February 22, 2011

By Email

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

RE: Regulation II; Docket No. R-1404
RIN 7100-AD63
75 Fed. Reg. 81722

Comments of the National Grocers Association
On Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

The National Grocers Association (N.G.A.) takes this opportunity to submit these comments on the Federal Reserve Board's notice of proposed rulemaking on Debit Card Interchange Fees and Routing on behalf of its retailer and wholesaler members throughout the United States. At the retail level, the independent sector represents nearly half of all grocery sales in this country. N.G.A. is the national trade association representing the retail and wholesale grocers that comprise the independent sector of the food distribution industry. An independent retailer is a privately owned or controlled food retail company operating a variety of formats. Most independent operators are serviced by wholesale distributors, while others may be partially or fully self-distributing. Some are publicly traded but with controlling shares held by the family and others are employee owned. Independents are the true "entrepreneurs" of the grocery industry and dedicated to their customers, associates and communities.

Virtually all independent retail food stores accept debit cards as a form of payment. The two largest card associations (Visa and MasterCard) and their biggest member banks have used their dominant market power to constantly increase the cost of accepting debit cards, as well as to unilaterally impose restrictive rules on those who accept debit cards as payments. As a result, Congress enacted needed reforms that have made these Federal Reserve proceedings of paramount concern to the N.G.A. constituency. N.G.A. appreciates, therefore, this opportunity to submit our views on the Board's proposed rules respecting debit card interchange fees and transaction routing, which begin the implementation of Section 920 of the Electronic Fund

Transfer Act (EFTA), as added by Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

First, we wish to compliment the Board and its staff on the quality and clarity of the rules proposed and the explanatory text that accompanies them in the Notice of Proposed Rulemaking (NPRM) in the December 28, 2010, Federal Register and strongly urge the Federal Reserve to issue final regulations as prescribed by the statute and without delay to become effective on July 21, 2011. Second, in addition to N.G.A.'s comments expressed here that are of particular concern to our members, N.G.A. strongly endorses the February 22, 2011 statement (and earlier submissions) of the Merchants Payments Coalition (MPC), of which N.G.A. is a founding member, that has been submitted by the law firm of Constantine Cannon.

I. <u>THERE SHOULD BE NO INTERCHANGE FEES FOR DEBIT CARD TRANSACTIONS.</u>

N.G.A. believes that interchange fees are misplaced in debit card transactions. There is little practical difference between a debit card transaction and a check, and the differences that do exist appear to *lower* costs for all parties but merchants and consumers. These facts are apparently recognized by the Board.[1] It is ironic that banks originally paid merchants a fee for every debit transaction. Today, many bank executives view debit cards as adjuncts to checking accounts by which depositors can access those accounts.[2]

It is also interesting to note that of the eight countries with the greatest debit card use (Canada, New Zealand, Iceland, Norway, Finland, Denmark, Netherlands and United States), only the United States permits an interchange fee on debit card transactions. In Canada, there has never been an interchange fee on debit card transactions, and those transactions *per capita* are greater than in this country.[3]

All of this suggests that there is no rational basis for the interchange distinction between the two main methods of accessing one's checking account: debit cards and checks. In fact, Section 920 requires the Board to consider the functional similarity between electronic debit transactions and checking transactions that are required to clear at par within the Federal Reserve banking system. N.G.A. strongly urges the Federal Reserve to adopt a standard that has debit transactions clear at par, similar to checks.

However, if the Board reads Section 920 of EFTA to *require* interchange fees to be charged on all debit transactions,[4] N.G.A. believes that the cost of authorization should be the only cost included in the interchange rate for debit card transactions.[5]

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[1] *See* Fed. Reg., Dec. 28, 2010, at 81734-81735.
[2] *See* MPC at **Section I. A.**.
[3] *Id.* at **Section I. A.**
[4] N.G.A. does not find any language in Subsection 920(a) upon which such a requirement can be based. Paragraph (1) of Subsection 920(a) gives the Board authority to create rules governing interchange fees that issuers impose or receive on debit transactions; paragraph (2) requires that any such fees charged or received be reasonable in amount and proportional to the actual costs incurred by the issuer with respect to the transaction; paragraph (3) establishes the time within which the final rules must be issued and contains other administrative provisions; paragraph (4) requires the Board to consider the "functional similarity" between debit card transactions and checking transactions, the latter of which clear at par; limits cost recovery through interchange by issuers to "incremental cost[s] incurred by an issuer … in the authorization, clearance, or settlement" of a debit card transaction; prohibits the inclusion in

II. THE SAFE HARBOR AND CAP RATES PROPOSED IN RULE 235.3 SHOULD BE REDUCED, NOT INCREASED, IN THE FINAL RULE.

The Board's proposed rule Section 235.3 contains two options for issuers to comply with the statute's requirement that debit card interchange fees be both "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." Section 920 provides this standard shall be effective as of July 21, 2011. The proposed rule's two options utilize a safe harbor and/or a cap approach in which seven cents is a safe harbor fee and twelve cents is a cap fee in Alternative 1, and twelve cents is a cap fee in Alternative 2.

If the Board proceeds to consider Section 235.3, rather than adopting debit at par as N.G.A. strongly supports in the preceding Section I, N.G.A. strongly opposes these limits that are far in excess of issuers' actual incremental, variable costs of authorization, clearance and settlement in a debit card transaction, and the limits should be reduced and not increased as the credit card associations and big banks have advocated. In its earlier January 20, 2011 submission to the Federal Reserve the Merchants Payments Coalition and First Annapolis Consulting reports the average per-transaction for acquisition, clearance and settlement to be 0.33 cent for PIN transactions and 1.36 cents for signature debit. However, the Federal Reserve reports that the issuers responding to the survey had an average per-transaction variable cost of approximately 4 cents per transaction.

The safe harbor, in N.G.A.'s view under Alternative 1, should be no more than one and one-half times the actual costs of authorization, clearance and settlement, and the cap should be twice that actual cost in both alternatives. If the cap and safe harbor are any higher, they create a strong disincentive for the highest cost issuers to reduce their costs. N.G.A. does not believe that Congress intended for the rules to promote inefficiency, and the greater the gap between issuers' actual costs and the safe harbor and cap rates set forth in the rule, the less likely the final rule will be an incentive to reduce processing costs and debit fees.

As between the two alternatives, N.G.A. strongly favors Alternative 1 with appropriate reduction in the safe harbor and cap rates, because it is closer to the costs of authorization, clearance and settlement as reported by First Annapolis Consulting and the average per-transaction variable cost reported by issuers in the survey. Alternative 2 should be rejected because it would promote continued inefficiency and anticompetitive fees by issuers in contradiction to the standards established and called for in the statute.

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interchange "costs … which are not specific to a particular electronic debit transaction; and requires consultation with officials of various federal agencies; paragraph (5) allows adjustments to be made to debit card interchange fees by rules dealing with costs incurred by issuers for fraud prevention; paragraph (6) exempts small issuers with less than $10 billion in assets from the rules issued under paragraph 3; paragraph (7) exempts certain government payment programs; paragraph (8) gives the Board limited rulemaking authority over network fees other than debit card interchange; and paragraph (9) provides the effective date of Subsection 920(a).

[5] The Board's suggestion of this approach appears at Fed. Reg., Dec. 28, 2010, 81735. One might argue that under Subsection 920(a) there is some logical inconsistency between the belief that the Board cannot require debit card transactions to clear at par, in essence ordering *no* interchange, and the Board ordering debit card interchange based only on one of the three recoverable costs (authorization) and barring recovery of the other two (clearance and settlement). However, the Board's rulemaking discretion under Subsection 920 seems broad enough to accommodate such a result.

III. ROUTING AND EXCLUSIVITY RULES SHOULD BE DESIGNED TO PRODUCE THE MOST COMPETITIVE DEBIT CARD SYSTEM POSSIBLE.

The rules presently under the Board's consideration will begin the long-needed process of transforming the electronic payment industry from an unregulated anticompetitive duopoly, where the credit card companies and their biggest banks exercise market power, into a system that has the incentive to reduce prices rather than increase them. One of the key rules for reaching this objective is proposed Section 235.7, which mandates the end of single-network routing and prevents issuers and networks from inhibiting merchants from directing the routing of their debit transactions. The main issue presented is the number of routing options from which merchants will be able to choose.

The Board has presented two approaches in proposed rule Subsection 235.7(a). The first, Alternative A, provides for a mandatory minimum of two unrelated networks. The other choice, Alternative B, provides for two unrelated networks for each method by which the debit card's use can be authorized, in effect, two for PIN use and two for signature. N.G.A. believes that Alternative B is far more likely to produce the more competitive result. But before explaining the reasons for that preference, there is another issue that must be examined: the treatment of Visa and MasterCard.

In N.G.A.'s view, it is imperative that the networks of Visa and MasterCard, the two firms that share the industry duopoly, be treated as affiliated. Without that approach, neither of the alternatives of proposed rule Subsection 235.7(a) will have a material affect on the existing duopoly. The market power of Visa and MasterCard over the debit card market will be bolstered by the very regulations that Congress intended to do just the opposite. Envision Alternative A if Visa's and MasterCard's networks are viewed as unaffiliated. Most issuing banks are members of both associations, and they would have every incentive to authorize both of those networks to process the cards they issue. Visa and MasterCard would be the only choices available to merchants. That result would strengthen Visa's and MasterCard's power in the market rather than introduce real competition into it. See Section I of the Merchant Payments Coalition statement for a thorough discussion and evidence of Visa's and MasterCard's affiliation.

Under Alternative B, it appears that the same result could obtain, because the rule does not prevent the same two networks from being chosen to process both PIN and signature transactions on a single card. From the extensive text accompanying the proposed rule, this obviously is not the result the Board envisions. The only way to avoid this result is to treat the Visa and MasterCard networks as affiliates under common control for purposes of Section 235.7(a) of the proposed rules.

Why does N.G.A. favor Alternative B? Simply put, Alternative B will produce a more competitive result by potentially doubling the number of merchant routing options compared to Alternative A. In addition, the Federal Reserve commentary on page 81734 confirms this competitive benefit. For checks, "The decision is often based on the avenue that offers the lowest clearing cost." For debit networks the merchant's routing choice is limited by higher cost issuer preferences, "Such preferences may result in a transaction being routed to a network that imposes a higher fee on the merchant's bank (and hence the merchant) than if the payment were processed on another available network." N.G.A. fully agrees with the Federal Reserve's assessment, and that is the reason why Congress has enacted this necessary reform for merchant's to have the choice to choose among more competitive routing options.

The Federal Reserve also suggests that it would be feasible to adopt Alternative B, but at a later date, January 1, 2013, rather than October 1, 2011, for Alternative A. N.G.A. does not believe it is an either/or proposition. N.G.A. recommends the Federal Reserve adopt a transition standard that requires at least two pin debit networks in 2011 and transitions fully to Alternative B for signature debit at a later date.

Other reasons, with which N.G.A. agrees, are set forth in greater detail in Section II of the MPC comment. In the long run, Alternative B is by far the better choice.

IV. PRICE DISCRIMINATION MUST BE PROHIBITED.

N.G.A.'s independent grocers and other merchants have for far too long been subjected to the market power and the anticompetitive price discrimination of the credit card associations and their big banks. The Federal Reserve's rule must assure the debit interchange fees are limited to the costs of authorization, clearance and settlement. For decades independent grocers, small businesses and other merchants have been subject to arbitrary supra-competitive fees based upon merchant size, merchant segment, and/or channel.

For example, the Visa U.S.A. Consumer Debit Interchange Reimbursement Fee effective October 16, 2010, has twenty-four different categories for debit and has a four-tier pricing system for supermarket debit that requires transaction minimums. From April 2009 until October 2010 Visa raised the Supermarket transaction minimums from 46.5 million to 52 million for Threshold I, from 27 to 30 million for Threshold II, from 7.4 million to 8.1 million for Threshold III, and then all other. In addition, Visa raised the dollar volume minimums from $3.0 billion to $3.4 billion for Threshold I, from $1.5 billion to $1.7 billion for Threshold II and from $430 million to $460 million for Threshold III. The 2009 rates were 0.62% + $0.13; 0.81% + $0.13; 0.92% + $0.15; and 1.03% + $0.15, respectively, and capped at $0.35. In 2010 Visa changed the rates for all others from 1.03% + $0.15 to 0.95% + $0.20. On a $15 dollar ring this would amount to over a 13% increase. MasterCard follows a similar tiered pricing system for supermarkets and others.

To illustrate the negative and anticompetitive effect of the perverse pricing set by Visa and MasterCard, N.G.A. provided the following example to the United States Government Accountability Office on July 16, 2009 for its study released in November 2009:

"To demonstrate the discrimination created in Visa and MasterCard's volume discount tiers N.G.A. polled one of its retailer-owned wholesalers who provided a sample of approximately 60 retail companies that covered about 175 retail locations and their February 2009 total credit card transaction volume. The stores provided are all independent operators with annual sales volumes that range from $1 million for the smallest single store operation to an eight store chain with annual sales of nearly $100 million. The monthly transaction total (all credit card brands) of these 175 stores <u>combined</u> only totaled 458,256. To put it another way, the estimated annual transactions for all credit card brands for all 175 stores would be less than 5 million. Visa's Tier III minimum transaction requirement is 7.4 million, a figure that is completely unattainable."

The point is that that a swipe is a swipe, whether for debit or credit, and the costs of authorization, clearance and settlement as reflected by the Federal Reserve for the debit survey and other studies do not merit this anticompetitive pricing that is dictated by a monopolistic duopoly. N.G.A.'s independent grocers and other small business merchants are unable to meet the arbitrary minimums set by the credit card networks. The reforms enacted by Congress and the implementation of final regulations of the Federal Reserve must prevent this discriminatory pricing that harms small businesses and consumers.

V. FRAUD-RELATED COSTS OF ISSUING BANKS SHOULD NOT BE ALLOWABLE COSTS INCLUDED IN THE INTERCHANGE FEE.

Paragraph (5) of Subsection 920(a) specifically permits the Board to "allow for an adjustment" in the interchange fee for debit card transactions due to issuers' costs incurred for fraud prevention.[6] The final regulations for a fraud prevention adjustment are to be issued by April 21, 2011, and effective July 21, 2011. N.G.A. strongly agrees with the Federal Reserve that "fraud" should be defined as the use of a debit card (or information associated with a debit card) by a person, other than the cardholder, to obtain goods, services, or cash without the authority for such use.

It is clear from the Federal Reserve survey results that the predominate problem with fraud losses rests with signature debit, which the credit card networks and big banks promote in order to impose higher debit interchange fees. In 2009 of the $1.36 billion in debit fraud losses only $200 million arose from PIN debit transactions. Based upon the issuers' responses, the Federal Reserve found that signature debit fraud losses were 3.75 times PIN debit fraud losses. In addition, issuers reported that on average it only cost 1.2 cents per transaction for fraud prevention and data security on PIN debit transactions

Under Section 920, there appears to be no permission to include fraud *losses* in electronic debit interchange fees, but these separate costs – fraud prevention and fraud losses – are very closely related. Under Section 920(a)(5), Congress allowed for an adjustment in the fee amount received by an issuer "if such adjustment is reasonably necessary to make allowance for cost incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer." It is clear from the statute that the fraud adjustment must be specific to an individual issuer and in a separate set of rules promulgated under Section 920(a)(5)(B), which also contains the factors that must be considered by the Board in issuing its fraud rules. Any fraud adjustment fees must take into consideration, *inter alia*, the extent to which the fraud occurrence depends on whether the authorization is based upon signature, PIN or other means. Thus, it is clear that any fraud adjustment must distinguish between PIN and signature debit due to the higher fraud risk for signature.

Some transactional fraud is inherent; it has nothing to do with the type of transaction involved, the size or nature of the merchant, or other factors that may affects the number of fraudulent transactions emanating from various groups of consumers or merchants. N.G.A. believes that by keeping the fraud-related costs and the interchange fees separate, it will be less likely that the interchange rate for a merchant with no card-not-present transactions will be increased by fraud arising from internet or catalog transactions from merchants with significant numbers of card-

[6] EFTA, Subsection 920(a)(5)(A).

not-present transactions. Similarly, the merchant's interchange fees would not be increased by any costs associated with attempting to reduce (or prevent) card-not-present fraud.[7]

Merchants bear fraud costs. As noted in the proposed rule "Merchants also have fraud-prevention and data-security costs, including costs related to compliance with payment card industry data-security standards (PCI-DSS)…". Additionally, it's important to note merchants bear fraud losses in the form of transaction "charge-backs", where contested transactions are debited from the merchant's account unless the merchant is able to prove that the contested transaction was indeed valid.

CONCLUSION

The National Grocers Association once again thanks the Federal Reserve for the balanced and open process in promulgating the notice of proposed rulemaking. N.G.A. strongly urges the Federal Reserve to continue its work and issue final regulations on Debit Card Interchange Fees and Routing as required by the statute and consistent with N.G.A.'s recommendations contained here and those of the Merchants Payment Coalition. N.G.A. looks forward to cooperating with the Federal Reserve on the regulations' implementation.

Respectfully,

Ronald A. Bloch, P.C.

Thomas F. Wenning
Executive Vice President and General Counsel

[7] N.G.A. assumes that the Board's rules on fraud would have little, if any, effect on the hypothetical merchant's fraud charges, because the costs of fraud prevention would be borne by the retailers whose transactions give rise to the fraud, rather than all by merchants.