MORRISON | FOERSTER

2000 PENNSYLVANIA AVE., NW
WASHINGTON, D.C.
20006-1888

TELEPHONE 202.887.1500
FACSIMILE 202.887.0763

WWW.MOFO.COM

MORRISON & FOERSTER LLP

NEW YORK, SAN FRANCISCO,
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SHANGHAI, HONG KONG,
SINGAPORE, BRUSSELS

Writer's Direct Contact
202.778.1614
OIreland@mofo.com

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*By Electronic Delivery*

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

RE: Docket No. R-1404; RIN No. 7100 AD63; Debit Card Interchange Fees and Routing

Ladies and Gentlemen:

This letter is in response to the proposed rules approved by the Board of Governors of the Federal Reserve System ("Board") on December 16, 2010 to implement Section 920 of the Electronic Fund Transfer Act ("EFTA"), as added by Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These proposed rules were subsequently printed in the Federal Register on December 28, 2010 ("Proposed Rules").[1] This letter is submitted on behalf of a group of twelve large and midsized debit card issuers ("Issuers") that collected historical data for calendar year 2009, using each Issuer's response to the Board Issuer Survey Request as a starting point. These data were collected on a confidential basis. We employed Argus Information and Advisory Services, LLC, a data processor familiar with the payment card industry, to compile and aggregate the data, as well as to work with each Issuer to ensure, to the extent possible, consistent data submissions.

Based on our analysis of this information, we believe that the interchange fee price structures proposed by the Board fail to include costs that are incurred by issuers in authorizing, clearing and settling electronic debit transactions and other costs incurred by issuers that are specific to electronic debit transactions. We believe that the Board's failure to include these additional costs is not supported by the plain language of Section 920, as the Board failed to

[1] 75 Fed. Reg. 81,722 (Dec. 28, 2010).

include these costs despite the costs being incremental and specific to particular electronic debit transactions. More broadly, we believe that:

1) the Board has failed to meet the requirements of section 904(a) of the EFTA, including in particular, demonstrating that the consumer protections of the Proposed Rules outweigh the compliance costs imposed upon consumers and financial institutions;

2) the Board has failed to consider adequately the functional differences between checking transactions that are required within the Federal Reserve bank system to clear at par and electronic debit transactions; and

3) the Board has failed to measure appropriately the incremental costs of authorization, clearance and settlement of electronic debit transactions and other costs that are specific to particular electronic debit transactions, which our analysis found to be at least 27¢ per transaction.

In addition, we believe that the Board should review carefully the language of Section 920, the purposes of the EFTA and the findings required by Section 904 of the EFTA, and that the Board should revisit its analysis of the functional similarities between electronic debit transactions and checking transactions that are required within the Federal Reserve bank system to clear at par. In order to fully appreciate how far the Board has deviated from the plain language of Section 920, we believe that it is useful to walk through the process of authorization, clearance and settlement of different electronic debit transactions. We address these issues in greater detail below. In addition, we note that Section 920 requires the Board to establish standards for assessing interchange transaction fees, not price caps. In this regard, for the reasons stated in our letter of November 5, 2010 to Louise Roseman of the Board staff, we believe that an average effective debit interchange rate framework established as a safe harbor would be more consistent with Section 920, would preserve the flexibility to more closely align interchange transaction fees and costs and would preserve an overall limit on the aggregate amount of interchange transaction fees.

**Section 920(a) of the EFTA**

Section 920(a) of the EFTA, as amended, provides that "[t]he amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[2] In this regard, the Board is directed to prescribe rules that "establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and

[2] 15 U.S.C. § 1693o-2(a)(2).

proportional to the cost incurred by the issuer with respect to the transaction."[3] In so doing, the statute states that the Board should 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" and "other costs incurred by an issuer which are not specific to a particular electronic debit transaction."[4] The statute specifies that the "other costs" that are not specific to a particular electronic debit transaction may not be considered a "cost incurred by the issuer with respect to the transactions."[5]

The statute states that the amount of any interchange fee that an issuer may receive with respect to a debit transaction must "be reasonable and proportional to the cost incurred by the issuer with respect to the transaction." This language does not indicate that a debit interchange fee for a given transaction may not exceed, or must be limited solely to, the relevant costs associated with the transaction; instead, the language simply requires that there be a "reasonable and proportional" relationship between the two. In other words, the fees must be both reasonable and proportional to costs. We read the term "reasonable" to modify fees, not costs. The statute goes on to 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" and "other costs incurred by an issuer which are not specific to a particular electronic debit transaction."

As the Board recognizes, these two concepts ("incremental costs" and "other costs") are not all inclusive. A narrow reading of the term "incremental" may exclude costs that are nevertheless specific to a particular electronic debit card transaction. The statutory language does not require such a reading. Section 920 does not require the Board to limit permissible issuer costs to those that are incremental in connection with the authorization, clearance and settlement of debit transactions. The only limitation actually imposed by Section 920 is that "other costs"—that is, costs incurred by an issuer that are not specific to a particular electronic debit transaction—may not be considered. As a result the Board has the discretion under Section 920 to consider issuer costs other than incremental costs for authorization, clearance and settlement so long as those costs are specific to a particular debit card transaction and to consider the costs incurred by an issuer in the authorization, clearance or settlement of a particular electronic debit transaction.

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[3] 15 U.S.C. § 1693o-2(a)(3)(A).
[4] 15 U.S.C. §§ 1693o-2(a)(4)(B)(i), (ii).
[5] 15 U.S.C. § 1693o-2(a)(4)(B)(i).

**Section 904 of the EFTA**

Section 904 of the EFTA establishes requirements for Board rulemakings under the EFTA. Specifically, Section 904(a) provides that the Board, in prescribing regulations to carry out the purposes of the EFTA, must: (1) "take into account, and allow for, the continuing evolution of electronic banking services and the technology utilized in such services"; (2) "prepare an analysis of economic impact which considers the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers . . . and 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"; and (3) to the extent practicable, "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions."[6]

We appreciate that implementing Section 920 in a manner that is consistent with these rulewriting requirements may present a unique challenge. While Section 920 may be dissimilar from other provisions in the EFTA, we believe that, in order to carry out Section 904(a), where the Board has discretion to implement various options for implementing Section 920, it should favor options that provide greater demonstrable consumer benefit; enhance competition among issuers, networks and acquirers; support cost-effective fraud prevention without unduly mandating specific technologies; and provide appropriate commercial and investment incentives to encourage the usage, growth and continued evolution of electronic debit transactions. We believe that implementing regulations that require below-cost pricing with the expectation that any costs that are currently recovered through interchange transaction fees will have to be recovered directly from cardholders would be inconsistent with the considerations required by Section 904.

**Comparison to Checks**

We believe that the Board has read the consideration relating to checks clearing at par within the Federal Reserve bank system selectively. The Board has disregarded the long history of par clearance, which, at various points, involved government subsidies, different treatment between Federal Reserve member banks and other private sector banks and limitations on its scope. Had Congress intended the Board to provide compensation to issuers only for the exact costs that are compensated to the bank from which a check is issued, Congress could have easily done so through express statutory language, but it did not. Congress only required that the Board consider the extent of functional similarities when adopting its implementing regulations.

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[6] 15 U.S.C. §§ 1693b(a)(1)-(3).

The Board appears to have disregarded the significant differences between debit cards and checks from a legal and functional perspective. The only thing these transactions seem to have in common is that the source of funds of a completed transaction is the same transaction account. The law of checks is established by uniform state laws so that the transfer of checks between parties is not limited and does not require any preexisting contractual link between the payor and the payee of the check or the parties to the check collection process. Accordingly, the process of paper check collection is highly standardized, and collecting banks compete only on speed and price in offering collection services for paper checks.[7] In addition, the rights of parties to a check are established by these laws, and there is no real competition among brands of check services to provide for consumer choice, and no differentiation among such services.

In contrast, debit card transactions are processed through multiple, independent closed systems where participants in each system are subject to a respective set of network rules, including network-defined chargeback and liability allocation rules, and network-defined processing and dispute handling requirements. These rules govern the rights of the parties to the transactions, although certain minimal rights are established under the EFTA. Once originated under a set of network rules to which the parties have agreed, a transaction cannot be transferred from one network to another network. Networks compete with each other as identified brands, and different networks offer and support different types of transactions and provide for different legal rights and services to cardholders, as well as merchants. While a merchant cannot alter the legal rights and remedies established by law for accepting checks or even mitigate them without additional cost (*e.g.*, by paying for check guarantee services), merchants can alter the legal rights of consumers in electronic debit transactions by deciding which debit card networks in which to participate based on services offered, including network requirements and pricing.

More fundamentally, checks are paper instruments where value resides in the possession of the actual instrument itself, while debit card transactions are electronic communications that create rights in the parties to the transactions. Moreover, the electronic communications of which debit card transactions are a part provide for dynamic authorizations and guarantees that provide merchants with comfort in accepting debit card transactions in circumstances and from persons from whom they would not accept checks. Debit cards also provide for different and broader consumer rights with respect to disputes related to transactions, and typically faster provisional settlement of transactions and more contemporaneous account balances to facilitate cash management by cardholders.

It is impractical, if not impossible, to use checks for many transactions for which debit cards are used routinely and in places where the speed of transaction is important; for example, online and telephone transactions, recurring transactions, automated fuel dispenser and vending

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[7] Electronic check collection occurs under separate bilateral agreements or clearinghouse rules.

machine transactions, parking garage transactions, quick service restaurant transactions and small dollar transactions at conveniences stores, self-service check-out and onboard airline flight transactions, as well as transactions at merchants that do not use check guarantee services and for transactions in foreign countries. Indeed, in many cases, merchants will not accept checks without an independent guarantee from a check guarantee service, which frequently charges 1% or more of a check's value for the guarantee service.[8]

Nor do consumers need to carry or have separate identification to use their debit cards. While checks can be used to pay for some limited types of transactions where debit cards are also used (albeit with more limited rights and functionality), the cost structure borne by issuers for debit card transactions reflects the need to support numerous transaction types where checks are not accepted. Given these significant differences, we believe that the Board's reliance upon analogies to check transactions in arriving at its limited view of allowable costs is wholly misplaced. Further, in considering its proposed fee limitations, we believe that the Board should also recognize the extent to which the cost of maintaining the payment guarantee in the debit card systems contributes to the liquidity and efficiency of retail transactions.

**Costs for Authorization, Clearance and Settlement**

Based on the data collected from the Issuers, and for the reasons set forth below, we believe that the costs for authorization, clearance and settlement of particular electronic debit transactions at the Issuers include:

(1) variable processing costs, as recognized by the Board in its Proposed Rules, at an average of 6¢ per transaction;
(2) network fees at an average of 4¢ per transaction;[9]
(3) fraud losses at an average of 3¢ per transaction;
(4) fraud prevention costs at an average of 3¢ per transaction;
(5) fixed processing and capital costs at an average of 2¢ per transaction;

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[8] As these services generally acquire the rights of the payee of the check against the drawer, they may obtain additional income from their collection efforts.

[9] Most of this amount represents network fees that are charged on a per-transaction basis and are, therefore, variable processing costs. The Board's stated rationale for excluding these fees is to avoid having the acquiring depository institution that acts on behalf of the merchant pay these fees. Although the Board recognizes that having the acquiring depository institution compensate the issuer for these costs would be similar to traditional paper check processing, an analogy on which the Board relies in other portions of the Proposed Rules, the Board excludes these costs from variable processing costs, apparently because doing so would be consistent with some electronic check processing models. We believe that the Board's failure to include these fees as variable processing costs was both arbitrary and capricious and not in accordance with the plain language of Section 920. Although a portion of these network fees are not charged on a per-transaction basis, we believe that the fees that are not charged on a per-transaction basis should be allocated across the transactions that do occur.

(6) card production and delivery costs at an average of 1¢ per transaction; and
(7) cardholder inquiry costs at an average of 8¢ per transaction.[10]

While we believe that these data are the best available information on the Issuers' costs we believe that these data likely understate issuer costs generally due to economies of scale at the Issuers that are not enjoyed by other, typically smaller, issuers. In addition, these data are based on records that were developed for each individual Issuer's business purposes with no expectation that these data would be used in connection with developing a debit card interchange rate structure. Although the Issuers have endeavored to identify and allocate costs appropriately, the experience of some of the Issuers in the Data Study strongly suggests that these data may materially understate fully allocated costs, even within the Issuers.

Further, a rate that is based on average costs at issuers will result in a substantial number of issuers not recovering costs for debit card transactions through interchange fees, even though the Board has based its standards for interchange fees on such costs. At the same time, these issuers will face competitive pressures from institutions that are not subject to the interchange limitations in Section 920, as well as those issuers that are subject to those limitations, but that are able to recover more of their costs under the established rate. For these reasons, we believe that setting the average effective interchange rate at a level that would recover the costs for a significant majority, if not all, of the depository institutions that issue debit cards, as estimated based on the best available data, would be most appropriate.

Finally, some electronic debit transactions are authorized, cleared and settled without incident.[11] Other electronic transactions require additional individual attention and significant additional costs to settle finally, due to inquiries and disputes. Further, depository institutions incur significant costs, including fraud prevention costs, to minimize the number of transactions that lead to inquiries or disputes. These costs both avoid costs to issuers to resolve disputes and minimize costs to consumers of making inquiries and raising disputes.

*Program Set Up*

The process of authorization, clearance and settlement begins with a customer establishing a deposit account with a depository institution that is a transaction account from which third-party payments can be made.[12] The depository institution must establish a debit card program, including:

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[10] We would be happy to discuss the details supporting these numbers with Board staff.
[11] The following illustrations are based on the use of a conventional signature debit card in a face-to-face transaction for purposes of simplicity. Other types of transactions are referred to in some cases as appropriate.
[12] Limited third-party payments can also be made by debit card from an MMDA.

(1) entering into necessary agreements with debit card networks and contracts to have debit cards produced;
(2) producing debit cards and delivering them to its customers; and
(3) developing and providing to the customers account terms for debit card transactions and initial disclosures for consumer debit card transactions, as required by the EFTA and Regulation E.

The costs of these activities must be incurred in order for the customer to undertake electronic debit transactions. Although these costs may be viewed as fixed costs that are not unique to any particular electronic debit transaction and may in fact be incurred even if the customer never uses the debit card for a debit transaction, we believe that appropriate cost accounting would allocate these costs to any electronic debit transactions that do occur on the account. While the costs of opening the transaction account would be shared with other transaction account activities, including over-the-counter transactions and check and ACH transactions, we believe that a portion of these costs are properly allocated to debit card transactions, particularly where the debit card activity on the account is significant.[13]

*Authorization*

If the customer chooses to use the debit card in a transaction at a merchant, the customer will present the card to the merchant, typically by swiping the card through a device that reads the magnetic stripe on the card and communicates information about the transaction to the account-holding depository institution through a payment card network. The depository institution issuing the debit card will receive this information, either itself or through a third-party service provider, and send a message back to the merchant that tells the merchant whether or not the transaction is authorized. As a part of this authorization process, the depository institution will check the available balance in the customer's account, as well as other transaction and account information, and apply fraud screens to determine whether the transaction fits into a pattern of fraudulent transactions generally, or whether the transaction is so unusual for the particular customer as to suggest fraud. If the depository institution believes that the transaction is fraudulent, or is not likely to be paid because of an insufficient balance or for other reasons, it will not authorize the transaction and will send back a message that the transaction is declined. These activities may be performed by the depository institution itself or by a service provider, including the payment card network, on behalf of the depository institution.

[13] In the case of a prepaid card, all of these costs would be allocated to debit card transactions exclusively because there would be no other payments.

Under the language of Section 920, both an authorized transaction and a transaction that is not authorized appear to be electronic debit transactions.[14] The payment card network will charge the account-holding depository institution a fee for the authorization message regardless of whether or not the transaction is authorized, and the depository institution will incur processing costs regardless of whether or not the transaction is authorized. All of these activities are specific to each particular debit card transaction. If this activity is conducted by the depository institution, the costs incurred in carrying out these activities will include costs for personnel and equipment. The number of personnel and the type and size of the equipment will be designed to accommodate peak levels of transaction activity in order to ensure that the customer receives uninterrupted service. Some of these costs will vary by individual transaction, while others will vary in a more stepped fashion as increased volumes require incremental personnel, equipment and other resource changes. If, on the other hand, this activity is carried out through a service provider, the depository institution is likely to pay for these services on a per-transaction basis.

*Clearance*

If the transaction is authorized, the customer will obtain the goods or services that are the subject of the transaction. In the case of a signature debit transaction, the merchant's bank will send a separate communication through the payment card network to the depository institution holding the customer's account in order to obtain provisional settlement for the amount of the transaction. In the case of a PIN debit transaction, the settlement and authorization are, in effect, combined in the same message. In either case, the depository institution will post the transaction to the customer's account and send a settlement payment to the payment card network, which in turn will send a settlement payment to the merchant's depository institution. The settlement payment will be provisional with respect to each individual transaction; that is, the transaction may be charged back in certain circumstances, such as because it is later found to not have been properly authorized by the customer. The payment card network will charge fees for these communication activities and payments. In most cases, for signature debit transactions, these settlement communications and payments will apply to more than a single transaction; however, they would be required even if only a single transaction was settled on a particular day. The activities described in this paragraph would be most properly characterized as clearance. As in the case of authorization, these activities may be performed in-house with personnel and equipment scaled to transaction volume and paid for accordingly, or by a service provider that bills on a per-transaction basis.

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[14] Section 920 defines the term "electronic debit transaction" as a transaction in which a person uses a debit card, which would appear broad enough to cover any situation in which a cardholder presents her debit card for payment, even if the transaction is ultimately declined. 15 U.S.C. § 1693o-2(c)(5).

Once the transaction has been authorized and provisionally settled, information concerning the transaction will be stored by the depository institution. If the customer is provided access to information about her account online, the depository institution will make information about the transaction available online. For consumer transactions, this information most likely will be in a format that would satisfy the requirements for transaction information in periodic statements under Section 205.9(b)(1) of Regulation E. If online access is not provided as the sole means of obtaining periodic statements, the depository institution will also provide a paper periodic statement to consumer customers for each month in which there is transaction activity and, if there is no such activity, quarterly as required by Section 205.9(b) of Regulation E. Periodic statements are not required by Regulation DD, Truth in Savings; however, they are often provided by depository institutions as a customer service and for purposes of various provisions of the Uniform Commercial Code with respect to check transactions. Nevertheless, the individual transaction descriptions for debit card transactions on periodic statements are legal requirements for consumer accounts with respect to the individual electronic debit transactions, and the costs attributable to providing these descriptions are costs that are particular to those electronic debit transactions.

*Settlement*

After the depository institution has posted the electronic debit transaction to a consumer customer's account and provided the customer with a periodic statement, under Section 205.11 of Regulation E, a consumer customer has 60 days to dispute the transaction as unauthorized or incorrect. Under Section 205.9(b)(5) of Regulation E, the periodic statement must, by law, include an address and telephone number to be used for inquiries or notice of errors. Accordingly, the depository institution must provide a "call center" and receive and process mail in order to respond to consumer inquiries with respect to electronic debit transactions. If the customer provides the depository institution with an oral or written notice that the transaction was not authorized or is incorrect, the depository institution must investigate and correct any error in the transaction. If a transaction was not authorized or is incorrect as received from a merchant, payment card network rules provide that: (1) the transaction is guaranteed and the amount of the transaction must be absorbed as a fraud loss; or (2) the transaction can be charged back to the merchant accepting the electronic debit transaction. An electronic debit transaction for a consumer account is not settled with respect to the consumer deposit account until this dispute period has passed and the depository institution has taken any required action with respect to the transaction, such as re-crediting the consumer's account. Similarly, a consumer electronic debit transaction is not settled with respect to a merchant until this period has passed and the application of any guarantee by the depository institution with respect to the authorization of the transaction has been established. Prior to this time, under Federal law and network rules, a consumer transaction cannot be said to have been settled.

Based on this process, under the plain language of Section 920, the costs incurred by a depository institution in posting an electronic debit transaction to the consumer's account, providing the consumer with a statement[15] that identifies the transaction and responding to inquiries and disputes with respect to the transaction are costs incurred in clearance and settlement of the transaction. Moreover, these costs are incremental and specific to particular electronic debit transactions. While there are electronic debit transactions where certain of these costs are not incurred, for example, where no inquiry or dispute is made, in other transactions these costs are incurred. As is the case of costs for authorization and clearance, if these activities are performed in-house, costs may be incurred for equipment and personnel that service multiple transactions or a service provider may perform the activities for the depository institution and bill the depository institution for these services on a per-transaction basis. Excluding fraud losses, the costs of settling a particular electronic debit transaction that is disputed by a consumer will greatly exceed the 12¢ cap proposed by the Board. Further, fraud losses are specific to a particular electronic debit transaction, albeit an unauthorized transaction, and are incurred in the process of reversing the provisional settlement of the transaction and are, therefore, part of the settlement of the transaction.

**Incremental Costs**

The Board takes the view in the Proposed Rules that the term "incremental" that describes costs for authorization, clearance and settlement that the Board is required to consider under Section 920(a)(4)(B)(i) should mean the per-transaction value of costs that vary with the number of transactions. The Board does not, however, clearly explain what it means for a cost to vary with the number of transactions. While the Board states that this measure would not consider costs that are common to all debit card transactions and could never be attributed to any particular transaction, it also appears to have rejected a measure of costs that varies by individual transactions and concludes by requesting comment on whether it should include fixed costs or limit costs to marginal costs.[16] While we believe that the Board is not limited to considering incremental costs in establishing standards for assessing reasonable and proportional interchange transaction fees, to the extent that the Board does consider incremental fees incurred by issuers in the authorization, clearance and settlement of electronic debit transactions, the Board's measurement of incremental costs in terms of variable costs, as the Board defined variable costs to arrive at 7¢, arbitrarily understates the costs that the Board should properly view as incremental.

Even if the Board were to adopt the view that incremental costs of authorization, clearance and settlement are limited to the costs necessary to authorize, clear and settle one

[15] Typically, only a portion of the statement costs are appropriately allocated to debit transactions.
[16] 75 Fed. Reg. at 81,736.

additional transaction, the foregoing discussion of the costs of authorization, clearance and settlement makes clear that the costs to authorize, clear and settle a transaction vary dramatically depending upon which transaction is considered. An uneventful, undisputed transaction will not involve cardholder inquiry costs that average 8¢ per transaction when the costs are spread across all transactions. However, if an inquiry is received or a transaction disputed, the cost of resolving inquiries is a much higher number. Thus, the costs of the next transaction depend on the characteristics of the next transaction. However, under the Board's analysis, the costs of responding to this inquiry would be considered to be fixed costs that would not be considered by the Board, apparently because the costs would be paid for in acquiring equipment and employing personnel on a basis other than a per-transaction basis when these services are provided by the depository institution itself. The Board also appears to view these costs as fixed costs even if they are billed by a service provider on a per-transaction basis.

This view of cardholder inquiry costs as fixed costs that are not incremental is an arbitrary distinction drawn by the Board in the Proposed Rules and finds no basis in Section 920. First, to the extent that a call center responds to inquiries on various aspects of a deposit account relationship, costs attributable to the debit card transactions on that account would vary within the total of the call center costs. More fundamentally, the costs of the call center itself are only fixed within artificial measurement periods that will vary from issuer to issuer. Call centers, like other personnel and facilities and equipment, are designed to service specific ranges of transaction volumes. At any point in time, these resources will be designed to accommodate anticipated peak volumes. As volumes increase over time, as has been the case in electronic debit transactions, the call center, as well as other resources, will be resized to accommodate new anticipated peak volumes. The costs incurred in upgrading these resources should properly be viewed as costs that are both incremental and variable with respect to the electronic debit transactions that are accommodated by the new level of resources that were not accommodated by the prior level of resources. Therefore, these costs are incremental and specific to that particular group of transactions.[17]

Even if the Board were to reject the view that these costs are incremental when incurred "in house," we can see no basis for excluding these costs from consideration if the related activities are performed by a service provider and billed on a per-transaction basis. However, we also believe that a rule that measures costs recovered through interchange fees based on whether the costs are incurred for services performed in-house or by a service provider would be arbitrary.

[17] As noted above, in the Proposed Rules, the Board rejected the view that costs were required to be specific to a single, individual transaction.

A better way to measure these incremental costs is to look at costs and transaction volumes over time. Because Section 920 was only enacted last year and the Board has only been able to collect data with respect to issuer costs for calendar year 2009, this method of measuring incremental costs is not available. Alternatively, it is possible to compare costs across different sized issuers at the same point in time by regressing individual issuer debit card transaction costs on the same issuer's transaction volume for a set of issuers. Here, the differences in volumes and costs between issuers serve as a surrogate for changes in individual issuer costs over time as transaction volumes increase. At the Issuers, this regression analysis shows that in addition to average variable costs for processing, network fees and fraud totaling 16¢ per transaction, as noted above, other incremental costs include:

(1) fixed processing and capital costs of 2¢ per transaction;
(2) card production and delivery costs of 1¢ per transaction; and
(3) cardholder inquiry and disputes costs of 8¢ per transaction.[18]

An economic analysis of why this is an appropriate measure of incremental costs by former Board economists David Humphrey and Edward Ettin is attached to the Visa Inc. comment letter, and we adopt that analysis by reference.

**Costs that are Specific to a Particular Electronic Debit Transaction**

Section 920(a)(4)(B)(ii) provides that the Board shall not consider costs that are not specific to a particular electronic debit transaction in establishing standards for assessing whether the amount of any interchange transaction fee is reasonable and proportional to cost incurred by the issuer with respect to the transaction. As discussed above in connection with the term "incremental," whether or not a cost is specific to a particular electronic debit transaction should not be dictated by whether or not the particular activity is paid for in-house through investment in equipment and compensation of personnel or by paying a service provider on a transaction-by-transaction basis. Nevertheless, we recognize that costs, by their nature, differ in how directly they relate to specific, particular electronic debit transactions. For example, a fraud loss relates directly to the unauthorized electronic debit transaction causing the loss. It is difficult to envision a more direct relationship. The Board has already recognized the relationship between certain variable costs and specific, particular electronic debit transactions. Network fees that are billed to issuers on a per-transaction basis also relate directly to specific, particular electronic debit transactions.

[18] These cost calculations are arrived at by a fundamentally different process than the costs listed on page 5, although the numbers are similar.

At the other end of the spectrum, card production and delivery costs might not be viewed as specific to a particular electronic debit transaction because they are incurred before any transactions are made and may be incurred whether or not any transactions take place with respect to a particular card. Nevertheless, as discussed above with respect to incremental costs, generally even these costs do vary over time with transaction volume and may be properly allocated to the transactions that do take place because they are reasonably incurred in providing for electronic debit transactions to take place. Moreover, with the exception of costs relating to accounts on which no electronic debit transactions occur, these costs must be incurred as a necessary precondition for the transactions to occur.

We believe that it is not appropriate for the Board to interpret Section 920(a)(4)(B)(ii) narrowly so that it excludes costs simply because those costs are not paid for on a transaction-by-transaction basis. First, as noted above, such an approach would have the odd result of excluding costs for some services provided-in house while including costs for the same services when provided by a service provider. In addition, a reasonable construction of the statutory language is that it recognizes that electronic debit transactions are provided out of a deposit account and, therefore, will share certain costs with other deposit account transactions. This reading would mean that this limitation to costs incurred with respect to identifiable electronic debit transactions excludes costs that are more properly allocated to check or ACH transactions or to the establishment of the deposit account generally. We believe that the costs listed above already exclude these costs and, therefore, that no further reduction in these numbers due to Section 920(a)(4)(B)(ii) is necessary or appropriate.

**Fraud Adjustment**

As described above, we believe that both fraud prevention costs that are specific to particular electronic debit transactions, such as the development and use of fraud screens, and fraud losses are part of the authorization, clearance and settlement of transactions. We believe that this analysis is consistent with the concept of final settlement, which is the defining event of when a payment transaction comes to an end. Nevertheless, we believe that preventing fraud in electronic debit transactions goes far beyond these costs and includes more general account security costs. The provision for a fraud adjustment in Section 920(a)(5) is not limited to particular electronic debit transactions and therefore recognizes this fact and allows the Board to provide for a fraud adjustment for costs incurred in fraud prevention that do not meet the requirement that costs be specific to a particular electronic debit transaction.

The Board has not proposed a fraud adjustment under Section 920(a)(5); rather, it has requested comment on two alternative approaches to this issue. The first alternative is a Technology Specific Approach that would allow issuers to recover costs incurred for implementing major innovations that would likely result in substantial reductions in fraud losses.

The Board would identify paradigm-shifting technologies that would reduce debit fraud in a cost-effective manner and allow issuers an adjustment in interchange fees to recover some or all of the costs associated with implementing the new technology. The other alternative is a Non-Prescriptive Approach, under which the Board would establish a more general standard that an issuer must meet to be eligible to receive an adjustment for fraud prevention costs.

As an initial matter, we understand that the Board believes that under either approach, issuers would not be able to recover fraud losses and that the Board believes that Section 920 prevents the Board from including fraud losses as a category of costs that may be recovered through the fraud prevention adjustment. We find this interpretation of Section 920 incompatible with the objective of preventing fraud. The idea of compensating issuers for fraud prevention must be to benefit merchants by preventing fraud. The EFTA already addresses consumer protections in fraudulent transactions, and these protections are not changed by Section 920. Simply put, any fraud loss absorbed by an issuer benefits a merchant because it is a fraud loss not incurred by the merchant. Therefore, issuer fraud losses prevent merchants from incurring fraud losses. Although we believe that the Board has the discretion to include fraud losses in a fraud adjustment, as discussed above, we believe that fraud losses, and most fraud prevention costs, are incremental costs incurred in the settlement of particular electronic debit transactions and are specific to those transactions, so we believe that these costs are more appropriately incorporated into the interchange transaction fees than into the fraud adjustment.

Nevertheless, to the extent that fraud prevention costs are not included in permissible interchange transaction fees, we strongly believe that the Non-Prescriptive Approach is the only viable approach to implementing a fraud adjustment. The Technology-Specific Approach would place the Board in the untenable position of being the policeman of fraud in electronic debit transactions and would require the Board to identify in advance successful fraud prevention technologies. This process is likely to be self-defeating as sophisticated perpetrators of fraud would receive advance warning of the technologies to be deployed and would have a head start at getting around them. At the same time, issuers would receive no compensation for other fraud prevention efforts and would have a strong incentive to push fraud losses back onto merchants, as is typical in check transactions, and issuers would have more limited incentives to prevent fraud in those transactions where the losses could be placed on merchants.

A far more practical course of action would be for the Board to adopt the Non-Prescriptive Approach. Under this approach, the Board's fraud prevention standards could be modeled on the information security standards issued by the Board and the other federal banking agencies to implement Section 501(b) of the Gramm-Leach-Bliley Act ("GLBA"). Under the GLBA information security standards, a bank must implement a risk-based information security program that includes, where appropriate, various information security measures identified by the agencies that are designed to protect customer information. A GLBA-like approach would provide a number of benefits. First, it would allow each covered issuer to tailor its fraud prevention program based upon the nature and scope of its actual debit card practices. Moreover, this approach would provide both the Board and covered issuers with the flexibility to adapt to changes in technology, as well as changes in fraud perpetration activities and techniques. A more detailed approach that prescribes specific controls that all issuers must adopt would provide issuers with far less flexibility in order to adapt to changing technologies and fraud patterns, and the Board would need to continually monitor and update the standards as appropriate. Finally, this approach also would increase costs for exempt issuers as it would likely become an industry standard that they would be required by market forces to meet.

**Timing**

The Board has proposed that the effective date of the interchange transaction fee limitations be July 21, 2011 to coincide with the apparent effective date of Section 920(a)(2). For several reasons, we believe that the Board should determine that current levels of interchange transaction fees are reasonable and proportional to costs for a period after July 21, 2011. It is unlikely that the Board will be able to publish a final rule before some time in April of 2011. This will leave only a few short months for debit card issuers and networks to change their operations and adapt their business plans to accommodate a reduction in interchange transaction fees that will typically exceed 70%, based on the Board's proposal. In addition, such a determination would also give the Board time to obtain a better understanding of issuer costs, the interplay between the routing and exclusivity provisions in Section 920(a), as well as the likely effects of both Section 920(a) and Section 920(b) on consumers and smaller institutions. An effective date that coincides with industry system changes in either October or April would further facilitate the transition to the new pricing environment.

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We appreciate the opportunity to comment on this important matter. If you have any questions, or if we may otherwise be of assistance in connection with this matter, please do not hesitate to contact me, at (202) 778-1614.

Sincerely,

Oliver Ireland
Morrison & Foerster LLP