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February 22, 2011

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

Re: Debit Card Interchange Fees and Routing, Docket No. R-1404

Dear Ms. Johnson:

The California Bankers Association writes this comment letter on behalf of its members, which are FDIC-insured depository financial institutions that do business in California. CBA is a non-profit organization established in 1891, and its members include banks of all asset-size categories, from local community banks to the largest banks in the country. Many of CBA's members offer debit cards to their customers and thus have a direct and significant interest in the Board's proposed rule ("Proposal").

Introduction

Section 1075 of the Dodd-Frank Act titled "Reasonable Fees and Rules for Payment Card Transactions" ("Durbin Amendment" or "Amendment") was added to the Dodd-Frank Act very late in the legislative process, and the monumental changes it prescribed were subject to very little debate. It is apparent that it reflects almost exclusively the long time interests of the retailers and merchants to reduce debit card interchange fees. The banking industry had very little input and very little time to analyze the impact the Amendment would have on financial institutions, especially issuers. We believe that it is incumbent upon the Board, whose responsibilities as a supervisory regulator include ensuring safe and sound banking, to act as an agent for balance with respect to this hasty and ill-conceived legislation.

CBA and its members oppose in principle any price caps levied on private sector firms that are engaged in a legitimate, indeed vital, business, especially caps that explicitly and by intention deprive those firms of the ability to recover costs. Even where direct rate regulation is imposed on public and public/private utilities, which can be wholly justified by reasons not present here, utilities are permitted allowances for infrastructure improvements and a reasonable rate of return on investment. The Board's draconian "cost-minus" approach, by its own calculation, slashes the interchange fee by up to 80% of current market-driven rates (or even more under the safe harbor rate), and this deprives issuers of the earnings necessary to reinvest in and improve debit card programs.

The rise in popularity of debit cards among consumers as a mode of payment is well documented, including by the Board itself. Income generated from debit card transactions by financial institutions, networks, processors, and other parties have fueled investments to expand the availability of debit cards. Consumers now are able to use their debit cards conveniently at more locations, on the world-wide web, and even at fast food outlets and coffee shops for small dollar purchases, often without the need to sign any receipts or enter a personal identification number. Consumers can monitor their debit card and other transactions at ATMs, on the internet and even mobile devices. Most consumers obtain these services bundled with their bank deposit account, for which they pay either nothing or a small fee.

It costs financial institutions a great deal to offer debit cards to their customers, and they do so because it makes economic sense. For the most part, banks' substantial investments in debit card technology and in the network infrastructure that makes debit card transactions possible have yielded returns, thus justifying continued investments and improvements. But none of this would be possible without also the willing participation of merchants to accept debit cards as a form of payment. Up to now, wholly without the benefit of price regulation, merchants by the millions have also made investments in debit card technology. They do so in spite of the interchange fee that they complain of for the same reason as banks: it makes economic sense for them.

The Amendment includes an exemption from the fee restrictions for issuers whose assets, together with affiliates, are less than $10 billion. In contrast, all issuers are subject to the routing restrictions of the Proposal. We write on behalf of both covered and non-covered institutions. Price fixing as a form of regulation and, more particularly, controlling fees for some firms and not others in an otherwise unregulated market, seldom produce the consequences intended. Far from protecting small issuers from below-cost caps, the Board's Proposal would depress interchange fees to such extreme and artificially low levels that small issuers' current fees would be untenable in the marketplace.

As we will explain more fully below, the Proposal is likely to undermine another implicit purpose of the Amendment and the EFTA which it amends, which is to benefit consumers. The Proposal is likely to hurt consumers rather than benefit them as below-cost price caps would force issuers to reduce or eliminate services, subsidize operations through other unregulated activities, or impose new fees. Thus, the burden of paying the fees needed to support debit card networks in the broader sense would shift away from merchants to issuers and, in some fashion, consumers—that is, the customers of both issuers and merchants.

The Board's Use of Strict Price Caps Is Unwarranted

Under Alternative A to the Proposal, the interchange fee would be capped at 12 cents per transaction for an institution that substantiates its allowable costs, or 7 cents if an institution wishes to forgo demonstrating its costs. Alternative 2 allows a fee of up to 12 cents per transaction regardless of the issuer's allowable costs. The Proposal further disallows networks and institutions from circumventing fee restrictions through the use of other, unregulated payments. Issuers may not receive "net compensation" from a network, by which the Board means that the amount received by an issuer from a network may not exceed that which it pays to the network. The Amendment is based on the unwarranted assumption that the existing, market-driven fees set by firms that are in competition with each other are nevertheless in need of federal regulation. As explained in greater detail below, acceptance of debit cards as a form of payment brings many advantages to merchants that the Board does not fully account for in the Proposal.

Section 920(a)(2) of the Amendment simply directs the board to establish standards for *reasonable and proportional* fees. The Board in short order conducted a survey to collect market information and then proceeded to establish interchange fee caps that, according to its own findings, do not cover issuers' costs. But nothing in the underlying statute suggests that the Board should adopt a price cap. The Board's extreme approach is simply inconsistent with the statute and is unwarranted.

Section 920(a)(4)(B) instructs the Board to distinguish between (i) the incremental costs incurred by an issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered, and (ii) other costs incurred by an issuer which are not specific to a particular transaction, which costs shall not be considered. The Board appears to construe this language taken together to mean that its regulation must permit issuers to be compensated through the interchange fee only for some but not all of their actual costs. There are several flaws to this approach.

The operative mandate is to establish standards for a reasonable and proportional fee. Section 920(a)(4)(B) should be construed in a manner that is consistent with that mandate. We contend that under no circumstances could a fee regulation be deemed reasonable that, on its face, prohibits the regulated entity from recovering actual costs and generating a reasonable return. Therefore, the limitation set forth in Section 920(a)(4)(B)(ii) can only be construed narrowly to encompass more distant costs such as general overhead, and not costs that issuers incur to support debit card operations.

Specifically, the Proposal would disallow "network processing fees," which the Board acknowledges are fees that issuers pay to a network for each transaction processed over the network. The reason that the Board articulates for this exclusion is that, if this actual incremental fee is allowed, then acquirers and merchants "might be in a position of effectively paying all network fees associated with debit card transactions." We do not believe that an actual fee that issuers incur should be excluded from the regulation because of the *potential* that parties could conspire to violate the anti-circumvention rule.

The Amendment prohibits circumvention and the Board has inherent authority, examination and otherwise, to enforce compliance. Network processing fees should not be excluded.

The Board construes the "authorization, clearance, or settlement" provision of the Amendment too narrowly. These activities broadly describe the essential functions of handling a transaction, and are but the visible manifestations of an entire infrastructure needed to complete them. Can the efficient "authorization" of a transaction take place if the issuer had not undergone the task of authenticating the customer at account opening, issued a card, and maintained a continuous relationship with the individual standing at the merchant's counter? Can the accounting and periodic disclosure of each transaction to the accountholder be separable from the concept of "settlement"?

Also, a "particular" transaction, to be representative of the issuer's costs, must account for the necessity of ensuring security, incurring credit losses, creating and replacing cards, handling disputes, and so forth. A portion of all transactions will encounter exceptions handling of some sort. While the number will be small compared with the number of overall transactions, these costly transactions cannot be ignored and should be factored into the notion of a "particular" transaction. All of these considerations suggest that the Board has taken an unnecessarily narrow approach to establish fee standards. Therefore, the Board should abandon both Alternative A and B and redevelop a more reasonable regulation.

Below-Cost Price Caps Harm Consumers

Support for the Amendment in Congress and by its proponents is based in part by the desire to protect consumers. But most of the likely consequences of the Board's Proposal would lead to higher consumer costs, fewer consumer services, and less consumer access. An issuer, confronted with the inability to cover the costs of its operations, is faced with only a limited number of choices. It could scale back its debit card program and investments in it, favoring only the most profitable elements or at least those that generate the least amount of losses under the Proposal. This option directly limits consumers' access to a popular and important product.

Another option is to support debit cards through other bank operations, such as by assessing or raising deposit account maintenance fees. An issuer could also assess its customers directly for obtaining debit cards. These options also harm customers and would produce the perverse effect of transferring the obligation to pay some of the debit card network costs from merchants to consumers, in direct contradiction of one of the purported goals of the Durbin Amendment. This transfer of costs would have a disproportionately negative impact on lower income consumers.

The third option is for the issuer to absorb losses. Indeed, as is often the case, banks are the victims of their own innovations as a product or service, once successfully introduced, is extremely difficult to retract. Many banks may indeed feel compelled to offer this important product at a loss under the Board's rule. But how long can this be sustained? The Board's rigid fee cap casts into doubt banks' prospects of generating a return, and thus undercuts their incentives to make investments, such as the recent efforts to allow consumers to make payments easier online and through mobile devices. And as the Board proposes to reset the caps on a periodic basis, the built-in disincentives against reinvestment are, by design, permanent. Indeed, issuers would have incentives *not* to make advances in efficiency for fear of inviting future reductions in allowable costs. In short, issuers' most rational and likely responses to the Board's Proposal are likely to harm consumers and are thus inconsistent with an implicit goal of the Durbin Amendment.

The Board asked whether the proposed rule should distinguish between PIN and signature based transactions in establishing fee standards. The Amendment makes no such distinction and we do not believe that the Board should do so. To do so would be tantamount to conferring regulatory favor to one form of payment over another, and any relationship there might be between an assigned fee limit and the costs and risks associated with a form of payment would be attenuated.

Board's Proposal Makes Small Bank "Exemption" Illusory

One indication of how haphazardly the Amendment was enacted is its simplistic treatment of smaller institutions. With sentiment against large financial institutions (derisively but inaccurately called "Wall Street Banks") riding high combined with a desire to protect smaller institutions ("Main Street Banks") Congress, without the benefit of serious fact-finding and reasoned analysis, simply carved out an exemption from the fee regulation for institutions with less than $10 billion in assets. At the time it was unknown, and it remains in serious doubt today, whether the exemption would achieve its intended goal. The fact that small institutions will not face a regulatory price cap is not a consideration that binds the networks, processors, merchants, or anyone else. Even if small issuers are exempt from regulatory price caps, they are not exempt from market forces.

Indeed the Board's extreme approach makes it highly unlikely that Congress' intent would be achieved. If adopted as proposed, the Proposal would create a significant and artificial price disparity between regulated and unregulated fees. To believe that small banks' current interchange fees can be sustained is to believe that an otherwise unregulated market does not react to price signals. Networks will make necessary investments to establish a two-tiered system only if they are confident that unregulated issuers can generate volume, which the Proposal, if adopted, casts into question. Small issuers will also have difficulty attracting arrangements with networks and other vendors on economically favorable terms because of these same doubts, since networks care most about volume. Merchants, of course, will have powerful economic incentives to drive transactions to lower cost networks. In time, the strongest likelihood is that interchange fees will settle at or near the regulated levels for all issuers, exempt or not.

If this is the outcome, small banks would be worse off competitively than they are today for an additional reason: because they have fewer options and resources to respond to the price caps. Their lack of scale and narrower product lines compared with larger institutions render them less able to negotiate favorable network fees, offer consumer incentives, shift costs, or simply absorb them over the long term. When fees are unregulated, as they are today, all issuers stand a chance to charge market rates and earn a return. In a cost-minus environment, small issuers have fewer options.

Fraud Adjustment

CBA recognizes that the Board had very little time to develop a regulation that is necessarily complex, and we commend the Board for having conducted a comprehensive survey in short order. Nevertheless CBA strongly opposes putting off the fraud adjustment until potentially after the fee regulation is adopted. Issuers are paid through the interchange fee in part to bear the reasonable risks of fraudulent transactions. While all of the participants in the networks are required to take reasonable measures to ensure security, and bear some of the risks of not complying with security standards, it is the issuer that holds the accounts from which funds are stolen through fraud. It is the issuer who thus is left to handle the customer relations fallout with the accountholder, and who has to monitor accounts, offer refunds, reissue cards, and even open new accounts. These responses are very costly.

As illustrated by several high-profile security breaches against large, national retailers, issuers often incur significant losses because of merchants' security lapses. In actuality, financial institutions face fraud threats on a continual basis, not just from incidents that make the headlines. The Board should not treat issuers' exposure to fraud as a problem to be dealt with when time permits. This approach puts all issuers in a financially non-viable position; failing to deter and respond to fraud is not an option. The Board should adopt an interim allowance that reasonably accounts for the approximate fraud-related costs incurred by issuers until it can develop, with public input, a more comprehensive regulation that accounts for fraud.

Automated Teller Machines

The Board asks whether ATM networks should be included in the fee regulation as regulated debit card networks. We do not believe that Congress had any intention to regulate ATM interchange fees. The Board itself articulated a dispositive reason that ATMs should not be covered: the interchange fee is defined in the Durbin Amendment as a fee charged for the purpose of compensating the issuer, while an ATM interchange fee is paid *by* the issuer. Regulation of the ATM interchange fee that an issuer "may receive or charge" thus would have no relevance in the marketplace today or for the foreseeable future. At any rate, the Board did not collect information pertaining to ATM fees and is not in a position to regulate them at this time. CBA believes that, regardless of what operational similarities there are between an ATM network and a debit card network, there is only scant statutory basis in the Durbin Amendment for the Board to include ATM networks in the regulation.

Comparing With Checks

We believe that the Board conducted an unnecessarily one-sided comparison between electronic debit transactions and checks. For a comparison to have any meaning, all of the benefits and costs of the two payment methods must be considered. It is conceded that neither a merchant nor issuer pays or receives the equivalent of an interchange fee in a check transaction. But this superficial fact hides a more complex picture. From the merchant's perspective, handling a check transaction is cumbersome compared to accepting a debit card. It takes more time for the customer to fill out the check, the clerk is obligated to check ID and examine the check, and any irregularities slow down the transaction even further. For these reasons, merchants are electing less and less to accept checks, and for some of the same reasons consumers are showing a preference for debit cards over checks.

After a transaction merchants are required to bring the checks into the bank or else "process" their own checks through remote deposit capture. The longer they take to reconcile, the later they get their money. But even more importantly, with checks, merchants assume the risk that the check will be returned unpaid. On top of that, returned checks usually come with a bank charge against the merchant. In an electronic debit transaction either the card is accepted or it is not. If the card is accepted, the merchant faces no risk of return as the issuer guarantees payment. If the card is not accepted, the consumer either uses another form of payment or does not go through with the purchase. Thus, in contrast to checks, in a debit card transaction the merchant is not put in a potential loss position. For all these reasons, the bare absence of a comparable interchange fee with respect to check transactions offers no support for the Board's below-cost interchange fee price cap.

Network Access

While we disagree with the requirement in the Durbin Amendment prohibiting networks and issuers from limiting the number of networks available for processing a transaction to fewer than two unaffiliated networks, the Board's Alternative A appears to be consistent with the statute. Here again, the single-minded purpose of the Amendment appears to be to afford merchants with additional advantages. As the Board itself noted, the merchant's interests with regard to network choice and the consumer's interests may be in opposition (for example, consumer card benefits are usually associated with one particular network). Also, whether a merchant is willing to acquire the ability to conduct transactions through multiple networks is a separate question. For some issuers, the need to provide a second network or to switch networks because of the bar against affiliation could be costly and disruptive. The Board is well aware of the operational and legal challenges of complying with any new regulation, particularly one that requires many institutions to enter into new network relationships. It is not simply a matter of finding a new vendor, as changes usually affect other aspects of debit card operations and entail acquisition and tailoring of new systems, developing new procedures, and training.

CBA adamantly opposes Alternative B, which prohibits limiting the number of available networks to fewer than two for each of the forms of authorization. In practice, this alternative would benefit only those retailers that could afford to take advantage of multiple network choices for each payment method—e.g., large merchants. Such a restriction would be expensive for issuers and networks, particularly for small issuers, and as described above, could be disadvantageous to consumers. To the extent that issuers have to comply with this alternative, they would be less likely to be able to secure such benefits to consumers because it would be difficult for issuers to meet volume expectations and because it would be costly to secure multiple networks in the first place.

Effective Date

For the reasons articulated above, CBA asks that the Board seriously consider adopting a delayed effective date for the network choice provisions of the Proposal.

Thank you for your consideration of these comments. CBA recommends that the Board withdraw the Proposal and redevelop a more reasonable proposal for public comment. It should be more balanced and include no price caps. Please do not hesitate to contact the undersigned if you have any questions.

Sincerely,

Leland Chan
General Counsel