Capital One Financial Corporation
1680 Capital One Drive
McLean, VA 22102

February 22, 2011

Ms. Jennifer J. Johnson
Secretary
Board of Governors
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
regs.comments@federalreserve.gov

Re: Regulation II Debit Interchange Fees and Routing Proposal (Docket No. R-1404; RIN No. 7100-AD63)

Dear Ms. Johnson:

Capital One Financial Corporation ("Capital One")[1] is pleased to submit comments on the debit interchange fee and routing rules proposed by the Federal Reserve Board ("Board").[2] The proposed Regulation II ("Proposed Rule") implements section 1075 of the Dodd-Frank Act ("Durbin amendment"), which adds a new section 920 to the Electronic Fund Transfer Act ("EFTA"). The Durbin amendment provides that, effective July 21, 2011, the amount of any interchange transaction fee that an issuer receives or charges with respect to an electronic debit transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. It also requires the Board to issue rules related to exclusive network arrangements for electronic debit transactions.

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[1] Capital One Financial Corporation (www.capitalone.com) is a financial holding company whose subsidiaries, Capital One (Europe) plc., Capital One Bank (Canada Branch), Capital One, N.A., and Capital One Bank (USA), N. A., collectively had $122.2 billion in deposits and $197.5 billion in total assets outstanding as of December 31, 2010. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients in the U.S., Canada and the UK. A top ten credit card issuer in the UK, Canada and United States and a Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol "COF" and is included in the S&P 100 index.

[2] 75 Fed. Reg. 81,722 (Dec. 28, 2010).

We note first that the Board has been charged with implementing a fundamentally flawed statute, which, without identifying any market failure, sets price controls within the electronic payments arena to the benefit of merchants and the detriment of consumers and the payments system. As described below, the debit card represents one of the most effective banking innovations of recent decades, bringing to merchants and consumers significant benefits beyond cash and checks. It is therefore incumbent upon the Board both as a policy matter and statutory matter under the EFTA to promulgate rules that, while consistent with the statute, avoid undue disruption to consumers and the debit card marketplace.

We believe that the Proposed Rule is inconsistent with the statutory mandate that requires that interchange fees be reasonable and proportional to costs, and will harm consumers, other participants in the payment system and the payment system itself. In particular, with respect to interchange fees, we urge the Board to expand significantly allowable costs; permit a reasonable rate of return on those costs; and set a safe harbor interchange rate at a reasonable level sufficient to ensure that it can and will be used by the majority of institutions. Given the complexity of this effort and its significant but unjustified impact on consumers and the payment system, we also urge the Board to utilize its discretion in delaying finalization of the Proposed Rule until further study can be conducted.

Capital One has participated in the drafting of and strongly supports the positions expressed in various industry comment letters submitted on this topic, most notably the joint comment letter filed by the American Bankers Association, The Clearing House Association, the Consumer Bankers Association, the Credit Union National Association, the Financial Services Roundtable, the Independent Community Bankers of America, the National Association of Federal Credit Unions, the Midsize Bank Coalition of America, and the National Bankers Association, dated February 22, 2011 ("Association Letter").[3] Given the significance of this topic, however, we thought it important to also submit our own letter.

* * *

The Debit Card Market Has Thrived at Current Interchange Levels

Debit cards are a valued payment mechanism for both consumers and those 8 million merchant locations that accept debit cards in the United States.[4] The benefits of debit card transactions are clear, including:

- ubiquity of acceptance;

[3] We also direct your attention to comment letters filed by Morrison & Foerster, on behalf of a consortium of large and midsized debit card issuers, dated February 22, 2011 ("Morrison & Foerster Letter"); the Consumer Bankers Association, dated February 22, 2011; and the Financial Services Roundtable, dated February 18, 2011.
[4] 75 Fed. Reg. at 81,723.

- ease, safety and security of consumer access to deposit accounts, freeing consumers from the risk and inconvenience of carrying cash;
- fraud protection under clear rules for both consumers and merchants;
- increased speed at checkout;
- facilitation of internet and telephone transactions; and
- availability of an inexpensive and effective payment mechanism for consumers who do not qualify for or wish to use credit cards.

Far from being an example of a market failure, the debit card interchange system is an example of an extraordinary story of market improvement and growth over the past decade. Survey data submitted to the Board indicates that there were approximately 37.7 *billion* debit and prepaid card transactions in 2009, valued at over $1.45 trillion.[5] But more than static volume alone, the recent *growth* in debit cards is remarkable. The Board acknowledges in the Proposed Rule that debit card payments have grown more than any other form of electronic payment over the past decade.[6] Indeed, U.S. debit card use increased 205% between 2000 and 2006, while total U.S. check use (by consumers, businesses and government) declined 27% during the same period.[7] This trend has continued in more recent years - the Federal Reserve System's 2010 Payments Study observes that debit card payments increased by approximately 15% annually over the period from 2006 to 2009, compared with a 7% annual decrease for checks over the same period.[8]

And merchants have responded, continuing in increasing numbers to accept debit cards, while refusing or aggressively discouraging the use of traditional checks. Consumers have noticed this trend: nearly half of consumers report that debit cards are "almost always accepted" while less than a fifth report the same for checks.[9] Since one would expect merchants to act in their own economic interest, this trend suggests that merchants recognize the value of debit cards and the significant direct and indirect costs associated with checks, especially bounced checks.[10]

Under the current free market framework, both consumers and merchants have proclaimed this payment product a great success, as evidenced by the popularity and adoption of debit cards. Merchants who believe that debit card interchange fees are too high, of course, always have the ability not to accept debit cards or to accept them but

[5] *Id.* at 81,725.
[6] *Id.*
[7] The 2008 Survey of Consumer Payment Choice. Federal Reserve Bank of Boston, April 2010, at 7.
[8] Federal Reserve System, The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006-2009 (Dec. 8, 2010), at 4. This trend is also evidenced by the Board's decision to close all but one check processing location "in response to this changing trend in check usage." *See, e.g.,* 68 Fed. Reg. 31,593 (May 28, 2003).
[9] Survey of Consumer Payment Choice, at 38.
[10] Returned checks amounted to $103 billion in 2009. Federal Reserve System 2010 Payments Study, at 9. Indeed, increasing the cost of debit cards will likely move more consumers back to checks, an inferior payment mechanism both for consumers and the payment system as a whole, as discussed throughout this letter.

920(a)(4)(B)(i) – which requires the inclusion of incremental ACS costs - as effectively limiting its authority. We disagree with both interpretations. As discussed below, we believe that such an interpretation, which fails to reimburse issuers for important and unavoidable costs, is misguided from a public policy perspective and is likely to harm consumers and other participants in the payment system.

Such an interpretation is also completely at odds with the operative statutory mandate that the fee must be reasonable and proportional to costs incurred with respect to the transaction, which connotes a broad consideration of costs. To read paragraph 920(a)(4)(B)(i) as limiting the costs that may be considered in setting interchange fees is to effectively gut the overall statutory mandate. As the brief filed by the U.S. Department of Justice, on behalf of the Board, in the TCF National Bank case acknowledges, the Board "can consider factors other than the authorization, clearance, or settlement costs that are specific to a particular electronic debit transaction".[14] If Congress intended issuers to be limited to ACS costs, it would have used that as the standard. It is difficult to understand how a fee that permits issuers to be reimbursed for only a narrow sliver of costs can be reasonable, as required by the statute. As described in detail in the Association Letter, such a narrow reading could also raise significant Constitutional and Administrative Procedure Act issues.

The Board appears to bolster its narrow interpretation of allowable costs with a selective consideration of the functional similarities between checks and debit cards, generally only including costs that a payor bank in a check transaction would receive from a payee or payee bank.[15] We believe this interpretation is incorrect. The check and debit card systems are entirely different payment systems; the only thing they appear to have in common from a legal and functional perspective is that they both debit funds from a deposit account.[16]

Considering "functional similarity" as required by the statute is not an instruction to limit costs to those a payor bank receives from a payee bank – that makes little sense given the differences in the payment mechanisms and the different costs incurred and benefits received by the participants in the two systems. For example, the merchant generally bears responsibility for insufficient funds when accepting checks, unless purchasing a check guarantee (at the average cost of 92 basis points).[17] In a debit card transaction, however, the issuer bears these costs, to the benefit of the merchant. Failing to permit issuers to recoup these costs because a payor bank would not receive them from a payee bank in a check scenario – when there would be no need for reimbursement because the payor bank has not provided the benefit nor incurred the cost – is mistaken logic. Indeed,

[14] 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, TCF National Bank v. Bernanke, et al., No. 10 civ. 04149 (LLP) (D.S.D. February 18, 2011) (dkt. No. 64), at 2.
[15] 75 Fed. Reg. at 81,735.
[16] For further discussion of the significant differences between the check and debit card systems, please see the Association Letter and the Morrison & Foerster Letter.
[17] *See Check Authorization* – 2009, The Nilson Report, Issue 953, July 2010, at 7.

discourage consumers from using them by offering discounts for other payment methods. Any increases in total interchange *costs* must be distinguished from increases in interchange fee *rates*. Put another way, claims by merchants that interchange costs are rising suggest, disingenuously, that these increased costs are driven by higher interchange rates rather than higher transaction volumes. Increases in transaction volumes, of course, are demand driven, and reflect consumers' strong preference for the convenience and benefits offered by debit cards. We believe that this is further indication of the debit card success story for all participants, rather than of a market failure.

We therefore disagree with the Proposed Rule's unnecessarily draconian approach because it will disrupt the growth of this valued payment mechanism and, in particular, harm consumers by forcing them to pay more for debit cards or seek inferior substitutes. As discussed below, the statute clearly provides the Board with ample discretion to act in a reasonable manner that will minimize damage to the thriving debit card market.

* * *

Consistent with the Durbin Amendment, the Board Should Expand Allowable Costs and Permit a Reasonable Rate of Return Above Those Costs

Statutory Mandate

The overarching interchange provision in the Durbin amendment provides that any interchange transaction fee for electronic debit transactions must be "reasonable and proportional to the *cost* incurred by the issuer with respect to the transaction."[11] Under the plain meaning of the statute, the interchange fee should consider the full range of costs the issuer incurs. Indeed, the language refers to those costs "with respect to" a transaction, which connotes inclusion not only of direct costs, but also those that are related to or associated with the transaction. This operative provision must, more than any other, guide the Board's rulemaking.

The Durbin amendment contains factors that the Board must consider in its rulemaking, including comparing the functional similarities between check and debit card transactions and distinguishing certain costs that must be considered from certain costs that may not be considered.[12] But there is no indication that such considerations are to be viewed as dispositive or exclusive. Rather, the Board is not limited in the costs it may consider, other than that it may not consider costs that are "not specific to a particular electronic debit transaction".[13]

In limiting allowable costs to those variable costs associated with authorization, clearance or settlement (together, "ACS"), the Board appears to have either (1) made a judgment that such approach is preferred from a policy perspective or (2) interpreted paragraph

[11] Sec. 920(a)(2), (a)(3)(A) (emphasis added).
[12] Sec. 920(a)(4).
[13] Sec. 920(a)(4)(B)(ii).

the payor bank does not need to be reimbursed for many costs in a check transaction because the payee and/or payee bank directly incurs the cost (*e.g.*, risk of insufficient funds or check handling and processing) as compared to debit cards, where the issuer incurs many costs to the benefit of the merchant. And, again, if Congress had intended to limit interchange fees to those fees that a payor bank would receive for its role in a check transaction, it easily could have done so, rather than tying interchange fees to cost incurred for the role of the issuer in a *debit card* transaction.

Given the broad statutory mandate, the limited restraint on the Board's authority in the statute and the public policy considerations at hand, we urge the Board to expand allowable costs for inclusion in the interchange fee to include, for example, costs reflecting:

- fraud prevention;
- fraud losses;
- network fees;
- customer inquiries and disputes;
- insufficient fund losses and associated collections costs;
- card production and delivery; and
- data processing, information technology and security costs.

Incremental Costs Associated with ACS

Even if the Board somehow concludes that paragraph 920(a)(4)(B)(i) should serve to limit allowable costs to those incremental costs incurred for ACS, we believe that the Board improperly applied its own test and must broaden allowable costs in several important ways.

First, despite the Proposed Rule's ostensible inclusion of average variable costs associated with ACS, the Proposed Rule excludes costs that are clearly variable according to the Board's own definition and that are incurred by the issuer for its role in ACS. Significant examples include fraud losses and network processing fees. A fraud loss relates directly to the unauthorized electronic debit transaction causing the loss and would not be incurred by the issuer were it not for the issuer's role in authorizing and settling the transaction. Similarly, most network processing fees are charged on a per-transaction basis and should therefore be included under the Board's stated definition.[18] The Board's failure to include fraud losses and network fees is not in accordance with paragraph 920(a)(4)(B)(i), the Board's own stated model for cost inclusion and exclusion.

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[18] The Board reasons that these fees should be excluded in order to avoid having the acquiring depository institution that acts on behalf of the merchant pay these fees. We fail to understand, however, why these fees should differ from other fees that the issuer incurs for debit card transactions. If the Board is concerned about circumvention of the interchange fee restrictions through network processing fees, it should handle this concern directly through its circumvention and evasion rulemaking, instead of excluding a very real fee that issuers incur for processing a transaction.

Second, the Board's definition of "incremental" as "average variable" costs is inconsistent with the word's plain meaning and is too narrow. In the Proposed Rule, the Board acknowledges commonly accepted definitions of "incremental," yet disregards them in favor of "average variable" cost.[19] The Board rejected these other definitions because the "increment of production is larger than the cost of any particular transaction" and therefore would not reflect the cost of a particular transaction.[20] With this statement, the Board appears to imply that it is possible to place a price on each particular debit card transaction. But as the Board implicitly acknowledges through its proposed use of average variable costs, any costs calculated for debit card transactions are, by their very nature, average costs - in a system with 37.7 billion transactions in 2009 alone, it is not possible to estimate a cost for each one individually. It is therefore not clear why the Board abandoned more common economic definitions of "incremental."

The statute does not use the terms "fixed" or "variable" and, as the Board must recognize, all fixed costs are variable at some level. For example, taking the view that cardholder inquiry and dispute costs are fixed costs that are not incremental is incorrect. Such costs clearly vary by transaction volume and are only fixed within artificial capacity levels that will vary from issuer to issuer. Whether a cost is considered for inclusion in the interchange fee should not turn on whether the cost is paid or charged on a per-transaction basis.[21] Consistent with the statutory mandate, the critical distinction should be whether the cost is borne by the issuer with respect to a debit card transaction. We believe that the Board's narrow view of "incremental" costs is ungrounded and should be expanded.

There are ways to define "incremental" that would produce more logical outcomes and be more consistent with the overall statutory mandate. We agree strongly with the Morrison & Foerster Letter and the economist paper referenced therein, which describe in greater detail the weaknesses of the Board's definition of "incremental" and propose an alternative analytical framework.

Non-Specific Costs

Under the Durbin amendment, the Board is not permitted to consider costs that are not "specific to a particular electronic debit transaction."[22] We recognize that costs, by their nature, differ in how directly they relate to particular electronic debit transactions. As discussed above, customer inquiries and disputes, fraud losses and network processing fees are clearly specific to a particular transaction. In addition, the following costs are

[19] 75 Fed. Reg. at 81,735. For example, the Board recognizes that "incremental" may be calculated using (1) the potential difference between the cost incurred by a firm if it produces a particular quantity of a good and the cost incurred by that firm if it does not produce the good at all or (2) the cost of producing some increment of output greater than a single unit but less than the entire production run.
[20] *Id.*
[21] For example, although customer inquiry and disputes investigation costs are not commonly paid on a per transaction basis, there is no reason that they could not be. How personnel handling these responsibilities are paid (*e.g.*, on an hourly basis or per transaction handled) should not affect the outcome here.
[22] Sec. 920(a)(4)(B)(ii).

clearly specific to a particular transaction: (i) insufficient fund losses, where a particular transaction is authorized yet inadequate funds exist when the transaction is settled; (ii) collection costs for fraud and insufficient fund losses; and (iii) data processing and information security costs, processes and protections that are critical to each and every debit card transaction.

We believe that debit card issuance, mailing and reissuance costs are also specific to a particular transaction, although they are incurred before any transactions are made and may be incurred whether or not any transactions take place with respect to a particular card. Consistent with the discussion above with respect to incremental costs, these costs generally vary over time with transaction volume and are properly allocated to the transactions that do take place because they are reasonably incurred in providing for any particular electronic debit transactions to take place. These costs must be incurred as a necessary precondition for the transactions to occur.

There are other costs that may not be deemed specific because they relate only tangentially to debit card transactions. These may include, for example, the cost of maintaining checking accounts and various overhead charges, such as costs of offices.

Fraud Prevention Costs

Fraud prevention costs, which are distinct from actual fraud losses, discussed above, should be included in the definition of allowable costs. There are significant costs to the issuer banks for fraud prevention, costs which provide value to both consumers and merchants.[23] To fail to reimburse issuers for such costs is bad policy and simply unfair to the issuers who bear them, particularly as compared to the merchants who benefit from these efforts. If the Board needs additional time to study the fraud prevention issue, the Board should delay finalization of the Proposed Rule, or, at a minimum, estimate such costs now and include them as allowable costs in an interim final rule.[24]

Debit card fraud harms all participants in the debit card payment system. Even with limited liability under network rules and Regulation E,[25] debit card fraud harms consumers, since they are required to spend valuable time obtaining refunds for fraudulent charges and handling card re-issuances after fraud incidents. Merchants also are worse off because they bear some liability for fraud losses through the chargeback process. Finally, card networks and the debit card industry generally are harmed by debit

[23] The Board acknowledges that according to its survey data, the majority of reported fraud losses were borne by issuers rather than merchants, and that the fraud losses borne by cardholders are negligible. 75 Fed. Reg. at 81,741.

[24] We also believe that many fraud prevention costs are costs that are specific to particular debit card transactions, such as the use of fraud screens and investigations, and that they are part of the authorization, clearance and settlement of transactions. Even if the Board has not separately completed its analysis for implementing the Durbin amendment's fraud prevention "adjustment", it should include fraud prevention costs for purposes of the allowable costs under paragraphs 920(a)(2) and (a)(3).

[25] *See* 12 C.F.R. § 205.6.

card fraud to the extent that fraud causes consumers to have less confidence in the debit card system and use other forms of payment in lieu of debit cards.

The Board asks for comments on which general approach it should adopt, a technology-specific approach or a non-prescriptive approach.[26] We believe the second approach is most appropriate and is consistent with the Board's technology-neutral approach taken in other contexts.[27]

Under the technology-specific approach, as contemplated, issuers would only be reimbursed for costs associated with paradigm-shifting technologies that the Board would identify. As the Board recognizes, this approach is problematic because it would cause issuers to under-invest in other technologies[28] and therefore put the Board in the position of choosing winners and losers among fraud prevention techniques. We believe that banks, not the federal government, are best suited to identify the most effective fraud prevention techniques. In addition to the risk of failing to identify the best fraud prevention techniques, the technology-specific approach is simply inconsistent with free market principles. We also note that regulatory reviews of emerging fraud defenses in order to obtain the "paradigm-shifting" designation required for reimbursement will slow the implementation of potentially salutary defenses and, therefore, could detriment banks and consumers alike. Finally, this process is likely to be self-defeating as sophisticated perpetrators of fraud would receive advance warning of the technologies to be deployed and would have a head start at circumventing them.

On the other hand, the second, non-prescriptive approach would permit issuers to be reimbursed for fraud prevention costs of its current fraud protection and data security and for costs incurred to develop and maintain an effective anti-fraud program. We believe that this simple, flexible approach would be more effective and readily administered and enforced than the technology-specific approach. It would allow each issuer to tailor its fraud prevention program based upon the nature and scope of its actual debit card practices and would also provide both the Board and issuers with the flexibility to adapt with changes in technology, as well as changes in fraud activities and techniques.

Issuers should receive the fraud adjustment if meeting general, risk-based fraud prevention standards and should receive a reimbursement for fraud losses based on industry levels. An issuer will therefore have a market-based incentive to reduce fraud, since the issuer will bear the cost of any fraud above the reimbursement amount and will enjoy the difference if fraud losses are below the reimbursement amount.

[26] 75 Fed. Reg. at 81,740-43.
[27] *See, e.g.,* information security standards issued by the Board and other federal banking agencies to implement Section 501(b) of the Gramm-Leach-Bliley Act.
[28] 75 Fed. Reg. at 81,742.

"Reasonable and Proportional" Rate of Return and Safe Harbor

Once the Board calculates allowable costs, as discussed above, the Board must include some reasonable rate of return above the costs in order to arrive at the acceptable interchange fee level. "Reasonable and proportional" to costs can only reasonably be defined to mean something above and beyond "equal to" costs. If Congress had meant for the Board to exclude a reasonable rate of return, it simply would have drafted the provision to state that fees must be equal to costs.

And, consistent with the Proposed Rule, a safe harbor approach is appropriate both to minimize administrative burdens and provide much-needed revenue and cost certainty for issuers and merchants, respectively. The safe harbor also provides market-like incentives to minimize costs, since issuers are able to benefit from the difference between the safe harbor and their issuer-specific costs. Finally, the safe harbor should be set at a reasonably high level (*e.g.,* at the 80th percentile of institutions' costs), so that a meaningful majority of institutions are able to achieve the safe harbor's benefits and still recover their costs.

Expanding Allowable Costs is Necessary to Avoid Significant Unintended Consequences to Consumers and Others

We urge the Board to expand allowable costs both in order to be consistent with the statutory language, as discussed above, and to avoid significant unintended consequences to consumers, banks and the overall payment system. As described at the beginning of this letter, debit cards are extraordinarily popular payment mechanisms, as evidenced by their rapid proliferation. From a policy perspective and as required under the EFTA, the Board must consider the potential negative consequences as it promulgates rules so that it does not disrupt the valued debit card market more than necessary. We touch on some of these policy issues below and direct you to the Association Letter for a more fulsome discussion.

EFTA Statutory Requirements

First, as a legal matter, Section 904 ("Section 904") of the EFTA requires that when promulgating regulations, the Board must analyze the costs and benefits to consumers (particularly low income consumers), financial institutions, and the payment system. Section 904 also requires that the Board take into account the continuing evolution of electronic banking services. We respectfully submit that the Board did not appear to have considered these factors in the Proposed Rules and believe that, if it had, the interchange fee restrictions would have been more reasonable. For example, the Proposed Rule contained no data or analysis on considerations that underlie the Board's conclusions, including how the extremely narrow cost standard in the Proposed Rule would impact the availability or cost of debit cards to consumers. Nor did it appear to consider the impact of the Proposed Rule on the continued growth of and innovation in the payments system.

Consumer Harm

In the face of interchange fee restrictions that will not permit banks to recover their costs for debit card transactions, banks will be forced to choose between losing money on their debit card business or increasing the consumer cost of debit card-related products and services, many of which are offered free of charge by banks today. We submit that the former raises significant safety and soundness concerns, so that banks will be forced to increase consumer costs. These cost burdens will likely be borne disproportionately by lower-income consumers, since fees will likely be higher on accounts with low balances. Any mitigating benefits to consumers are speculative, as merchants are not required under the Durbin amendment to pass on any savings to consumers. Chairman Bernanke[29] and FDIC Chairperson Sheila Bair[30] each acknowledged this concern in separate testimony before the Senate Banking Committee on February 17, 2011.

As a result of cost increases, consumers may be discouraged from using debit cards and move towards cash and checks, less safe and secure payment mechanisms.[31] In particular, as compared to checks, consumers enjoy debit cards' ubiquity of acceptance; clear fraud liability under Regulation E, as opposed to the more comparative fault and deposit contract-based framework of checks; and additional protection of consumer information (since checks often involve the leaving of at least name, residential address, and bank account number, if not more, with a retail clerk).

Some consumers may withdraw from the mainstream banking system altogether, in favor of money orders, check cashers and similar deposit access substitutes, which may ultimately be more expensive.[32] The traditional demand deposit account has also 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 or familiarity with mainstream banking necessary to receive a bank loan. As a consequence, these consumers are more likely to be relegated to the ranks of the un- or under-banked, thus likely increasing their need and demand for costly check cashing and other non-traditional financial services. Notably, the *Washington Post* and *Chicago*

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[29] 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.").

[30] Sen. Banking Tr. at 42 ("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.").

[31] *See, e.g.,* 12 C.F.R. 205.6 (limiting consumer liability for unauthorized debit card transactions).

[32] *See, e.g.,* Federal Deposit Insurance Corporation, *FDIC National Survey of Unbanked and Underbanked Households,* December 19 at 25, available at http://www.fdic.gov/householdsurvey/full_report.pdf ("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).") In addition, nearly four out of five previously banked households had used alternative financial services at some point in the past. *Id.*, at 28.

Tribune recently published articles describing the efforts of large retailers like Wal-Mart and K-Mart to aggressively enter the non-traditional financial services market, including check cashing services.[33]

We direct you to the Association Letter for further discussion of likely consumer harm.

Payments System Harm

As noted above, as a result of cost increases, consumers will be discouraged from using debit cards. While this may harm individual consumers, it will also likely result in an overall increased use of cash, presenting heightened opportunities for money laundering, theft and tax evasion, and checks, which, as discussed throughout this letter, would be detrimental for consumers, merchants and banks. Such a result takes several steps backwards from the Board's historical support of the electronification of payments (*e.g.*, Check 21) and threatens to harm the payment system itself.

Setting caps below even basic debit card costs will discourage issuers from investing in the innovation, improvement, maintenance and security of the debit card payment system. Indeed, the popularity of debit cards among consumers and merchants underscores the benefits achieved by the market's ability to preserve the careful balance between issuers and merchants in this two-sided market. The current system constitutes a clear and equitable "win-win-win" for consumers, merchants and issuers, each of whom bears a cost and enjoys a corresponding benefit. One participant's refusal to contribute its fair share of the cost in the hopes of improving its short-term financial position (even at the expense of its longer term interests) puts the entire system at risk. The Board should be seeking to use the discretion provided in the statute to preserve this balance, not hasten its demise.

Small Bank Harm

Finally, although small banks and credit unions are technically exempted from the Durbin amendment, it is uncertain whether a two-tiered system will be implemented on each network to differentiate covered and non-covered institutions. Even if it is, it is difficult to imagine how small issuers will not be negatively impacted by the significant distortion that will be caused to the debit card market, particularly given the network exclusivity rules that provide merchants the ability to choose the network over which transactions are processed. Inserting a significant market distortion into a free market, where merchants have every incentive to drive costs to the lowest-cost providers, is bound to drive interchange revenue down for smaller issuers as well as larger ones. During their recent testimony before the Senate Banking Committee, Chairman Bernanke[34] and Chairperson

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[33] *See The Washington Post*, "Retailers offer financial services to 'unbanked'," January 31, 2011 and *The Chicago Tribune*, "K-Mart trying out financial centers in Illinois," January 11, 2011.

[34] 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

Bair[35] explicitly recognized these threats to the effectiveness of the exemption. That is why smaller institutions and the groups that represent them continue to oppose the statute and the Proposed Rule, as evidenced by their participation in the Association Letter.

Network Exclusivity Alternative A Is The Preferable Approach And Is Consistent With The Durbin Amendment

The Proposed Rule asks for comment upon two alternatives for implementation of the network exclusivity restrictions in the Durbin amendment. Alternative A would require multiple, unaffiliated networks on a debit card, while Alternative B would require multiple, unaffiliated networks for each method of authorization on a debit card.[36] As the Board recognizes, Alternative A, without more, is consistent with the requirements of the Durbin amendment.[37]

We have significant concerns with Alternative B, which goes beyond the requirements of the Durbin amendment to cause unnecessary and avoidable harm with little offsetting benefits. First, requiring multiple networks for transactions authorized via signature would create significant technical and operational challenges and financial burdens for networks and issuers. Second, requiring multiple networks for each method of authorization would stifle innovation. If no new authorization method may be utilized until two networks are able to provide the service, innovation will be slowed both because of adoption time and decreased incentives to develop new methods. Finally, as the Board recognizes, having multiple networks for each authorization method would increase consumer confusion about card benefits.[38]

The principal benefit of Alternative B relative to Alternative A is greater merchant routing choice for PIN transactions. However, in the vast majority of cases, PIN transactions are unavailable to a merchant only because a merchant has voluntarily elected not to support multiple debit authorization methods. Promulgating rules beyond the Durbin amendment's mandate in a way that would require significant changes to the payment and debit card system, curtail innovation and harm consumers, while providing only tenuous countervailing benefits, neither seems prudent nor consistent with the EFTA.[39]

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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.")

[35] *See supra* at n. 30.

[36] 75 Fed. Reg. at 81,749.

[37] The Board acknowledged 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." 75 Fed. Reg. at 81,749.

[38] *Id.* at 81,748-49.

[39] We do not believe that Alternative B meets EFTA Section 904's mandates both to demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions and to support the continuing evolution of electronic banking services.

Finally, we believe that additional time beyond the timeframes provided in the Proposed Rules is needed to comply with either Alternative A or B. In addition to requiring time to overcome the technical challenges associated with the compliance process (particularly with respect to Alternative B), issuers will need sufficient time to establish the commercial arrangements with networks necessary to satisfy the requirements. This process will require developing and distributing requests for proposals, evaluating proposals, conducting due diligence, and negotiating and documenting business and legal terms. The implementation timeline for Alternative B, which would require the enablement of multiple networks per method of authorization, will be even longer and less predictable.

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Capital One appreciates the opportunity to comment on the Proposed Rule's debit card interchange fees and network exclusivity provisions. If you would like to discuss our comments, please contact me at (703) 720-1000.

Sincerely,

Andres L. Navarrete
Senior Vice President
Chief Counsel – Card, Regulatory and Enterprise Governance