenience.

The Proposed Rule would mean that merchants would receive all the benefits of debit card transactions while paying only a fraction of what it costs the issuers to provide those services, let alone paying the issuers a reasonable profit for those services. The resulting potential windfall to merchants is enormous, and especially benefits the very largest retailers, which will receive billions of dollars of annual savings.

V. <u>The Proposed Rule Should Not Impose Government Price Caps On Transactions Between Private Parties.</u>

The strong American principle against government price caps on transactions between private parties should preclude the Federal Reserve from imposing such caps unless clearly compelled by Congress (which did not do so here). As Chairman Bernanke recognized during the December 16, 2010 meeting of the Board of Governors, "[t]here's a presumption that prices will be set by market competition, generally".[152] The major exception to this rule is government regulation of electric utility monopolies, but this is obviously not analogous to the non-monopolistic debit card interchange system. That system features thousands of competing issuers, at least 20 different point of sale networks, and other payment options (credit cards, check, and cash) that consumers may use. Moreover, even in the case of elastic utility models, they are authorized to charge amounts that create a reasonable rate of return.

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151 FEDERAL RESERVE SYSTEM, THE 2010 FEDERAL RESERVE PAYMENTS STUDY: NONCASH PAYMENT TRENDS IN THE UNITED STATES: 2006-2009, at 9 (Dec. 8, 2010), available at http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf.

152 Open Meeting Transcript at 8.

The other recent exceptions to the American principle against government price caps have been generally limited to times of major war or hyperinflation, and even then such caps are typically limited to basic needs such as food, housing, and materials used in military production. Obviously, debit card interchange fees do not fit into any of those categories.

Because government price caps outside the normal exceptions listed above almost inevitably lead to unintended and undesirable consequences and market inefficiencies, Congress almost always repeals them. For example:

- Prior to 1986, and pursuant to authority then codified at 12 U.S.C. § 371b (§ 19(j) of the Federal Reserve Act), the Federal Reserve, through Regulation Q, set maximum rates of interest payable on time and savings deposits.[153] In 1980, Congress enacted the Depository Institutions Deregulation Act, which amended Section 371b to remove that authority, and mandated that the Federal Reserve was to "provide for the orderly phase-out and the ultimate elimination of the limitations on the maximum rates of interest and dividends" in six years.[154] As such, on March 20, 1986, the Federal Reserve issued a final rulemaking amending Regulation Q and removing, among other things, 12 C.F.R. 217.7, which contained these restrictions.[155]

- Under the Credit Control Act, the President could authorize the Federal Reserve to regulate and control any or all extensions of credit, if he determined that such action was necessary or appropriate to prevent or control inflation.[156] The extent of the proposed rule's control was set out in 12 U.S.C. § 1905, which empowered it to: "(6) prescribe the maximum amount of credit which [could] be extended on, or in connection with, any loan, purchase, or other extension of credit [and] (7) prescribe the maximum rate of interest, maximum maturity, minimum periodic payment, maximum period between payments, and any other specification or limitation of the terms and conditions of any extension of credit". On December 8, 1980, 12 U.S.C. § 1910 was added, which provided that the authority conferred by the Credit Control Act was to terminate at the close of June 30, 1982. The Federal Reserve's above-stated authority to set caps was thus eliminated.

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153 *See* 12 C.F.R. § 217.7 (now repealed).

154 *See* 12 U.S.C § 3501.

155 51 Fed. Reg. 9,636.

156 *See* 12 U.S.C. § 1904.

VI. <u>The Proposed Rule Is Based On the Inaccurate Assumption that Government Price Caps Will Increase Competition In the Area of Debit Card interchange Fees.</u>

The Proposed Rule appears to be based, in part, on the incorrect view that, although "in most markets increased competition leads to lower prices . . . in payment card markets, competition between networks tends to drive interchange fees higher", because (i) the customers using debit cards do not see the associated fees that the merchants pay and so have no incentive to drive down the price of those fees, and (ii) the networks encourage higher fees as an incentive for issuers to issue more debit cards.[157] This view mistakenly equates the interchange fee to the "price" for debit card services.

First, as a matter of basic economic theory, the concern expressed about the debit card interchange market can be expressed about any two-sided market. One example is shopping malls, which attract customers in various ways that cost the mall operators money and then pass those costs along to the merchants that own stores in the malls in the form of higher rent. Customers then pay higher prices for goods and services in those merchants' stores, without ever seeing the hidden costs the merchants bear from the mall operators. Yet no one claims that shopping malls are examples of market failures. This is because economists have long recognized an important distinction between two questions concerning two-sided markets: (i) are the prices and costs efficient?; and (ii) which side of the market bears those costs? As described above, the Proposed Rule would not reduce costs and prices, but rather shift the burden of the costs of operating the debit card system from merchants onto customers.

Second, very often increased competition in consumer technology markets (such as the debit card market) yields innovation and the addition of new and improved services, while the prices stay flat or even increase. This is decidedly the case here, given the litany of improvements of debit card goods and services over the past two decades, despite relatively stable effective interchange fee rates over the past few years.

Third, far from being an example of market failure, the debit card interchange system is an example of one of the great stories of market improvement and growth over the past decade. Merchants that believe that interchange fees are too high—*i.e.*, that the fees are greater than the value provided by the interchange system—always have the opportunity of not accepting debit cards. Moreover, merchants cannot possibly claim that accepting debit cards is a necessary part of operating their businesses, as (i) many merchants choose not to accept debit cards, and (ii) merchants always have the ability to accept debit cards, but discourage customers from using them

[157] Open Meeting Transcript at 8.

by offering discounts for other methods of payment. This latter option would not only allow merchants to balance the convenience of accepting debit cards versus the fees required for such payments, but also would allow customers to see the supposed additional prices that they pay on goods and services as a result of debit card interchange fees. (Presumably merchants could also show customers the costs they incur as a result of the merchants' costs of processing other forms of payment as well.)

Fourth, there is no validity to the argument that interchange fees will continue to spiral upward regardless of the issuers' costs, as issuers need to consider the possibility of merchant discrimination against their cards if the associated interchange fee exceeds the value of accepting the card. And, as an empirical matter, debit card interchange fees have remained flat for several years.

VII. <u>The Federal Reserve Should Fundamentally Revise the Interchange Fee Portion of the Proposed Rule and Delay Its Implementation.</u>

The Proposed Rule's creation of a government price cap on debit card interchange fees represents a series of incorrect legal conclusions and poor public policy. We strongly urge the Federal Reserve to issue a final rule as follows:

- The final rule should only set standards for assessing fees, not impose government price caps.

- The final rule's standards should use a cost baseline that is based on an issuer's average total costs per transaction, not average variable cost, and exclude only those costs that are clearly precluded by the statute. Because the Proposed Rule effectively binds issuers that are supposedly exempt under the Durbin Amendment, the Federal Reserve should take the time to determine the average total costs of smaller issuers as well, and include those costs in the baseline.

- The final rule should allow for a fee reasonable and proportional to the cost baseline, permitting issuers to earn a reasonable rate of return on their debit card services. This return should be sufficient to avoid burdening customers with higher fees and to allow for continuing investment and innovation in the debit card market.

- The final rule should set a safe harbor equal to a high decile of the various issuers' average total per transaction costs plus a reasonable rate of return. Again, this safe harbor must be based on the allowable costs of all issuers—not just issuers with over $10 billion in assets.

In addition, we strongly urge the Federal Reserve to delay promulgation of a final rule regarding debit interchange fee restrictions, which under the circumstances would be legally justifiable. *First*, such a delay is necessary to study the impact of any rule on smaller issuers—something the Federal Reserve did not consider because it proceeded on the incorrect assumption that smaller issuers would be truly exempt from the Proposed Rule's price caps. Such a study would also need to collect cost information from smaller issuers and then incorporate that information into new standards for assessing whether a debit interchange fee is reasonable and proportional to the issuer's cost incurred for that transaction.

Second, the three months between the Federal Reserve's planned promulgation of the final rules on April 21 and the Federal Reserve's planned effective date of July 21, 2011, for the interchange fee restrictions is unreasonably short and will cause significant disruptions in the payments system. Current network rules typically require that networks provide issuers with several months' notice prior to the implementation of even minor interchange fee or related processing changes. Compliance with the interchange fee restriction portion of any final rule will require a fundamental change to the current interchange fee structure and will require much more than three months to complete. Regardless of whether the final rule differs from the Proposed Rule, the compliance process will require substantial time and effort on the part of both networks and issuers.

Third, a reasonable delay would allow the Federal Reserve to develop and issue fraud prevention guidelines, which could then allow fraud prevention costs to be included in any newly issued standards for assessing fees.

Fourth, in circumstances such as these, where delayed promulgation and effectiveness of the final rule are required to avoid unnecessary harm to the debit marketplace and consumers, such delays are legally justifiable. Even if there were a private right of action in this case, which there is not,[158] courts will decline to enforce a statutory deadline for the promulgation of final rules provided the regulatory agency delay is reasonable.[159] The Federal Reserve presumably acknowledges its legal authority to delay implementing rules beyond a statutory deadline, because it has already done so by not issuing the fraud prevention guidelines by the deadline set forth in the Durbin Amendment. We also note that the statutory provisions on debit interchange fees will become effective on July 21, 2011, but there is no statutory requirement that the corresponding final rules must be effective by that date.

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158 *See* § 920(d).

159 *See, e.g., In re Bluewater Network*, 234 F.3d 1305, 1315 (D.C. Cir. 2000) (to compel an agency to issue regulations by a certain date, "we not only must satisfy ourselves that there indeed exists such a duty, but that the agency has 'unreasonably delayed' the contemplated action.") (citing Administrative Procedure Act, 5 U.S.C. § 706(1)).

Our recommendation for a delay encompasses the assumption that there would be no regulatory enforcement action as to interchange fees, because there would be no final rule.

VIII. The Federal Reserve's Exercise of Its Authority to Prescribe Rules to Prevent Circumvention or Evasion of the Proposed Rule Is Excessive.

Likewise, we have significant concerns about the prescriptions concerning the circumvention or evasion of the Proposed Rule. Under the Durbin Amendment, Congress granted the Federal Reserve authority to prescribe rules that (1) prohibit the use of network fees "to directly or indirectly compensate an issuer with respect to an electronic debit transaction" or to circumvent or evade the interchange fee restrictions,[160] and (2) prohibit other forms of circumvention or evasion of the interchange fee restrictions.[161] The Federal Reserve proposes to implement Congress's anti-circumvention mandate with a reasonable rule that classifies any net compensation from a network to an issuer with respect to electronic debit transactions (other than allowable interchange fees) as *de jure* circumvention or evasion (the "Net Compensation Restriction"). However, the Federal Reserve adopts an application of the Net Compensation Restriction that is legally defective and that unjustifiably expands on the statutory grant of authority as well as the text of its own Net Compensation Restriction by prohibiting *any* net compensation from a network to an issuer "for debit card related activities".[162] In so doing, the Federal Reserve proposes not only to prevent networks and issuers from circumventing the interchange fee restrictions as directed by Congress, but to also prohibit legitimate and necessary payments not related to electronic debit transactions if those payments relate to debit card related activities. The Federal Reserve's interpretation of Congress's anti-circumvention mandate and rulemaking authority (i) is unsupported by the text of the Durbin Amendment, (ii) will undermine the ability of networks to enhance the efficiency of the payments system, and (iii) will diminish competition among networks.

Consistent with Congress's statutory mandate, the Federal Reserve's proposed Net Compensation Restriction prohibits net compensation "with respect to electronic debit transactions",[163] but in related Supplementary Information the Federal Reserve substantially expands on the plain meaning of the restriction, stating that the requirement prohibits net compensation "for debit card related activities".[164] Congress

[160] § 920(a)(8)(B).

[161] § 920(a)(1).

[162] 75 Fed. Reg. at 81,762.

[163] *Id.* at 81,756.

[164] *Id.* at 81,762.

did not direct or authorize the Federal Reserve to prohibit *all* payments from a network to an issuer for debit card related activities (which could be construed to include virtually all payments from networks to issuers), but only those payments that *compensate an issuer for an electronic debit transaction*. Compensation paid with respect to electronic debit transactions constitutes a much narrower realm of payments than compensation paid for debit card related activities. Application of the Net Compensation Restriction to all payments for debit card related activities is overbroad and inconsistent with Congress's mandate and grant of rulemaking authority to the Federal Reserve. Further, prohibiting compensation for all debit card related activities would unnecessarily prohibit certain activities and payments that are not in circumvention of the limitations on interchange fees for electronic debit transactions and that are desirable and pro-competitive.

One function of payments from networks to issuers is to promote risk allocation and efficiency among participants in the network. For example, networks assess fees to acquirers and merchants for data security breaches and use the resulting proceeds to defray the costs to issuers of card re-issuance and related services necessary to respond to the acquirer or merchant data security breach. Networks' use of fees to allocate data security responsibility among network participants enhances efficiency and fairness of the payments system. Nevertheless, any such payments to issuers, while wholly unrelated to interchange fees and not related to electronic debit transactions, may well be subject to the Net Compensation Restriction if the Federal Reserve applies that restriction to all payments for debit card related activities.

In addition, networks often offer signing bonuses and other promotional payments to attract and retain issuers and to advance strategic goals or address security concerns. For example, a network may offer an issuer an incentive payment for the issuer to upgrade the issuer's systems to increase uptime and decrease network connectivity issues. Network payments to attract issuers to the network and to encourage certain desirable behaviors by issuers, even if associated with debit card related activities, should not be prohibited as circumvention unless the payments vary with the number or volume of debit card transactions processed on the network. Nevertheless, the overly restrictive approach to the Net Compensation Restrictions proposed by the Federal Reserve will substantially inhibit—if not eliminate—the ability of networks to use incentives (or any other financial means) to attract issuers to the network and will deprive networks of the ability to use compensation to induce efficiency-enhancing issuer behavior that is ultimately beneficial to all payments system participants, including merchants and consumers.

The Federal Reserve must abide by Congress's statutory mandate and should limit the prohibition on circumvention to only those payments from networks to issuers that specifically relate to electronic debit transactions, such as payments made in exchange for the issuer achieving certain electronic debit transaction count or volume thresholds. In its current form, the anti-circumvention portion of the Proposed Rule will prohibit payments currently used to properly allocate liability among the various network participants, promote efficiency, and drive marketplace competition. Any regulations restricting these types of payments would not promote the objective of prohibiting circumvention of the interchange fee restrictions but would bring substantial and unnecessary harm to the debit card marketplace.

IX. The Proposed Rule's Network Exclusivity Restrictions Should Also Be Revised.

As discussed below, we also believe that there are several significant legal problems with the Proposed Rule's alternative proposals addressing the network exclusivity restriction provisions of the Durbin Amendment.

A. Description of the Network Exclusivity and Routing Restrictions Under the Durbin Amendment

Under the Durbin Amendment, Congress directed the Federal Reserve to prescribe regulations that prohibit a payment card network or issuer from: (1) restricting the networks on which an electronic debit transaction may be processed to a single network or affiliated group of networks (the "Network Exclusivity Restrictions");[165] and (2) inhibiting the ability of any person who accepts debit cards for payments to route an electronic debit transaction over any network that is enabled to process the transaction (the "Routing Restrictions," collectively, the "Network Exclusivity and Routing Restrictions").[166] Specifically, under the Network Exclusivity Restrictions, Congress directed the Federal Reserve to prescribe regulations "providing that an issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to (i) 1 such network; or (ii) 2 or more such networks which are owned, controlled, or otherwise operated by (I) affiliated persons; or (II) networks affiliated with such issuer".[167] Under the Routing Restrictions, Congress directed the Federal Reserve to prescribe regulations "providing that an issuer or payment card network shall not, directly or through any agent, processor, or licensed member of the network, by contract, requirement, condition, penalty, or otherwise, inhibit the ability of any person who accepts debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions".[168]

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165 § 920(b)(1)(A).

166 § 920(b)(1)(B).

167 § 920(b)(1)(A).

168 § 920(b)(1)(B).

B. Description of the Network Exclusivity and Routing Restrictions Portion of the Proposed Rule

Under the Proposed Rule, the Federal Reserve offers two alternatives for implementing the Durbin Amendment's Network Exclusivity Restrictions: Alternative A, which prohibits networks and issuers from limiting the number of networks available for processing an electronic debit transaction to fewer than two unaffiliated networks, *regardless of the means by which a transaction may be authorized*; and Alternative B, which prohibits networks and issuers from limiting the number of networks available for processing an electronic debit transaction to fewer than two unaffiliated networks *for each method by which a transaction may be authorized*.[169]

The Federal Reserve, through Supplementary Information, broadens the scope of the Routing Restrictions to include "certain practices that may affect the network choices available to the merchant at the time the transaction is processed".[170] This additional authority provides merchants with an enhanced ability to promote their preferred routing choice through activities such as steering cardholders to select a particular method of authorization or setting their preferred method of authorization as the default.[171]

C. The Proposed Rule's Approach to Implementing the Network Exclusivity Restrictions Portion of the Durbin Amendment is Legally Defective.

Certain aspects of the Federal Reserve's implementation of the Network Exclusivity Restrictions portion of the Durbin Amendment are overly broad and not authorized by the statute. Specifically, the Federal Reserve exceeds or contradicts statutory authority by (i) distinguishing between transactions by method of authorization in Alternative B and (ii) prohibiting *all* arrangements between networks and issuers that in *any way* restrict the networks made available on a debit card for processing a transaction.

1. Alternative B is Inconsistent with the Statutory Text of the Durbin Amendment.

As further discussed in Section IX.F below, Alternative A fully satisfies the text and intent of the Network Exclusivity Restrictions and, when coupled with the Routing Restrictions, provides merchant choice in all but the most limited circumstances. On the other hand, Alternative B, which prohibits limiting the number of networks available for

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169 75 Fed. Reg. at 81,749.

170 *Id.* at 81,752.

171 *Id.* at 81,752.

processing a transaction to fewer than two unaffiliated networks *for each method by which a transaction may be authorized*, is inconsistent with the plainest reading of the statutory text of the Durbin Amendment. The Durbin Amendment expressly characterizes electronic debit transactions without regard to the method of authorization used to initiate the transaction. Specifically, the Durbin Amendment defines an "electronic debit transaction" as a "transaction in which a person uses a debit card".[172] "Debit card" is defined in the Durbin Amendment as "any card, or other payment code or device, issued or approved for use through a payment card network to debit an asset account . . . *whether authorization is based on signature, PIN, or other means*".[173] Congress did not distinguish anywhere in the Durbin Amendment, and did not authorize the Federal Reserve to differentiate, between authorization methods. The Federal Reserve even acknowledges this fact by stating that "the statute does not expressly require issuers to offer multiple unaffiliated signature and multiple unaffiliated PIN debt card network choices on each card",[174] but then nevertheless proposes Alternative B in promotion of its own policy objective in an attempt to ensure every merchant that accepts debit cards of routing choice, even where the merchant has voluntarily limited choice by declining to support multiple transaction authorization methods and notwithstanding the substantial cost burden this would cause for issuers and networks. It seems logical, and is most consistent with the Durbin Amendment, that Congress intended merchants to have routing choice, but not where the merchant voluntarily deprives itself of routing choice by declining to support various authorization technologies.

2. The Proposed Rule Will Arbitrarily Prohibit *All* Arrangements Between Networks and Issuers That in *Any Way* Restrict the Networks Made Available on a Debit Card for Processing a Transaction.

While the Durbin Amendment only requires the Federal Reserve to prescribe regulations that prohibit an issuer or network from restricting the number of networks over which an electronic debit transaction may be processed to a single network or affiliated group of networks, the Proposed Rule prohibits *all* arrangements between networks and issuers that in *any way* restrict the networks made available on a debit card for processing a transaction. Specifically, through Supplementary Information, the Federal Reserve provides that all "[n]etwork rules or contract provisions limiting or otherwise restricting the other payment card networks that may be enabled on a particular debit card" are prohibited under the Proposed Rule.[175] Given this prohibition,

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[172] § 920(c)(5).

[173] § 920(c)(2) (emphasis added).

[174] 75 Fed. Reg. at 81,749.

[175] *Id.* at 81,763.

an issuer may not, for example, agree to limit the number of networks enabled on its debit cards to no more than two networks per method of authorization even though such restriction does not in any way violate the requirements of the Durbin Amendment or the proposed regulatory text of the more expansive Alternative B. The Federal Reserve's prohibition of all arrangements between networks and issuers that in any way restrict the networks made available on a debit card is an arbitrary and unauthorized expansion of the text of the Durbin Amendment.

D. The Network Exclusivity Restrictions Portion of the Proposed Rule Impairs the Debit Marketplace.

The adoption of Alternative B will cause unnecessary and avoidable harm to the debit marketplace through a multitude of unintended negative consequences, including (1) presenting networks and issuers with significant technical challenges and financial burdens, and (2) stifling innovation, without a material offsetting benefit. Ultimately, as discussed below, the principal benefit of Alternative B relative to Alternative A would be the provision of greater merchant routing choice in those instances where a merchant has voluntarily elected not to support multiple debit authorization methods.

1. Adoption of Alternative B Will Present Networks and Issuers With Significant Technical Challenges and Financial Burdens.

As the Federal Reserve recognizes in the Supplementary Information, there are substantial technological and financial hurdles to enabling multiple signature networks on a debit card, which would be required under Alternative B for all but a very small minority of debit cards that are not enabled with signature debit functionality. For instance, as the Federal Reserve notes, enabling multiple signature debit networks on a card would require a multitude of changes within the electronic payments system, including "the replacement or reprogramming of millions of merchant terminals as well as substantial changes to software and hardware for networks, issuers, acquirers, and processors in order to build the necessary systems capability to support multiple signature debit networks for a particular debit card transaction".[176] And since there is no precedent of debit cards being enabled for multiple signature debit networks, the specific technology burdens and costs associated with implementation, while known to be high, are uncertain, as is the necessary implementation timeline.

In addition to effort and expense associated with the initial replacement or reprogramming of the additional terminals and other system components required by Alternative B, issuers and networks would also be burdened by the ongoing effort and expense associated with maintaining and updating the additional hardware and software. The increased financial burdens associated with Alternative B would be

176 *Id.*

particularly acute given the interchange fee constraints imposed by the Proposed Rule: not only would issuers be unable to recover the full costs of their current debit programs, but they also would be forced under Alternative B to incur even more unrecoverable costs. Compliance with Alternative B could be particularly onerous for smaller issuers. The Federal Reserve itself acknowledges that "small debit card issuers could be disproportionately affected by a requirement to have multiple networks for each method of debit card authorization" and that "Alternative A would minimize the overall compliance costs for these issuers".[177]

2. Adoption of Alternative B Will Stifle Innovation.

As described above, the Durbin Amendment is codified under the EFTA. Section 904 of the EFTA requires that the Federal Reserve, when proposing new regulations under the EFTA, take into account and allow for the "continuing evolution of electronic banking services and the technology utilized in such services".[178] It appears that although the Federal Reserve, in Supplementary Information, recognizes that requiring at least two unaffiliated networks per authorization method would be likely to inhibit the development and deployment of new authorization methods and technologies,[179] the Federal Reserve generally disregards the impact of the Proposed Rule on innovation in the electronic payments industry in proposing Alternative B. New forms of authorization, many of which may reduce fraud and/or create greater efficiencies in the processing of electronic debit transactions, may not be developed or implemented as these authorization methods may be, at least initially, technologically incapable of being processed on multiple unaffiliated networks (as would be required under Alternative B). The Federal Reserve specifically acknowledges that enabling multiple signature networks on a debit card may not be feasible in the near term and that "requiring unaffiliated payment card networks on a debit card for each method of card authorization could potentially limit the development and innovation of new authorization methods".[180] Additionally, networks and issuers may have less incentive to develop and deploy new technologies if they are required to share their proprietary work with competitors in order to comply with the Proposed Rule. The resulting lack of new innovation will ultimately result in reduced consumer choice in terms of payment methods available and will stifle the growth of these innovations that have benefited merchants and consumers, as well as the integrity of the debit marketplace as a whole.

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177 *Id.*

178 15 U.S.C. § 1693b(a)(1).

179 75 Fed. Reg. 81,749, 81,751.

180 *Id.* at 81,749.

E. Alternative B Would Cause Unnecessary Harm to Consumers.

Section 902 of the EFTA states that the primary objective of the EFTA is the protection of consumer rights.[181] Further, Section 904 of the EFTA requires the Federal Reserve to consider the costs and benefits to consumers, particularly low-income consumers, when proposing any regulation pursuant to the EFTA.[182] The Federal Reserve is also required, to the extent practicable, to "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions".[183] Nowhere in the Proposed Rule or its accompanying discussion does the Federal Reserve indicate that it considered consumer harm associated with proposed Alternative B. Had it done so, the Federal Reserve likely would have determined that Alternative B would have a negative impact on consumers with little or no offsetting benefit.

In addition to the indirect harm they will experience as a result of the unintended consequences of Alternative B to the debit marketplace, consumers will be directly harmed under Alternative B. As the Federal Reserve acknowledges in Supplementary Information, adopting Alternative B would likely deprive consumers of knowledge and control regarding the network over which any particular electronic debit transaction will be routed, potentially depriving them of rights, privileges and benefits granted by certain debit card networks.[184] For instance, certain networks offer cardholder benefits in connection with the processing of electronic debit transactions, including zero cardholder liability for fraud, enhanced chargeback rights, extended warranty protection on purchases, insurance benefits, fraudulent activity detection and alerts and rewards.[185] Multiple network options per method of authorization, as proposed under Alternative B, in conjunction with merchant routing choice would likely reduce a cardholder's ability to obtain these desired benefits (which are often tied to specific networks) because cardholders will have no control over or even knowledge of the network on which their transactions are processed. As the Federal Reserve further acknowledges, Alternative B presents the separate challenge to networks and issuers of informing their customers that they will only receive certain benefits based on the routing option chosen by a given merchant and that these benefits will vary across merchant and transaction type, without much, if any, control on the part of the consumer.[186] In practice, an issuer may need to eliminate certain benefits if there is no

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181 15 U.S.C. § 1693(b).

182 15 U.S.C. § 1693b(a)(2).

183 15 U.S.C. § 1693b(a)(3).

184 75 Fed. Reg. at 81,748-49.

185 *Id.*

practical, legally compliant way to disclose how and when a consumer may or may not receive such benefits.

In contrast, under Alternative A, while the merchant would be permitted under the Routing Restrictions to steer the consumer to a particular method of authorization, unless the issuer enabled multiple networks per method of authorization, the consumer would have knowledge and control of the network over which the transaction would be routed based on the method of authorization.

F. Alternative A Fully Implements the Network Exclusivity Restrictions and Provides Adequate Merchant Choice Regarding Routing.

Alternative A is entirely consistent with and achieves the intended objectives of the Durbin Amendment by prohibiting networks and issuers from limiting the number of networks available for processing a transaction to fewer than two unaffiliated networks. The Federal Reserve acknowledges as much, noting that "[n]othing in EFTA Section 920(b)(1)(A) specifically requires that there must be two unaffiliated payment card networks available to the merchant once the method of debit card authorization has been determined".[187] Nonetheless, the Federal Reserve—substituting its own policy objectives for Congress's—proposes Alternative B due primarily to concerns that the adoption of Alternative A would not afford merchants that do not support multiple debit authorization technologies with a sufficient level of routing choice.[188] However, this concern is unwarranted and addressing it results in an unjustifiable and unfair cost shift to networks and issuers.

Almost all instances where only one method of electronic debit transaction authorization is available result from merchants' voluntary elections, usually due to a lack of economic incentive to make investments in the equipment and technology necessary to accept PIN debit.[189] These merchants' consequential effective lack of

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(. . . footnote continued)

186 *Id.* at 81,749.

187 *Id.*

188 *Id.* at 81,749-50.

189 Merchants now have the ability to process PIN debit transactions via the Internet and receive the full benefit of Alternative A. New applications are available that allow consumers to elect to process their payment via signature or PIN. If the consumer selects PIN, they enter their PIN number to complete the transaction. This new technology further benefits online merchants because now they now are able to accept PIN only debit cards to increase sales. Some of the largest payments processors now offer their merchant customers the option to accept PIN debit transactions over the Internet. *See*, *e.g.*, Digital Transactions, February 14, 2011, *available at* http://www.digitaltransactions.net/news/story/2925/.

ability to process transactions over multiple networks is not due to any restriction on the part of networks or issuers. If and when it becomes economically efficient for a merchant that currently only accepts one method of authorization to accept another method of authorization, the merchant will make the election to do so. Admittedly, there are other limited instances where PIN debit functionality is not currently as practical, such as payments for lodging and car rentals, because many PIN debit networks do not yet offer the same variety of authorization options. However, rapid technological advancements may provide alternative authorization methods for such purchases, provided such advancements are not impeded by the Federal Reserve's adoption of Alternative B (as discussed above). For example, Internet PIN debit solutions are becoming increasingly available in the marketplace to those merchants that elect to support this technology.

Not only are the Federal Reserve's expressed concerns regarding the effectiveness of Alternative A for providing merchants with adequate routing control unwarranted, but the Federal Reserve's implementation of Alternative B is statutorily unauthorized and would unnecessarily cause significant harm to the debit marketplace and consumers.

G. The Federal Reserve Should Revise the Network Exclusivity Restrictions Portion of the Proposed Rule.

The Network Exclusivity Restrictions portion of the Proposed Rule includes several provisions, including proposed Alternative B, that are not authorized by the Durbin Amendment and would result in unnecessary harm to the debit marketplace and consumers. The Federal Reserve should revise the legally defective portions of the Proposed Rule and Supplementary Information to accurately follow the statutory text of the Durbin Amendment. Specifically, the Federal Reserve should adopt Alternative A and not Alternative B because Alternative A faithfully implements the statutory text and intent, and avoids unnecessary and harmful disruption to the debit marketplace. In addition, the Federal Reserve should clarify that the Proposed Rule does not prohibit all arrangements between networks and issuers that in any way restrict the networks made available on a debit card for processing a transaction, but rather only prohibits the restriction of the networks on which an electronic debit transaction may be processed to a single network or affiliated group of networks.

Further, we submit that the potential effective dates suggested by the Federal Reserve for the final rule implementing the Network Exclusivity and Routing Restrictions do not allow sufficient time for compliance. Compliance with the rule implementing the Network Exclusivity and Routing Restrictions will require tremendous effort, regardless of whether the Federal Reserve adopts Alternative A or Alternative B. In addition to requiring time to overcome the technical challenges and financial hurdles associated with the compliance process, issuers will need sufficient time to establish the commercial arrangements with networks necessary to satisfy the Network Exclusivity

Restrictions. The process of establishing those arrangements—developing and distributing requests for proposals, evaluating proposals, conducting due diligence, and negotiating and documenting business and legal terms—necessarily requires significant time. Due to the extra complexity inherent in Alternative B, the implementation timeline for final rules that require the enablement of multiple networks per method of authorization will be even longer and less predictable. For these reasons, we request that the Federal Reserve extend the Network Exclusivity and Routing Restrictions rule effective date to October 1, 2013, if Alternative A is adopted, and one year after that date if Alternative B is adopted.

* * *

Thank you for considering the views expressed in this letter. We appreciate the opportunity to share our views and would be pleased to discuss any of them further at your convenience. Please feel free to contact Paul Saltzman, President and General Counsel of The Clearing House Association (Paul.Saltzman@theclearinghouse.org, (212) 613-0138), Rob Hunter, Deputy General Counsel of The Clearing House Association (Rob.Hunter@theclearinghouse.org, (336) 769-5314), or Rodge Cohen of Sullivan & Cromwell LLP (Cohenhr@sullcrom.com, (212) 558-3534), who have been coordinating the participation in this letter of all the trade associations listed below.

Sincerely,

/s/
Frank Keating
President and CEO,
American Bankers Association

/s/
Paul Saltzman
President
The Clearing House Association L.L.C.

/s/
James D. Aramanda
CEO,
The Clearing House Payments Company L.L.C.

/s/
Richard Hunt
President,
Consumer Bankers Association

/s/
Bill Cheney
CEO,
Credit Union National Association

/s/
Steve Bartlett
CEO,
Financial Services Roundtable

______/s/___________________
Camden R. Fine
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Independent Community Bankers of America

______/s/___________________
Russell Goldsmith
Chairman and CEO of City National Bank,
Chairman of the Midsize Bank Coalition of America

______/s/___________________
Fred R. Becker, Jr.
President/CEO
National Association of Federal Credit Unions

______/s/___________________
Michael A. Grant
President and CEO,
National Bankers Association

cc: Hon. Timothy F. Geithner
Chairman, Financial Stability Oversight Council and
Secretary, Department of the Treasury

Hon. Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System

Hon. Janet Yellen
Vice Chair
Board of Governors of the Federal Reserve System

Hon. Kevin Warsh
Member
Board of Governors of the Federal Reserve System

Hon. Elizabeth Duke
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Hon. Daniel Tarullo
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Hon. Sarah Bloom Raskin
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Hon. Sheila Bair
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Mr. John Walsh
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Mr. William M. Daley
Chief of Staff
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Hon. Debbie Matz
Chairman
National Credit Union Administration

Mr. William Haraf
Commissioner
California Department of Financial Institutions,
on behalf of the Conference of State Bank Supervisors

Hon. Timothy P. Johnson
Chairman
United States Senate Committee on Banking, Housing and Urban Affairs

Hon. Richard C. Shelby
Ranking Member
United States Senate Committee on Banking, Housing and Urban Affairs

Hon. Spencer Bachus
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APPENDIX A

The American Bankers Association

The American Bankers Association ("ABA") represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities. Learn more at www.aba.com.

The Clearing House

Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which employ 1.4 million people in the U.S. and hold more than half of all U.S. deposits. The Clearing House is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs and white papers the interests of its owner banks on a variety of systemically important banking issues. The Clearing House Payments Company provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

The Consumer Bankers Association

The Consumer Bankers Association ("CBA") is the only national financial trade group focused exclusively on retail banking and personal financial services—banking services geared toward consumers and small businesses. As the recognized voice on retail banking issues, CBA provides leadership, education, research, and federal representation on retail banking issues. CBA members include most of the nation's largest bank holding companies as well as regional and super-community banks that collectively hold two-thirds of the industry's total assets.

The Credit Union National Association

The Credit Union National Association ("CUNA") is the largest credit union advocacy organization in the country, representing approximately 90 percent of our nation's nearly 7,700 state and federal credit unions, which serve approximately 93 million members. CUNA benefits its members by partnering with our state leagues to provide proactive representation, the latest information on credit union issues, economic reports, regulatory analyses, compliance assistance, and education. Visit www.cuna.org for more information about CUNA.

The Financial Services Roundtable

The Financial Services Roundtable ("Roundtable") represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $74.6 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

The Independent Community Bankers of America

The Independent Community Bankers of America ("ICBA"), the nation's voice for community banks, represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold over $1 trillion in assets, $900 billion in deposits and $750 billion in loans to consumers, small businesses and the agricultural community. Visit ICBA at www.icba.org.

Midsize Bank Coalition of America

The Midsize Bank Coalition of America ("MBCA") is a group of 22 US banks formed for the purpose of providing the perspectives of midsize banks on financial regulatory reform to regulators and legislators. The 22 institutions that comprise the MBCA operate more than 3,300 branches in 41 states, Washington, D.C., and three U.S. territories. Our combined assets exceed $322 billion (ranging in size from $7 to $25 billion) and, together, we employ approximately 60,000 people. Member institutions hold nearly $241 billion in deposits and total loans of more than $195 billion.

The National Association of Federal Credit Unions

Founded in 1967, the National Association of Federal Credit Unions ("NAFCU") exclusively represents the interests of federal credit unions before the federal government. Membership in NAFCU is direct; no state or local leagues, chapters or affiliations stand between NAFCU members and its headquarters in Arlington, VA. NAFCU provides its members with representation, information, education, and assistance to meet the constant challenges that cooperative financial institutions face in today's economic environment. NAFCU represents nearly 800 federal credit unions, accounting for 63.9 percent of total FCU assets and 58 percent of all FCU member-owners. NAFCU represents many smaller credit unions with limited operations as well as many of the largest and most sophisticated credit unions in the nation, including 82 out of the 100 largest FCUs. Learn more at www.nafcu.org.

National Bankers Association

The National Bankers Association was founded in 1927 as the trade association to serve as an advocate for the nation's minority and women owned banks on legislative and regulatory matters concerning and affecting the members and the communities they serve.

APPENDIX B

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