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February 22, 2011

Via Electronic Mail

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

RE: Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson:

MasterCard Worldwide ("MasterCard")[1] submits this comment letter in response to proposed Regulation II and its accompanying Official Staff Commentary ("Proposal") issued by the Board of Governors of the Federal Reserve System ("Board") to implement the debit interchange fee limitation and the network exclusivity and routing provisions in Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Act").[2] MasterCard appreciates the opportunity to provide its comments on the Proposal.

BACKGROUND

Section 1075 of the Act added to the Electronic Fund Transfer Act ("EFTA") a new section 920 which regulates debit card interchange fees. Under these provisions, which were added to the Act through an amendment offered by Senator Richard Durbin, debit interchange fees paid to debit card issuers must be "reasonable and proportional to the cost incurred by the

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[1] MasterCard advances global commerce by providing a critical link among financial institutions and millions of businesses, cardholders and merchants worldwide. In the company's roles as a franchisor, processor and advisor, MasterCard develops and markets secure convenient and rewarding payment solutions, seamlessly processes more than 20 billion payments each year, and provides analysis and consulting services that drive business growth for its banking customers and merchants. With more than one billion cards issued through its family of brands, including MasterCard®, Maestro® and Cirrus®, MasterCard serves consumers and businesses in more than 210 countries and territories, and is a partner to 23,000 of the world's leading financial institutions. With more than 25 million acceptance locations worldwide, no payment card is more widely accepted than MasterCard.

[2] *See* Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (Dec. 28, 2010).

issuer with respect to the transaction." These provisions direct the Board to promulgate standards to implement the reasonable and proportional requirement and provide "considerations" for the Board to use in developing its standards.

In addition to the interchange fee regulation, the statute directs the Board to issue regulations providing that neither an issuer nor a payment card network may establish exclusive network arrangements for debit cards or inhibit the ability of a merchant to choose among the different networks enabled on a debit card for routing debit transactions.

The Proposal reflects the Board's initial attempt to implement the statute. As discussed below, however, the Board has not taken into account essential components of its statutory mandate and, consequently, fails to properly implement the interchange standard. The net result is that the Proposal impermissibly precludes issuers from recovering the bulk of their costs through interchange fees and improperly shifts those costs to consumers. We recognize that the Board was handed a difficult task and is under tight time constraints to implement the statute, and we think the best response to these pressures would be for the Board to postpone its rulemaking and enforcement of the statute to provide time to adopt a flexible and well considered market-based regulatory regime.

OVERVIEW OF COMMENTS

Interchange Proposal

The Board has failed, in the Proposal, to implement the statutory directive that interchange fees be set at levels "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." Instead, the Proposal sets fees at levels that would, under the Board's own analysis, expressly preclude issuers from recovering the vast majority of their costs through interchange fees. The following highlights key flaws in the Proposal.

- First, the Board has failed to consider the consequences the Proposal would have on key payment system constituencies, including consumers, community banks and credit unions, and small merchants.

- Second, the Board has ignored the operative provision calling for interchange fees that are "reasonable and proportional to the cost incurred by the issuer" and reads this provision as being "silent" regarding the costs that must be included in interchange fees. As a result, the Board has impermissibly excluded entire categories of costs expressly included by the statute.

- Third, for those cost categories the Board decided to consider (*i.e.*, a subset of the "incremental" costs of authorization, clearing, and settlement or so-called "ACS" costs), the Board improperly construed those costs too narrowly. For authorization costs, for example, the Board notes that authorization is "integral" to debit card transactions, describes elements of the authorization process but then excludes most of the costs issuers incur for this integral process.

- Fourth, the Board's data collection process was flawed, and its interpretation of the data incorrect. (See comments from Edgar, Dunn & Company, attached hereto as APPENDIX A, for a discussion of these issues.)

- Fifth, the Board ignored almost a century of legal precedent, including Supreme Court decisions, defining how to properly regulate fees.

- Sixth, the Board failed to address relevant competition, service and consumer welfare considerations in adopting its Proposal. (See Professor Christopher M. James's *Comments on the Federal Reserve Board's Debit Card Interchange Fees and Routing Proposal* ("James Paper"), attached hereto as APPENDIX B, for a discussion of these issues.)

- Finally, the Board's failure to follow the statutory direction to compare debit card transactions and check transactions has resulted in an interchange proposal that does not account for the many costs issuers incur to create the substantial benefits merchants receive through debit card transactions.

With respect to this last point, we note that the Board appears to have specifically neglected to consider that debit cards in their current form (as opposed to checks) enable merchants to obtain a payment guarantee once a debit card transaction authorization request is approved. The cost of this guarantee is a settlement cost incurred by issuers when they pay funds to acquirers to settle the transaction and the cardholder has insufficient funds in the account to cover the transaction. Yet the cost of providing this guarantee to the merchant was completely ignored by the Board. In essence, the Proposal precludes an issuer from recovering the cost of the guarantee (much less profit) through the interchange fee. It simply is not the case that Congress intended issuers to give the guarantee to merchants for free. (This is like forcing an online retailer to sell its products for the price of shipping and handling—*i.e.*, without recovering for the cost of making the product or any profit.) Moreover, there is little or no economic rationale for issuers to continue to provide the guarantee if the Board fails to allow issuers to be compensated for it through interchange fees.

Unintended Consequences of the Board's Approach

<u>*Harm to Consumers*</u>

The net effect is that the Board's Proposal would impermissibly set interchange fees at levels that preclude issuers from recovering most of their costs, including costs specifically allowed under the statute. As the Board indicates several times in the Proposal, the Board's rate limitations result in a cost shift to consumers.[3] This cost shift, which amounts to as much as $14 billion in new fees for consumers, is impermissible under the statute. The statute calls for interchange fees which are reasonable and proportional to an issuer's costs that, by definition, are paid by acquirers. By ignoring this directive and expressly precluding issuers from recovering their costs, the Board's rate setting effectively imposes new fees on consumers. Nowhere does

[3] *See*, *e.g.*, 75 Fed. Reg. 81,733, n. 44 (observing that "issuers have other sources [*i.e.*, consumer customers], besides interchange fees, from which they can receive revenue to cover their costs of operations and earn a profit").

the statute provide the Board authority to impose fees on consumers. In fact, if Congress understood how the Board would implement the statute, it seems highly unlikely that the underlying provisions would ever have been enacted into law.

In other words, because the Board would prevent issuers from recovering their costs through interchange fees, card issuers will have no choice but to seek increased revenue from other sources. In the case of debit cards the only other source is the consumer, which will result in increased fees for consumers. Because of the extraordinarily restrictive nature of the Board's Proposal, however, it is unlikely issuers will succeed in making up all of their costs through consumer fees. As a result, they will also be forced to reduce consumer benefits to reduce costs.

Experience with this type of regulatory price control demonstrates these harmful effects and highlights that when merchants stop paying their fair share for the benefits they receive from card acceptance, consumers end up paying the price in the form of fewer choices, higher payment card fees, and fewer benefits. This is precisely what happened in Australia when the Reserve Bank of Australia ("RBA") adopted regulations reducing interchange in Australia. The net effect of the RBA's arbitrary limits has been that consumers have seen annual fees and finance charges increase while consumer benefits have decreased. Moreover, we are unaware of any evidence that merchants have lowered prices to consumers as a result of their paying lower fees for card acceptance.

Of course, when consumer costs increase, those who can least afford it—lower and moderate income families—are hit the hardest. While wealthier families will always have multiple options, for many struggling families debit cards provide their sole means of obtaining an affordable deposit relationship and transacting electronically. This is increasingly important because without access to electronic payments, these families would find it difficult if not impossible to engage in basic transactions that most people take for granted, such as purchasing products online, renting a car, reserving a hotel room, or purchasing an airline ticket over the phone. Moreover, carrying cash raises security hazards particularly for those who reside in high-crime areas. The Board's Proposal will essentially force these families to make a difficult choice—either give up their cards, or use their scarce financial resources to pay the higher fees necessary to cover their share of the $14 billion in merchant costs the Proposal will shift to consumers.

Impact on Smaller Institutions

Consumers will not be the only ones harmed by the Proposal. As the Board is acutely aware, the underlying statutory provisions continue to be strongly opposed by community banks and credit unions because those institutions rely heavily on interchange fees in many cases just to break even on their debit card programs. Under the Proposal, however, these institutions will find the viability of those programs undermined as the competitive marketplace is unlikely to support a system in which community banks and credit unions receive market rates and an unfair competitive advantage. Thus, while many smaller banks and credit unions are technically "exempt" from the interchange price controls, the Board's Proposal renders the so-called small issuer exemption essentially unworkable given the significant disparity between the proposed rates and market rates. Indeed, this is why community banks and credit unions so strongly opposed the Durbin amendment in the first place.

Moreover, even assuming a two-tier interchange structure is developed, it is unlikely that the tier for exempt entities would be materially higher than for regulated entities given concerns regarding the potential for merchants to discriminate against higher fee cards. For example, if debit cards issued by smaller institutions are 4-5 times more costly for merchants to accept, smaller institutions might very well find that merchants will pressure their cardholders to use another form of payment or even decline their cards. We believe the Board erred in failing to gather cost data from the smaller issuers and in failing to assess the impact of the Proposal on those issuers. We urge the Board to address this by conducting an appropriate cost study of issuers with assets below $10 billion and fully assessing the impact of the Proposal and any subsequent rule on such institutions.

Impact on Merchants

Merchants, particularly smaller ones, also will suffer under the Proposal as the statute does not address merchant fees and the largest merchants will continue to use their bargaining power to lower fees while smaller merchants are unlikely to have the same success. Indeed, the largest merchants have a strong track record in doing just that, and today many pay their banks little more than the interchange fee (and in many cases even get rebates for reaching various volume levels). The net result is likely to be a cost savings windfall for the largest retailers and little, if any, cost savings for small merchants. This occurs, of course, because the largest merchants, given their size and geographic presence in communities across the country, generate card transaction volumes that smaller merchants are unable to achieve. Also, because the net effect of the Proposal would be for debit cards to become more expensive for consumers to have and use them, merchants should expect to handle greater numbers of less efficient forms of payment like cash and check.

Collateral Effects

Movement back to cash and check has broader complications as well. For example, shifting transactions to cash makes purchase transactions less transparent and facilitates "underground" commerce, which undermines important anti-money laundering and tax enforcement efforts. Movement back to paper-based transactions also has more basic implications. For example, more transactions would be required to take place "face to face." Longer lines at airports, hotels, and state departments of motor vehicles and fewer online transactions means less efficiency and a greater drain of resources impacting the economy and driving up costs.

Scope and Routing Issues

The Board requested comment on the appropriate application of the interchange fee standards to debit transactions carried over three-party networks and non-traditional networks such as PayPal, as well as on how the network exclusivity and routing provisions should be applied to such networks. The statute clearly covers three-party networks and non-traditional networks. PayPal, for example, uses a three-party model in which it enables consumers (*i.e.*, "cardholders") to use accounts established with PayPal to pay merchants authorized to accept PayPal payments. In particular, PayPal: (i) issues account numbers for use in debiting "accounts" through its network and, thus, meets the definition of "issuer;" (ii) contracts with merchants to settle the merchants' debit transactions through its network and, thus, meets the definition of "acquirer;" and (iii) provides the services, infrastructure and software for "authorization, clearance, and settlement" of debit transactions and, thus, meets the definition of "payment card network." Therefore, based on the statute and the Board's proposed interpretation, PayPal and the other three-party networks, whether "traditional" or "non traditional," must be covered by the restrictions imposed under the statute.

Moreover, whatever policy considerations related to issuer cost recovery that apply to traditional debit systems apply equally to equivalent debit transactions effected over emerging payments systems. If these networks were improperly excluded from coverage, it would have distorting effects (including by artificially diverting investment and technology development, and providing incentives for issuers to use inferior processes) that could jeopardize the soundness of the general payment infrastructure and harm consumer welfare. Without this equitable regulatory coverage, three-party and other emerging payment models would be able to capitalize on the existing infrastructure, marketing, and value-added services of the four-party models without facing equal price and routing controls. Such a condition would likely lead to significant under-investment in consumer and merchant safety, utility, and innovation, especially given the rapidly developing nature of payments innovation. Finally the creation of this regulatory gap would create undue incentives for avoidance of the Board's regulations.

To avoid further compounding the harms generated by the interchange fee regulations, the Board must ensure that it properly implements the so-called exclusivity and routing provisions included in the statute. In particular, the Board must ensure that it adheres to the statutory language and simply provides that each debit card must be capable of operating on two unaffiliated networks. This can clearly be implemented by ensuring that each card can be processed on one signature network and one unaffiliated PIN network. It is essential that the Board not mandate dual signature functionality on each debit card because such an approach would permit merchants to override consumer choice and would undermine the intensive competition and innovation that has produced exclusive benefits for consumers, merchants, and other participants in the payment card networks. Additionally, the Board should confirm that the network exclusivity and routing provisions do not extend to ATM transactions. Those provisions apply only to point of sale transactions and must not affect ATM transactions.

DETAILED COMMENTS

COMMENTS ON DEBIT INTERCHANGE FEE REGULATION

Statutory Requirements

The Act requires that debit interchange fees be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction" and directs the Board to issue standards to implement that requirement.[4] To guide the Board, the statute sets forth "considerations" for the

[4] EFTA §§ 920(a)(2) and (3).

Board to use in developing its standards. Specifically, the statute provides that the Board must "consider" the functional similarity between debit transactions and check transactions that are "required to clear at par."[5] The statutory instructions also direct the Board to "distinguish between…the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered," and "other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered…."[6]

The Board's Proposal

Under the Proposal, the Board has taken a very restrictive approach to implementing the interchange fee provisions and has limited the costs that may be considered to only certain costs for authorization, clearing, and settlement services. The result is that only a narrow segment of an issuer's total costs of debit card transactions is included in the analysis.

The Proposal sets forth two alternative proposals for determining whether an interchange fee complies with the standard. Under the first alternative, issuers would be entitled to collect a per-transaction interchange fee up to 7 cents per transaction regardless of their per transaction costs. Issuers could seek a higher fee to the extent their total allowable costs divided by the total number of their debit card transactions justify a fee more than 7 cents. In no event, however, could the fee exceed 12 cents per transaction. The second alternative would allow any issuer to receive an interchange fee of up to 12 cents per transaction. The Board has also requested comment on other alternative approaches, including approaches based on the average effective interchange fee.

The Board's alternatives are a striking departure from existing market-based interchange rates which, according to the Board, average around 44 cents per transaction. As discussed below, both alternatives improperly construe the statute and would set debit interchange fees at impermissibly low levels. As a result, the Board must substantially revise its Proposal to ensure that each issuer is permitted to receive interchange fees that are "reasonable and proportional to the cost incurred by the issuer" as required by the statute.

The Board's Proposal Erred In Its Construction and Implementation of the Statute's Debit Interchange Fee Restrictions

The first step in complying with or implementing the debit interchange provision is determining "the cost incurred by the issuer with respect to [a debit card] transaction." There is no evidence in the Proposal, however, that the Board has properly undertaken this exercise.

As the Board is aware, but failed to take into account, there are many different types of costs issuers must incur to enable debit card transactions. Indeed, many of these costs are incurred to comply with the Board's extensive regulation of debit cards themselves. These costs include, for example, the cost of providing disclosures to cardholders, the cost of sending notices

[5] EFTA § 920(a)(4)(A).

[6] EFTA § 920(a)(4)(B).

regarding changes in terms, costs associated with providing statements, and costs associated with maintaining procedures as well as personnel for resolving errors or disputed transactions.

Other mandatory costs include expenditures and investments to comply with anti-money laundering regulations such as the customer identification requirements established under the USA PATRIOT Act and the long-standing currency reporting and other compliance requirements under the Bank Secrecy Act. These mandatory costs, though extensive, are only part of the costs debit card issuers must incur for each transaction.

To estimate the total amount of these costs incurred by issuers with respect to a debit transaction, MasterCard retained Edgar, Dunn & Company to conduct a cost survey of debit card issuers participating in the MasterCard system ("EDC Survey"). Based on that survey (which included issuers with assets above and below $10 billion), the average total cost per debit transaction is approximately $1.00. For issuers with assets in excess of $10 billion, the total average costs per debit transaction are approximately 65 cents to 75 cents. This raises the question how the Board determined to propose interchange rates that fail to cover the vast majority of those total costs. The simplest answer appears to be that, instead of complying with the statutory mandate and considering all of these "cost[s] incurred by the issuer," the Board considered only the most basic administrative or processing costs—a very small portion of total costs—without an appropriate basis for doing so.

Based on the Proposal and the Board's consideration of it at its open meeting, it is clear that the Board's failure to properly implement the statute is based on a misinterpretation of its statutory mandate. The most glaring problems stem from what appears to be a series of misinterpretations of the plain language of the statute.

The Board Erred in Concluding That the Requirement to Establish Interchange Fees "Reasonable and Proportional to the Cost Incurred by the Issuer with Respect to the Transaction" Is "Silent" Regarding the Relevant Costs

The first and most fundamental error is the Board's analytical misstep in interpreting the operative portion of the statute. As noted above, the statute calls for interchange fees that are "reasonable and proportional to the cost incurred by the issuer in connection with the transaction."[7] In a twist of statutory interpretation, the Board reads this language as "silent" with respect to the costs to be included in the interchange fee calculation.[8] As can be seen from the highlighted language, however, the statute is not silent but quite express—the costs that must be included are those that are *incurred by the issuer with respect to the transaction*. Indeed, unless

[7] EFTA § 920(a)(2) (emphasis added).

[8] *See, e.g.,* 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) (stating, for example, that "I do want to suggest something that the statute was silent on, and that has to do with costs that are related to a particular transaction that are not related to authorization, clearance and settlement").

those costs are included, any interchange fee set by the Board (or anyone else) cannot be "reasonable and proportional" to those costs.[9]

The Board Erred in Concluding That the Statutory "Considerations" for Implementing the Interchange Limitation Override the Limitation Itself

Next, the Board's misinterpretation of its statutory guidance seems to have contributed to its decision to impermissibly ignore the operative portions of the statute. As noted above, to guide the Board, the statute directs the Board to "distinguish between": (i) the incremental cost incurred by an issuer for the role of the issuer in the "authorization, clearance, or settlement" of a particular electronic debit transaction, which the Board must consider; and (ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which the Board may not consider.[10]

This language simply provides guidance to the Board to "consider" for purposes of implementing the "reasonable and proportional" interchange limitation. The Board itself recognizes that the statute "requires only the *consideration* of those factors…."[11] And, this provision of the statute in no manner limits recoverable costs to ACS costs, as the Government—including Board counsel—has itself argued before a federal district court.[12] Yet the Board reads the considerations as if they were the interchange limitation itself and limited recoverable costs to ACS costs. Based on the Supplementary Information to the Proposal, it is clear that this error is based on a number of analytical missteps. The chief problem again stems from the Board's erroneous conclusion that Congress was "silent" when it directed that interchange fees be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." (If the Board were to correct this error, it would be well on its way to correcting much of the fatal flaw in the Proposal.) Having made this error, the Board then looks to the statutory "considerations" for evidence of congressional intent as to which costs should and should not be included and finds that only those costs specifically mentioned in the "considerations" should be included when implementing the operative provision of the statute.

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[9] The Board compounded this error through a related mistake in seeking to implement its mandate. The Board appears simply to have assumed that its role was to set particular fee levels untethered by the recovery of issuer costs, yet the statute directs the Board only to "prescribe regulations … to establish standards for assessing whether [interchange fees are] reasonable and proportional to the cost incurred by the issuer with respect to the transaction." *See* EFTA § 920(a)(3). As the Government has elsewhere acknowledged, and indeed affirmatively argued, this provision "does not obligate the Board to set a specific rate for debit interchange fees." *See Memorandum in Support of Defendants' Motion to Dismiss, TCF National Bank v. Bernanke et al.*, at 28, Case No. 4:10-cv-04149-LLP (D.S.D., S. Div., filed Feb. 18, 2011).

[10] EFTA § 920(a)(4).

[11] 75 Fed. Reg. 81,734 (emphasis in original).

[12] *See Memorandum in Support of Defendants' Motion to Dismiss, TCF National Bank v. Bernanke et al.*, *supra*, at 28 ("Under the statute, the Board can consider non-ACS costs that are specific to a particular electronic debit transaction. *See* 15 U.S.C. § 1693o-2(a)(4)(B)(ii).").

The Board's notion that the "considerations" for implementing the interchange fee limitation are more indicative of congressional intent than the language of the limitation itself, cannot be sustained. In fact to reach the Board's conclusion, one would need to ignore the way the statute actually reads and conclude that when Congress called for interchange fees based on the "cost incurred by the issuer" it actually meant that interchange fees should be based on the "*authorization, clearing and settlement* costs incurred by the issuer." This is not what Congress directed in the statute, and while the Board may be entitled to exercise certain discretion in implementing the statute, the Board certainly does not have the authority to rewrite the statute. Based on the clear reading of the statute, therefore, the Board must substantially revise the Proposal to account for all of the "cost incurred by the issuer" with respect to debit card transactions.

These revisions are not only required based on the plain meaning of the statute, they are compelled by applicable judicial precedent. It is well established that when Congress directs an agency to "consider" a factor, "[t]hat means only that [the agency] must 'reach an express and considered conclusion' about the bearing of a factor, but it is not required 'to give any special weight' to it."[13] This applies with even greater force to the considerations presented to the Board, which call upon the Board to "distinguish between" two types of costs—one of which (incremental ACS costs) "shall be considered under paragraph (2) and others "which…shall not be considered under paragraph (2)." Nothing in this provision suggests that this "distin[ction]" or these "consider[ations]" should be used to ignore the full content of the interchange limitation calling for fees that are reasonable and proportional to the "cost incurred by the issuer." For those reasons the Board must implement the statute as it is written and enable issuers to charge interchange fees that are reasonable and proportional to the costs they incur with respect to their debit card transactions.

The Board Improperly Limited "Incremental Costs" To Mean "Average Variable Costs"

The Board erred in adopting a standard based on "incremental ACS costs" in place of one based on the "costs of debit card transactions." That error is dramatically compounded by the Board adopting an impermissibly narrow definition of "incremental" costs to include only costs that vary with the number of transactions sent to the issuer (referred to as "average variable costs"). As the Board acknowledges, the accepted economic understanding of "incremental" costs, set forth most prominently by Professors Baumol and Willig, encompasses the incremental expenditures associated with a firm's undertaking a particular service. That standard, which would permit far broader recovery of costs than the Board's proposal permits, has been applied in and designed especially for the rate setting context. The standard definition reflects basic economic theory regarding the costs and cost recovery that most closely reflects firms' behavior in fully competitive markets, and is designed to produce the investment efficiencies and consumer welfare benefits that efficient markets produce.

The Board provides no adequate theoretical or economic reason for rejecting this standard and the theory that generated it. Instead, the Board stated that it would adopt a

[13] *Time Warner Entertainment Co. v. FCC*, 56 F.3d 151, 175 (D.C. Cir. 1995 (quoting *Central Vermont Ry., Inc. v. ICC*, 711 F.2d 331, 336 (D.C. Cir. 1983)).

narrower definition of "incremental cost" because here "the increment of production is larger than the cost of any particular transaction."[14] While this explanation is unclear, it is clearly wrong to the extent it suggests that the standard economic definition of "incremental costs" is inconsistent with the statute's references to the costs of particular transactions. The Baumol/Willig theory is designed just for that purpose. Like the Board's own use of aggregate survey results, a traditional economic incremental cost approach examines a firm's costs across the aggregation of service transactions, and yields a per transaction price on that basis.

As a matter of statutory construction, Congress' direction to the Board to consider the incremental ACS cost of a "particular transaction" must be read in the context of the overall directive to establish interchange fees that are "reasonable and proportional to the cost incurred by the issuer with respect to *the transaction*." (Emphasis added.) The "particular transaction" referred to in the ACS cost directive is simply "the transaction" referred to in the reasonable and proportional standard. In other words, there is nothing special about the reference to a "particular transaction" in the ACS directive given that the "reasonable and proportional" requirement is written in terms of an individual transaction. The Board has already correctly concluded that the standard actually calls for a rule applicable to all non-exempt issuers' transactions—*i.e.*, not a rule imposing limitations on a transaction-by-transaction basis. Having determined that the reasonable and proportional standard applies to all transactions, the Board cannot then decide that the ACS directive used to implement that standard is supposed to be applied on a transaction-by-transaction basis.

Limiting "incremental costs" to "average variable costs" is not consistent with sound economic policy. The plain effect of this interpretation is to exclude substantial categories of fixed costs from allowable costs, even if they are properly allocable to ACS. If issuers are not allowed to recover such fixed costs, they obviously will reduce or eliminate their investments in them and there will be resulting declines in the quality and functionality of debit card services. The Board does not address these implications, including consequences on consumers or competition, but merely moves to a "lowest cost" interpretation. This approach is ill-advised because of its impact on future investment in fixed costs needed to provide debit card services. Moreover, it is fundamentally unfair (and confiscatory) to the extent it prevents issuers from receiving interchange fees to cover the millions, if not billions, of dollars of fixed costs that issuers have already invested in building a debit card system that provides real-time authorization for debit card transactions.

Moreover, Congress can be presumed to legislate against the backdrop of standard rate-making principles, which encompass a broader range of costs and tie them specifically to particular regulated transactions and individual fees charged for those transactions. In traditional rate-making, the regulated fee—on a per transaction basis—reflects not only the particular operational costs associated with completing the unit of regulated service, but also the capital costs (investment) and allocated common costs that were necessary to the completion of each particular transaction. A depreciation charge is an essential portion of the costs recovered in and associated with the fee for the particular unit of service, and that charge reflects the capital costs

[14] 75 Fed. Reg. 81735.

that the regulated entity must incur to complete particular transactions. The calculation of the fee allocates the capital and other costs that are thus "specific" to the "particular transaction."[15]

Consider, as an example, the regulation of hourly electricity fees. Under the Board's construction of "costs…specific to a particular…transaction," the regulated utility would be able to charge only for the additional costs it incurs in providing each hour's worth of electricity to a consumer, but could not recover for the plant construction, general operation costs (overhead), maintenance, and infrastructure replacement costs required to produce and deliver the electricity—including production and delivery of the particular hour's worth of electricity subject to the fee. The results are readily foreseeable: the plant would soon fall into disrepair; customer service would be reduced or terminated; the plant operator would eventually go bankrupt; and no future electricity plants would be built in that jurisdiction. Under the traditional ratemaking understanding, however, "costs…specific to a particular…transaction" extends to a broader range of costs, and the plant (and its customers) would thrive. Fees would include a pro rata (and thus transaction-"specific") depreciation charge, as well as the general operational and maintenance costs that are required to produce that unit of service. The depreciation charge is clearly related to costs incurred in and necessary to the provision of the electricity, and reflects the portion of capital expenditures that specifically supports the provision of the particular unit of service. Indeed, the specific depreciation charge is *directly* linked to the particular transaction: provision of each hour's worth of electricity slightly degrades the plant and slightly makes the electric wires less valuable, and the depreciation charge—while calculated based on investment—is essential to permit recovery of the specific costs incurred in the provision of the particular unit of service.

The Board Improperly Limited the Costs Included in ACS Costs

Again, the Board erred in adopting a standard based on "incremental ACS costs" in place of one based on the "cost incurred by the issuer with respect to the transaction." However, even assuming that allowable costs are limited to ACS costs, the Proposal adopts an improperly narrow interpretation of ACS costs. For example, the Board excludes the network fees which are an integral component of the ACS process and related costs. In fact, issuers must incur these costs to interconnect with other system participants and carry out their role in the ACS processes. The Board also excludes all of the other ACS costs except a small subset of processing or administrative costs. All of the ACS costs must be included as part of calculating any reasonable and proportional debit interchange fee. The EDC Survey highlights the magnitude of the costs inappropriately excluded by the Board. Based on that survey, we estimate total ACS costs to range between 30 cents and 35 cents per transaction—amounts that far exceed the 7 to 12 cents the Board permits under the Proposal.

[15] Similarly, Section 920(a)(4)(B) limits "other costs" (*i.e.*, non-ACS costs) that are not costs of providing debit card transactions and thus not costs specific to such transactions. This would preclude, for example, including in allowable costs an issuer's costs that relate to general operations rather than providing debit card services. However, Section 920(a)(4)(B)(ii) would not exclude (properly allocated) costs incurred in providing debit card services merely because they are common to providing the related deposit account.

The exclusion of most of the ACS costs is another example of where the Board was given a clear instruction but chose to bypass it in favor of an interpretation resulting in highly restricted interchange fees. The Board's approach to authorization costs is instructive in this regard. The Board observes that "[p]ayment authorization is an integral part of the processing of a transaction on a debit card network" and acknowledges that Congress instructed it to consider these costs.[16] Despite the "integral" nature of the authorization costs and the Congressional directive to consider those costs, however, the Board excluded most of them. The Board notes that "[a]s part of the payment authorization process, a card issuer determines, among other things, whether the card is valid and whether there are sufficient funds to cover the payment."[17] To determine whether the "card is valid" the issuer must first build, and then update and maintain, a profile of the cardholder and the cardholder's behavior. This is the foundation of the authorization process, and for each cardholder and each transaction the issuer incurs incremental costs.

These are just some of the costs involved in the authorization process, of course. While the "authorization process" occurs in a matter of milliseconds, it is a highly sophisticated process which is costly for card-issuing banks to establish and maintain. In many cases, advanced algorithms are used to determine whether the card is being used by an imposter, and those systems require substantial investment to establish, maintain, and upgrade over time. These systems also are essential to delivering value to merchants because when the bank sends an authorization message, it is guaranteeing that the merchant will get paid even if the cardholder ultimately has insufficient funds to cover the transaction. The Board's Proposal, however, excludes almost all of the costs of authorization and instead essentially focuses on the cost of sending the message back and forth.

The Board also improperly excluded most of the costs associated with the clearing and settlement categories. The most basic of these costs cover activities such as processing the clearing and settlement messages and posting each transaction to the appropriate account. Clearing and settlement also include the costs of providing monthly statements and responding to cardholder inquiries as required by federal law because "settlement" is not final until these activities are complete. Yet, the Board excluded the bulk of these costs.

In addition, the Board neglected to consider that debit cards in their current form (as opposed to checks) provide merchants a guarantee once a debit card transaction authorization request is approved. We estimate that 99.98% of debit transactions in our system result in payment to the merchant without any dispute. In the .02% of transactions where a dispute occurs, issuers pay 73% of those transactions. The cost of this guarantee is a settlement cost incurred by issuers when they pay acquirers funds to settle the transaction and the cardholder has insufficient funds in the account to cover the transaction. Yet the cost of providing this guarantee to the merchant was completely ignored by the Board. In essence, the Proposal precludes an issuer from recovering the cost of the guarantee (much less profit) through the interchange fee. It simply is not the case that Congress intended issuers to give the guarantee to merchants for free. (This is like forcing an online retailer to sell its products for the price of

[16] 75 Fed. Reg. 81,734.

[17] *Id*.

shipping and handling—*i.e.*, without recovery for the cost of making the product or any profit.) Moreover, there is little or no economic rationale for issuers to continue to provide the guarantee if the Board fails to allow issuers to be compensated for it through interchange fees.

The Board's failure to account for the guarantee is all the more puzzling because, as noted above, Congress specifically directed the Board to compare checks and debit card functionality as part of its rulemaking. The guarantee is just one of many critical differences between checks and debit cards that support higher debit card interchange fees. Under the check system, because checks are not authorized or guaranteed the way debit cards are, merchants have been forced to seek private sector solutions to the "bounced check" problem. When merchants try to approximate a portion of the functionality of the debit card authorization/guarantee process, they use check guarantee services for which they pay a fee. For example, a quick search of the Internet shows check guarantees advertised for 1.25% to 1.5% of the face value of the check (plus a respective per transaction fee of between 20 and 22 cents) for every check accepted for payment.[18] Based on the Board's own analysis this would amount to a fee of 70 to 78 cents per transaction on an average transaction of $38.58. These fees far exceed the 7 to 12 cent interchange fee allowed under the Board's Proposal for debit cards which automatically include the guarantee (at least for now).

Of course, even if a merchant purchases check guarantee services, check functionality falls far short of debit functionality, a key point that the Board's Proposal does not even acknowledge, despite its statutory mandate to do so. The significance of this point is highlighted by the following observation: contrary to the plain language of the statute, the Board has determined that issuers should receive 7 to 12 cents in total compensation for all aspects of debit card acceptance, including providing merchants guaranteed payments and all of the merchant efficiencies debit cards bring, while merchants routinely pay 70 to 78 cents a transaction to obtain a guarantee for a far less efficient check payment. Beyond the cost of the check guarantee merchants must purchase separately, checks involve other extensive costs as well. Merchants must separately purchase check conversion (to electronic funds such that checks do not have to be deposited into the bank), and pay fees that typically can include set-up fees, transaction fees (as noted above), as well as monthly service fees and terminal fees.

The fact that the Board chose not to conduct such an in-depth study appears to have contributed to its decision to so severely restrict interchange fees. Accordingly, MasterCard strongly encourages the Board to greatly expand the scope and depth of its comparison between electronic debit transactions and checking transactions, as we believe that such a comparison will demonstrate the superior efficiency, benefits, features and functionality of electronic debit transactions and help inform the Board as it seeks to comply with this statutory requirement.

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[18] *See, e.g.*, http://www.merchantseek.com/checkg.htm (1.25% + $0.22 per transaction); http://www.instamerchant.com/check-guarantee.html (1.39% + $0.25 per transaction) (noting that "industry standard" is 1.85% plus a $0.35 to $0.50 per item fee); and http://www.1nbcard.com/content/check_guarantee_merchant_services.html (1.5% + $0.20 per transaction).

The Board Improperly Construed the Debit/Check Comparison As Limiting Interchange Fees

The Board's error in excluding the payment guarantee and failing to account for other factual differences between checks and debit cards are not the only errors the Board made in its debit/check comparison. The Board also misinterpreted the relevant statutory language as well. The specific statutory instructions to the Board are to:

> *"'(A) consider the functional similarity between—*
>
> *'(i) electronic debit transactions; and*
>
> *'(ii) checking transactions that are required with the Federal Reserve bank system to clear at par….'"*[19]

This comparison, when done properly, provides useful information, including by demonstrating how little value checks provide to merchants because they are required to "clear at par" (in contrast to debit cards which compensate issuers through interchange). Because checks "clear at par" the merchant and its bank provide no compensation to the consumer's bank in connection with a check transaction. As a result, issuers have little or no incentive to innovate or create value for merchants in connection with checks, and this lack of incentive shows itself quite clearly in the stunted functionality of checks, particularly as compared to debit cards. This is an important point because, by identifying the many benefits debit cards provide over checks, the comparison helps demonstrate the relevant value for which interchange fees help compensate issuers. For example, checks take much longer to process at the point of sale, generating higher labor costs and consumer dissatisfaction for customers waiting in line behind the check payer. As noted above, checks also "bounce" while debit cards do not.

However, although the Proposal runs through a basic comparison of checks to debit cards and identifies some of the benefits debit cards provide merchants, the Board does not properly account for any of them in its Proposal. Instead, the Board interprets its mandate to compare checks and debit cards as requiring it to exclude from interchange fees those "costs that a payor's bank [(*i.e.*, the equivalent of the issuer)] in a check transaction would not recoup through fees from the payee's bank [(*i.e.*, the equivalent of the acquirer)]."[20] This is incorrect. The whole point of the new interchange provision is to establish interchange fees that are paid by acquirers to card issuers—in other words, to establish an issuer compensation system entirely different from the one used in the check system.

To adopt the Board's interpretation, one would need to adopt a reading of the statute that is not available. In fact, to support the Board's interpretation one would essentially have to read the statute as follows—when Congress instructed the Board to compare debit cards and checks in implementing the requirement that debit interchange fees be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction," Congress actually intended that the

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[19] EFTA § 920(a)(4)(A).

[20] 75 Fed. Reg. 81,735.

Board should establish interchange fees based on what a merchant's bank pays a consumer's bank for a check transaction. We are not aware of any basis to read the statute in that way. Indeed, Congress' instruction to compare debit card transactions to checking transactions would be rendered meaningless if all that was intended by Congress was for the Board to require debit card transactions to "clear at par." In other words, if Congress intended for the Board's functional comparison to both begin and end with par clearing, it certainly could have stated that in the statute. This, however, is not what Congress directed by instructing the Board to perform a functional comparison between the two payment instruments, which must include the guarantee debit cards provide merchants.

The Proposal itself highlights that its interpretation of the check and debit card comparison is wrong. The Proposal notes that the Board's interpretation of the check and debit comparison would support excluding debit clearing and settlement costs because while "[c]learing and settlement occur for both debit cards and checks…for checks there is nothing analogous to an interchange fee to reimburse the issuer for the cost of clearing and settling a transaction."[21] Again, the statute does not allow the Board's interpretation because the statute expressly requires the Board to consider clearing and settlement costs.[22]

We submit that when the Board's interpretation of the check/debit comparison directly conflicts with its mandate to include clearing and settlement costs, the Board's interpretation must be rejected. Instead of resolving the conflict by revising its interpretation of the check/debit comparison, however, the Board requests comment whether it should ignore the statute and limit allowable costs to only those involved in "authorization." In response, we urge the Board to: (i) clarify that the full range of ACS costs must be included in the determination of debit interchange fees; and (ii) more fully consider the many benefits debit cards provide over checks as part of its functional comparison of checks and debit cards.

The Board's Interpretation of "Reasonable and Proportional" Is Inconsistent with Longstanding Precedent

"Reasonable" Rates Ensure Cost Recovery

Congress legislated against a backdrop of more than a century's worth of rate regulation statutes and judicial decisions, all of which use language very similar to the language Congress used for regulating debit interchange fees and all of which have been construed as protecting the regulated entity by requiring that recovery of costs of service include a reasonable return on investment. The rate making language was initially used in the Interstate Commerce Act of 1887, which mandated "reasonable and just" rates, and was repeatedly used in subsequent statutes to establish the minimum recovery that regulated entities were guaranteed.[23]

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[21] *Id*.

[22] EFTA § 920(a)(4)(B)(i).

[23] *See, e.g.*, Federal Power Act of 1920, 41 Stat. 1063, 1073 ("reasonable, nondiscriminatory, and just" rates); Communications Act of 1934, 48 Stat. 1064, 1070 ("just and reasonable" rates); Natural Gas Act of 1938, 52 Stat. 821, 822 (same).

Ensuring broad recovery of costs for the regulated entity, including return on investment, has been a consistent element of Congress' rate regulation and judicial decisions implementing statutes similar to the debit interchange restrictions. "More than a century ago, reviewing courts charged with determining whether utility rates were sufficiently reasonable to avoid unconstitutional confiscation took as their touchstone the revenue that would be a 'fair return' on certain utility property known as a 'rate base.'"[24] Ratemaking assumed its modern form following *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), where the protection for regulated service providers shifted from ensuring fair value to ensuring the recovery of "costs," including the cost of capital reflected in profits.[25] Under that standard, costs would be recovered and return would be enough to "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed."[26] Even where (unlike here) Congress mandates a departure from rate-based ratemaking and requires forward-looking rates, rates under the "just and reasonable" standard must still permit recovery of costs related to the provision of service.[27]

Congress' use of similar language in the Act's interchange provisions compels a similar approach here. "Reasonable and proportional" rates are simply a formulation of the "reasonable and just" touchstone of the ICA and later statutes that have always served as Congress' approach to ratemaking. Indeed, Congress in the debit interchange provisions slightly departed from the traditional language in a manner that confirms and underscores the importance of cost recovery, and the limitation on Board discretion, here. Instead of "just and reasonable," the debit interchange provisions call for "reasonable" and "proportional" fees and expressly built into the statute the issuer's right to recover "the cost incurred by the issuer with respect to the transaction." In contrast, as described above, the Board's approach clearly excludes recovery of the vast amount of reasonably incurred costs and will, for every single covered issuer, mandate below-cost rates.

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[24] *Verizon Communications Inc. v. FCC*, 535 U.S. 467, 481 (2002); *see Smyth v. Ames*, 169 U.S. 466 (1898).

[25] *See Verizon Communications Inc.*, 535 U.S. at 483-85.

[26] *FPC v. Hope Natural Gas Co.*, 320 U.S. at 605; *see also, e.g.*, *id*. at 603 (just and reasonable rates allow for "enough revenue not only for operating expenses but also for the capital costs of the business"); *FPC v. United Gas Pipe Line Co.*, 386 U.S. 237, 243 (1967) (agency's statutory duty "is to determine just and reasonable rates which will be sufficient to permit the company to recover its costs of service and a reasonable return on its investment"); *Memphis Light, Gas & Water Div. v. FERC*, 707 F.2d 565, 567 (D.C. Cir. 1983) (similar); *ExxonMobil Oil Corp. v. FERC*, 487 F.3d 945, 951 (D.C. Cir. 2007) ("Just and reasonable rates are rates yielding sufficient revenue to cover all proper costs … plus a specified return on invested capital") (internal quotation marks omitted); *United States v. FCC*, 707 F.2d 610, 612 (D.C. Cir. 1983) (similar). Early in the construction and implementation of the Interstate Commerce Act and related rate setting measures, the Supreme Court established that rates must enable the regulated entity to recover costs. *See, e.g., Covington & Lexington Turnpike Rd. Co. v. Sandford*, 164 U.S. 578, 592-95 (1896); *Reagan v. Farmers' Loan & Trust Co.*, 154 U.S. 362 (1894); *Railroad Commission Cases*, 116 U.S. 307 (1886).

[27] *See Verizon Communications, Inc.*, 535 U.S. at 518-19 (upholding purely forward-looking definition of costs because terms were flexible enough to permit recovery of sunk costs and investment).

No Basis for the Board to Disregard Established Limits on Rate Setting

Even as the Board acknowledges the potential force of this ratemaking history, it offers two reasons for disregarding this rate-regulation precedent—and both are without merit.[28] Both arguments attempt to distinguish the "just and reasonable" rate regulation standards as limited to the "public utility" context, and that is simply incorrect—the standard originated to regulate railroad and other shipping rates, and applies as well to fully competitive contexts such as gas production.[29]

Even apart from that basic error, the two arguments fail on their own terms as well. The Board's first reason is that the debit card offering is distinguishable from the services offered by utilities in that utilities (unlike card issuers) typically must make their services available to the general public. This fails to justify the Board's departure from legal precedent, and it actually reinforces the need for a market-based approach that ensures that costs are recovered. Because debit card issuers do not have "captive customers" like utilities, the traditional rationale for rate regulation does not even apply. As a result, the Board must be more cautious about its rate regulation than would be the case for an agency regulating a monopoly service. If the Board does not take this key factor into account, it increases the risk that its rule will not pass muster under long-standing precedent for proper rate setting.

The Board's second reason for departing from long-standing precedent is that card issuers (unlike utilities) have alternative potential revenue streams. But the Board fails to recognize that the statute itself forecloses this argument as the debit interchange provisions clearly tie the interchange fee to the issuer's cost of providing service. It does not suggest that only some costs may be recovered or that there is any relevance to other potential mechanisms for recovering costs.[30] Indeed, there is no rational basis to rest an entire regulatory structure on an assumption that Congress intended $14 billion in merchant costs to be shifted to consumers. Even if the Board's point were relevant to the statute's construction (and it is not), it is without merit. Traditional rate regulated entities often have alternative revenue streams (*e.g.*, gas producers, cable television providers, and networked industries including regulated and unregulated services) and this does not exempt the regulator from implementing rates that ensure the regulated entity can recover costs for provision of the regulated service.

Price Cap Regulation Especially Requires Cost Recovery

Other U.S. regulators' use of price cap regulation underscores and confirms the economic and legal flaws in the Board's approach. The Board's fee cap proposal relies heavily on purported incentives for the regulated entity to achieve efficiency gains and to avoid improper cost allocation, and the Board claims that "[t]hese incentives have motivated authorities in other

[28] 75 *Fed. Reg*. 81,733, n. 44.

[29] *See, e.g.*, *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

[30] While the current market-based approach to setting interchange fees takes into account this type of consumer/merchant balancing, there is no indication in the statute suggesting that Congress intended the Board to use its Proposal to impose new fees on consumers.

contexts to set price caps in many regulated industries….”[31] In fact, U.S. price cap regimes have succeeded, and been upheld by reviewing courts, only because they create those incentives while also ensuring that the regulated entity maintains the opportunity to recover all its costs of providing the regulated service efficiently.[32] They thus confirm that the Board's partial-cost recovery approach is not only inefficient, it is unlawful.

Price cap regulation has been developed after extensive regulatory proceedings and economists' input in two industries in particular: local telecommunications services and cable television services. Both are designed to ensure that regulated entities can recover all of their costs of service provision that would be incurred by efficient entities in a competitive environment. Telecommunications price caps, for example, rely upon three key features of these regulatory regimes, all of which are absent in the Board's Proposal. First, the regulator established a pricing benchmark based on the total, actual costs of providing service as demonstrated by historical practice—not a dramatically truncated subset of costs such as in the Board's approach.[33] Second, reductions in the cap below the benchmark pricing focus on the efficiencies that the regulated entity can be expected to achieve, and ensures that the regulated entity is not penalized for any change in costs beyond the service provider's control (exogenous costs).[34] That is, the regulated entity is provided with an assurance that it can recover all input costs that, if it operated as an efficient service provider, it would bear. Again, the Board's approach radically departs from this protection designed to ensure cost-based rate regulation and cost recovery by the regulated service provider. Third, the FCC built into its regulations a mechanism to permit regulated entities to increase rates if returns would otherwise fall below minimum levels.[35] In contrast, the Board's approach ensures that, for virtually all regulated issuers, the fee cap guarantees a negative return on service provision.

Similarly, regulation of cable television charges to subscribers is also predicated on the service provider's recovery of the full costs that the provider would incur in a competitive environment, and embodies protections to ensure that fees reflect total actual costs. In that context, the FCC benchmarked the regulated rate initially based on actual costs incurred where service providers were subject to competition.[36] Here, too, the FCC ensured that increases in

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[31] 75 Fed. Reg. 81,738.

[32] The Proposal also refers to the Australian precedent of price caps for debit interchange fees. *See* 75 Fed. Reg. 81,738. The Proposal does not, however, address the extensive economic and industry analysis that show that, precisely because the Australian regulator also chose not to permit cost recovery, the customer service and consumer welfare implications of the Australian price cap have been profoundly negative. *See, e.g.*, Robert Stillman *et al*., *Regulatory intervention in the payment card industry by the Reserve Bank of Australia*, CRA International (2008).

[33] *See Nat'l Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 182-83 (D.C. Cir. 1993) ("total cost recovery" at the core of FCC approach to achieve efficient service provision).

[34] *See id*, at 178 (FCC "chose existing rates, *plus* an escalator based on general price inflation, *minus* an annual percentage reduction for expected savings from innovation and other economies").

[35] *See USTA v. FCC*, 188 F.3d 521, 528 (D.C. Cir. 1999).

[36] *See Time Warner Entertainment Co. v. FCC*, 56 F.3d 151, 164 (D.C. Cir. 1995).

exogenous costs would be reflected in rates, and that a service provider that expanded service would "fully recover…the actual level of programming expense incurred along with an overhead charge and a 7.5 percent markup."[37] The FCC also provided a "safety valve" whereby a service provider could recover full costs when it would otherwise be forced by the price cap regime to provide service at below-cost rates.[38] It did so even though cable television is a two-sided market, with service providers securing revenue not only from the regulated subscriber fees but also from advertising, including programming access payments.

Reviewing courts upheld these price cap regimes only because, and only to the extent that, they protected service providers against the prospect of below-cost service provision. For example, the Court of Appeals for the D.C. Circuit upheld the telecommunications price cap, focusing in part on the regulatory protection against too low a return on investment, which "avoided raising the nontrivial constitutional question" that below-cost pricing would present.[39] The lesson was even clearer for the review of the cable television price cap. The D.C. Circuit upheld the cable television price cap in large part based upon the "safety valve" that protected service providers against having to provide below-cost services. That mechanism addressed "the constitutional necessity of avoiding confiscatory rates" in light of "the distinct possibility that an unexceptional rate reduction could unconstitutionally yield confiscatory rates for cable systems that have not exercised market power significantly to raise rates in the past."[40] Indeed, the court set aside, as arbitrary and capricious, one aspect of the cable television price cap system where the FCC had created a "gap period" whereby the cap did not reflect increases in costs during that period.[41]

[37] *Id*. at 183 (internal quotation of FCC order omitted).

[38] *Id*. at 169.

[39] *USTA*, 188 F.3d at 528.

[40] *Time Warner Entertainment Co. v. FCC*, 56 F.3d at 170; *see also id*. at 172 (safety valve addresses "the constitutional concern that arises if a cable company is required to absorb costs to the point that its allowed rates become confiscatory"). The Board's fee cap and cost regulations, in contrast, directly present these constitutional concerns related to confiscatory rates adverted to in *USTA* and *Time Warner Entertainment* because they do not incorporate such safety valves and especially because their design does not remotely permit the regulated entity to recover its reasonably incurred costs plus a reasonable return on investment. *See also Southwestern Bell Tel. & Tel. Co. v. FCC*, 781 F.2d 209, 215 (D.C. Cir. 1986) (rate would be "constitutionally confiscatory" if regulated entity could not recover costs and return based on "depreciation rates [that] provide the company with a 'reasonable opportunity' to recoup its past investment"); *D.C. Transit System v. WMATA*, 466 F.2d 394, 418 (D.C. Cir. 1972) ("It is, of course, well settled that a governmentally-fixed rate confining a public utility's return from operations to an amount below the point of confiscation violates due process."). Separately, rates are also arbitrary and capricious when, contrary to agency policy, they do not permit an entity to recover costs plus a return on investment. *See, e.g.*, *American Tel. & Tel. Co.* v. FCC, 836 F.2d 1386, 1389-90 (D.C. Cir. 1988).

[41] *See Time Warner*, 56 F.3d at 173-74.

<u>The Board's Construction of Statutory Terms Is Not Reasonable</u>

Further compounding these statutory construction errors, the Board's Proposal provides no articulation of the basis or rationale for its interpretation of key statutory terms. Ignoring the standards articulated in a century's worth of cases, the Board does not offer any affirmative or alternative construction of what Congress intended by the terms "reasonable" or "proportional," nor does it set forth a construction of how the term "the cost incurred by the issuer" in fact means only "a small sub-set of costs incurred by the issuer." Indeed, the Board provides no content to the term "proportional" and no indication of how the fees prescribed by the Board are "proportional" to the cost incurred by issuers with respect to debit transactions. The term is effectively written out of the statute by the Board.

In many cases, the Board simply asserts that the terms of the debit interchange provisions are consistent with a certain policy preference, but provides no justification for how the statutory terms support the interpretive discretion the Board has exercised. Even if the plain language of the statute did not require that the issuers recover their costs of service provision (and it does), and even if Congress might be thought to have ignored its prior ratemaking commands and the historical implementation of those commands in crafting the debit interchange provisions (and it did not), the Board would still have to establish that each application of the statute's terms was a reasonable construction of the statute that is permissible in light of Congressional intent and the statute's context and structure.[42] Given the adverse implications for consumers, competition, and service provision guaranteed by the Board's disallowance of cost recovery for debit service transactions, and especially its repeated assumption that a very significant portion of those costs will be shifted to cardholders, the Board's implicit construction of the debit interchange provisions fails even this relatively deferential standard.

The Board's Interpretation of "Reasonable and Proportional" Conflicts With Its Own Precedent

The Board's interpretation of "reasonable and proportional" in the Proposal is inconsistent with its own interpretation of the same language in the CARD Act provision on penalty fees. In the Proposal, the Board interprets the standard as imposing two requirements: (i) the fee must be reasonable, and (ii) the fee must be proportional to allowable costs. In the CARD Act, the Board interpreted the requirement as "reasonably proportionate" to allowable costs and indicated that "proportionate" meant the total costs incurred should be appropriately allocated among all persons paying the fee. The Board does not offer any valid reason for distinguishing the approach in the CARD Act. Moreover, any such distinction would be quite difficult to make in light of Senator Durbin's explanation of the amendment when he stated that the underlying congressional intent was to "use the same mechanism [Congress] used in credit card reform."[43]

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[42] *See, e.g., Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984); *see also Household Credit Servs. v. Pfennig*, 541 U.S. 232 (2004).

[43] *Cong. Rec*. S3588 (May 12, 2010) (statement of Sen. Durbin); *see also, id* at S3589 (stating that the amendment's language "is the same standard which the Banking Committee and Senator Dodd offered when it came to credit card reform," and that "[i]t is in the law already").

The Board's Proposal Failed To Address Relevant Competition, Service, and Consumer Welfare Considerations

The Board's analysis of both its fee cap and the severe limits on recoverable costs fails to address the most basic consequences of its policy choices, including their likely effect on competition, service provision, and consumer welfare. Nor does the Board's analysis address the relative costs and benefits of alternative approaches to its proposed rate-setting approach. As discussed below and in the attached paper by Professor Chris James, the Board's interchange fee policies will clearly have adverse consumer welfare and competitive effects, degrading service and increasing costs for all participants in debit card transactions—cardholders, issuers, networks, and merchants. The absence of any reasoned analysis supporting the Board's choices fails the most basic administrative law standards and leads the Board to a set of results that Congress could not possibly have intended or viewed as falling within the Board's discretion.

The minimum process requirements that the Board must meet—but fails to do so here—arise from two sources. The first relates to basic administrative law requirements. An agency must "articulate a satisfactory basis for its action including a 'rational connection between the facts found and the choices made."[44] And, agency action must be "based on consideration of the relevant factors," and a reviewing court "may not supply a reasoned basis for the agency's action that the agency itself has not given."[45] These standards apply to the Board as they do to any administrative agency.[46]

Second, Congress has specifically elaborated what these general standards require of the Board when it formulates rules such as those at issue here. The proposed rules would be issued pursuant to Section 920 of the EFTA, and Congress directed that "in prescribing such regulations, the Board shall…prepare an analysis of economic impact which considers the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers…."[47] The Board's consideration must extend to "the effects upon 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."[48]

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[44] *Motor Vehicle Manuf. Ass'n. v. State Farm Ins.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines v. U.S.*, 371 U.S. 156, 168 (1962)).

[45] *Bowman Transp. Inc. v. Arkansas-Best Freight*, 419 U.S. 281, 285-86 (1974) (internal quotations omitted).

[46] *See, e.g., Mourning v. Family Pub. Serv., Inc.*, 411 U.S. 356 (1973).

[47] EFTA § 904(a)(2). Section 1084 of the Dodd-Frank Act, which revised Section 904, struck the initial sentence of Section 904 but not the considerations the Board must address in rulemaking, and that provision in any event goes into effect only in July, 2011. *See* Section 1100H of the Dodd-Frank Act. In any event, the Section 904 factors set forth basic policy considerations that any rational and adequately articulated rulemaking would have to address under general administrative law principles.

[48] *Id*.

The Board's analysis of the effects of implementing a below-cost fee cap and of barring issuers' recovery of broad classes of costs related to completing debit transactions does not remotely meet the requirements of either administrative law or Section 904. For example, the Proposal contains no analysis of the following, basic considerations (See APPENDIX B for further discussion of these considerations).

Increased Cardholder Costs

The Proposal repeatedly acknowledges that issuers are likely to shift to cardholders and other banking consumers the billions of dollars in debit transaction costs that will be newly unrecoverable through interchange fees as a result of the Board's rules. Even so, the Board's Proposal contains no analysis of the related effects of the rule. This is understandable, because those effects can demonstrably be tied to consumer harms and are profoundly negative. As discussed in APPENDIX B, cardholders will inevitably bear greater costs and reduced account-related services as a result of the Board's policies. Cardholders will be forced toward sub-optimal payment systems, and poorer consumers in particular will increasingly be deprived of the economic and service benefits associated with use of debit services.

Innovation and Investment

In its discussion of fraud prevention, the Board acknowledges that creating incentives for investment is essential to developing debit card transaction services and enhancing consumer benefits. Even so, the Board completely fails to analyze the adverse impact that disallowance of cost recovery is inevitably going to have on the incentives for issuers to invest in basic research and development related to debit card transactions and related services. One of the clearest consequences and risks associated with the Board's approach is less innovation and resulting fewer benefits for consumers, merchants, and issuers themselves.

Customer Services Associated with Debit Transactions

The Board's proposed policies bar cost recovery for customer services associated with debit transactions, yet the Board fails to assess or address the implications of this policy choice. Those implications are obvious: they create incentives for issuers to provide fewer services to consumers associated with the use of debit cards, with resulting adverse effects not only for consumers but for merchants as well.

Competitive Effects on Small Service Providers

By imposing very severe fee regulation on larger issuers, the Board has inevitably created a set of competitive dynamics that have potentially adverse effects for exempt, smaller issuers. Networks may adopt practices that do not distinguish fully between regulated and unregulated issuers, or market pressures exerted by merchants and others may cause smaller, so-called exempt issuers to be significantly impacted by the levels set for regulated issuers. Indeed, the Government (including Board counsel) in litigation has affirmatively pointed to these adverse effects on exempt issuers, explaining that "exempt banks will likely receive lower interchange fee income" due to "the expected effects of the implementation of the Board's debit card routing rules….”[49] Congress could not have intended these effects, and the economic impact on smaller issuers is of obvious importance to consumers, especially to consumers in smaller, rural, and otherwise underserved areas. The Board, however, has completely failed to analyze or to account for these effects in its formulation of policy.

Adverse Network Effects and Harm to Merchants

Debit card networks have established the interchange fee using market-based signals to allocate costs among beneficiaries of the networks in a manner that increases those benefits and takes advantage of the powerful, positive network effects available in two-sided markets. Whenever interchange fees decrease without an appropriate commercial basis, and costs are shifted to cardholders and issuers, one of the clearest implications is to create incentives for both sets of network participants to lessen or abandon their participation in the network: cardholders shift to inferior substitute services, and issuers lessen their investment and spending related to network operations, with the potential to abandon the network altogether. Both of these effects reduce the pool of cardholders and the quality of debit-related services, which in turn diminishes and puts at further risk the benefits secured by merchants from a robust debit network. As costs are borne by a decreasing base of cardholders and issuers, these adverse network consequences may accelerate. Nowhere in the Board's consideration of its Proposal to decrease interchange rates dramatically did it even address these risks or network market dynamics.

Distortion of Competition Among Networks

The Board did acknowledge that its proposed course might impose significantly different costs and consequences on established four-party debit systems, compared to three-party systems and emerging payment systems. At the same time, the Board confessed ignorance regarding how to address these competitive imbalances and related distortions to competition. As indicated in APPENDIX B, these competitive distortions inevitably reduce consumer welfare and prevent the efficient allocation of capital and other inputs. Nevertheless, the Board pursues its proposed fee reductions despite the acknowledged risks in its approach.

Economic Analysis of the Impact of the Proposal

The analysis undertaken by Professor Chris James (APPENDIX B) details the significant omissions in the Board's analysis and its failure to consider basic consumer welfare and competition implications of its proposals. Professor James's analysis also shows what conclusions the Board would have reached had it conducted a basic economic analysis—the Board's proposals are very likely if not certain to harm competition and consumer welfare, and produce inefficient results that hurt consumers, merchants, small issuers, the networks, and the overall provision of debit services. As elaborated in the detailed discussion set forth in the study attached at APPENDIX B, the James Paper includes the following points:

[49] *Memorandum in Support of Defendants' Motion to Dismiss*, *TCF National Bank v. Bernanke et al.*, *supra*, at 40.

Reduced Consumer Welfare and Efficiency Generally:

- "[T]he Board has taken an approach that ignores economic efficiency and consumer welfare. It has refrained from articulating any economic logic that might enable its regulatory intervention to take the effects on consumer welfare into account. The result will almost surely be a reduction in consumer welfare."[50]

- "The Board has offered no economic analysis that would enable it to conclude that shifting transactions from debit cards to credit cards, cash, or checks will enhance consumer welfare. In fact, …economic logic implies that this regulation will make consumers worse off than they are in the unregulated market."[51]

Negative Impact on Consumers:

- "[I]f the interchange fee were to decline—especially to the extent envisioned in the proposed rule—issuers would pass on some or all of the cost increase to cardholders in the form of higher fees, reduced benefits, or reduced services."[52]

- "[I]ncreasing the consumer cost for debit card services is likely to disproportionably affect low-income consumers. Low-income consumers are less likely to have credit cards and, when faced with a higher cost of debit, may be unable to switch to a credit card for transactions."[53]

- "Consumers will lose from the imposition of higher costs for debit services [and] …will also be affected by a reallocation of investment by issuers in response to the reduction in interchange fees."[54]

- "Issuers are also likely to reallocate investments in service and product development to other, more profitable products. The market currently supports a wide range of debit products that are differentiated in several dimensions: the cards offer different rewards and different fraud protection features, for example. This diversity, which benefits a consumer base with diverse preferences, is supported by issuer investments. These investments will likely be curtailed as interchange fees are squeezed."[55]

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[50] *Id*. at 17.

[51] *Id*. at 18.

[52] *Id*. at 19.

[53] *Id*. at 20.

[54] *Id*. at 22.

[55] *Id*. at 22-23.

Negative Effect on Merchants:

- "In the long run, however, it is not obvious that merchants will benefit or that any benefit accruing to some merchants will be realized by all or even most merchants. Debit cards have been commercially successful because this payment method is attractive to consumers and merchants at current prices. Imposing a regulation that reduces the prices faced by merchants and increases the prices faced by consumers will result in a decline in the volume of debit transactions. That decline will reduce the share of merchant transactions that are made with debit cards as consumers choose some other payment system, perhaps one that is more costly to the merchant."[56]

- "Even at market prices, debit is often less expensive for merchants than other payment methods.… Hence, as consumers respond to the reduction in debit card benefits and the increase in debit card fees by substituting to cash, checks, or credit cards, the merchant cost for payment services may rise. As noted earlier, a shift from debit cards to checks would expose merchants to an increased risk that no payment is received, and would also increase check-out times."[57]

Smaller Issuers Harmed:

- It costs smaller issuers more to provide debit services and thus the Board's Proposal exacerbates a competitive disadvantage, and "[m]erchants would have strong incentives to discriminate against the more expensive exempt cards."[58]

Particular Effects of Cap:

- "Given the proposed cap, at least half—and probably a much larger percentage—of the surveyed issuers of prepaid cards would not be able to cover their costs for [non-exempt] cards. In view of the importance of these products to lower-income, unbanked, and underbanked consumers, this result seems particularly difficult to justify from a consumer welfare perspective."[59]

- "By setting a cap that makes these products unprofitable, the Board has arbitrarily limited the diversity that currently characterizes issuers and creates choice for consumers."[60]

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[56] *Id*. at 23-24.

[57] *Id*. at 24.

[58] *Id*. at 25.

[59] *Id*. at 29.

[60] *Id*. at 29.

No Basis for Incremental Cost Approach:

- "[T]he Board's definition of allowable cost is inconsistent with the concept of incremental cost that is standard in economic analysis."[61]

- "From an economic perspective, variable cost properly includes all costs that vary with output, including investment in infrastructure, R&D, and other capital expenditures made to create capacity for future debit transaction and/or enable new debit services. If issuers cannot anticipate earning a normal return on their investments in debit cards, they have no incentive to invest in them. The Board has proposed a regulatory regime in which innovation and growth are discouraged."[62]

- "Instead of using the definitions of incremental cost that are standard in economic analysis, …the interpretation made by the Board has economic consequences that do not appear as objectives of the legislation."[63]

Network Exclusivity Proposal Harms Competition:

- The Board's signature debit proposal (so-called Alternative B) would eliminate "[c]ompetition for cardholders [that] has been instrumental in producing innovations such as new security features, 'zero liability' policies, insurance coverage, and many other card enhancements, as each network innovates to distinguish itself from the competition. Merchants also benefit from [that] competition between debit systems because networks need wide merchant acceptance to be successful. Indeed, consumers (and therefore issuers) will move away from cards that are not accepted by many merchants. The need for wide merchant acceptance ensures that market-based interchange fees for debit cards are low relative to the value they provide to merchants."[64]

- "The networks would have very little incentive to promote the use of cards by consumers because the consumers would no longer be the decision makers. [The network's] incentive to invest in innovative services targeting consumers would be dramatically reduced if there were a chance that the consumers' use of the card would benefit the competing network on the card as much as or more than it benefited [that network]."[65]

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[61] *Id*. at 30.

[62] *Id*. at 32.

[63] *Id*. at 31.

[64] *Id*. at 33.

[65] *Id*. at 34-35.

- "At the same time that the consumer is asked to pay a higher price for using debit cards, the consumer is denied the benefits that come from competition among the networks for cardholders."[66]

The Board's Proposal Leaves Key Questions Unanswered

The failure of the Proposal to address these central regulatory and market issues is compounded by the evidence of key, unanswered questions reflected in the Board's public meeting on December 16, 2010, where the Board endorsed the issuance of the Proposal. Members of the Board raised certain of these key regulatory and market issues and received responses that confirmed the lack of analysis that underlies the approaches contained in the Proposal and confirmed that the Board has no record of some of the most elemental likely effects of its Proposal. For example, at the Board's meeting adopting the Proposal, a number of logical questions regarding the effect of the Proposal on consumers, debit card usage, competition, and other important factors were raised. While the responses to those questions took different forms, the substance was largely the same and demonstrated that the analysis has not been undertaken to adequately answer these questions.

The lack of a sufficient analysis of these points might usefully be contrasted with the extensive proceedings undertaken by other agencies that have imposed price cap regulation. In that context, using the market and regulatory experiences in the industry developed over decades, the agencies develop rate regulation through multiple, painstaking proceedings where the analysis was set forth and refined over a period of years, followed by further analysis and refinement after judicial review.[67] The resulting regulations, apart from permitting cost recovery as a baseline economic and policy assumption, were fine-tuned to separately address the particular circumstances presented by distinct services and to permit regulated entities and the agencies to anticipate and to respond to potential market and regulatory failure. The rates themselves were based on extensive economic analysis made public and scrutinized by affected consumer and industry groups. In contrast, the Board's approach is a hasty resort to a broad, imprecise approach—essentially a single rate regime proposed to address a variety of debit services, supported by no analysis of competitive conditions or effects, and based on no identification of the purposes of the regulation or the requisite regulatory response to identified market issues.

The Board and staff are, of course, under onerous statutory deadlines. The appropriate response to those deadlines, however, would be to postpone its rulemaking and enforcement of the statute to provide time to adopt a flexible and well considered market-based regulatory regime (as suggested by Congress' direction to develop "standards" for assessing costs, see section 920(a)(3)), not to attempt to impose in haste the most difficult, onerous, and potentially disruptive form of rate regulation in a context where it has never been attempted. Finally, significantly below-cost rate regulation may amount to an unconstitutional taking, deprivation of

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66 *Id*. at 35.

67 *See, e.g.*, *USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999); *Nat'l Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

due process, and equal protection violation. The fact that the proposal does not allow regulated issuers to recover their debit-related costs or any rate of return certainly raises all of these issues.

Specific Comments on Alternatives 1 and 2

Fee Cap Is Impermissible

As noted above, the statute provides that debit interchange fees paid to debit card issuers must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." As a result, the statute provides that each issuer can recover its costs through interchange fees. As the Board recognizes in the Proposal, however, the Board's use of a cap would expressly preclude many issuers from recovering their costs. While we understand and appreciate the Board's desire to provide some measure of clarity and to facilitate administrative efficiency, any approach that precludes full cost recovery (such as the cap approach proposed by the Board) cannot be sustained under the statute.

Indeed, the Board acted arbitrarily by adopting a fee cap at the 7 or 12 cent levels.[68] Contrary to the Board's view, the statute does not impose a single requirement that the fees be reasonable. Instead, as Senator Durbin himself made clear, the "reasonable and proportional" standard was taken from the CARD Act which means that the Board must read "reasonable" together with "proportional" just as the Board did when it implemented the corresponding CARD Act provision. The fee cap, together with the Board's improperly narrow reading of the statute, is a key reason that the rates proposed by the Board are below cost and do not properly implement the statute and its underlying policy objectives. The fee cap does not generate reasonable rates because it does not permit cost recovery. The fee cap cannot be reconciled with the statutory provision that rates be "proportional" to the costs incurred by issuers. Further, the statutory language neither encourages nor requires the Board to pass judgment as to what level of cost is appropriate. Certain issuers, despite best efforts, may never achieve the level of cost efficiency the Board apparently believes to be attainable. By adopting a fee cap, the Board is virtually guaranteeing that these issuers will be unable to continue to provide the same level of service and compete effectively for banking customers. It is unreasonable to assume that Congress' intent was to reduce competition in the debit card issuing market, yet the Board's rule will do just that.

The Board's fee cap is contrary to law and particularly irrational to the extent that the Board, without analysis, simply objects to high-cost service provision—even though niche or specialized service providers may incur higher costs by targeting high-cost market segments or by providing a higher level of service. The Board does not expressly conclude that debit service is a commodity product, and indeed, the Board's differentiation of various sub-products and sub-markets with different cost structures is inconsistent with any such conclusion and with its per se objection to high-cost services. The statutory and policy objections to the Board Proposal

[68] The unreasonableness of the Board's approach is compounded under Alternative 1 (which provides a safe harbor at 7 cents and allows higher fees up to a cap of 12 cents for issuers with higher costs) because of the complexity of the process an issuer must use to establish eligibility for the higher rates. While such a cumbersome process might be more appropriate if the higher rates enabled issuers to recover their costs, the process is simply unjustifiable when the maximum return is interchange fees capped at levels where services would be provided at a loss.

outlined above could largely be addressed by eliminating use of caps on issuer-specific rates and, consistent with the statute, broadening the scope of recoverable costs to include all of the statutorily prescribed "cost incurred by the issuer with respect to the [debit card] transaction."

We also submit that the Board's policy rationale used to justify imposition of a cap is unsound and contrary to law. When rate regulation prevents significant cost recovery, it creates incentives for underinvestment and diversion of capital and other resources—not more efficient service provision. An incentive for more efficient service provision is created only when a service provider has the prospect of achieving positive return on capital; otherwise, the incentive is to exit and to underinvest to reduce capital losses. The Board provides no analysis of the likely service and competitive results of such a deeply discounted price cap, and fails to explain how under the Proposal service provision will improve. As noted above, price cap regimes that have been used in other regulatory contexts for this reason seek to ensure that service providers can recover all costs.

The Board Should Establish A Safe Harbor

MasterCard supports the adoption of a properly calculated safe harbor. Administrative considerations (and related consumer welfare implications) for both issuers and networks support the implementation of a safe harbor set at an appropriately high level. Under this approach, any issuer would be permitted to charge debit interchange fees up to the safe harbor amount while issuers with costs in excess of the safe harbor would be permitted to charge higher rates to the extent those higher rates are justified based on the issuer's higher costs. The process used for higher cost issuers should be the process contemplated under the Proposal whereby each issuer's supervisor would verify that the amount of any interchange fee received by an issuer is commensurate with the safe harbor or justified if higher than the safe harbor.

Based on the EDC Survey, the average total cost per transaction for all issuers (above and below $10 billion) is approximately $1.00 per transaction. The survey estimates that for issuers with assets above $10 billion, the total average cost per debit transaction is between 65 cents and 75 cents. Note that the 65-75 cent figures both support higher interchange fees than the 44 cent average documented by the Board. Nonetheless, we recommend that the safe harbor initially be set by the Board at 44 cents per transaction—the level the Board has determined to represent the average market-based interchange fee. This would largely leave in place the current market based interchange rates while the Board continues to study the issue in an effort to properly implement the statute.

COMMENTS ON THE ADJUSTMENT FOR FRAUD-PREVENTION COSTS

Scope of Fraud Adjustment and Relationship to ACS Costs

Under the statute, the Board is authorized to increase debit interchange fees for fraud prevention costs. This must be read together with the statute as a whole, which as described above *requires* the Board to include ACS costs in setting reasonable and proportional interchange fees. This is an important point because many fraud-prevention costs are incurred in connection with the authorization, clearing or settlement processes, and thus *must* be included in setting interchange fees regardless of any fraud adjustment the Board chooses to adopt.

Unfortunately, the Board impermissibly excluded most of the ACS costs incurred by issuers, including the extensive fraud-prevention and detection costs involved in authorization and the fraud losses involved in the settlement process. Prior to adopting any fraud prevention adjustments, the Board must fix this problem by expanding the allowable costs to cover all ACS costs. We urge the Board to then promptly adopt a fraud prevention adjustment which covers additional fraud-related costs not already included in the ACS costs.

All participants in the debit card industry (including consumers, merchants, merchant banks, networks and issuers) have a strong interest in creating appropriate incentives to reduce fraud losses. Merchants, merchant banks, and issuers all share directly in fraud losses and, although MasterCard and some of its competitors have adopted zero fraud loss rules for consumers, the EFTA also allows issuers to impose fraud losses on consumers. Moreover, apart from the direct financial cost of fraud losses, debit card fraud imposes indirect costs on all participants, such as time costs to investigate and resolve fraud issues, potential loss of confidence in the security of the payment device, and reduced debit card transaction volume.

MasterCard notes that the Board's authority to adopt a fraud-prevention adjustment is broad and is not limited by the Board's narrow definition of "allowable costs" under proposed Section 235.3(c). For example, the statute permits the Board to allow an adjustment for fraud-prevention costs irrespective of the Board's interpretation of incremental costs (or what the Board has defined as average variable costs) or the costs of check transactions. MasterCard submits that there are strong policy reasons across the payments chain for the Board to exercise this authority and to do so promptly. Indeed, given the importance of fraud prevention and detection to the integrity of any payment system, the Board's failure to include fraud-related costs in its interchange fee rulemaking seems virtually impossible to justify.

Technology-Specific Approach Must Be Avoided

The Proposal outlines two general approaches to implementing the fraud-prevention adjustment. Under the first, referred to as the "technology-specific approach," the Board would identify specific and "paradigm-shifting" technologies that would reduce fraud in a cost effective manner, and the adjustment would be set to reimburse issuers for some or all of the costs associated with implementing the new technology. The second approach, referred to as the "non-prescriptive approach," would involve a more general standard that would require issuers to take steps reasonably necessary for an effective fraud-prevention program, but not prescribe specific technologies that must be employed as part of the program.

The language of the statute shows that a technology-specific approach should not be adopted. It contemplates an adjustment that is "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions involving that issuer." That statutory standard points to recovery of all fraud-prevention costs undertaken by a particular issuer based on the technology preferred and adopted by the issuer. The technology-specific alternative proposed by the Board would permit recovery for only a small portion of fraud-prevention costs and would exclude all such costs if the issuer did not pursue the government-approved technology.

Moreover, it would be ill-advised as a policy matter to require the government to select a particular technology solution. For example, any suggestion that a fraud adjustment should be adopted for PIN transactions only (or for Chip and PIN only) must be rejected. As the Board acknowledges in the Proposal, there are many potential next-generation technologies that may provide fraud-prevention solutions. These include a wide variety of technologies such as Chip and PIN, contactless payments with dynamic CVC2, Certaflash, and end-to-end encryption, just to name a few. Issuers and networks have every incentive and the relevant expertise to develop fraud-prevention solutions that fit customers' and market-participants' requirements, while the government lacks the expertise to select among technology "winners" and "losers." The nature of developing technology is that no one can predict which technology is best, and the Proposal offers no reason why the Board is required to become involved in attempting to do so when the marketplace is best positioned to determine which method(s) should be adopted. Indeed, a cumbersome public approval process will provide notice to fraudsters of prevention efforts being undertaken and will limit issuers from quickly responding to new fraudulent practices.

The Board's own identification of policy considerations points heavily against the technology-specific alternative. The Proposal emphasizes the need to create incentives to invest in fraud-prevention technologies and initiatives, but the technology-specific alternative would prevent recovery of much of that investment in various fraud-prevention activities. The Proposal identifies that considerable market and technological uncertainty surrounds which fraud-prevention solution will eventually prove to be most effective, which is precisely the circumstance in which requiring adoption of a particular technology is least likely to be successful.

The Board Should Not Impose Limits On Fraud-Prevention Costs

The Proposal identifies several potential limitations that might be imposed on fraud-prevention costs included in an adjustment. For example, the Proposal raises the possibility that there might be a cap on the fraud-prevention costs of an issuer that could be included in an adjustment. The Proposal also requests comment on whether the fraud-prevention adjustment should be limited to fraud prevention in PIN (and not signature) debit card transactions, and whether the adjustment should include the costs of only activities that benefit merchants.

MasterCard believes strongly that the Board should not adopt any of these limitations on costs that should be included in the fraud-prevention adjustment. Issuers have no incentive to adopt fraud-prevention methodologies unless they have determined that they are likely to reduce fraud and improve the debit card product offered to their customers, and thus the Board does not need to impose artificial restraints on the normal business decisions made by issuers who are in the best position to decide which fraud-prevention approaches should be adopted. Moreover, imposing artificial limitations is likely to limit issuers' investment and innovation with respect to fraud-prevention to the detriment of all industry participants.

For example, imposing a cap on the fraud-prevention costs included in the interchange adjustment will naturally restrict investment, even if the issuer determines such investment would otherwise be a good business decision. Similarly, restricting fraud-prevention costs to only certain types of debit card transactions will improperly distort fraud-prevention efforts towards the transactions for which costs are recoverable and away from other transactions. The

Board has offered no reason why it is in a position to make these important business decisions and should allow issuers to make them as part of their ordinary operations.

A Fraud Adjustment Should Be Adopted Promptly

MasterCard believes it is very important for the Board to act promptly in adopting an appropriate fraud-prevention adjustment. As described above, the Proposal would dramatically reduce interchange fees received by issuers, and will likely increase consumer costs and reduce debit card availability and/or functionality. Against this background, it is especially important that the Board move quickly to implement the statutory authority to adopt a fraud adjustment.

To that end, MasterCard requests that the Board consider whether general guidance could be provided on the fraud-prevention adjustment in connection with the finalization of the Proposal. For the reasons stated above, MasterCard does not believe it is appropriate to impose artificial limitations on the ability of issuers to invest in, and recover the cost of, fraud-prevention technology. If the "non-prescriptive approach" is adopted, MasterCard believes that it should be possible to publish a proposal on the fraud-prevention adjustment in the next few months with a view towards finalizing it by July 2011. Absent such prompt action, there is a significant risk that issuers will reduce investment in fraud prevention and limit transaction authorizations on debit cards, or raise consumer prices until this important issue is resolved.

COMMENTS ON EXEMPTIONS

For the exemption rules, the key issue is how to implement the three principal exemptions (small issuer, government-administered, and reloadable prepaid cards), and specifically whether Board rules should establish a certification and reporting process for exempt entities or government-administered accounts, or whether instead the networks should undertake to establish their own process, or otherwise. In our view, the small issuer exemption should be administered through a process in which the issuer of the card certifies that it qualifies for the exemption and the certification is subsequently reviewed by the issuer's primary supervisory agency during regularly scheduled examinations. This process would be similar to that already proposed by the Board for issuers seeking interchange fees in excess of the limits set by the Board. We also urge the Board to publish annually a list of issuers that are covered under the statute or by the small issuer exemption. In addition, for the small issuer exemption, we urge the Board to adopt a U.S.-based calculation of asset size rather than the global calculation of assets set forth in the Proposal. This approach would be consistent with the Board's well founded position that the Proposal does not apply to foreign accounts or foreign-located merchants.

The process for administering the government card and reloadable prepaid card exemptions, on the other hand, must be administered between the parties without direct agency involvement. Hundreds of new government and prepaid programs are added each year, and a government approval process simply would not be commercially feasible. We urge the Board to make it clear that issuers may qualify for these exemptions by certifying to the applicable networks that their cards qualify for the exemption and that the exemptions can be approved by the networks on the basis of the certification. Those certifications would later be subject to subsequent agency review during regularly scheduled examinations of the issuers.

COMMENTS ON PROHIBITION ON CIRCUMVENTION OR EVASION

MasterCard agrees that the statute does not, and the regulation may not, regulate network fees charged to issuers and acquirers for network services. The statutory authority to regulate "network fees" is expressly limited to the use of such fees to compensate issuers with respect to electronic debit transactions or to prevent circumvention or evasion of limits on interchange fees. Networks should have broad authority to allocate costs of network operations among all participants, and maintain an appropriate balance among acquirers and issuers sharing network costs. The statute only restricts interchange fees, which are defined as payments to the issuer for its role in an electronic debit transaction. Payments to issuers for other purposes should, by definition, be outside the anti-circumvention rule. For example, funds provided to issuers to reimburse them for costs incurred in connection with addressing merchant and related data breaches must not be covered, and we ask the Board to clarify that such costs are outside the scope of the anti-circumvention rule. MasterCard agrees that circumvention and evasion must be determined on a case-by-case basis. The Board also should recognize that conduct designed to circumvent or evade, by its very nature, is not susceptible to pre-determined rules and should minimize the unintended consequences of rules that try to do so.

MasterCard believes that the Board's "net compensation" test can provide helpful guidance regarding this provision. As part of this guidance, the Board should continue to emphasize in the final rule that the rule does "not seek to set or establish the level of network fees that a network may permissibly impose on any network participant for its services." In addition, the Board should make it clear that an issuer's receipt of a net compensation from a payment network does not necessarily constitute circumvention or evasion of the interchange limits because the statute does not limit the ability of an issuer to receive compensation for purposes other than in its role in an electronic debit transaction. If the Board decides to retain the "net compensation" rule, however, the Proposal should be revised. The *per se* rule should apply, and the Official Staff Commentary should be revised to make clear that the *per se* rule applies, in both directions. In other words, if a "net payment" *per se* establishes circumvention or evasion, the absence of a "net payment" should *per se* establish no circumvention or evasion.

COMMENTS ON NETWORK EXCLUSIVITY AND ROUTING REQUIREMENTS

Statutory Provisions

The statutory provisions regarding network exclusivity and transaction routing generally provide that neither an issuer nor a payment card network may establish exclusive debit network arrangements or inhibit the ability of a merchant to choose among different networks for routing debit transactions.[69] As recognized by the Board, the plain language of the statute does not require that issuers enable cards to be processed over two unaffiliated networks for each method of authorization that may be used by a cardholder.[70] Instead, the plain language of the statute

[69] EFTA §§ 920(b)(1)(A) & (B).

[70] 75 Fed. Reg. 81,749 (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

reflects that Congress was aware of the difference between signature and PIN authorization methods and would have specified multiple networks for each type of authorization method if that was what Congress intended.

Based on the plain language of the statute, these provisions boil down to two very simple propositions: (1) issuers or payment card networks cannot restrict electronic debit transactions to a single network; and (2) merchants must have the freedom to route a transaction to any network enabled by the issuer. In other words, the statutory language by its plain terms does not support a mandate for requiring dual signature functionality on a debit card. Moreover, we submit that such an outcome would undermine the substantial benefits consumers derive from debit card networks and would be contrary to the EFTA's overarching purpose of protecting consumers and their right to exercise choice with respect to payment initiated with a debit card.[71] It is critically important that the network exclusivity and transaction routing rules not place merchant interests over consumer interests in choosing the method by which they want to make a payment.

Proposed Alternatives

The Proposal sets forth two alternatives that the Board believes could implement network exclusivity and transaction routing provisions. Under the first alternative, Alternative A, a debit card would meet the requirements of the statute as long as it could be used in at least two unaffiliated networks. For example, a card would satisfy this requirement if the issuer enabled its cards to be used exclusively on a single signature network and a single PIN network provided that the two networks are not affiliated. The second alternative, Alternative B, would require each debit card to function in at least two unaffiliated networks for each method of authorization that the cardholder could use for transactions (*i.e.*, two signature and/or two PIN networks). The Board recognizes that, under either alternative, the merchant routing provisions permit merchants to route to any network enabled on the card—this is an important point which must be retained in the final rule.

Alternative A Mandated By Statute

MasterCard believes that Alternative A is the only approach that would implement the plain language of the statute. Just as important, Alternative A preserves consumer choice when it is implemented by enabling one signature and one PIN network on the card. This approach ensures that consumers can select the card with the combination of brands they want and then ensure that their choice of brands is honored at the point of sale by electing to use the card for either a signature or PIN transaction. Limiting the merchant's choice to the brands enabled on the card also protects the consumer's right to choose. Preserving this choice for consumers is essential to protect competition among networks for improved card features and ensure continued innovation that will benefit consumers. As discussed below, consumer choice cannot be protected if two signature networks are enabled on the card.

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been determined [by the issuer]," and observing that "the statute does not expressly require issuers to offer multiple unaffiliated signature and multiple unaffiliated PIN debit card network choices" on their debit card).

[71] *See* EFTA § 902.

Alternative B Would Harm Consumers, Competition, and Innovation

Under Alternative B, each card must be capable of operating on two competing networks for each authorization method enabled on the card. For the reasons discussed below, this approach must be avoided. As the Board itself recognizes, different networks offer different business propositions to consumers, including different consumer protections and other product features. However, if each card were capable of being processed over multiple signature networks, and the merchant controlled how to route each transaction, the consumer would have no idea as to which network proposition or protections apply. And while the networks and functionality already exist for routing over different PIN networks, the infrastructure does not readily exist for routing signature transactions over different networks and would be extremely expensive to develop.

A dual signature rule also would significantly undermine competition and innovation. For example, if under such a rule, each signature debit card were required to operate on both the MasterCard and Visa networks, the merchant rather than the consumer would decide whether each transaction is a MasterCard or a Visa transaction. As the Board itself recognizes, consumers would not even know which network rules or features applied to a transaction under Alternative B because the merchant, not the consumer, would make that choice. If consumers no longer get to choose whether to carry or use a MasterCard or Visa card, the extensive competition between the networks for consumers that exists today would be significantly undermined. Indeed, it would be difficult, if not impossible, to justify the investment in the type of consumer innovations and benefits that consumers enjoy today if those innovations and benefits cannot be delivered on a card or device that offers a value proposition that is distinct from those offered by competing networks and brands.

For example, our extensive investment in the development of *inControl* helps to illustrate this point. With *inControl*, spending limits and controls can be set on payment accounts to enable account owners to determine exactly where, when and how their cards are used. Coupled with these controls, real-time email or text alerts can be sent to account owners to provide transparency into the spending activity occurring on the account. For consumers, *inControl* provides a new level of financial control and awareness that is unmatched in today's market. Cardholders create personalized spending profiles for themselves and their family members by setting up spending limits according to budget goals and account security concerns. Cardholders can also choose to receive real-time alerts on specific transactions as well as when spending is nearing their budgeted amount. Our substantial investment in innovations like *inControl* can only be justified if we can deliver it to consumers in ways that differentiate MasterCard from our competitors. Alternative B makes this brand distinction impossible to deliver.

More broadly, economic theory indicates that Alternative B will clearly reduce consumer welfare and the benefits consumers secure from competition. As elaborated in the analysis by Professor James attached as APPENDIX B, the Board's signature debit proposal would eliminate "[c]ompetition for cardholders [that] has been instrumental in producing innovations such as new security features, 'zero liability' policies, insurance coverage, and many other card enhancements, as each network innovates to distinguish itself from the competition."[72] Indeed,

[72] *See James Paper*, App. B. at 33.

"[m]erchants also benefit from [that] competition between debit systems because networks need wide merchant acceptance to be successful."[73] The Board's Proposal also affects innovation. If the proposal were adopted, the networks' "incentive to invest in innovative services targeting consumers will be dramatically reduced if there is a chance that the consumers' use of the card would benefit the competing network on the card as much as or more than it benefited [that network]."[74]

As the Board is aware, consumer benefits, such as insurance benefits, limits on liability, and special promotions also are often administered at the network level. Allowing merchants to disregard consumer preference and choose from among multiple networks for each type of authorization would take the choice of payment method away from the consumer in favor of the merchant. Alternative B also involves excessive expense and delay in implementation, as the Board expressly recognizes in the Supplementary Information. In this regard, we note that the Board correctly points out the complete juxtaposition of merchant and consumer interests associated with mandating that multiple networks be enabled on a card. Even assuming the availability of multiple networks on a debit card could "result in the lowest cost to the merchant," and therefore may be attractive from the merchant perspective, requiring multiple payment card networks could have "adverse effects for consumers," including limits on the cardholder's ability to obtain certain card benefits, such as zero liability protection or enhanced chargeback rights. There is nothing in the statute to suggest that Congress intended to harm consumers in this way.

We also generally believe that the Proposal should preserve, as much as possible, the ability of issuers to decide the networks with which they want to do business. Issuers choose networks for a variety of important business reasons, including the stability of the network, protection against financial risks, and technological capabilities, among others. Any desire to lower costs to merchants must be balanced against forcing issuers to enter into business arrangements with networks that the issuer may not want to contract with, for legitimate reasons.

There also are a number of other risks associated with Alternative B, including increased consumer confusion, increased costs to merchants, operational complexity and system disruption, and the challenge of developing a new industry standard. Merchants themselves would bear much of the costs associated with these issues either directly (through the point of sale and terminal systems they maintain) or indirectly (through increased network fees imposed on acquirers). Indeed, retooling the payment marketplace would require broad and significant investments in operations, rules, branding, technology, and connectivity, resulting in new costs. These expenses cannot be absorbed under current pricing structures, necessitating new fees for merchants and consumers. For example, acquirers would have to build new routing management processes and would likely pass these costs to merchants. Similarly, networks will have to enhance their computer systems and transaction routing processes. This would require multiple cycles of development, testing, and implementation, all of which would require considerable investment and lead time by network participants.

[73] *Id*.

[74] *Id*. at 34.

In addition, we note that the logic of Alternative B is predicated upon existing authentication methods and could ultimately undermine the development of new networks or additional authentication methods. For example, if a third authentication method comes to market, Alternative B would appear to require issuers to enable up to six networks on a single card. This not only compounds the issues noted above with respect to entering into new contractual arrangements (a lengthy and costly process), it serves as a regulatory barrier to entry for new providers and technologies.

Also, consistent with the concerns raised above in the context of the Board's Proposal to implement the statutory provisions on interchange, we note that small issuers are not exempt from the network exclusivity and routing provisions of the statue. Small issuers have expressed concern that the burden of coming into compliance with these provisions will be both expensive and time consuming as new contractual arrangements will need to be entered into. We think this yet another reason why the Board must not adopt Alternative B under the final rule.

Finally, we note that the Board's concerns that the "effectiveness" of the merchant routing rule could be limited under Alternative A are unfounded. Merchants who do not currently accept PIN payments have limited their payment options as a matter of their own discretion and choice. If these merchants wish to choose to accept PIN payments, they could easily do so by installing the appropriate equipment at costs that are manageable for even the smallest merchants.

Effective Dates

The Board requested comment on a potential effective date of October 1, 2011 for Alternative A or, alternatively, an effective date of January 1, 2013 if the Board were to adopt Alternative B in the final rule. For the reasons set forth above, we strongly urge the Board to adopt Alternative A and not Alternative B. Assuming the Board adopts Alternative A, we think a more appropriate effective date would be October 1, 2013. As discussed below, this additional time is necessary to ensure that network system changes and protocols can be tested and implemented, cards can be reissued, and new contracts negotiated and reasonably entered into. We believe that the October 1, 2011 timeframe proposed by the Board for Alternative A would unnecessarily compress the commercial negotiation process for entering into new contractual arrangements and potentially jeopardize the ability of institutions and program managers to conduct necessary due diligence. This additional lead time is necessary because literally thousands of new contracts with networks will need to be entered into. For similar reasons, if the Board adopts Alternative B, we believe the effective date should be no earlier than October 1, 2014.[75] Indeed, the Board itself recognizes that Alternative B would be significantly more complicated for the industry to implement and would require significant investment, notably at precisely the same time issuers' debit interchange revenue is likely to be dramatically reduced.

[75] For example, we note that the Europay, MasterCard and Visa chip standard (the so-called "EMV Standard") took approximately 3-5 years to develop and implement in Europe.

Network Branding

In the context of implementing the exclusivity and routing provisions, the Proposal would impose certain limits on the ability of issuers and networks to contract, including with respect to contractual provisions that may limit the number or location of network brands, marks, or logos that may appear on a debit card. We recognize that this is an important part of implementing the statute but we request that the Board make certain clarifications in order to prevent unintended consequences. In particular, we request that the Board permit issuers and networks to enter into reasonable contractual arrangements to protect card design, prevent trademark dilution, and preserve the acceptance proposition offered by the card.

To achieve this, each network that offers signature debit cards must be free to contract with issuers to retain the signature brand as the exclusive brand on the front of the card and the only signature brand on the card, consistent with Alternative A above. We agree that networks are not permitted to contractually restrict the other brands that are enabled on the card, but networks and issuers should be free to determine which is the primary brand for the card and limit the trademark or logo placement of other brands enabled on the card to the back of the card. This approach is consistent with consumer expectations in the marketplace and would ensure that consumers can readily determine the acceptance proposition offered by the card, including when traveling outside of the U.S. Indeed, to require anything further would be akin to a mandate that the Coke and Pepsi brands be featured on the same can. In other words, we view network branding as reflecting the acceptance proposition offered by the card, and network branding must be protected while implementing the statutory requirement that debit cards be enabled for processing over unaffiliated networks. In this regard, we note that current card designs (including network logo placement, security holograms, and security signature panels) enable both merchants and consumers to determine a card's authenticity.

Network Reach

To implement the statutory network exclusivity and routing provisions, the Proposal provides that a payment card network must meet certain geographic or merchant acceptance requirements, including a requirement that a network generally be national in reach. We agree that, in order to comply with the network exclusivity and routing provisions, each of the two competing networks enabled on the card must operate nationwide. To satisfy this standard, each network enabled on the card must itself be widely accepted by merchants in each of the 50 states—reciprocal agreements with other networks should not be considered for determining national reach. Also, ATM access is irrelevant for determining the scope of merchant acceptance because ATMs are not merchants. Therefore, any particular network's reach with respect to ATMs should not be used in determining whether the network is accepted nationwide. We believe the Proposal is consistent with this view and urge the Board to maintain that requirement under the final rule.

Application of Exclusivity and Routing to HSA, FSA and Other Prepaid Cards

Cards with Limited Functionality

The Board must recognize that the exclusivity and routing provisions cannot apply to certain cards with limited functionality. For example, many prepaid cards, including Health Savings Account ("HSA"), Health Reimbursement Arrangement ("HRA"), and Flexible Spending Account ("FSA") cards, as well as government-administered prepaid card programs, typically enable only signature capability and must be processed by a single network in order to ensure compliance with the legal restrictions applicable to those cards. We do not believe that it is operationally possible to enable these types of cards to operate on multiple networks in a way that would be economically feasible in the near term. Accordingly, we request that the Board use its statutory authority under the EFTA to exempt these cards from the exclusivity and routing provisions.[76]

We also note that an exemption for these cards would be in line with the language of the statute. As noted above, the statute prohibits "an issuer or a payment card network" from restricting a card to a single network. Given the market context in which this provision was enacted, it was clearly intended to address recent business arrangements in which cards that traditionally were capable of being processed over multiple networks are being limited by agreements and rules to a single network (or single group of affiliated networks). Note that the statute does not require the development of new technologies or modifications to existing systems. It simply stops business practices that restricted the use of existing processes that previously were widely used.

The HSA, HRA, and FSA cards present an entirely different set of circumstances in which legal and technological limitations, not business arrangements, are the primary drivers of the network limitations applicable to those cards. The HSA, HRA, and FSA cards all are subject to strict legal requirements which limit the ways in which the cards can be used. To enable compliance with these requirements, technology has been developed in which the cards run on a single network and typically are enabled only for signature, not PIN acceptance. This technology does not accommodate multiple networks or multiple authorization methods and cannot do so without substantial changes. In essence, it is the legal requirements, and the technological response to those legal requirements, that have given rise to particular network arrangements rather than "an issuer or a payment card network" entering into the business arrangements the statute seeks to address. As a result, we believe an exemption from the exclusivity and routing provisions is not only appropriate but is important to properly implement the intent of the statute. Indeed, without an exemption, networks and issuers would be required to adopt new technologies—an outcome which is not contemplated in the statute.

[76] The plain language of the EFTA grants the Board broad discretion to "provide for such adjustments and exceptions for any class of electronic fund transfers, as in the judgment of the Board are necessary or proper to effectuate the purposes [of the EFTA]." 15 U.S.C. § 1693b.

Government Card Programs

Government programs also should be exempt. Government-administered payment programs typically have both PIN- and signature-based access already but are financially difficult programs to manage. Requiring the program manager to participate in another network would negatively impact program profitability and require higher fees on cardholders to compensate the program manager for the additional costs that would be incurred by entering into and managing another network arrangement. Additionally, the trend in the public sector market is to combine multiple programs under a single card program blending both restricted and non-restricted access. Requiring multiple networks could slow this development in the industry and eliminate the benefits this would provide to both the states and cardholders alike.

Transition Period / Effective Date

If the Board does not use its statutory authority under the EFTA to exempt limited use and government-administered card programs from the network exclusivity and routing provisions, we strongly urge the Board under the final rule to provide for an effective date of October 1, 2013 or, in the case of government-administered programs, a timeframe that is no less than the minimum term of the contract, whichever is greater. Such a transition period is necessary to ensure that network system changes and protocols can be tested and implemented, cards can be reissued, and new contracts negotiated and reasonably entered into. We believe that a shorter time period would raise safety and soundness concerns because it would compress the commercial negotiation process for entering into new contractual arrangements and potentially jeopardize the ability of institutions and program managers to conduct necessary due diligence.

COMMENTS ON OTHER ISSUES RAISED BY THE PROPOSAL

Credit Products

The Proposal generally applies to transactions involving "debit cards," which are defined under the Proposal as any card (or other payment code or device) issued for use through a payment card network to debit a transaction, savings, or other asset account established for any purpose (including business-purpose accounts), regardless of whether authorization is based on signature, PIN, or other means, and the issuer holds the account.[77] The Proposal also contemplates coverage of so-called deferred debit cards, where transactions are not immediately posted to an account, but instead funds are blocked and debited after the expiration of a designated period of time.[78] Such cards would be covered, regardless of the time period chosen by the issuer for deferring posting.

The Proposal also would cover decoupled debit cards, where the card is issued by a financial institution other than the institution that holds the account, and the card issuer collects funds via an ACH transaction to the account.[79] In the context of this discussion, the Board

[77] *See* proposed §§ 235.2(f)(1); 235.2(a); and Comment 2(a)-1.

[78] *See* proposed Comment 2(f)-2.

[79] *See* proposed Comment 2(f)-3.

expressed concern about whether issuers might design hybrid cards with credit features to avoid the interchange limitations on debit cards.

If the Board retains this position with respect to deferred and decoupled card programs, it must provide clarification to ensure the regulation is not inappropriately read to cover credit products simply because those products offer a cardholder the ability to pay down a credit line prior to the end of the billing cycle. For example, the Proposal should not cover programs under which all transactions will be authorized solely on the basis of the consumer's credit line and not with reference to or otherwise accessing the consumer's demand deposit or asset account. Indeed, we believe the Board should make it clear that a credit card falls outside of the definition of debit where the card simply provides the cardholder the ability to pay down a credit line prior to the end of the billing cycle by designating that purchases on the card will be paid on a preauthorized basis from available funds (if any) in a designated demand deposit account at some specified time but only after the purchase has already been authorized, cleared and settled solely against the credit line when presented for payment. This is no different than a cardholder making a payment by check prior to the end of the billing cycle to reduce the outstanding credit balance or going online to a bank's online banking portal to instruct that automatic payments be made to pay down the cardholder's credit account before the end of the billing cycle. In other words, providing an innovative and efficient means for consumers to reduce their outstanding credit balance and expand their available credit does not make the transaction a debit transaction.

Therefore, we seek clarification from the Board that a product that is authorized, cleared and settled solely against a cardholder's credit line, notwithstanding that the cardholder can designate preauthorized payments to be made from available funds prior to the regular billing cycle, is a credit product. This clarification would be consistent with the Special Master's report as endorsed and adopted by Judge Gleeson in the *In re Visa Check/MasterMoney Antitrust Litigation*.[80] We also ask the Board to make clear that transactions governed by Regulation Z will not be deemed to be subject to the final rule.

Coverage of Three-Party and Non-Traditional Networks

The Board requested comment on the appropriate application of the interchange fee standards to debit transactions carried over three-party networks and non-traditional networks such as PayPal, as well as on how the network exclusivity and routing provisions should be applied to such networks. The statute clearly covers three-party networks and non-traditional networks. PayPal, for example, uses a three-party model in which it enables consumers (*i.e.*, "cardholders") to use accounts established with PayPal to pay merchants authorized to accept PayPal payments. In particular, PayPal: (i) issues account numbers for use in debiting "accounts" through its network and, thus, meets the definition of "issuer;" (ii) contracts with merchants to settle the merchants' debit transactions through its network and, thus, meets the definition of "acquirer;" and (iii) provides the services, infrastructure and software for "authorization, clearance, and settlement" of debit transactions and, thus, meets the definition of "payment card network." Therefore, based on the statute and the Board's proposed interpretation, PayPal and the other three-party networks, whether "traditional" or "non

[80] A copy of the Magistrate's report is attached hereto as ATTACHMENT C.

traditional," must be covered by the restrictions imposed under the statute. We also note that if these networks were improperly excluded from coverage, it would have distorting effects that harm consumer welfare (including by artificially diverting investment and technology development, and providing incentives for issuers to use inferior processes) and create incentives for avoidance of the regulatory requirements. Moreover, whatever policy considerations related to issuer cost recovery that apply to traditional debit systems apply equally to equivalent debit transactions effected over emerging payments systems.

Accordingly, the Board must develop an approach to enforcing the interchange and other limitations with respect to such networks. Because the three-party networks traditionally perform the issuing, network, and acquiring roles and charge for those activities with a single merchant discount fee, we recognize that the Board must implement special procedures for ensuring compliance with the interchange fee limitation. We believe this could be achieved in the following way.

First, all debit payment products must adhere to the same regulatory standards, regardless of the type of business model which provides them or the manifestation of the product—physical card, virtual account number, cloud-based wallet, etc. Second, all three-party and emerging debit payment network acquirers must offer at least two unaffiliated debit brand acceptance options on their cards. Third, all three-party networks and any emerging payment network that provides both issuing and acquiring services must expose their internal revenue, cost and pricing methodologies to regulatory oversight. Each three-party network must be required to separately account for its costs associated with its issuing, network, and acquiring functions and must retain information regarding the merchant discount fees it imposes on merchants. In addition, each three-party and emerging payment network must maintain records allocating the total merchant discount fee to the three separate components of cost and must document its basis for determining that the portion of costs allocated to the issuing function is properly allocated based on generally accepted accounting principles and must be independently audited for these purposes.

Under such an approach, the federal banking agency responsible for supervising each three-party and emerging payment network must examine the records maintained by the three-party network and determine whether the network is in compliance with the statute and final regulation. As part of the assessment, the banking agency supervisor must examine, compare and contrast the merchant discount fees charged in connection with four-party network transactions to ensure that a three-party network is not impermissibly imposing higher merchant discount fees to pay for issuing-related activities. For example, any higher fees imposed based on cardholder characteristics (*e.g.*, cardholder spend) should not be permitted even though cardholder behavior traditionally has been an appropriate justification for higher interchange under a free market approach. Under the statute's approach, these market-based adjustments above the safe harbor would not be allowed and any compensation received by the issuer must be justified on cost alone.

Coverage of ATM Transactions and Networks

As the Board correctly points out in the Supplementary Information, ATM transactions and networks are not covered by the statutory provisions of the Act and should therefore not be included within the scope of the regulation.[81] For example, the exclusivity and routing provisions, which must be read together, apply only in the context of a "person who accepts debit cards for payments" and, therefore, clearly do not apply to ATM transactions. Moreover, application of the regulation to the ATM channel is inconsistent with the underlying rationale for the statutory provisions. An ATM cash disbursement is not a payment for goods and services between a consumer and merchant. Rather, it is a means for consumers to access their own funds. Thus, unlike retail transactions for goods and services, the ATM channel is and has always been exclusively card actuated. As a result, the Board's regulation should not extend to ATM transactions, and all card issuers should continue to have the option to designate exclusive ATM arrangements and brand mark. Further, it would be beneficial for the Board to incorporate a provision restricting the ability of a point of sale network from requiring an issuer to route transactions over participating ATMs when using its network to meet the point of sale exclusivity/routing provisions. Without such a provision, the exclusivity and routing provisions would affect transaction routing over network ATMs—a result clearly not intended by the statute.

Moreover, if the Board were to deem ATM transactions as "electronic debit transactions" under the regulation, it would have a negative effect on consumers, ATM networks, and banks of all sizes. For example, ATM operators, acquirers, networks and banks that issue ATM cards would be required to incur significant operational costs to come into compliance with the regulation, and those costs would likely be passed on to consumers. In addition, the vast majority of ATM cash disbursements are inter-bank or intra-bank events and in any event typically do not involve a non-bank party such as a merchant.

Unlike retail merchants, for ATM operators the great majority of the economic impact from a payment card transaction is not interchange but is the surcharge fees assessed directly to consumers. During the past decade, surcharge fees have risen steadily and in 2010 averaged $2.33 per cash disbursement. In some locations, ATM surcharge fees can be much higher than $2.33, especially in locations where consumers have limited mobility or choice (for example, stadiums, casinos, and airports). Because ATM operators in the US have unlimited discretion to levy direct charges on consumers, imposing the exclusivity and routing provisions on ATMs would increase issuer costs, which in turn will likely further increase consumers' already high cost of cash access.

In most markets outside the U.S. where ATM operators have discretion to apply surcharge fees on consumers, ATM operators that elect to surcharge consumers receive no interchange fees for surcharged transactions. Interchange fees are paid only if the ATM cash disbursement is free to the consumer. For example, under payment regulations in Australia, interchange has been eliminated in the ATM channel and ATM operators' revenue is solely based on their discretion to set surcharge fees.

ATM network exclusivity is necessary to many debit and prepaid card programs that are required to provide surcharge-free ATM access. The federal government and many state governments throughout the country are increasingly shifting delivery of benefit programs from

[81] *See* 75 Fed. Reg. 81,727.

paper-based forms (*e.g.*, vouchers, coupons and stamps) to debit and prepaid cards. Many private companies also are shifting payroll programs from paper checks to debit and prepaid cards. Cash access via the ATM channel is essential to many of these card programs and in many cases free cash access is required by law (particularly with respect to government benefits). Free cash access is often secured by card issuers via exclusive agreements with dedicated surcharge-free ATM networks. In some cases, dedicated surcharge-free networks have also deployed ATMs that accept only their own brand. Accordingly, it is important that the Board not extend the statute beyond its plain terms. ATM transactions and ATM networks are not covered under the statute and must not be covered under the regulation.

* * * * *

Again, MasterCard appreciates the opportunity to provide comments on the Proposal. If you have any questions regarding our comments, please do not hesitate to contact me at (914) 249-5061, or our counsel at Sidley Austin LLP in connection with this matter, Michael F. McEneney at (202) 736-8368, James A. Huizinga at (202) 736-8681, or Richard D. Klingler at (202) 736-8063.

Sincerely,

Shawn Miles
Senior Vice President, Group Head
Global Public Policy & Regulatory Strategy Counsel

Attachments:

Appendix A: Peter T. Dunn, Edgar, Dunn & Company, Comments on the Federal Reserve Board's Debit Card Interchange Fees and Routing Proposal, February 22, 2011

Appendix B: Christopher M. James, Comments on the Federal Reserve Board's Debit Card Interchange Fees and Routing Proposal, February 22, 2011

Appendix C: *In re Visa Check/MasterMoney Antitrust Litigation* Magistrate Report

cc: Michael F. McEneney, Esq.
James A. Huizinga, Esq.
Richard D. Klingler, Esq.

APPENDIX A

Comments on the Federal Reserve Board's Debit Card Interchange Fees and Routing Proposal

Peter T. Dunn
Edgar, Dunn & Company

on Behalf of MasterCard Worldwide

Submitted to
The Board of Governors of the Federal Reserve System
Concerning Its Proposed Rule Pursuant To
Section 920 of the Electronic Fund Transfer Act

February 22, 2011

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Introduction

On behalf of MasterCard Worldwide the following provides Edgar, Dunn & Company's ("EDC") comments on the process used for, and the results of, the Proposal by the Board of Governors of the Federal Reserve System ("Board") to establish standards for assessing whether an interchange fee received by an issuer for electronic debit transactions is reasonable and proportional to the cost incurred by an issuer in connection with the transaction. It specifically addresses what we believe are serious deficiencies in the Board's process for gathering data and the reliability of the data the Board received which underpin the Board's Proposal. This discussion does not include comments on the routing proposals or a detailed analysis of prepaid transactions.

The views set forth in this letter are based on our over 30 years of practice as a global management consulting company with significant experience with card products and interchange fees and costs. For example, EDC has worked extensively with MasterCard and other payment card industry participants since 1978 on interchange issues and has developed the cost studies and frameworks that form the basis for existing market interchange rates in the U.S. and many other countries and regions. We also have significant experience in working with regulators in Europe, the Americas and Asia on interchange-related issues. Our work includes years of cost accounting project experience in several individual countries and analyses related to European Debit Interchange Fees as well as being designated as the Cost Experts for MasterCard in the implementation phase of the Reserve Bank of Australia's interchange proposals. For a complete description of EDC, please refer to our website www.edgardunn.com.

Our comments, as set forth below, are based on the cost analysis we conducted of MasterCard debit card issuers during the Summer and Fall of 2010, a review of a limited sample of Board questionnaire responses provided to EDC by respondents, our expertise gained over the past 30 years in conducting similar cost analyses globally, and our understanding of the payments market in general and the debit market in particular.

We are pleased to offer our comments on the Board's Proposal and would welcome the opportunity to discuss any aspect of this paper with the Board at its convenience.

Background

In preparation for implementation of Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, MasterCard retained EDC to conduct a cost analysis of MasterCard debit issuers. Our work began in the July of 2010 and included a survey and analysis of U.S. MasterCard issuers representing a significant share of MasterCard debit volume. As part of our work we also carefully analyzed the survey and instructions sent by the Board to debit card issuers and subsequently used by the Board as the basis for its Proposal. We also had the opportunity to examine a limited number of the issuer responses provided to the Board. Based on our work, we have significant concerns about the reliability of the data used by the Board and how that data was translated as the basis for the Proposal. Our specific concerns and conclusions regarding these issues are set forth below.

The Board's Issuer Cost Survey Was Deeply Flawed and Produced Unreliable Results

During late summer of 2010, the Federal Reserve Board Staff prepared a "Card Issuer Survey" which was distributed to a sample of debit card issuing institutions with assets in excess of $10 billion. These questionnaires were prepared relatively quickly and distributed well before any conceptual framework or agreement on a standard for assessment was established or any clear understanding was reached about what was required by the statute or the significance of the data requested. In fact, the meaning and implications of many of the questions asked by the Board and their placement in the questionnaire did not become apparent until the Board released its Proposal. The participants were given about thirty days to complete the questionnaires – a relatively short period.

Perhaps because of the short timeframe the Board was given to implement the statute, the issuer survey instructions are quite complex, confusing, and, at times, seem contradictory. Although we have spent a great deal of time reviewing the survey, we remain confused about the precise meaning of many of the data elements in the questionnaire, their relationship to each other, and their use in the Proposal. This is not a theoretical concern but one that has real implications for the Board's work. Based on our work with issuers who responded to the survey, we know that its complexity, conflicting instructions and format created confusion on the Board's part of respondents. As a result, issuers arrived at materially different interpretations and consequently provided different information to the same questions. For example, our review of a sample of responses indicates the percentage of total processing cost represented by "network fees" (III,A,3) ranges from 0% to 75% -- a totally unrealistic range which can only mean that issuers failed to understand the Board's questions. We also know that in some cases issuers failed to respond to critical questions or left out entire categories of cost because they were unable to determine how the costs fit within the survey questions. Those survey flaws were compounded by the fact that few, if any, issuers account for costs in the manner requested by the Board.

The Board touches on this problem in its Proposal when it states that "some respondents were not able to provide information on all data elements requested in the surveys. For example, most respondents provided cost data at an aggregate level, but some were unable to provide cost data at the level of granularity requested in the surveys. In addition, there were inconsistencies in some data that were reported within individual responses and across responses." 75 Fed. Reg. 81,725. The Board indicates it attempted to address this issue by reviewing "the submissions for completeness, consistency, and anomalous responses" and basing its statistics on a "subset of the responses received…." *Id*. Based on our work, however, we believe that the level of confusion was so significant that the problem cannot be resolved by simply discarding "anomalous" results and focusing on a subset of responses. In fact, some of the responses that the Board refers to as "anomalous" are just as likely to be ones that properly included a larger percentage of their costs. We believe the Board must revise its process and conduct a new survey if it hopes to collect reliable data upon which to base its regulation.

The Board Failed to Collect or Take into Account the Costs Incurred by Issuers with Respect to Debit Transactions

The statute provides that debit interchange fees must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." In our view, the words "cost incurred by the issuer with respect to the transaction," have recognizable meaning to those of us who are expert in analyzing payment system costs. Simply stated, those costs are the costs of the activities necessary to engage in and complete a debit card transaction whether they are fixed or variable, direct or indirect. The Board, however, failed to collect many of those costs and instructed issuers to provide only selected data elements. For example, among the crucial omissions, the instructions either ignored or specifically instructed participants not to include: costs for activities required to establish account and account holder parameters; statement production costs; and various corporate and shared overhead items. As a result, the total cost to an issuer incurred for an electronic transaction was never established by the Board. Thus, any output could not possibly be numerically stated as being proportional to total issuer cost, nor could the Board assess the implications of the excessively narrow interpretation of allowable costs in relation to the language of the statute.

The Board's failure to collect this data produced materially inaccurate results. Based on our cost survey of issuers with assets above and below $10 billion, we estimate that the total average per transaction cost of debit transactions (not including a return) incurred by an issuer is about $1.00. For Issuers with assets over $10 billion, we estimate total costs of debit card transactions are about $0.65 to $0.75. The fact that the Board proposed a cost recovery of only $0.07 to $0.12 highlights just how significantly the Board's survey failed to reflect a proper scope of costs. The safe harbor of $0.07 would recover an average of about 10% of the midpoint of large issuers' total cost incurred; and the cap less than 20% of the total. There are numerous examples of inconsistent and confusing explanations and procedural and conceptual errors in the discussion of the Proposal. It is, however, the overall result -- a proposal that reduces present fees, which themselves recover only about two-thirds of total estimated transaction costs incurred by issuers, by up to 90% -- that demonstrates that the Board's interpretation is not economically viable, or commercially sound.

The Board Improperly Narrowed the Allowable Costs to Only Incremental Authorization, Clearing, and Settlement Costs

In ensuring that debit interchange fees are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction," the statute directs the Board to consider "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction." The Board has further limited incremental costs to only limited aspects of the "variable" costs of authorization, clearance, and settlement. In our experience, interpreting these instructions in the manner chosen by the Board would be quite unusual, if not unprecedented. If provided instructions to "consider" certain factors, we certainly would do just that by giving weight to those factors as part of the overall assignment. We are not aware of any precedent in our experience, however, for taking "considerations" as the sole measure of costs, particularly when the directive for identifying the appropriate costs is so clearly stated as "the cost incurred by the issuer with respect to the transaction." Moreover, we are not aware of any issuer or network that would measure costs in this way when establishing interchange fees.

Nonetheless, even if we measure only authorization, clearance, and settlement costs related to the transaction, the costs we found are multiples higher than those measured by the Board. Based on our cost survey, we estimate that costs of authorization, clearance, and settlement incurred by issuers are themselves about $0.30 to $0.35 for debit transactions. Again, these costs far exceed the $0.07 to $0.12 limits contemplated by the Board's Proposal.

The problem flowing from the Board's decision to treat "considerations" as its sole directive are compounded by the Board's highly unique definition of "incremental." The Board concluded that incremental costs are limited to those "costs that vary with the number of transactions (*i.e.*, average variable costs)…." We are not aware of anyone who would measure incremental costs that way. Management teams in most businesses across the U.S. measure incremental costs frequently in order to help decide whether to invest in and incur those costs in connection with proposed new products or services. Generally, incremental cost is arrived at by examining the investment and current expenses necessary to produce and deliver the product to the market. These costs might be fixed or variable in nature, they may be direct or indirect.

The Board, however, measures incremental costs by skipping over the costs of designing, investing in and creating, building and administering the product and focuses only on a fractional subset of the "variable" costs associated with delivering the product. The Board's description of variable is more similar to a subset of "direct costs" than what an industry practitioner would label as variable. Although we have spent considerable time examining and analyzing the statutory instructions provided to the Board, we are unable to identify how those instructions support the Board's interpretation of "incremental" cost or the narrow nature of the costs chosen. (As the Board acknowledges, it had to reject a widely used definition of "incremental cost" to arrive at its unusual definition.) We urge the Board to revise its approach and to adopt a more realistic definition. In our view, the appropriate interpretation of incremental cost is the additional cost to providing debit card transactions for an issuer already providing a deposit account. This cost recognizes all costs related to the debit card portion of the relationship whether they be fixed or variable, direct or indirect -- and independent of what organization (in house, network, third party) provides them.

The Board's Exclusion of Network Fees is Without Basis and Conflicts with Its Overall Mandate

The Board excluded network fees from allowable costs. In doing so, the Board appeared to rely upon the interpretation that network fees do not relate to the issuer's role in authorization, clearance, and settlement. This interpretation is incorrect, particularly for fees related and charged directly for each transaction authorized, cleared and settled. One of the most fundamental elements of an issuer's role in authorization, clearance, and settlement is the process of communicating information to and receiving information from acquirers. The only way an issuer can communicate with acquirers for these purposes is through a network or through another party providing that connection. Thus, the communications through the network and the fees necessary to achieve that communication are not only part of the issuer's role in authorization, clearance, and settlement, they are an essential element of that role, without which issuers could not authorize, clear, or settle a single transaction. Those fees also are undoubtedly incremental (even under the Board's unusual definition) and excluding those fees could only be achieved arbitrarily.

The Board Misapplied the Comparison Between Checks and Debit Cards

Another consideration the Board was directed to take into account was the functional similarity between debit cards and checks. The Board seems to have misinterpreted this guidance to mean that issuer compensation for debit card transactions should largely parallel that of checks. We cannot understand this approach because if the Board's interpretation were taken to its logical conclusion, debit interchange would be zero, which would seem to make the statute meaningless.

Based on our expertise in the payments arena, it seems to us that a more logical reading of this directive is to help frame why debit interchange fees are appropriate while checks "clear at par." Even a basic comparison of the two payment types demonstrates just how different checks and point of sale debit transactions are and highlights the far greater functionality debit cards provide over checks. For example, the 2010 Federal Reserve Payments Study referred to in the Proposal estimates that less than 15% of checks are written at the point of sale. Merchants do not readily accept checks -- especially checks written by non-local persons -- unless they are guaranteed or verified, a service that can cost merchants up to 2-3% of the face value of an average transaction (an amount substantially more than current debit interchange fees which range from .75% to 1.4%). Any discussions comparing customer account access devices (checks, debit cards) and identifying costs needs to recognize these fundamental functional differences -- one product (debit) includes the authorization process and the guarantee, while the other (check) does not. Indeed, were it not for these significant differences, it seems unlikely that merchants and consumers would have developed such an overwhelming preference for debit products over checks. While the Board notes some of these differences, it applies none of them in its determination of interchange fees. We are not aware of any commercial or industry basis under which this approach can be justified.

To assist the Board in more properly conducting the check/debit card comparison, it may be helpful to examine the economic significance of just one of the functional differences—the authorization process for debit, which does not exist for checks. This is a good example because the importance and value of the authorization function is difficult to overstate. Consider the fact that about 5% of debit authorization requests are declined. One measure of the incremental value of the debit authorization process over a check and the value of these investments in individual and account authorization systems and monitoring is to estimate the risk of fraudulent transactions were there no authorization process for electronic debit transactions. If these declined transactions were accepted, the risk of fraud losses would increase by about 50 times (5% ÷ .10%) the current amount of losses for signature transactions and about 500 times (5% ÷ .01%) for PIN debit. This increase would equate to over $50 billion of potential fraudulent activity and losses. These amounts assume the status quo in attempted fraudulent activity, but without the authorization systems, the attempts at higher dollar value transactions and the sophistication of these attempts would surely increase. It is critical that issuers, networks, acquirers and merchant continue to invest in authorization systems and related fraud prevention activities. Yet the Board's interchange fee limits do not account for these costs and indeed discourage such investment.

The Board has Failed to Consider the Longer Term Implications of its Proposal

To ignore or minimize the fundamental differences between checks and electronic debit transactions is to invite the separation of the debit transaction into those pieces that mimic a check and other services which might be provided to the acquirer and merchant. For example, it is possible that separate fees could be established to guarantee, clear and perform other activities associated with settling the transaction. If the merchant or its bank did not pay for the guarantee, the transaction would be returned to the acquirer and the merchant just like a check. The likely result of such a separation would be fees for comparable service that are considerably higher than the market-based interchange fees paid today, and a higher overall cost for large segments of merchants and transaction types. In addition, without the guarantee the growth in acceptance of debit and its associated sales without a guarantee would likely be reduced. Most important, any step that makes use of electronic transactions relatively less preferable to paper would be a significant step backwards in the evolution of the payments industry. Finally, the Board's failure to include a factor to provide a return on the issuer costs will make the investment in these services less attractive when compared to other investments.

The eventual result of implementing the Board's Proposal is likely to be one or a combination of the following scenarios; none of which were objectives of the legislation.

1. Consumers will be asked to pay disproportionately (billions of dollars) for a payment service that delivers significant value to merchants;

2. The debit product will be diluted to the point where merchants will not be able to rely on a guarantee and thus will suffer loss of sales or substantially increased costs for the current level of assurance;

3. Smaller institutions will be forced out of the debit market; and

4. Growth of electronic debit transactions will slow in favor of cash and paper-based transactions.

The Board's Interpretation of Its Congressional Directive is Unprecedented in Our Experience

As noted above, while we do not purport to be legal experts, we have more than 30 years experience in carrying out interchange-related costs studies. Based on our extensive experience and the instruction the Board received from Congress, the proper way to account for issuer costs is far different than the way the Board has done it. Indeed, if we had been given precisely the same instruction as the Board, we would have calculated issuer costs incurred by issuers with assets of $10 billion or more to be about $0.65 to $0.75 for debit transactions and even the costs related only to authorization, clearing and settlement to be several times higher than the Board's proposed fees. We can state unequivocally that we would not, under any circumstances, have understood the statutory instructions to support the Board's narrow view of costs or its shocking low results.

Summary and Conclusion

The recommended fees for a safe harbor and cap are simply too low and do not represent a reasonable or proportional amount when compared to the cost incurred by the issuer to provide the activities and services required and related to the transaction. These results are the consequence of a number of procedural and conceptual weaknesses in the Board's analysis and the inherent flaws in the quality of the cost information elicited by the Board's survey. In addition, implementation of a fixed fee of any amount or a standard computed on an issuer-by-issuer basis does not allow for the flexibility needed to account for differences in transaction size, merchant type, risk, brand competition, new merchant categories, customer service, customer base or other relevant factors.

The data gathering done by the Federal Reserve did not include identification of all issuer costs or even all costs required for authorization, clearing and settlement and, therefore, could not and should not have been used to assess whether any specific fee amount was reasonable or proportional. Ultimately, the Proposal unsuccessfully attempts to solve this issue by "defining out" those costs that were not collected from the allowable list even though it inexplicably describes several of them as included in the definitions and descriptions in the Proposal.

In short, we believe that for various reasons, the data the Board collected is not accurate and the data that was collected was not accurately translated into the definitions in the Proposal. As a result, the Board's data and the Board's assessment of that data do not, in our view, provide a credible basis for implementing the Board's mandate.

We recommend the Board regroup and reevaluate its conceptual basis. Once that is done, it can augment or collect additional data to support an appropriate implementation of the statutory language.

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We would be happy to discuss any aspect of these comments at your convenience and to provide ongoing support for the Board's efforts.

APPENDIX B

Comments on the Federal Reserve Board's Debit Card Interchange Fees and Routing Proposal

Christopher M. James

on Behalf of MasterCard Inc.

Submitted to
The Board of Governors of the Federal Reserve System
Concerning Its Proposed Rule Pursuant To
Section 920 of the Electronic Fund Transfer Act

February 22, 2011

I. Background

I am the William H. Dial / SunBank Eminent Scholar in Finance and Economics at the University of Florida. I received a Ph.D. in Economics from the University of Michigan in 1978 and an MBA from the University of Michigan in 1977. Prior to joining the faculty of the University of Florida, I taught at the University of Oregon and the University of Michigan.

I have held positions at the Federal Reserve Bank of San Francisco, the Federal Deposit Insurance Corporation, and the Treasury Department. I have served as a senior economic advisor to the Comptroller of the Currency where I evaluated the economic consequences of regulatory changes for bank safety and soundness. I served on the Board of Directors and the Advisory Board of SunTrust Bank of Florida between 1989 and 2005. As part of my Board duties, I served on the bank's executive committee that approved all major investment activity (e.g., credit extensions, mortgages, and loan restructurings). From 1995 to 2002, I also served on the academic board of the Turnaround Management Association. I currently serve as the SEC-approved independent distribution consultant for the Janus Mutual Fund complex and as a consultant to the Federal Reserve Bank of San Francisco.

My research has been widely published in academic and professional journals in the areas of financial economics, law and economics, antitrust policy, and applied econometrics. I am currently the editor of the *Journal of Banking and Finance* and an associate editor of the *Journal of Managerial and Decision Economics*, the *Journal of Financial Economics*, and the *Journal of Financial Services Research*. I have also served as a consultant to several government agencies and a number of financial institutions and other private corporations. As a consultant, I have analyzed competitive conditions in a variety of industries and advised on a variety of public policy issues. I have also consulted in the areas of product pricing, valuation, corporate assets, bank lending and risk management, competitive strategies, and corporate financial policy. I have also provided expert witness testimony on issues concerning loss causation, bank product pricing, the estimation of damages, and corporate restructurings. A copy of my curriculum vitae is attached as Exhibit A.

I have been asked by MasterCard to assess the economic consequences of the Federal Reserve Board Regulation II, Debit Card Interchange Fees and Routing, proposal pertaining to the level of debit interchange fees and to network exclusivity for debit cards.

II. Summary of Opinions

Based on my analysis, I have formed the following opinions:

1. The existing debit payment systems are an economically important payment method in the U.S. that is widely chosen and relied upon by consumers and merchants *at current, market-determined prices* when other payments methods are available. The commercial success of debit cards in a competitive, unregulated market is an indication that debit payment systems provide a service that is valuable to both consumers and merchants.
2. The Board has proposed regulatory changes to the market equilibrium for these services unguided by evidence of any market failure that could be ameliorated by the proposed regulations and without any attempt to show that the regulations would enhance consumer welfare.
3. The interchange fee cap proposed by the Board would cause a dramatic change in the way debit services are priced to merchants and to consumers by shifting costs that are currently borne by merchants to consumers.
4. The interchange fee cap proposed by the Board would result in a decline in the use of debit by consumers and merchants and an increased reliance by them on checks, cash, and credit card payment methods that can more expensive for them than debit payment systems currently are.
5. As a result of the proposed interchange fee cap, consumers would be left paying more for debit services with reduced benefits and merchants would be left with less expensive but degraded debit services that are less attractive to, and therefore less used by, their customers.
6. The proposed interchange fee cap would also disadvantage small issuers. Because economies of scale in issuing create a cost advantage for larger issuers, the

limitation on the revenue issuers can collect from merchants imposed by the cap would be particularly injurious to small issuers.

7. If the interchange fee cap were not applied with equivalent effect to debit services provided by three-party systems and also to emerging, debit-like payment systems, the regulation would create a competitive disadvantage for the four-party systems that currently are widely used by both merchants and consumers.
8. The proposed interchange fee cap would reduce debit interchange fees to a level below the true incremental transaction costs incurred by issuers and result in reduced investment by issuers in innovation and in the infrastructure necessary to meet any growth in demand.
9. The Board has proposed a network exclusivity regulation (Alternative B) that would require two signature debit networks on each debit card, but has failed to provide any evidence or analysis of a market failure that warrants this regulatory intervention.
10. Proposed Alternative B would make issuer investments in promoting signature debit less valuable to the networks and therefore lead them to reduce their investments in competing for issuer services.
11. Together, the proposed cap on interchange fees and network exclusivity proposal Alternative B would shift the *benefits* of competition by debit systems to merchants while shifting the *costs* of debit services to consumers. The Board has offered no rationale for imposing regulations that are so clearly anti-consumer.

I begin my analysis by summarizing my understanding of the Durbin Amendment and the rules proposed by the Federal Reserve Board of Governors.

A. The Durbin Amendment

I understand that Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act comprises an amendment proposed by Senator Durbin (the "Durbin Amendment") to the Electronic Fund Transfer Act. Among other things, the Durbin Amendment gives the Federal Reserve Board of Governors ("the Board") certain authority to regulate debit card interchange fees (the per transaction fees that acquirers pay to issuers) and to prohibit network exclusivity for electronic debit transactions.[1]

The Durbin Amendment requires the Board to establish regulations setting forth standards for assessing whether debit interchange fees are "reasonable and proportional to the cost incurred by the issuer with respect to the transactions."[2] The statute specifies that the cost considered when promulgating the interchange fee regulation should include at least "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction."[3] The statute also states that the Board may not consider costs which are not specific to a particular transaction. The statute exempts any issuer that, together with its affiliates, has assets of less than $10 billion from any debit interchange fee regulation established by the Board.[4]

The Durbin Amendment also calls for the Board to impose regulations that would prohibit issuers or networks from restricting the number of payment card networks on which transactions made with a particular debit card may be processed to a single network or to multiple networks owned by the same entity.[5] In addition, the statute calls for a prohibition against an issuer or a network inhibiting "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."[6]

On December 16, 2010 the Board published its proposed Regulation II, Debit Card Interchange Fees and Routing. My comments in this submission reflect my analysis of the proposed interchange fee rules and the proposed rules on network exclusivity contained in the Board's rulemaking proposal.

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[1] Public Law 111-203, 7/21/2010, 124 Stat. 2068, 2072.

[2] Public Law 111-203, 7/21/2010, 124 Stat. 2068.

[3] Public Law 111-203, 7/21/2010, 124 Stat. 2069. The statute also specifies that the Board may allow for an adjustment to interchange fees for fraud prevention costs if such adjustment is "reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud" and if the issuer complies with the requirement to take effective steps to reduce the occurrence of fraud and fraud-related costs. Public Law 111-203, 7/21/2010, 124 Stat. 2069.

[4] Federal Reserve Board of Governors, 12 CFR Part 235, "Regulation II, Debit Card Interchange Fees and Routing Notice of Proposed Rulemaking" (hereafter "Notice"), 12/16/2010, p. 18.

[5] Public Law 111-203, 7/21/2010, 124 Stat. 2072.

[6] Public Law 111-203, 7/21/2010, 124 Stat. 2072.

B. Proposed Rules on Interchange Fees and Network Exclusivity

The Board has proposed two alternative regulatory rules for debit interchange fees: (1) an issuer-specific standard with a safe harbor and a cap; and (2) a common cap for all issuers.[7] In both instances the proposed rule would set the interchange fee cap at $0.12 per debit transaction. It is this cap that is the focus of my interchange fee analysis.[8]

The Board also proposes two alternatives for network exclusivity restrictions.[9] Under the first proposed alternative ("Alternative A"), an issuer or a network would be prohibited from restricting the number of payment networks enabled on a debit card to fewer than two. Most debit cards currently available can be used as either a PIN debit card or as a signature debit card.[10] Under this alternative, a debit card that can be processed on a single signature debit network and a single PIN debit network, provided that the two networks are unaffiliated, would meet the regulatory standard. Many of the debit cards currently in circulation satisfy this criterion.[11]

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[7] Notice, p. 15.

[8] Under the first alternative, the issuer is permitted to collect an interchange fee that does not exceed its allowable costs as long as its costs are no greater than $0.12 per transaction. For those issuers whose allowable costs are below the cap, the maximum interchange fee would be issuer-specific. This alternative also includes a safe harbor provision specifying that if an issuer's per-transaction interchange fee does not exceed $0.07 per transaction (the "safe harbor amount"), the issuer does not need to justify the fee by calculating its allowable costs. Under the second alternative, all issuers are permitted to collect an interchange fee of no more than $0.12 per transaction. The issuers are not required to calculate their allowable costs under this alternative. Notice, p. 31.

[9] Notice, p. 32. The Board also proposes that merchants be permitted to direct the routing of a debit card transaction to any of the networks that are enabled on the debit card. Notice, pp. 31–33.

[10] Notice, p. 20. For a transaction on a signature network (e.g., VisaNet), a cardholder approves a debit transaction by signing the receipt. For a transaction on a PIN network (e.g., Maestro), a cardholder approves a debit transaction by entering a Personal Identification Number (PIN).

[11] According to the Board's survey, for covered issuers 70 percent of debit cards (including prepaid) or 87 percent of debit cards (excluding prepaid) have both signature and PIN functionality. Notice, p. 20.

While Discover offers signature debit, its market share is negligible, so virtually all signature debit cards are either Visa or MasterCard cards. Meeting Between Federal Reserve Staff and Representatives of Discover Financial Services (Discover), 10/28/2010, p. 10.

MasterCard-affiliated PIN debit network, Maestro, has less than 1 percent share of all PIN debit point of sale transactions and Visa-affiliated PIN debit network, Interlink, has less than 40 percent share of all PIN debit point of sale transactions. ATM & Debit News: EFT data book, 2009 Edition, pp. 5, 10.

Hence, the remaining 60 percent of PIN debit transactions are on PIN networks that are not affiliated with either Visa or MasterCard.

Also, about half of Visa debit cards have a second unaffiliated network on them. JPMorgan North America Equity Research, 11/15/2010, p.7.

Under the second proposed alternative ("Alternative B"), an issuer or a network may not restrict the number of payment networks on a debit card to fewer than two unaffiliated networks for each debit type. Under this alternative, a debit card would need to be enabled on two unaffiliated signature networks and two unaffiliated PIN networks to meet the regulatory standard. It is this variant of the proposed rule that I address.

III. The Proposed Interchange Fee Cap Will Harm Consumers, Merchants and Competition

PIN debit and signature debit payment systems compete with each other and with other payment systems, including checks, cash, and credit cards, for transaction volume.[12] Debit networks compete intensely with each other by marketing directly to consumers and by providing incentives to issuers to promote their products. As described below, the interchange fee is one of the competitive tools employed by payment systems to compete for issuer loyalty and to induce issuers to provide cardholders with lower price and/or higher quality products.

Recent academic studies provide evidence that consumers substitute among payment systems. For example, several researchers have studied the effects of price on payment method choice by comparing how differences in relative prices affect the choice of payment method. Zinman (2009) found that cardholders responded as economic theory would predict, shifting purchases to the lower-cost alternatives.[13] Sprenger and Stavins (2008) and Jin and DeVaney (2005) report similar findings.[14] Simon, Smith, and West (2009) consider the effects of participation in a credit card loyalty program and access to an interest-free period, "both of which lower the price of credit card use," and find that both "tend to increase credit card use at the expense of alternative payment methods, such as debit cards and cash."[15] Other studies I

[12] Foster, Kevin, Meijer, Erik, Schuh, Scott and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Discussion Paper No. 09-10, 4/2010, pp. 2, 10; Herbst-Murphy, Susan, "Trends and Preferences in Consumer Payments: Lessons from the Visa Payment Panel Study," Federal Reserve Bank of Philadelphia Discussion Paper, 5/2010, pp. 1–2.

[13] Zinman, Jonathan, "Debit or Credit?" *Journal of Banking & Finance*, Vol. 33, 2009, pp. 358–66 at p. 358.

[14] Sprenger, Charles and Joanna Stavins, "Credit Card Debt and Payment Use," Financial Services Review, Vol. 19, 2010, pp. 17–35; Jin, Rui and Sharon A. DeVaney, "Determinants of Debit Card Use: A Study from the Consumers' Perspective," *Consumer Interests Annual*, Vol. 51, 2005, pp. 62–70.

[15] Simon, John, Smith, Kylie, and Tim West, "Price Incentives and Consumer Payment Behaviour," Reserve Bank of Australia Research Discussion Paper 2009-04, 6/2009.

have reviewed also support the proposition that cash, checks, credit cards and debit cards compete for consumer transactions and that most consumers substitute across the payment methods available to them.[16]

Debit network executives also believe that debit competes with other payment methods. MasterCard's[17] and Visa's[18] SEC filings describe debit cards as competing with other payment systems, including paper-based systems (cash and checks), other card-based systems (credit, charge, and other general purpose cards), and electronic systems (such as wire and Automated Clearing House payments). Recently, the traditional debit systems have also began facing competition from emerging payment systems such as mobile payments and PayPal.[19] Despite the

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[16] See, e.g., Ching, Andrew T. and Fumiko Hayashi, "Payment Card Rewards Programs and Consumer Payment Choice," *Journal of Banking and Finance*, Vol. 34, 2010; Borzekowski, Ron, Kiser, Elizabeth K. and Shaista Ahmed, "Consumers' Use of Debit Cards: Patterns, Preferences and Price Response," *Journal of Money, Credit and Banking*, Vol. 40, No. 1, 2/2008; Borzekowski, Ron and Elizabeth K. Kiser, "The Choice at the Checkout: Quantifying Demand Across Payment Instruments," *International Journal of Industrial Organization*, Vol. 26, Issue 4, 7/2008; Public Policy Discussion Paper No. 07-1, Federal Reserve Bank of Boston, Benton, Marques, Blair, Krista, Crowe, Marianne and Scott Schuh, "The Boston Fed Study of Consumer Behavior and Payment Choice: A Survey of Federal Reserve System Employees," 2/14/2007; Finance and Economics Discussion Series Working Paper, Federal Reserve Board, Washington, D.C., Klee, Elizabeth, "Families' Use of Payment Instruments During a Decade of Change in the U.S. Payment System," 2/16/2006; Finance and Economics Discussion Series Working Paper, Division of Research and Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., Klee, Elizabeth, "Paper or Plastic? The Effect of Time on Check and Debit Card Use at Grocery Stores," 2/16/2006.

[17] MasterCard 10-K for the period ended 12/31/10, p. 5 ("We operate in the global payments industry, which consists of all forms of payment including: Paper—cash, personal checks, money orders, official checks, travelers checks and other paper-based means of transferring value; Cards—credit cards, charge cards, debit cards (including Automated Teller Machine ('ATM') cards), pre-paid cards and other types of cards; and Other Electronic and Emerging—wire transfers, electronic benefits transfers, bill payments, Automated Clearing House payments and mobile devices, among others.") and p. 19 ("MasterCard programs compete against all forms of payment, including paper-based transactions (principally cash and checks), card-based payment systems, including credit, charge, prepaid, private-label and other types of general purpose and limited use cards, and electronic transactions such as wire transfers and Automated Clearing House payments. As a result of a global trend, electronic forms of payment such as payment cards are increasingly displacing paper forms of payment, and card brands such as MasterCard, Visa, American Express and Discover are benefiting from this displacement. However, cash and checks still capture the largest overall percentage of worldwide payment volume.")

[18] Visa 10-K for the period ended 9/30/10, p. 17 ("We compete in the global payment marketplace against all forms of payment, including paper-based forms (principally cash and checks), card-based payments (including credit, charge, debit, ATM, prepaid, private-label and other types of general purpose and limited use cards) and other electronic payments (including wire transfers, electronic benefits transfers, automatic clearing house, or ACH, payments and electronic data interchange)").

[19] Becker, Krista, "Mobile Payments: New Way to Pay?", Federal Reserve Bank of Boston Emerging Payments Industry Briefing, 2/2007, p. 1; Shy, Oz, "Person-to-Person Electronic Funds Transfers: Recent Developments and Policy Issues," Federal Reserve Bank of Boston Public Policy Discussion Paper 10-1, 3/2/2010, p. 7.

availability of these other payment systems, debit cards have been widely accepted by consumers and merchants.

A. Debit Cards Have Been Widely Accepted by Merchants and Consumers at Competitive, Unregulated Market Prices

Although debit is a relatively new payment system, it has been widely accepted by U.S. consumers and merchants and has been the fastest-growing payment method since 2003.[20] Its success in capturing transaction share is evident in the data presented in Exhibit 1 that report recent trends in the shares of various payment methods used for U.S. personal consumption expenditures. Exhibit 2 presents analogous data for shares of transaction volume in dollars.

Debit card share of personal consumption expenditures doubled from 2003 to 2009, increasing from 13 percent to 26 percent of the number of transactions and from 9.7 percent to 18.6 percent of the value of transactions.[21] In contrast, credit card share declined from 17.1 percent to 16.7 percent based on the number of transactions and increased only slightly from 23.5 percent to 24 percent based on the value of transactions during the same period.[22] There have been more debit card transactions than credit card transactions since 2004.[23] Among debit transactions, PIN transactions have increased more rapidly than signature transactions. PIN debit transactions grew 15.6 percent per year and signature debit grew 14.3 percent over 2006–2009; the disparity was greater in the 2003–2006 period in which PIN debit grew 20.6 percent per year and signature debit grew 15.8 percent per year.[24]

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[20] Nilson Report, Issues 939, 962.

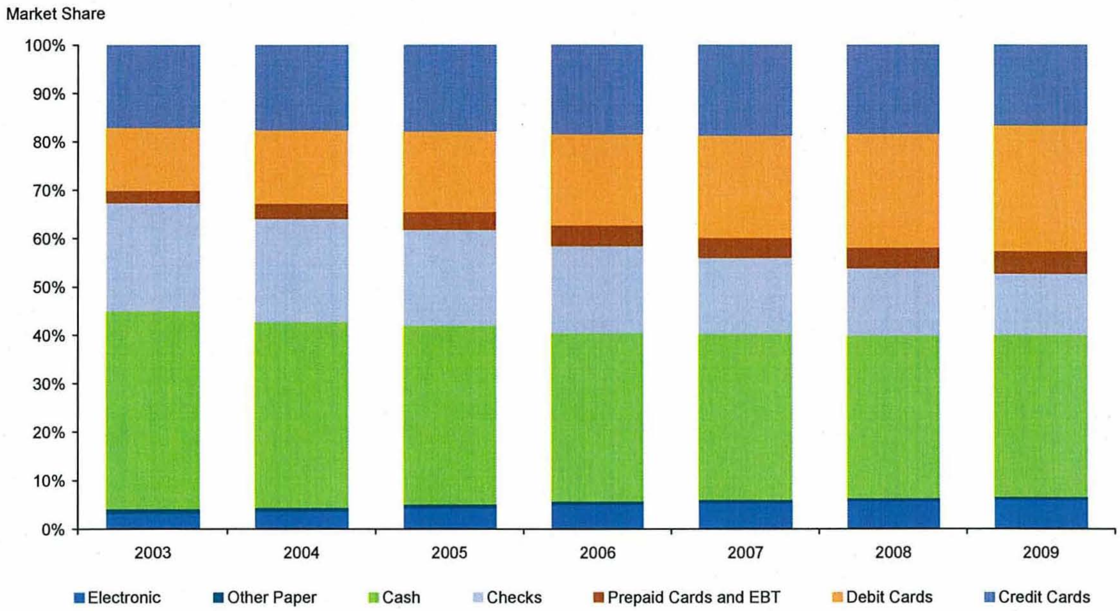
[21] Nilson Report, Issues 939, 962.

[22] Nilson Report, Issues 939, 962.

[23] Nilson Report, Issue 842.

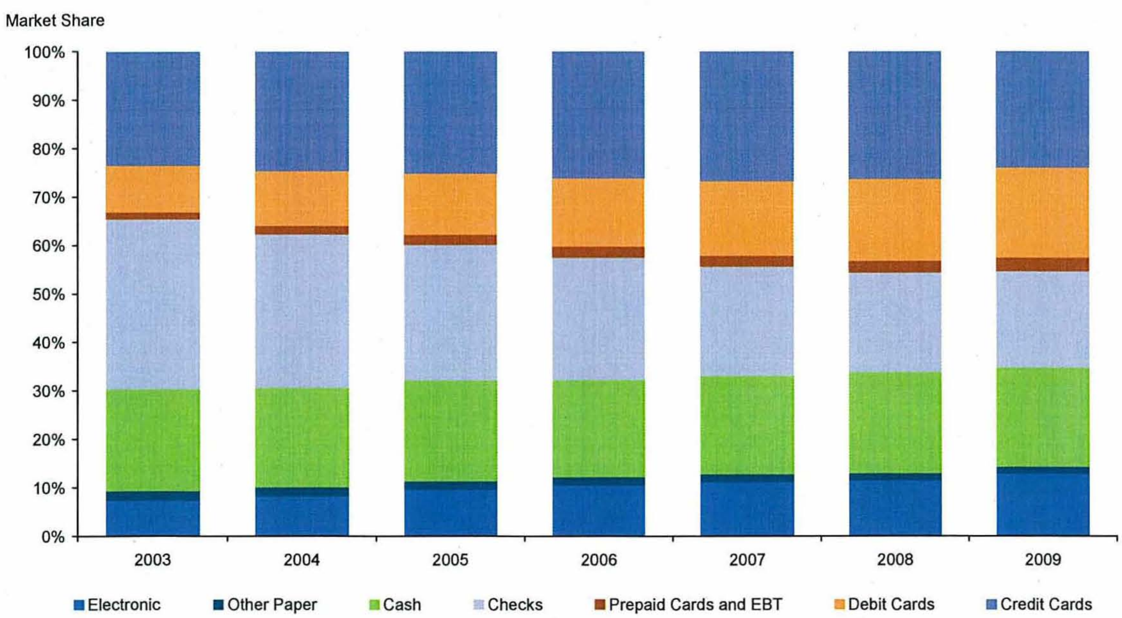
[24] "The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States," Federal Reserve System, 12/8/2010, p. 16; "The 2007 Federal Reserve Payments Study: Noncash Payment Trends in the United States," Federal Reserve System, 12/10/2007, p. 10.

Exhibit 1
Market Share of U.S. Consumer Payment Systems by Number of Transactions



Source: Nilson Report Issue 962; Issue 939; Issue 915; Issue 890; Issue 847

Exhibit 2
Market Share of U.S. Consumer Payment Systems by Value of Transactions



Source: Nilson Report Issue 962; Issue 939; Issue 915; Issue 890; Issue 847

More than 80 percent of U.S. consumers use debit cards according to the 2008 Survey of Consumer Payment Choice conducted by the Federal Reserve.[25] Consumers rely heavily on debit cards to access their bank accounts; nearly 60 percent of consumers with bank accounts rely exclusively on debit cards for account access.[26] Seventy percent of the surveyed consumers use debit cards for purchases.[27] Debit is the most popular payment method among the survey respondents, accounting for 30 percent of all transactions.[28] Another survey shows that many consumers describe debit cards as their payment method of choice; this survey found that 36 percent of consumers want to pay with debit cards "all the time."[29]

Debit cards are accepted by millions of merchants[30] and have characteristics that make them superior to cash and checks from the merchants' perspective. Unlike checks and cash, signature debit cards can be used for "card not present" transactions, such as purchases made over the internet or the telephone. They can also be used to guarantee payment when the amount of the purchase is not known in advance as is the case, for example, for hotel reservations.[31] Transactions made with PIN or signature debit cards rather than cash reduce the cash merchants need to hold and reduce cash handling costs related to labor, counterfeit bills, and employee error and theft. Debit cards also allow the merchants' customers to make purchases that exceed the amount of cash they happen to be carrying. Debit cards reduce customer check-out time because processing debit card transactions at the point of sale is faster than processing checks or cash.[32]

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[25] Foster, Kevin, Meijer, Erik, Schuh, Scott and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Discussion Paper No. 09-10, 4/2010, Table 4.

[26] Foster, Kevin, Meijer, Erik, Schuh, Scott and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Discussion Paper No. 09-10, 4/2010, Table 1.

[27] Foster, Kevin, Meijer, Erik, Schuh, Scott and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Discussion Paper No. 09-10, 4/2010, Table 14.

[28] Foster, Kevin, Meijer, Erik, Schuh, Scott and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Discussion Paper No. 09-10, 4/2010, Table 19.

[29] Herbst-Murphy, Susan, "Trends and Preferences in Consumer Payments: Lessons from the Visa Payment Panel Study," Federal Reserve Bank of Philadelphia Discussion Paper, 5/2010, p. 4.

[30] Meeting between Federal Reserve Board Staff and Representatives of JPMorgan Chase, Chase Paymentech and Morrison & Foerster LLP, 8/4/2010, p. 8.

[31] Meeting between Federal Reserve Board Staff and Representatives of JPMorgan Chase, Chase Paymentech and Morrison & Foerster LLP, 8/4/2010, p. 7.

[32] Meeting between Federal Reserve Board Staff and Representatives of JPMorgan Chase, Chase Paymentech and Morrison & Foerster LLP, 8/4/2010, p. 9.

A recent study shows that transaction time for PIN debit cards, for example, is 25 seconds shorter than transaction time for checks.[33]

Unlike checks, debit cards guarantee payment to the merchant. Debit networks guarantee payment for authorized debit transactions, but banks offer no such guarantee for checks even when drawn on the same asset account. Debit cards also offer better fraud protection to merchants. A recent study reports that 52 percent of the brick-and-mortar store transactions that are not authorized are linked to checks.[34] It also reports that 34 percent of fraudulent transactions at merchants (both brick-and-mortar and online stores) involve checks and only 8 percent involve debit cards.[35]

Merchants can purchase check verification and check guarantee services from third parties,[36] but this service is expensive. For example, Certegy charges fees for authorization that vary from 1.15 to 2.0 percent of the check value in addition to fixed monthly fees.[37] TeleCheck charges an average rate of 1.64 percent of the check value to guarantee check payment.[38] The Nilson Report reports that merchants paid $0.08 per check for check verification services and an additional 0.92 basis points of check value for check guarantee services.[39] Merchants' willingness to pay for these services is evidence that the security provided by debit cards at no additional charge is valuable to merchants.

The widespread use of debit cards is evidence that they are also preferred by consumers relative to other payment systems for a substantial number of transactions. Many of the characteristics that make debit cards appealing to merchants also make using debit cards attractive to consumers. Debit cards reduce the consumers' convenience cost of obtaining cash and the risk of carrying cash. Debit cards offer better fraud protection for cardholders, including zero liability protection if the card is lost or stolen and for disputed transactions. Consumers, like merchants, benefit from using debit cards because they can be used for "card not present

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[33] Klee, Elisabeth, "How People Pay: Evidence from Grocery Store Data," *Journal of Monetary Economics*, Vol. 55, 2008, p. 533.

[34] Javelin Strategy & Research, 2009 LexisNexis True Cost of Fraud Study, p. 34.

[35] Javelin Strategy & Research, 2009 LexisNexis True Cost of Fraud Study, p. 54.

[36] According to a recent survey, 29 percent of merchants purchased check verification services in 2009. Javelin Strategy & Research, *2009 LexisNexis True Cost of Fraud Study*, p. 58.

[37] http://www.emerchantprocessing.com/docs/Certegy_Check_Agent_Sales_Kit.pdf.

[38] http://www.telechecksales.com/rates_fees.

[39] Nilson Report, Issue 953; Notice, p. 28.

transactions" and also provide shorter check-out time.[40] Debit cards also enable international transactions and cash withdrawals. Consumers describe debit cards as easier to use than cash and checks, and note that debit cards offer a better record-keeping option than cash, allow transactions to be completed more quickly than checks, and are more secure than cash or checks.[41]

Given the consumer perception of debit cards' merits relative to checks and the benefit that merchants derive from debit card use, it is not surprising that transactions continue to migrate from checks to debit cards.[42] The 2010 Federal Reserve Payments Study shows that since 2006, "the debit card has eclipsed the check as the most used non-cash instrument...the number of debit card transactions increased at 14.8 percent per year from 2006 to 2009...the number of checks paid declined 7.2 percent per year."[43]

In summary, debit is an economically important payment method in the U.S. and is widely chosen and relied upon by consumers and businesses *at current, market-determined prices* when other payments methods are available. The commercial success of debit cards in a competitive, unregulated market is an indication that this method of payment provides a service that is valuable to consumers and merchants. Absent evidence of market failure — evidence the Board has, quite understandably, not claimed exists — the market outcome should be deemed efficient. The Board should thus craft its regulations with the maximum reliance on market mechanisms and with the minimum displacement of market outcomes that are consistent with the statute. The Board proposes instead a regulatory regime that will cause a dramatic change in the way debit services are priced to merchants and to consumers. As I shall show, this change will harm consumers and, in the long run, may well harm merchants.

In the remainder of this section, I describe the economics of two-sided payment systems and the economic effects that occur if the interchange fee is set by regulation rather than by market forces. In short, a regulation that reduces the interchange fee for debit transactions will

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[40] Meeting between Federal Reserve Board Staff and Representatives of JPMorgan Chase, Chase Paymentech and Morrison & Foerster LLP, 8/4/2010, p. 7.

[41] Foster, Kevin, Meijer, Erik, Schuh, Scott and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Discussion Paper No. 09-10, 4/2010, Table 27.

[42] Foster, Kevin, Meijer, Erik, Schuh, Scott and Michael A. Zabek, "The 2008 Survey of Consumer Payment Choice," Federal Reserve Bank of Boston Discussion Paper No. 09-10, 4/2010, p. 10.

[43] "The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States," Federal Reserve System, 12/8/2010, p. 4.

shift the costs of the debit system from merchants to cardholders and consumers will respond by shifting some purchases that would be made using debit cards, given their current prices and quality, to credit cards, cash, and checks. Under the proposed interchange fee cap, consumers will face an increased cost of making transactions with debit cards and merchants will be left with a debit system that is inexpensive for them but less attractive to, and therefore less used by, their customers.

B. The Role of Interchange Fees in the Debit Payment System

To understand the effects that a substantial reduction in the interchange fee for debit transactions would have, it is helpful to step back and consider how the interchange fee is currently set and the role it plays in the provision of debit services. A debit payment system is composed of three functions: an issuing function through which debit cards are offered to consumers and cardholder accounts are served; an acquisition function through which debit payment services are offered to merchants and merchants accepting debit cards are served; and a network function through which the brand and the processing infrastructure are built and maintained, and contracts with issuers and acquirers are created.

In a so-called "four-party" or "open" system, these functions are provided by separate firms. Both Visa and MasterCard operate as open systems and there are thousands of issuing and acquiring banks participating in each.[44] Within a given four-party system the issuers compete with each other for customers willing to hold and use the cards they offer. As part of this competition, issuers have developed different strategies and customized card offerings.

In contrast, in a so-called "three-party" or "closed" payment system, these three functions are integrated within a single firm. Discover, for example, functions as a signature debit network, and as the acquirer and the issuer of Discover signature debit cards.

Payment systems are referred to as competing in a "two-sided" market because they serve two distinct groups of end customers (cardholders and merchants) and because the demand from each of these groups depends on the demand from the other group.[45] All else being equal, when more merchants accept a given card the more likely it is a consumer will want to hold and use

[44] Evans, David S. and Richard Schmalensee, *Paying with Plastic,* Cambridge, MA: The MIT Press, 2005, p. 12.

[45] Rysman, Marc, "The Economics of Two-Sided Markets," *Journal of Economic Perspectives*, Vol. 23, No. 3, Summer 2009, pp. 125, 128.

that card, and, conversely, higher consumer demand for using the card will make a merchant more willing to accept it.[46]

Because transactions on an open system involve multiple, independent firms, there must be terms of trade established among them. There are typically three payment system firms involved in each transaction on an open system: the network, an issuer, and an acquirer. Each plays an essential role in each debit transaction and each must be compensated for its contribution to enabling the transaction. Merchants accepting a payment system benefit from the issuers' investments in building a cardholder base. The interchange fee is the compensation the issuer receives from the merchant for providing the cardholder base it brings to the system. In the absence of this cost allocation merchants would take significant benefit from the network without compensating the issuers that created much of the benefit.

Because there are thousands of issuers and acquirers that would, absent rules set by the network, need to negotiate prices with each other, the network sets the prices acquirers and issuers pay for access to the debit card system. The prices set by the network include per transaction network service fees that are paid to the network by acquirers and issuers.[47] The terms set by the network also include per transaction interchange fees that are paid to issuers by acquirers. The network interchange fees are "default" fees that apply in the absence of an agreement between the issuer and acquirer in a given transaction. Although the network sets the default interchange fees, these fees are not revenue for the network because they are paid to issuers. The network's per transaction revenue comes instead from network service fees. A higher interchange fee, then, does not increase the per transaction margin earned by the network. If a network wants to increase its per transaction margin it would do so by increasing the network service fees.

Conditional on the level of the network service fees, network profits are higher when transaction volume is higher. The objective of the network, conditional on the level of its service fees, is to increase the transaction volume on its network. MasterCard (and each of the other four-party networks) sets the default interchange fee to maximize the volume of debit

[46] Evans, David S. and Richard Schmalensee, *Paying with Plastic,* Cambridge, MA: The MIT Press, 2005, p. 143.

[47] There are other payments flowing between issuers and the network and between acquirers and the network. I focus here on the per-transaction fees and refer to the net per-transaction payments made to the network as "network service fees."

transactions on its network by allocating the combined costs issuers and acquirers incur to provide debit service between debit cardholders on the one hand and merchants accepting debit cards on the other. Holding constant other prices and service characteristics, a higher interchange fee imposes a higher share of the costs of the payment system on merchants. Conversely, a lower interchange fee imposes a higher share of the costs of the payment system on consumers.

In general, an increase in the interchange fee has two immediate effects. It increases the acquirer's cost of providing services to merchants. As an acquirer cost, it is passed through, in whole or in part, to merchants in the form of a higher merchant discount. Because the interchange fee is paid to issuers, a higher interchange fee makes each transaction more valuable to the issuer and therefore provides a greater incentive for the issuer to compete for cardholders and card use by offering higher-quality or lower-priced products to consumers. This change in the quality and/or price of the cards offered to consumers increases their demand for card services. From the merchants' perspective, the increase in consumer demand makes accepting the card more valuable as a way to compete for sales with other merchants.

It is widely accepted by economists studying payment systems that the allocation of costs between merchants and cardholders will affect transaction volume even if it has no effect on the total price (i.e., consumer plus merchant prices) of the service.[48] That is, holding constant the sum of the fees paid by the merchant and the consumer for a given debit transaction, altering the share of those fees paid by merchants will affect the volume of debit transactions. More generally, economists agree that the level of interchange fee affects transaction volume on the payment system and is set by the network to maximize transaction volume.[49]

In an unregulated, competitive market, the volume-maximizing interchange fee chosen by the network imposes a share of the costs on the merchant. This cost allocation reflects the

[48] See, for example, Rysman, Marc, "The Economics of Two-Sided Markets," *Journal of Economic Perspectives*, Vol. 23, No. 3, Summer 2009, pp. 129–131; Evans, David S., "Two-Sided Market Definition," ABA Section of Antitrust Law, *Market Definition in Antitrust: Theory and Case Studies*, Forthcoming, pp. 6–7.

[49] "Higher interchange fees give issuers the incentive to compete for cardholders by offering greater rewards or lower cardholder fees," and "competition between payment systems for issuance recently has led to increased interchange fees." Klein, Benjamin, Lerner, Andres V., Murphy, Kevin M. and Lacey L. Plache, "Competition in Two-Sided Markets: The Antitrust Economics of Payment Card Interchange Fees," *Antitrust Law Journal*, Vol. 73, 2006, pp. 571–626 at pp. 596, 598. Also, Wright, Julian, "The Determinants of Optimal Interchange Fees in Payment Systems," *The Journal of Industrial Economics*, Vol. LII, No. 1, 3/2004, p.3

differences in demand for debit services by merchants and consumers and is consistent with market outcomes in a wide variety of services. Merchants typically pay for advertising, helpful sales staff, customer parking, and so forth without imposing user fees on customers. There is nothing that bars a merchant from asking customers to pay for parking or charging for advice provided by sales staff. Merchants, however, typically do not levy these kinds of user fees on consumers because doing so would cause the merchant to lose sales to its competitors that do not charge customers for parking or service. Similarly, merchants do not charge different prices for different methods of payment (e.g., discounts for cash) because doing so is not profitable for them. The fact that the market outcome in payment systems has the merchants bearing a share of the service cost rather than cardholders directly paying all of those costs is not an anomaly. Rather, it is an outcome based on the same retailing logic that leads the merchant to pay for other services without imposing user fees on its customers or charging differentiated prices through discounts.

Because closed payment systems do not need an interchange fee to balance merchant and consumer demand, there is no direct analog to the interchange fee for three-party systems. This does not change the economics of the payment system, however; three-party systems also allocate the cost of the payment system between merchants and consumers in a way that maximizes the transaction volume on the system. In the process, three-party systems too impose a share of the costs on the merchant.

C. Effects of the Proposed Interchange Rules

The Board has proposed an interchange fee regulation that would dramatically reduce debit interchange fees. It has done so in the absence of any evidence of a market failure that would make the market-determined interchange fees "too high" and without any economic analysis that suggests the interchange fee it proposes would increase consumer welfare. Economic theory shows that the prices set in a competitive market tend to maximize consumer welfare.[50] Economic theory also shows that market failures can occur that make the market

[50] "To evaluate a market outcome, we often ask whether it achieves economic efficiency—the maximization of aggregate consumer and producer surplus." "Welfare effects [measure] gains and losses to consumers and producers" by evaluating changes in consumer and producer surplus. "First theorem of welfare economics... states the following: If everyone trades in the competitive marketplace, all mutually beneficial trades will be completed and the resulting equilibrium allocation of resources will be efficient." Pindyck, Robert S. and Daniel L. Rubinfeld, *Microeconomics,* Sixth Ed., pp. 306, 301–303, 590.

outcome suboptimal.[51] Imposing a regulation that substitutes a public policy outcome for a market outcome is unlikely to improve consumer welfare unless there is a clear and substantial market failure that is ameliorated by the policy.

A classic example of a situation in which setting a regulated price can increase consumer welfare comes from local electricity distribution in which economies of scale make a monopoly supplier the cost-efficient outcome. In this situation, creating a regulated monopoly supplier allows for efficient service provision, and price regulation prevents the inefficient electricity pricing that would occur were the monopoly firm able to set the price unconstrained. In this situation there is an economic argument that regulation will increase consumer welfare.[52] Similarly, when there is some kind of externality involved in the supply of a service or product, the externality might provide a rationale for regulatory intervention as a means of increasing consumer welfare.[53] Economists recognize, for example, that a firm that produces pollution as a by-product of its manufacturing process will not take the social costs of pollution into account and a regulation that leads the firm to bear the cost of the pollution could improve consumer welfare.[54] In both instances, there is an economic rationale that suggests public intervention might improve on market outcomes. If, however, there is no market failure, altering the market outcome will likely reduce rather than enhance economic efficiency and consumer welfare.

Instead of conducting an economic analysis derived from evidence of a market failure that its regulatory powers might be used to alleviate, the Board has taken an approach that ignores economic efficiency and consumer welfare. It has refrained from articulating any economic logic that might enable its regulatory intervention to take the effects on consumer welfare into account. The result will almost surely be a reduction in consumer welfare.

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[51] "In some situations, a market failure occurs: Because prices fail to provide the proper signals to consumers and producers, the unregulated competitive market is inefficient—i.e., does not maximize aggregate consumer and producer surplus." Pindyck, Robert S. and Daniel L. Rubinfeld, *Microeconomics,* Sixth Ed., p. 306.

[52] "[M]arket failures; that is imperfections that lead unregulated markets to perform suboptimally relative to some social welfare function (usually the sum of consumer and producer surplus). Natural monopoly, externalities, public goods, information failures, and variations of these themes are standard normative rationales for government intervention into a market economy." Joskow, Paul L. and Nancy L. Rose, "The Effects of Economic Regulation," Ch. 23 of *The Handbook of Industrial Organization,* Vol. II, Ed. by R. Schmalensee and R.D. Willig, 1989, p. 1451.

[53] Pindyck, Robert S. and Daniel L. Rubinfeld, *Microeconomics,* Sixth Ed., p. 641.

[54] Pindyck, Robert S. and Daniel L. Rubinfeld, *Microeconomics,* Sixth Ed., pp. 641-643.

An economic analysis that concludes that the interchange fee should be reduced by regulation to enhance consumer welfare must first consider whether there are any facts showing that the market fee is "too high." If there were such evidence, a corollary to that determination would be that the quantity of debit services is "too low." Again, the natural monopoly example is instructive. The regulatory challenge posed by a monopoly distributor of electricity is that the firm will charge a price for electricity that is higher than the competitive price. That high price will cause its customers to purchase less electricity than they would at the lower, competitive price. Compared to the outcome that would maximize consumer welfare, the market price would be too high, and the quantity of electricity consumed would be too low.

Not only has the Board conducted no analysis that leads to the conclusion that the interchange fee is too high, the regulation it has proposed would *reduce* the quantity of debit services consumed. Because the market-determined interchange fee maximizes the volume of debit transactions, altering the allocation of the cost of debit card services will necessarily reduce the volume of debit transactions in the U.S. The dramatic reduction in interchange fees proposed by the Board would — as it acknowledges — lead to higher consumer prices for debit services in the form of issuer charges to debit cardholders.[55] The higher relative price for debit services faced by consumers will induce them to substitute to credit cards, cash, and checks for many of the transactions for which debit cards are used given current market prices. The change proposed by the Board would therefore lead to fewer transactions that rely on debit cards and more that rely on other payment systems.[56]

The Board has offered no economic analysis that would enable it to conclude that shifting transactions from debit cards to credit cards, cash, or checks will enhance consumer welfare. In fact, as I show below, economic logic implies that this regulation will make consumers worse off than they are in the unregulated market.

To trace through the effects of a reduction in the interchange fee, we need to examine its impacts on issuers, merchants, and consumers. Because the interchange fee is paid to issuers, a reduction in it has the same impact as an increase in their debit transaction costs. Because the

[55] Notice, p. 71.

[56] The Board has calculated that the average interchange fee for PIN debit is $0.23 or 0.56 percent of the transaction amount; the average for signature debit is $0.56 or 1.53 percent of the transaction amount, and the average for pre-paid cards is $0.50 or 1.53 percent of the transaction amount. Notice, p. 27.

interchange fee contributes to the fees charged to merchants, the effect on them of a reduced interchange fee is similar to a reduction in the transaction fees they pay for debit card services.

1. The Impact of the Interchange Fee Regulation on Issuers and Consumers

For an issuer the interchange fee is a source of revenue which partially compensates it for the benefits it creates for merchants. If an issuer does not receive interchange fees or receives fees at inadequate levels, it cannot cover its current cost of creating merchant benefits, including — but not limited to — the cost of transaction authorization, clearance, and settlement. Issuers also incur other costs, including those related to customer service, reward programs, fraud prevention and fraud losses, marketing, and overdraft management. These costs support activities that are essential to creating benefits for merchants. An issuer can incur these costs because they are (at least partially) offset by the interchange fee. Because the interchange fee partially offsets the per transaction cost incurred by the issuer, it affects the per transaction "price" the issuer charges the cardholder for debit service.[57] When the interchange fee rises, competition among issuers leads them to pass some or all of the resulting cost reduction on to cardholders in the form of lower fees or increased benefits or enhanced services. Conversely, if the interchange fee were to decline — especially to the extent envisioned in the proposed rule — issuers would pass on some or all of the cost increase to cardholders in the form of higher fees, reduced benefits, or reduced services.

One source of evidence on this point comes from the observed effect on the prices charged to cardholders by issuers of credit cards in Australia when the Reserve Bank of Australia (RBA) imposed a cap on average interchange fees for Visa and MasterCard credit cards.[58] The regulation required the average interchange fee on Visa and MasterCard credit card transactions to decline from 0.95 percent to 0.5 percent of the transaction value.[59] The RBA reports that the reduction in interchange fees on Visa and MasterCard credit cards resulted in higher cardholder

[57] For expositional simplicity, I refer here only to price, but that term should be construed to include the vector of fees, rewards, and other characteristics that affect the quality-adjusted price of the debit transaction to the cardholder.

[58] Reserve Bank of Australia Payment System Reforms, at http://www.rba.gov.au/payments-system/reforms/index.html.

[59] "Reform of Australia's Payment System: Issues for the 2007/2008 Review," Reserve Bank of Australia, 5/2007, p. 19, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-issues.pdf.

fees for credit cards as well as a reduction in the value of cardholder reward programs.[60] Annual fees increased by about 40 percent and fees for cash advances, late payment, and over-the-limit transaction also increased.[61] In total, average fees on personal credit cards increased from around AUS $40 per account prior to the regulation to around AUS $80 per account three years after the regulation.[62] Credit card rewards declined by more than 20 percent over the same period.[63] Overall, the RBA found that the effective cardholder price for a $100 credit card transaction increased by 20 cents.[64] More difficult to measure is the reduction in product quality that may have been caused by this regulation as issuers responded to an increase in cost by limiting their investments in cardholder services. The analogy to the rule proposed by the Board for debit interchange in the U.S. is straightforward: consumers will pay more for debit card transactions under the proposed interchange fee cap regulation.

Furthermore, increasing the consumer cost for debit card services is likely to disproportionably affect low-income consumers. Low-income consumers are less likely to have credit cards and, when faced with a higher cost of debit, may be unable to switch to a credit card for transactions. Instead they will need to rely on cash, which is inconvenient and has a higher risk of loss, or on checks, which are not widely accepted by merchants.[65]

The Board has anticipated that the price cardholders pay for debit services will increase if the debit interchange fee is reduced by regulatory fiat: "[t]he Board notes that...issuers have sources of revenue in addition to interchange fees, such as cardholder fees, to help cover their

[60] "Reform of Australia's Payment System: Issues for the 2007/2008 Review," Reserve Bank of Australia, 5/2007, pp. 22–23, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-issues.pdf.

[61] "Reform of Australia's Payment System: Issues for the 2007/2008 Review," Reserve Bank of Australia, 5/2007, p. 23, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-issues.pdf.

[62] "Reform of Australia's Payment System: Issues for the 2007/2008 Review," Reserve Bank of Australia, 5/2007, p. 23, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-issues.pdf.

[63] "Reform of Australia's Payment System: Issues for the 2007/2008 Review," Reserve Bank of Australia, 5/2007, p. 23, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-issues.pdf.

[64] "Reform of Australia's Payment System: Preliminary Conclusions of the 2007/2008 Review," Reserve Bank of Australia, 4/2008, p. 17, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-pre-conclusions.pdf.

[65] "Grocery Chain to Test No-Checks Policy," *American Banker*, 12/31/2009, Vol. 174 Issue 231, p9.

costs."[66] Despite acknowledging that costs will be shifted to cardholders, the Board has not conducted an analysis of how this shift will affect consumers.

Economics tells us that as the price of debit card services rises, consumers will use debit cards less than they otherwise would have. In addition to the academic studies of substitution across payment types cited earlier, the evidence in Australia is also consistent with this prediction. In Australia a reduction in the credit card interchange fee led to slower growth in the volume of credit card transactions while the growth rate of debit card transaction increased over the same period.[67] The RBA concluded that the increase in the total cardholder price for debit services affected consumers' choices of payment methods, and pointed to slower growth in the number of credit card transactions and a contemporaneously more rapid growth in the number of debit card transactions as evidence of substitution by consumers across payment systems.[68]

In the case of the Board's proposed reduction in the *debit* interchange rate, this implies that the interchange fee cap would cause the volume of debit card transactions to decline and the number of credit card transactions to increase relative to the volumes that would have been the market outcome. Given that debit cards are also alternatives to cash and checks, some of the reduction in debit card transactions might be absorbed by these other payment methods. Again, there is no analysis in the proposed rulemaking of the effect these shifts would have on overall economic efficiency or on consumer welfare.

The increase in the cardholder price of credit cards in Australia occurred because the cost of credit card services was shifted from merchants to cardholders. All else equal, this implies that Australian credit cardholders were harmed by the regulatory intervention there. The RBA maintained when it imposed the regulatory cap on the interchange fee that this loss to cardholders would be offset by a decline in retail prices for goods and services facing all consumers. The RBA anticipated that merchants would respond to the reduction in the cost of credit card services by lowering the prices they charge for the goods and services they sell. Although the RBA has sought confirmation of the anticipated decline in retail prices, it has been

[66] Notice, p. 71.

[67] "Reform of Australia's Payment System: Preliminary Conclusions of the 2007/2008 Review," Reserve Bank of Australia, 4/2008, p. 19, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-pre-conclusions.pdf.

[68] "Reform of Australia's Payment System: Preliminary Conclusions of the 2007/2008 Review," Reserve Bank of Australia, 4/2008, p. 19, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-pre-conclusions.pdf.

unable to find any evidence that retail prices have actually declined.[69] The Australian evidence clearly shows that cardholders faced higher prices for credit card services; it does not provide any support for the claim that this loss in consumer welfare will be offset by lower retail prices for goods and services.

Again, the analogy to the proposed debit regulation in the U.S. is straightforward. Consumers will lose from the imposition of higher costs for debit services. It is more difficult to conclude that there will be an offsetting, indirect gain from lower retail prices. Nor has the Board made any claim that the loss to consumers from higher debit card prices will be offset by lower prices for goods and services.[70]

Consumers will also be affected by a reallocation of investment by issuers in response to the reduction in interchange fees. As described above, issuers will pass on at least some of the reduced interchange payments to cardholders in the form of higher card fees and reduced card benefits. While the increased cardholder prices and reduced cardholder benefits will offset some of the revenue issuers lose from reduced interchange fees, the net effect will be to reduce issuer profit. This follows from the observation that an increase in cost will not increase profit. Given the reality of reduced profitability in debit cards, issuers will reallocate their marketing efforts, reducing promotional expenditure on debit cards and increasing it on other products. In particular, the large issuers that issue both credit cards and debit cards will promote credit cards more and debit cards less. This reallocation will exacerbate the shift of transactions from debit cards to credit cards.

Issuers are also likely to reallocate investments in service and product development to other, more profitable products. The market currently supports a wide range of debit products that are differentiated in several dimensions: the cards offer different rewards and different fraud protection features, for example. This diversity, which benefits a consumer base with diverse preferences, is supported by issuer investments. These investments will likely be curtailed as

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[69] "Reform of Australia's Payment System: Preliminary Conclusions of the 2007/2008 Review," Reserve Bank of Australia, 4/2008, pp. 22–23, at http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-pre-conclusions.pdf.

[70] The Chairman of the Federal Reserve Board of Governors, Dr. Ben S. Bernanke testified that there is no guarantee that merchants will pass on the savings from reduced interchange fees to consumers. Transcript of February 17, 2011 Hearing before the Senate Banking Committee on Implementing Provisions of the 2010 Financial Regulatory Overhaul Law, p. 60.

interchange fees are squeezed. The Board has conducted no analysis of how a reduction in the variety of debit cards available in the market will affect consumers.

The Board has acknowledged that issuers will have an incentive to shift their product portfolios away from debit cards and toward some less regulated alternative. "[T]he Board understands that there may be incentives for some issuers to design or offer products with 'credit-like' features in an effort to have such products fall outside the scope of the interchange fee restrictions to be implemented by this rulemaking."[71] This incentive is treated by the Board as a regulatory problem rather than as a problem for economic efficiency and consumer welfare. As described in the proposal, the Board is concerned that the issuers may try to circumvent the debit interchange fee cap by inventing some new payment mechanism that is debit-like but does not fit the regulation's definition of debit cards. The issuers' incentives to do this are clear and the Board is correct that its proposal creates strong incentives to move to alternative products that fall outside the regulation.

2. The Impact of Interchange Fee Regulation on Merchants

While merchants are the apparent beneficiaries of the regulation, the effect on them may be less favorable than it initially seems. The immediate effect of a reduction in interchange fees will be to lower the cost of debit card transactions to merchants, assuming that acquirers pass the reduction through to merchants. If merchants are able to avoid competing away the benefit of this cost reduction, their margins on transactions made with debit cards would increase. While this would benefit merchants, it implies that consumers would bear the increase in the cost of payment services with no even partially offsetting decline in the cost of goods and services they purchase.

In the long run, however, it is not obvious that merchants will benefit or that any benefit accruing to some merchants will be realized by all or even most merchants. Debit cards have been commercially successful because this payment method is attractive to consumers and merchants at current prices. Imposing a regulation that reduces the prices faced by merchants and increases the prices faced by consumers will results in a decline in the volume of debit transactions. That decline will reduce the share of merchant transactions that are made with

[71] Notice, p. 42.

debit cards as consumers choose some other payment system, perhaps one that is more costly to the merchant.

Even at market prices, debit is often less expensive for merchants than other payment methods. One often-cited study finds that debit cards are the lowest-cost payment method for merchants for some transactions (e.g., for a $100 transaction at a grocery store).[72] Hence, as consumers respond to the reduction in debit card benefits and the increase in debit card fees by substituting to cash, checks, or credit cards, the merchant cost for payment services may rise. As noted earlier, a shift from debit cards to checks would expose merchants to an increased risk that no payment is received, and would also increase check-out times. A shift to cash for some transactions would increase merchants' cash handling and labor costs and increase the risk of counterfeit bills and employee theft. The current interchange fee for credit transactions is higher than the current interchange fee for debit transactions so that consumer substitution from debit to credit will lead to an increase, not a reduction, in the cost of payment services for merchants. The number of transactions (e.g., internet transactions) for which cash and checks cannot be used is increasing, a change that implies that substitution from debit cards to credit cards, rather than to checks or cash, will be increasingly common.

3. The Proposed Rule Will Disadvantage Small Issuers

Because payment card issuance is characterized by economies of scale, larger issuers, holding product mix constant, have lower costs.[73] It is likely, for example, that the higher cost issuers among those surveyed by the Board are disproportionately smaller issuers.[74] This is implicit in the difference between the simple and weighted average transaction costs reported by the Board. The simple average of variable costs, which weights all issuers equally, is $0.13, but

[72] Garcia Swartz, Daniel D., Hahn, Robert W. and Anne Layne-Farrar, "The Move Toward a Cashless Society: Calculating Costs and Benefits," *Review of Network Economics,* Vol. 5 Issue 2, 6/2006, p. 201, Table 2-1. The data used in this study is somewhat dated, but I was unable to find a similarly comprehensive study with more recent figures.

[73] Levitin, Adam, "Interchange Regulation: Implications for Credit Unions," Filenes Research Institute, 2010, p. 39.

[74] Notice, p. 72.

the weighted average, which gives more weight to larger issuers, is $0.04.[75] It follows that the smaller surveyed issuers have costs above the $0.12 cap proposed by the Board. Importantly, the Board did not include exempt issuers in its survey, so the smaller high-cost issuers it surveyed will be subject to the regulatory cap on the interchange fee. As a result, the interchange fee cap will exacerbate the competitive disadvantage already borne by small, high cost issuers.

Exempt issuers are even smaller than those surveyed by the Board and therefore likely to have even higher costs. Because these institutions are exempt from the regulation, it is possible that the networks will set a higher default interchange fee for them. It seems unlikely, however, that the competitive marketplace would sustain such a two-tiered approach. Merchants would have strong incentives to discriminate against the more expensive exempt cards. This would drive cardholders to use other forms of payment and would put downward pressure on the exempt interchange rates.[76]

Another way these exempt issuers would be negatively affected by the fee cap is that it would induce large issuers to shift their investment away from the debit systems. It is the large issuers that are responsible for generating the volume necessary to sustain the national and global debit systems. This is clear from thinking about an extreme case: few merchants would accept a debit product promoted only by very small banks and credit unions.

To the extent that smaller issuers are particularly disadvantaged by the regulation, it is likely that the proposed interchange fee cap will lead to increased concentration of debit services among very few, very large, and very efficient issuers. In addition, because debit cards are used as the sole method of accessing bank accounts by 60 percent of consumers, it is possible that an increased concentration in debit card issuance would lead to increased concentration in personal bank account holdings as consumers move their accounts to banks that issue debit cards. Not only would this further reduce competition in banking services, it would have a detrimental effect on small issuers for which providing bank account services is an important component of

[75] Levitin, Adam, "Interchange Regulation: Implications for Credit Unions," Filenes Research Institute, 2010, p. 39.

[76] The view that a two-tiered interchange system might not be sustainable was acknowledged by Dr. Bernanke, the chairman of the Federal Reserve Board of Governors in recent congressional testimony. He noted that merchants may not accept debit cards with higher interchange fees and networks might be unwilling to set two different rates. Transcript of February 17, 2011 Hearing before the Senate Banking Committee on Implementing Provisions of the 2010 Financial Regulatory Overhaul Law, p. 79.

their service offerings, but which lack the scale necessary to be efficient debit issuers.[77] The Board has not offered any analysis of the effect on consumer welfare (or community institution welfare) of increased concentration among the providers of debit services.

4. Three-Party Networks and Emerging Payment Systems May Be Competitively Advantaged by Incomplete Regulation

While the Board has correctly taken the position that that the regulatory framework should apply to both four-party and three-party debit networks, the proposed rule has been developed for four-party networks, and the Board has acknowledged that it has yet to fashion a similar regulation for the three-party networks.[78] To avoid inefficient distortions of competition in debit systems, the Board should apply equivalent regulatory requirements to different types of networks; the competitive consequences of failing to do so could be significant. As I have pointed out, dramatically reducing the interchange fee will limit the four-party networks' ability to compete for issuer services and for cardholders. If there is no similar limit on the per transaction payment a three-party system can charge merchants or the per transaction benefits it can offer to cardholders, the regulatory disparity will give a competitive advantage to three-party systems.

Absent regulation, four-party payment systems have been at least as successful as three-party systems. A preferential regulatory status for three-party systems may change that. Not only would this alter the market equilibrium, it would reduce the share of consumers who get the benefit of competition among issuers that characterizes four-party systems. Discover debit cards are overwhelmingly issued by Discover; Visa and MasterCard debit cards are offered by thousands of competing issuers.

The regulatory dilemma posed by the three-party systems will also arise with the currently available debit-like systems (e.g., PayPal) that compete with traditional debit payment systems and with any new payment system that is sufficiently "debit-like" to be considered subject to the regulation. The characteristics of these payment systems may well differ from those of the traditional four-party debit systems in ways that make it challenging to apply a

[77] Levitin, Adam, "Interchange Regulation: Implications for Credit Unions," Filenes Research Institute, 2010, p. 36.

[78] Notice, pp. 35–36.

common regulatory regime. If these challenges are not overcome, the regulation will impose a competitive disadvantage on the regulated systems relative to these new payment systems.

Any change in the marketplace created by the disadvantages to four-party debit systems imposed by the regulation would have at least three effects. It would, as discussed above, decrease the competition from which consumers currently benefit and lead to a shift in share to unregulated systems that moves the economy away from the competitive market outcome. It would also make the regulation itself less effective. As the share of covered transactions shrinks, the goal of imposing interchange fees that are "reasonable and proportional to cost" becomes more difficult to attain.

D. A Below-Cost Interchange Fee Cap Would Exacerbate These Effects

Any substantive reduction in the interchange fees for debit cards will lead to higher debit service prices for cardholders and to a reduction in the use of debit cards. The draconian reduction currently proposed by the Board will have pronounced effects on debit card prices and usage. All issuers, including the most efficient, currently have costs above the proposed interchange fee cap of $0.12 per transaction. The proposed fee cap is substantially below many issuers' current costs even considering only the narrowly defined "allowable" costs in the proposed rule.

1. The Proposed Interchange Cap is Below the Board's Measure of Variable Cost

The Board has interpreted the language of the Durbin Amendment to mean that the interchange fee should be (approximately) equal to the cost currently incurred by issuers for a very small subset of issuer activities. Although the statute refers to "incremental cost," the Board has chosen to consider only a very narrow set of costs that excludes many costs economists normally treat as incremental. Its definition of allowable cost (limited to what the Board refers to as "per transaction variable processing cost") includes only (some of) the costs of authorization, clearance, and settlement that can be tied to a specific debit transaction, thereby excluding other transaction-specific costs.[79] I address the lack of any economic foundation for

[79] Notice, p. 58. For example, this excludes costs related to customer service, reward programs, fraud prevention and fraud losses, marketing, and overdraft management. Note that even within the cost categories defined as allowable by the Board, certain costs are excluded. For example, allowable

this definition of incremental cost in the section below. First, however, I point out that the interchange fee cap proposed by the Board is below its own measure of incremental cost for many banks.

To develop cost estimates the Board conducted a survey of issuers that requested information on costs related to the authorization, clearance, and settlement (collectively "processing") of a transaction. Based on the survey responses, the Board determined that the median variable per transaction processing cost for the survey respondents was $0.071[80] and that the average was $0.13.[81] The Board also reported that 20 percent of the responding issuers have a variable per transaction cost above $0.13.[82]

An interchange cap of $0.12 per transaction, then, implies that more than 20 percent of the issuers surveyed have an allowable cost that is above the cap proposed by the Board. Even if one were to accept the definition of allowable cost proposed by the Board, a substantial share of the current issuers would be operating below allowable variable cost if they were to rely on the regulated interchange fee to cover their costs. It is well-established in the economics literature that no firm will continue to operate at a price below variable cost. The Board justifies a cap below its measure of variable cost for a substantial share of existing issuers by claiming that it "does not believe it is reasonable for the interchange fee to compensate an issuer for very high per transaction costs" and noting that banks have other sources of revenue, presumably a reference to cardholder fees.[83] The Board, however, has undertaken no analysis to suggest whether any of the issuers' costs are, as an economic matter, "very high." Such an analysis would require an assessment of many factors, including issuer efficiency, service quality, and product design to determine whether reimbursement for the underlying costs would be appropriate. Indeed, it is possible that some of the issuers with the highest costs actually offer products that provide more value relative to cost than the products offered by their competitors. The Board would have no way of knowing this because the Board undertook no such analysis.

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authorization costs exclude costs related to fraud prevention in connection with authorization, and allowable clearance costs exclude costs related to receiving cardholder inquiries about particular transactions. Notice, pp. 159–160.

[80] Notice, p. 28.

[81] Notice, pp. 71–72.

[82] Notice, p. 72.

[83] Notice, p. 71.

Although it conducts no efficiency analysis, the Board notes that there could be many reasons for issuers to be relatively high-cost, including offering high-cost cards to customers who prefer the card characteristics associated with higher interchange debit cards.[84] For example, the fee cap likely makes unprofitable some kinds of debit cards that currently offer per transaction rewards in the form of cash back or reward program points. The Board also has proposed a fee cap that makes unprofitable many non-reloadable prepaid cards. The Board reports that the median per transaction variable cost for prepaid cards is $0.258, more than twice the magnitude of the proposed interchange fee cap of $0.12.[85] Given the proposed cap, at least half — and probably a much larger percentage — of the surveyed issuers of prepaid cards would not be able to cover their costs for these cards. In view of the importance of these products to lower-income, unbanked, and underbanked consumers, this result seems particularly difficult to justify from a consumer welfare perspective.[86]

The Board, with no economic analysis or rationale, has decided that both higher-cost firms and higher-cost card types that provide services preferred by some consumers should be penalized by the regulation even though these firms and products are able to compete at current market prices. By setting a cap that makes these products unprofitable, the Board has arbitrarily limited the diversity that currently characterizes issuers and creates choice for consumers. The Board has undertaken no economic analysis that would enable it to conclude that reducing the diversity of issuers and products in the market would enhance consumer welfare.

2. True Incremental Cost Is Higher than the Cost Considered by the Board

The Board acknowledges that an interchange fee that covers all of what it defines as variable per transaction costs would still not cover all the debit processing costs incurred by issuers. It estimates "per transaction *total* processing costs" to be $0.119 for the median issuer.[87] That is, half the issuers surveyed are incurring per transaction costs for debit transactions that are

[84] Notice, p. 71.

[85] Notice, p. 28.

[86] FDIC National Survey of Unbanked and Underbanked Households, Executive Summary, 12/2009, p. 5, at http://www.fdic.gov/householdsurvey/Executive_Summary.pdf and http://www.economicinclusion.gov/print_pdfs/Key_Findings_Unbanked.pdf.

[87] Notice, pp. 27–28.

higher than the proposed cap of $0.12 per transaction. As is the case for its estimates of variable per transaction processing costs, the Board's survey reveals differences in total per transaction processing costs across debit card types. The Board estimates that the median total per transaction processing cost is $0.137 for signature debit, $0.079 for PIN debit, and $0.636 for prepaid cards.[88]

The Board's estimates of total processing cost are substantially lower than those estimated by other parties. According to the survey of issuers conducted by Edgar Dunn Company (EDC) at the request of MasterCard, issuers incur costs related to authorization, clearance, settlement, and to the processing of debit transactions overall, that are much higher than the Board's estimates.[89] If the EDC is correct, this implies that the cap proposed by the Board is dramatically below cost. I have not undertaken a cost study and have no opinion on whether the actual costs are closer to the levels estimated by EDC or by the Board, but the wide range of these estimates implies that further study is warranted before using cost measures developed by the Board to impose a very low interchange fee cap.

What is clear without a full and detailed exploration of the costs borne by issuers is that the Board's definition of allowable cost is inconsistent with the concept of incremental cost that is standard in economic analysis. In applying its definition of variable cost, the Board has chosen to exclude all costs that do not increase with an additional debit transaction. That is, if the cost at issue does not increase when one more transaction is processed, the Board has decided it should not be included in variable costs. This definition excludes many costs that are properly viewed as incremental as acknowledged by the Board:

> "There is no single, generally-accepted definition of the term 'incremental cost.' One commonly-used economic definition of 'incremental cost' refers to the 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. Other definitions of incremental cost consider the cost of producing some increment of output greater than a single unit but less that the entire production run. [references omitted]."[90]

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[88] Notice, p. 28.

[89] Edgar Dunn & Company, "A Review of Issuer Electronic Debit Transaction Costs: Discussion with Staff at the Federal Reserve Board," 11/16/2010, pp. 3, 18.

[90] Notice, p. 64.

The first definition of incremental cost cited by the Board was developed specifically for multiproduct firms,[91] a context well suited to the analysis of an issuer's decision to offer debit cards. It captures the costs incurred by the firm when it supplies a product as an increment to its existing products. The decision to offer another product will take into account the incremental cost of offering it (i.e. the difference in the firm's costs with and without the new product). This is an appropriate framework for considering the decision to offer debit services. Each issuer and network supplying debit services supplies other services as well. MasterCard, for example, provides network services for credit cards and debit cards. Citibank issues credit cards and debit cards, accepts demand deposit accounts, and offers many other retail banking services. In both cases, the decision to supply debit services is a decision to supply a product as an increment to its other products.

The second definition of incremental cost cited by the Board accommodates costs that may be specific to an increment larger than a single transaction. For example, expansions of processing capacity to accommodate growth in demand are often lumpy. Issuers invest in additional capacity to process many – not just one – additional transactions. While the Board implicitly recognizes that variable costs include those costs that are necessary to meet additional demand, it makes no provision in its allowable cost for the incremental costs of additional capacity.[92]

Instead of using the definitions of incremental cost that are standard in economic analysis, the Board uses a definition that it believes will "appropriately reflect the incremental cost of a particular transaction to which the statute refers."[93] I have no expertise in interpreting statutes, but I can point out that the interpretation made by the Board has economic consequences that do not appear as objectives of the legislation. For example, the Board's interpretation implies that investments in infrastructure necessary to accommodate demand in a growing market are not properly incremental. Under its treatment of allowable cost, the costs necessary to achieve an increase in transaction volume to meet the growth in demand for debit services would have to be funded by fees paid by current cardholders. This is particularly odd because it is the

[91] Baumol, William J., Panzar, John C. and Robert D. Willig, *Contestable Markets and the Theory of Industrial Organization*, Harcourt, Brace, Jovanovich, 1988, pp. 65–67.

[92] "In contrast, fixed costs are those costs that do not vary with changes in output up to existing capacity limits within a calendar year." Notice, pp. 160–1.

[93] Notice, p. 64.

merchant that benefits from the expansion of the debit card network. The consumer gets no direct benefit from an increase in debit card transaction volume, but the value of the payment system to the merchant directly increases with transaction volume.

Alternatively, suppose an issuer wants to introduce an innovative product that would attract many new cardholders and, correspondingly, make the product more attractive as a payment mechanism for merchants. Not only would the research and development for that new feature be excluded from allowable costs, the costs of launching and distributing the card to new cardholders and the investment in additional infrastructure to serve them would also be excluded.

The Board offers no analysis of the economic consequences of its proposed regulation and only assumes that the issuers can fund these activities by levying additional fees on cardholders. From an economic perspective, variable cost properly includes all costs that vary with output, including investment in infrastructure, R&D, and other capital expenditures made to create capacity for future debit transaction and/or enable new debit services. If issuers cannot anticipate earning a normal return on their investments in debit cards, they have no incentive to invest in them. The Board has proposed a regulatory regime in which innovation and growth are discouraged.

The Board also offers no explanation for why all but a narrow subset of the costs of debit are properly borne by cardholders rather than by merchants. The benefits merchants gain from using debit surpass the costs they currently pay to use this payment method. If that were not true, merchants would refuse to accept debit cards. The rule proposed by the Board implies that merchants will pay no more than a small fraction of the substantial per transaction benefit they receive from using the debit payment system.

IV. Proposed Exclusivity Rules

One of the two alternatives for the exclusivity rule that the Board is considering (Alternative B) would require that each card with signature debit functionality be enabled to process signature transactions over at least two signature debit networks. This requirement, in conjunction with the proposed routing rule that would allow the merchant to choose which of these networks to use for a given signature debit transaction, would have a profound negative effect on competition.

Currently, a firm that decides to issue a signature debit card has the choice of issuing it on one of several debit systems, and once that choice is made, can choose how much to invest in marketing, card program development and services, and distribution of the cards it issues on that network. Both the decision to issue cards on a given signature debit network and the subsequent investment it makes in promotional activity increase transaction volume for that signature network and are therefore valuable to the network. As a result, networks compete with each other to be the one signature network on the card. Issuers, particularly large issuers, take advantage of this competition by engaging the networks in a bidding war for the right to be the sole signature network on the debit card.

It is important to note that the exclusivity at issue here is quite limited and does not reduce competition. One of the advantages of the four-party payment system structure is that there are many competing issuers. A contract in which an issuer agrees to offer some debit cards that can run only on the Visa network does not prevent MasterCard from competing for that contract, nor does it prevent MasterCard from entering into contracts with other issuers. Furthermore, some issuers issue "exclusive" debit cards for more than one network.[94] As a result, currently there is robust competition for issuer services between Visa and MasterCard as acknowledged by the Board.[95]

Consumers and merchants benefit from this competition. To make their services attractive to issuers, payment systems must make their products attractive to consumers. Competition for cardholders has been instrumental in producing innovations such as new security features, "zero liability" policies, insurance coverage, and many other card enhancements, as each network innovates to distinguish itself from the competition. Merchants also benefit from competition between debit systems because networks need wide merchant acceptance to be successful. Indeed, consumers (and therefore issuers) will move away from cards that are not accepted by many merchants. The need for wide merchant acceptance ensures that market-based interchange fees for debit cards are low relative to the value they provide to merchants. Merchants not only accept the cards; many actively encourage their use through

[94] For example, in 2009 JPMorgan Chase was among the top ten issuers of Visa signature debit cards and also among the top ten issuers of MasterCard signature debit cards. Nilson Report, Issue 947.

[95] Notice, pp. 111–112.

merchant-funded promotions.[96] If the value merchants receive from debit cards did not exceed the cost, merchants would not accept the cards and consumers would therefore not carry or use them. A number of larger merchants take advantage of this fact to negotiate substantially discounted acceptance costs from MasterCard and Visa.

The proposed rule's Alternative B would undermine this competition that benefits consumers and merchants, and replace it with a scheme in which, at best, only merchants benefit. Alternative B would reduce the incentives of the networks to compete with each other for issuer services and cardholder loyalty. Currently, MasterCard benefits every time a consumer chooses to use a debit card exclusive to its network because each use of the card increases MasterCard transaction volume. If consumers can no longer choose to transact on the MasterCard network because the merchants can divert the transaction to, say, the Visa network, MasterCard's incentive to compete and innovate for the benefit of consumers is severely reduced. Some share of the transaction on the "dual network" card will be processed by Visa rather than by MasterCard and make no revenue contribution to MasterCard. Network competition then shifts almost entirely to the merchant side, with each network competing to convince the merchants to prefer its brand.

Indeed, the sole impact considered by the Board in proposing this regulation appears to be its potential for increasing competition by the networks for merchants. The Board, however, has offered no analysis that would demonstrate that competition among the debit networks for merchants is currently insufficient to provide an economically efficient outcome. As noted above, some large merchants currently have negotiated substantial discounts from the debit networks.

Even if increased competition for merchants by networks benefited merchants, it would impose a cost on consumers. Because the merchant rather than the consumer would choose the debit network for a given transaction, competition for consumers would decline. The networks would have very little incentive to promote the use of cards by consumers because the consumers would no longer be the decision makers. MasterCard's incentive to invest in innovative services

[96] For example, a "merchant-funded website, MasterCard MarketPlace operates like a rewards program, but with no commensurate cost to a financial institution. Cardholders simply enroll for free, indicating their merchant category preferences in an engaging user interface. They then can choose the coupons or discount codes they want and use them whenever they make purchases with their MasterCard consumer debit, credit, or prepaid card." http://www.mastercard.com/us/company/en/whatwedo/marketplaceb2b.html

targeting consumers would be dramatically reduced if there were a chance that the consumers' use of the card would benefit the competing network on the card as much as or more than it benefited MasterCard. In fact, the Board acknowledges that "[f]rom the cardholder perspective, however, requiring multiple payment card networks could have adverse effects"[97] because the cardholder would be unable to control and may not even know over which network the transaction was routed. The cardholder's inability to choose the network for the transaction, the Board notes, would "reduce the likelihood that the cardholder would be able to obtain benefits that are specific to a particular card network."[98] That, in turn, would reduce the network's incentive to invest in features that benefit cardholders.

Coupled with the cap on interchange fees, the exclusivity provision will shift the *benefits* of competition to merchants while shifting the *costs* of the cards to consumers. Because the interchange fee under the Board's proposal is capped below cost, the cardholder will be forced to bear a much larger share of the cost than under the current, competitive regime as the networks try to cover their costs by raising cardholder prices. At the same time that the consumer is asked to pay a higher price for using debit cards, the consumer is denied the benefits that come from competition among the networks for cardholders. The Board has offered no rationale for imposing regulations that are so clearly anti-consumer.

[97] Notice, p. 112.

[98] Notice, pp. 112–113.

Exhibit A

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PAPERS AND PUBLICATIONS:

"The Technology of Risk and Return," American Economic Review, June, 1981.

"Self-Selection and the Pricing of Bank Services, An Analysis of the Market for Bank Loan Commitments and the Role of Compensating Balance Requirements," Journal of Financial and Quantitative Analysis, December, 1981.

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CURRENT RESEARCH:

"Industry Conditions and the Terms of Bank Lending" with A. Kizilaslan.

"Distress Costs in Crisis: The Determinants of Debt Restructurings and Bankruptcy" with C. Demiroglu.

"Credit Market Conditions and the Determinants and Value of Banking Relationships, (with C. Demiroglu and A. Kizilaslan), under review.

"Works of Friction? Originator-Sponsor Affiliation and Losses on Mortgage Backed Securities", (with C. Demiroglu), under review.

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OTHER PAPERS AND PUBLICATIONS:

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"Loan Rate Indexation and the Allocation of Bank Credit," Proceedings of a Conference on Bank Structure and Competition, May, 1980.

SERVICE ACTIVITIES:

Editor: Journal of Banking and Finance, 2007-present.

Associate Editor: Journal of Financial Economics, 1993-present.

Associate Editor: Journal of Financial Services Research, 1989-present.

Associate Editor: Journal of Managerial and Decision Economics, 1988-present.

Editorial Board: Federal Reserve Bank of New York: Economic Review, 1997- 2007.

Academic Board: Turnaround Management Association, 1990-2002.

Associate Editor: Journal of Banking and Finance, 1999-2001

Associate Editor: Journal of Finance, 1988-2000.

Co-Editor: Journal of Financial Intermediation, 1988-1999.

Associate Editor: Journal of Financial and Quantitative Analysis, 1982-1984.

Reviewer: Journal of Finance; Journal of Money, Credit and Banking; Journal of Financial Economics; Journal of Financial Management; Journal of Banking and Finance; Journal of Business and Economics; Journal of Monetary Economics; American Economic Review; Journal of Political

Economy; Review of Financial Studies; Journal of Corporate Finance; Journal of Law and Economics; Journal of Accounting and Economics.

Program Committee: Financial Management Association, Western Finance Association, American Finance Association, European Finance Association and Utah Winter Finance Conference.

CONSULTING/EXECUTIVE EDUCATION ACTIVITIES:

Board of Directors/Chairman, ID^2, Inc.

Senior Advisor, Cornerstone Research.

Independent Distribution Consultant, Janus Funds

Advisory Board Big Brothers Big Sisters of North Central Florida 2000-present.

Advisory Board and Board of Directors, SunTrust Banks of Florida 1989-2006.

Consultant, Federal Reserve Bank of New York, 1997, 2004.

Consultant, Federal Reserve Board of Governors, 1995, 1998.

Research Director, Garn Institute of Finance, Salt Lake City, Utah, 1987-1989.

Instructor, Pacific Coast Banking School: Commercial Lending, Financial Markets, Workout Lending.

Instructor, Bank Board of Directors School: Workout Lending.

Instructor, Swiss National Bank, Gerzensee, Switzerland, Bank Safety and Soundness Regulation.

Executive Seminars on bank deregulation, valuation, venture capital, strategic management, lender liability, and asset and liability management.

Expert Witness: Cases involving antitrust, portfolio management, securities valuation, bank management, valuation, and regulatory matters.

Consultant: Product pricing, valuation, portfolio management, utilities regulation, valuation of securities, mergers and acquisitions, and risk management.

Consultant to the Office of the Comptroller of the Currency, 1982-1983: Bank and Thrift Mergers.

Consultant to the Investment Company Institute, 1983: Bank Offerings of Mutual Funds.

Consultant to the FDIC, Costs of Resolving Bank and Thrift Failures.

Recipient of a grant from MidAmerica Institute to study management compensation in banking, 1992.

Recipient of grant from Federal Home Loan Bank Board to study the information content of savings and loan accounting information.

Member: Research Committee: Garn Institute of Finance, 1989-1992.

Research Associate at the Business Regulation Study Center, 1980.

AWARDS:

Valedictorian, Michigan State University, 1973.

Harry R. Jacobs, Professional Service Award, University of Oregon, 1985.

Outstanding Teaching Award: MBA Association, University of Oregon, 1985.

Outstanding Teaching Award: MBA Association, University of Florida, 1994, 1996, 1998, 1999, 2000.

APPENDIX C

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF NEW YORK
---x

IN RE VISA CHECK/MASTERMONEY ANTITRUST LITIGATION

MASTER FILE NO. CV-96-5238
(Gleeson, J.)

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REPORT AND RECOMMENDATION

In this antitrust action, a Class of approximately five million merchants alleged, among other things, that defendants Visa U.S.A. Inc. ("Visa") and MasterCard International Incorporated ("MasterCard") were illegally tying their debit products to their credit cards, in violation of the Sherman Act. On June 4, 2003, the plaintiffs entered into preliminary settlement agreements with the defendants, agreements that provided, among other things, for the creation of a $3.05 billion settlement fund. These agreements were later approved by this Court. *In re: Visa Check/MasterMoney Antitrust Litigation*, 297 F. Supp. 2d 503 (E.D.N.Y. 2003), *aff'd*, 396 F.3d 96 (2d Cir. 2005). By Order dated February 17, 2004, Judge Gleeson appointed me Special Master to issue reports and recommendations regarding referred disputes arising out of or relating to the Visa and MasterCard Settlement Agreements.

By letter dated September 23, 2010, MasterCard International, Incorporated ("MasterCard") requested resolution of "a dispute between MasterCard and the Class under the Settlement Agreement, dated June 4, 2003, as to whether a new MasterCard consumer credit card program falls within the definition of 'Other MasterCard Product' (as MasterCard believes) or 'MasterCard POS Debit Device' (as the Class contends)." On October 11, 2010, Lead Counsel responded by letter asserting that the proposed product is properly classified as a MasterCard POS Debit Device. MasterCard replied in a letter dated October 18, 2010. By order dated November 5, 2010, Judge Gleeson referred the dispute to me for a Report and Recommendation.

For the reasons set forth below, I respectfully recommend that this Court find that MasterCard's proposed product falls within the Settlement Agreement's definition of an Other MasterCard Product. I further respectfully recommend that this Court deny plaintiff's request for discovery regarding the proposed product.

BACKGROUND

In a complaint filed on October 5, 1996, the named plaintiffs "alleged that the defendants' practice of requiring merchants who accepted defendants' credit cards to also accept their debit products . . . was an illegal tying arrangement, in violation of section 1 [of the Sherman Act]." *In re: Visa Check/MasterMoney Antitrust Litigation*, 297 F. Supp. 2d 503, 507 (E.D.N.Y. 2003), *aff'd*, 396 F.3d 96 (2d Cir. 2005). They "further alleged that, through these tying arrangements and other anticompetitive conduct, the defendants attempted to monopolize the debit card market, in violation of section 2 [of the Sherman Act]." *Id.* This Court certified the Class by Order dated February 22, 2000. *Id.* The Second Circuit affirmed on October 17, 2001. *Id.* at 507-08.

After motion practice, and on the brink of trial, the plaintiffs entered into preliminary settlement agreements with each of the defendants providing for "the creation of a $3.05 billion settlement fund" as well as other injunctive relief. *Id.* at 508. In this regard, the final MasterCard Settlement Agreement imposed the following obligations on MasterCard:

- Paragraph 5(a) requires issuers to place the word "Debit" in "clear and conspicuous letters" on the face of all debit devices, which are referred to in the agreement as MasterCard POS Debit Devices.

- Paragraph 7(a) requires MasterCard to cause its debit devices to have a unique Bank Identification Number so that merchants are able to distinguish between debit devices and Other MasterCard Products.

- Paragraphs 4(a) and (b) prohibit MasterCard from requiring merchants to accept debit devices as a condition of accepting Other MasterCard Products, and to permit merchants to accept MasterCard POS Debit Devices only, Other MasterCard products only, or both MasterCard POS Debit Devices and Other MasterCard Products.

- Paragraph 4(h) requires MasterCard to provide Lead Counsel with 60 days advance notice before offering a MasterCard Branded Product that incorporates the payment function of both a MasterCard POS Debit Device and an Other MasterCard Product.

In furtherance of the foregoing obligations, the "Additional Definitions" section of the MasterCard Settlement Agreement defines "MasterCard POS Debit Device" and "Other MasterCard Product" as follows:

- Paragraph 1(l): "'MasterCard POS Debit Device' means any MasterCard branded consumer product, device, program, or service issued within the continental United States (and Hawaii and Alaska) by United States member financial institutions, that, when presented for payment in the United States, accesses, debits, holds or settles funds from the consumer's demand deposit or asset account. Attached hereto as Exhibit A is a list of all current MasterCard products, devices, programs, or services that, as determined by MasterCard through its reasonable efforts, qualify as a MasterCard POS Debit Device. Notwithstanding the foregoing, the term MasterCard POS Debit Device shall not include (i) any product, device, program or service that accesses debits, holds or settles funds from the user's demand deposit or asset account fourteen (14) days or more after the date of purchase, (ii) any cards issued under the specific brokerage account deferred debit programs listed on Exhibit B, or (iii) any cards issued under the specific brokerage account deferred debit programs listed on Exhibit H to the Visa Settlement Agreement to the extent that MasterCard and any of its issuers convert the cards in such programs to MasterCard branded cards, and so long as those cards are issued under the same brokerage account deferred debit card program."

- Paragraph 1(q): "'Other MasterCard Product' means any MasterCard branded product, device, program, or service that does not fall within the definition of MasterCard POS Debit Device."

On August 18, 2003, Lead Counsel sought this Court's approval of the Settlement Agreements and plan of allocation. *Visa Check/MasterMoney*, 297 F. Supp. 2d at 506-07. On

December 19, 2003, after conducing a fairness hearing, this Court issued an Opinion and Order approving the Settlement Agreements and plan of allocation. *See id.* at 526, *aff'd*, 396 F.3d 96 (2d Cir. 2005).

On July 20, 2010, MasterCard's counsel wrote to inform Lead Counsel "regarding a new consumer credit card program that MasterCard's issuers intend to offer their cardholders." MasterCard asserted that the new program "would fall within the definition of 'Other MasterCard Product' under the Settlement Agreement, and would be subject to consumer credit acceptance rules." It further asserted that the program would have "the following parameters":

- "A credit-based program that MasterCard issuers may choose to make available to their cardholders."
- "All purchases made with the card will be authorized, cleared and settled against the cardholder's credit line."
- "All purchases will default to the issuer's regular billing cycle with the cardholder having the option of an automatic pay feature pursuant to which the cardholder may select that certain types of purchases that are residing on their credit line would be paid off at some regularly set intervals during the regular billing cycle (e.g., weekly)."

MasterCard asked Lead Counsel to advise whether there were any objections to the program by July 28, 2010.

By responsive letter dated August 5, 2010, Lead Counsel noted MasterCard's obligations under the Settlement Agreement: "As you know, under the Agreement, upon issuance of new MasterCard POS Debit Devices after January 1, 2004, or if MasterCard offers a multi-function product that incorporates the payment functions of both a MasterCard POS Debit Device and an Other MasterCard Product, MasterCard must satisfy the requirement for a clear and conspicuous debit identifier under Paragraph 5. In addition, MasterCard must also provide Lead Counsel, within sixty days before implementing a multi-function product, written notice of the unique identifier that would be used to denote the multi-function nature of such a product."

On August 12, 2010, MasterCard's counsel wrote back, explaining MasterCard's view that the new product would fall within the definition of an "Other MasterCard Product."

> Under the Settlement Agreement, a MasterCard POS Debit Device is expressly defined as one that "*when presented for payment* in the United States, accesses, debits, holds or settles funds from the consumer's demand deposit or asset account." As I informed you on our call last week, the new MasterCard consumer credit card program will *not* access, debit, hold or settle funds from the consumer's demand deposit or asset account when the card is presented for payment in the United States. Rather, the card will be presented to the merchant and processed as a credit card transaction. The issuer will authorize a transaction *solely* on the basis of the consumer's credit line and not with reference to or by accessing the consumer's demand deposit or asset account.

Lead Counsel responded by letter dated September 13, 2010:

> According to the letters and the telephone conversation we had to discuss the program, under it, while all transactions will initially hit against a cardholder's line of credit, the cardholder may pre-designate that certain transactions be ultimately paid from the cardholder's demand deposit account at specified periods of time in the billing cycle. The letters assert that this program would fall within the definition of "Other MasterCard Product" under the Settlement Agreement, and ask whether the Class has any objections to this program.
>
> While the Class does not object to this program *per se*, it disagrees with the conclusion that these products necessarily fall within the definition of "Other MasterCard Products." In our view, a product that gives cardholders the ability to pre-designate that certain transactions – for example, supermarket transactions – shall be ultimately paid from the cardholders' DDA, should be designated as "MasterCard POS Debit Devices" under the Settlement Agreement for those transactions. In effect, when the card is presented for payment, and the cardholder has predesignated the transaction to be paid at a later date from the DDA, such transactions meet the definition of "MasterCard POS Debit Devices" set forth in the Settlement Agreement. In addition, we believe these products meet the definition of a "multi-function MasterCard Branded Product" under Paragraph 4(h) of the Settlement Agreement.
>
> As a result, the Class reserves its right to object to any card issued under this program should they be introduced and made subject to the Honor All Cards rules applicable to "Other MasterCard Products."

By email dated August 31, 2010, Lead Counsel posed "a follow-up question relating to whether the proposed card would memo post to a DDA [demand deposit account] at the time of purchase if the transaction fell within the parameters set by the cardholder for a transaction that would be paid off from the DDA. So, for example, if the cardholder configured the card to pay all supermarket transactions from its DDA ten days after the purchase would the transaction hit the line of credit and memo post to the DDA at the time of purchase when the card is used in a supermarket." MasterCard's counsel responded by letter dated September 1, 2010: "The answer is no, it does not memo post at the time of purchase; the transaction only touches the line of credit."

By letter dated September 23, 2010, MasterCard described a product that "MasterCard's issuers intend to offer their cardholders" and "respectfully request[ed] that the MasterCard consumer credit card program as represented to the Class be determined to fall within the definition of Other MasterCard Product." In a letter to the Court dated October 11, 2010, Lead Counsel asserted "that the program described in MasterCard's September 23 Letter is properly classified as a 'MasterCard POS Debit Device' under the terms of the Settlement Agreement." MasterCard replied to Lead Counsel's arguments in an October 18, 2010 letter.

I heard oral argument on November 19, 2010. I thereafter asked the parties to submit supplemental briefs on the question of whether a case or controversy had been presented within the meaning of Article III. The parties complied in letters dated December 14, 2010, and December 17, 2010.

ANALYIS

The first question is whether this Court has been presented with a case or controversy within the meaning of Article III. MasterCard contends that it has. Lead Counsel disagrees, and also argues that, in any event, the dispute is unripe for judicial decision.

The Supreme Court has cautioned that, when adjudicating claims for declaratory relief, courts must be mindful of Article III's "case or controversy" requirement and restrain themselves from issuing opinions "advising what the law would be upon a hypothetical state of facts." *Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 241 (1937). "The difference between an abstract question and a 'controversy' . . . is necessarily one of degree." *Md. Cas. Co. v. Pac. Coal & Oil Co.*, 312 U.S. 270, 273 (1941). For there to be Article III jurisdiction over a request for declaratory relief, there must be "a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment." *Id.* at 273.

At oral argument, MasterCard indicated that it was seeking "guidance" on the question of how the proposed product is properly categorized under the Settlement Agreement. Tr. at 6. In addition, when I asked MasterCard's counsel whether a consumer using the proposed product could pre-designate that <u>all</u> of her purchases be paid from the demand deposit account, MasterCard's counsel responded (Tr. at 59):

> I don't think there is going to be restrictions on what you can designate. I don't know whether they've decided on anything. So I don't know whether there is going to be a restriction or not a restriction.

Based upon these statements, I had some concern that the product was still early enough in the development phase such that there was a risk that a ruling by this Court would be advisory in nature.

In the course of briefing the question of subject matter jurisdiction, counsel for MasterCard represented to the Court that "the new product *is* being introduced by MasterCard." Dec. 17, 2010 Ltr. at 4 (emphasis in original). In light of this representation, *see* Fed. R. Civ. P. 11(b)(3), it is clear to me that this is not a case, like *Wembly, Inc. v. Superba Cravats, Inc.*, 315 F.2d 87, 90 (2d Cir. 1963), where subject matter jurisdiction is lacking because the moving party is seeking greater legal clarity regarding a proposed course of action even though it has failed to assert – perhaps because it cannot assert – that it is "about to" undertake that action.

It is also clear to me that MasterCard and Lead Counsel have conflicting legal positions regarding the application of the Settlement Agreement to this new product. MasterCard has consistently taken the position, in letters to Lead Counsel and to this Court, that the proposed product is an "Other MasterCard Product." By contrast, Lead Counsel's position is that "the program described in MasterCard's September 23 Letter is properly classified as a 'MasterCard POS Debit Device' under the terms of the Settlement Agreement." Oct. 11, 2010 Ltr. at 2.

Given MasterCard's representation that "the new product *is* being introduced by MasterCard," given the parties' conflicting legal positions, and given the significant obligations that the Settlement Agreement imposes on MasterCard in connection with issuing new products – obligations that turn on how a proposed product is defined – I believe that this Court has been presented with "a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment," and therefore that Article III jurisdiction exists.

Lead Counsel's claim that – notwithstanding its consistently stated position that the product described by MasterCard falls within the Settlement Agreement's definition of a MasterCard POS Debit Device – it has not actually objected to MasterCard's proposed issuance of the new card as an Other MasterCard Product, but has instead reserved its right to object *after* MasterCard has already issued the card, does not persuade me otherwise. Dec. 14, 2010 Letter at 3 ("The Class only reserved its rights to object to any cards issued under the program should they be introduced and made subject to the Honor All Cards rules applicable to 'Other MasterCard Products.' The Class's reservation of rights does not create a dispute of 'sufficient immediacy and reality to warrant the issuance of a declaratory judgment.'" (citation omitted)). Rather, it is my view that, against the background of its consistently expressed view that the product as described by MasterCard is a MasterCard POS Debit Device, Lead Counsel's reservation of rights creates sufficient uncertainty, insecurity, and controversy such that MasterCard's request for clarity gives rise to Article III jurisdiction.

For all of these reasons, I respectfully recommend that this Court find that MasterCard's application creates a case or controversy within the meaning of Article III.

Lead Counsel makes the further argument that, even if there is a case or controversy within the meaning of Article III, this Court should nevertheless refrain from deciding this dispute because it is not yet ripe: "Until MasterCard actually implements its new program (at which time the Class may learn the specifics of the program and the manner in which MasterCard or its issuers markets the card to consumers), and until the Class is able to make an informed assessment as to whether the program as implemented runs afoul of the Settlement Agreement, the purported dispute between the Class and MasterCard is unripe for judicial determination." Dec. 14, 2010 Ltr. at 6.

Based upon the letters submitted, I agree with MasterCard that, for purposes of this dispute, MasterCard has provided as much detail as is necessary on the central question underlying the dispute: whether "when presented for payment in the United States," the product "accesses, debits, holds or settles funds from the consumer's demand deposit or asset account." Though it has had the opportunity to do so, Lead Counsel has not asked for additional specifics about the program that MasterCard did not subsequently provide, nor has it identified any additional areas of inquiry that, if pursued, would bear on the question of how the card should be classified.[1] I also agree with MasterCard that the manner in which the new product is marketed does not bear on its proper classification under the Settlement Agreement, a document that does not mention marketing in furtherance of defining MasterCard POS Debit Devices and Other MasterCard Products. I therefore respectfully recommend that this Court reject Lead Counsel's argument that the dispute is unripe.

Assuming that this Court agrees that subject matter jurisdiction exists and that the dispute is ripe, the question presented by the parties is how the new product should be classified under the Settlement Agreement.

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[1] As noted above, during oral argument, I asked whether a consumer using the proposed product could pre-designate that all of her purchases to be paid from the demand deposit account. Having reviewed the parties' briefs, I am persuaded that, whatever the answer to this question, it is not relevant to the question of whether, "when presented for payment in the United States," the product "accesses, debits, holds or settles funds from the consumer's demand deposit or asset account."

As noted above, the Settlement Agreement defines a MasterCard POS Debit Device as follows:

> "MasterCard POS Debit Device" means any MasterCard branded consumer product, device, program, or service issued within the continental United States (and Hawaii and Alaska) by United States member financial institutions, that, when presented for payment in the United States, accesses, debits, holds or settles funds from the consumer's demand deposit or asset account. Attached hereto as Exhibit A is a list of all current MasterCard products, devices, programs, or services that, as determined by MasterCard through its reasonable efforts, qualify as a MasterCard POS Debit Device. Notwithstanding the foregoing, the term MasterCard POS Debit Device shall not include (i) any product, device, program or service that accesses debits, holds or settles funds from the user's demand deposit or asset account fourteen (14) days or more after the date of purchase, (ii) any cards issued under the specific brokerage account deferred debit programs listed on Exhibit B, or (iii) any cards issued under the specific brokerage account deferred debit programs listed on Exhibit H to the Visa Settlement Agreement to the extent that MasterCard and any of its issuers convert the cards in such programs to MasterCard branded cards, and so long as those cards are issued under the same brokerage account deferred debit card program.

Under the same agreement, a MasterCard product that does not meet the above definition is an Other MasterCard Product.

In its October 11, 2010 letter, Lead Counsel argued that, pursuant to the above definition, the question of whether a product qualifies as a debit device turns on "whether the device 'accesses, debits, holds or settles funds from the user's demand deposit or asset account' within 14 days of the date of purchase." Based upon this construction of the Settlement Agreement, Lead Counsel maintained that, because the pre-designation feature "concededly gives cardholders the ability to pre-designate that certain transactions . . . shall be automatically paid from the cardholder's demand deposit account at intervals specified by the cardholder," it therefore qualifies as a debit device. Oct. 11, 2010 Ltr. at 1.

At oral argument, Lead Counsel appeared to have abandoned this argument – one that appears in any event to proceed from a misreading of the terms of the Settlement Agreement. Under the definition of a MasterCard POS Debit Device, the relevant inquiry is whether, "when presented for payment in the United States," the product "accesses, debits, holds or settles funds from the consumer's demand deposit or asset account." If it does not, then it is not a MasterCard POS Debit Device. If it does, then it is a MasterCard POS Debit Device – unless, though it "accesses, debits, holds or settles funds from the user's demand deposit or asset account," it does so "fourteen (14) days or more after the date of purchase" (or it falls within the other exceptions set forth above), in which case, it is still not a "MasterCard POS Debit Device." MasterCard explained that the fourteen day exception "was included to address a MasterCard deferred debit product that already existed, which the parties agreed would not be considered a MasterCard POS Debit Device under the Settlement Agreement." Oct. 18, 2010 Ltr. at 4.

In its October 11, 2010 letter to the Court, Lead Counsel also argued that the pre-designation feature renders the card a "MasterCard POS Debit Device" because, "[i]n effect, when the card is presented for payment, and the cardholder has pre-designated the transaction to be paid at a later date from the demand deposit account, such transactions meet the definition of 'MasterCard POS Debit Devices' set forth in the Settlement Agreement." In response to this argument, MasterCard's counsel represented that: (1) "[a]ll purchases made with the card will be authorized, cleared and settled *solely* against the cardholder's credit line when presented for payment"; (2) "[t]he issuer will authorize a transaction *solely* on the basis of the consumer's credit line when the card is presented for payment and not with reference to or by holding any amount from the cardholder's demand deposit account"; and (3) "[a]ll transactions on the card will be subject to consumer credit acceptance rules." MasterCard's Oct. 18, 2011 Ltr. at 1-2. It argued that, "[f]or those reasons alone, the new MasterCard consumer credit program properly falls under the definition of Other MasterCard Product in the Settlement Agreement." *Id.* at 2.

Based upon MasterCard's representations, I agree with MasterCard that its new consumer credit program does not, "when presented for payment . . . access[], debit[], hold[] or settle[] funds from the consumer's demand deposit or asset account," and therefore that it does not meet the Settlement Agreement's definition of a MasterCard POS Debit Device.[2] Indeed, at oral argument, Lead Counsel all but conceded that the card does not meet this definition, and instead focused on arguing that it should nevertheless be treated as one because MasterCard is "attempt[ing] an end around [sic] on the settlement." Tr. at 32. In Mr. Shinder's words (Tr. at 35-36, 56-57):

> MR. SHINDER: . . . . [L]ook, I can't say that it doesn't access, debit[], hold[] or settle[] against the DDA immediately. It is configured to sit within that language, based upon – I'll say this, based upon what, and I have no reason to dispute anything counsel has said, based upon the description that's been given to me, it does not hit against the DDA right away. . . .
>
> . . . .
>
> MS. WILCOX: So you don't think that it fits within, which section are you pointing at?
>
> MR. SHINDER: I'm pointing to the definition [of a MasterCard POS Debit Device], and I'm giving you, you know, a completely candid answer. That based upon the description that's been given to us, that the product, you know, initially is authorized against a credit card line. That's the way they've structured it, such that it will be outside of this definition. . . . .

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[2] In a footnote to its October 11, 2010, Lead Counsel also argued that the proposed product "meets the definition of a multi-function MasterCard Branded Product under Paragraph 4(h) of the Settlement Agreement" – i.e., that it "incorporates the payment functions of both a MasterCard POS Debit Device and an Other MasterCard Product." Settlement Agreement ¶ 4(h). Based upon MasterCard's representation, it is clear to me that the proposed product does not incorporate the payment functions of a MasterCard POS Debit Device. I therefore respectfully recommend that this Court reject this argument as well.

. . . .

> MR. SHINDER: So based upon how they've constructed that product, the authorization of that product, in the authorization, clearing and settlement process, what usually happens is one to three days after a MasterCard or Visa transaction, all of that is happening against a line of credit. So I'm not going to sit here and say that, you know, that it meets the strict terms of how that's written. I can't. What I'm saying to you, and this is how I reconcile the two positions, and I'll leave it to you to decide where we end up at the end of the day, is that when the product has been marketed to people to move them from debit to credit and it gives that person the ability to predesignate, to me that's the distinction that distinguishes the subsequent example, writing a check, it's not like that. That the card that – that the transaction will almost certainly be funded by their demand deposit account, that effectively is a debit transaction. And I'm inviting you to invoke the spirit if not the letter of this settlement agreement. That is our position.

Whether, as Lead Counsel alleged, MasterCard intentionally structured the product so as to fall outside the definition of the MasterCard POS Debit Device is, in my opinion, beside the point. I see no legal reason why MasterCard is not allowed to do that. Nor am I necessarily persuaded that the pre-designation feature is an evasion of the "spirit" of the Settlement Agreement, as Lead Counsel has argued. To the contrary, as MasterCard has repeatedly emphasized, purchases on the card "are authorized, cleared and settled *solely* against the cardholder's credit line" and are authorized by the issuer "*solely* on the basis of the consumer's credit line when the card is presented for payment and not with reference to or by holding any amount from the cardholder's demand deposit account." Oct. 18, 2011 Ltr. at 1-2. At the end of the day, as was discussed extensively at oral argument, the pre-designation feature only operates if there is money in the demand deposit account.[3]

[3] Citing Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Lead Counsel also asserted that "the Class is concerned that MasterCard's development of this product at this time is intended to circumvent new federal regulation of debit transactions." Lead Counsel's Oct. 11, 2010 Ltr. at 2. However, at oral argument, Lead Counsel conceded that this issue is not for this Court to decide. Tr. at 39 ("In Washington, yes, clearly that's not for you. I bring it up only that a circumvention of Dodd-Frank is also a circumvention of the settlement agreement.").

CONCLUSION

For the reasons set forth above, I respectfully recommend that this Court find that the proposed product qualifies as an "Other MasterCard Product" under the MasterCard Settlement Agreement. Because I do not believe that the Settlement Agreement is ambiguous on these issues, I further respectfully recommend that this Court deny Lead Counsel's request for discovery. *See* Oct. 11, 2010 Ltr. at 2 ("If you find the Settlement Agreement is ambiguous on this issue, the Class submits that disclosure of MasterCard's documents concerning this program is necessary.").

Pursuant to Paragraph (g) of Judge Gleeson's February 17, 2004 Order, objections to the Special Master's report and recommendation must be filed within "ten business days, following service."

Robin M. Wilcox

Dated: January 31, 2011
New York, New York