



February 22, 2011

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

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

Dear Ms. Johnson:

Citigroup Inc., a financial holding company ("Citi"), is pleased to have the opportunity to present to the Board of Governors of the Federal Reserve (the "Federal Reserve") comments on the Federal Reserve System's proposed "Debit Card Interchange Fees and Routing" rule (the "Proposed Rule") issued at a Meeting of the Federal Reserve on December 16, 2010<sup>1</sup> pursuant to Section 1075 (the "Interchange Amendment") of the Dodd Frank Wall Street Reform and Consumer Protection Act.<sup>2</sup>

Citi supports the arguments presented in the comment letter, of even date herewith, submitted jointly by numerous trade organizations, including The American Bankers Association, The Clearing House Association, The Consumer Bankers Association, The Credit Union National Association, The Financial Services Roundtable, The Independent Community Bankers of America, The Midsize Bank Coalition of America and The National Association of Federal Credit Unions (the "Joint Trades Letter"). We also agree with the analysis provided in the comment letter, of even date herewith, submitted by Morrison & Foerster LLP on behalf of a consortium of various institutions ( the "Consortium Letter").

Given the potential industry-wide impact of the Proposed Rule, as well as the impact on Citi, we have decided to submit a separate letter to emphasize some of our particular concerns. We are encouraged how, given the significance, uniqueness and complexity of the Proposed Rule, the Governors have expressly recognized the need for the Federal Reserve to remain particularly "open minded" to comments.<sup>3</sup>

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<sup>1</sup> 75 Fed. Reg. 81722-81763 (proposed Dec. 28, 2010) (to be codified at 12 C.F.R. Part 235)

<sup>2</sup> Codified as Section 920 of the Electronic Funds Transfer Act (the "EFTA") at 15 U.S.C. § 1693o-2.

<sup>3</sup> Transcript of Fed. Res. Bd. Open Meeting at 53-56 (Dec. 16, 2010) ("Open Meeting Transcript"), available at <http://www.cq.com/doc/financialtranscripts3782728>.

**I. The Proposed Rule will, by capping debit card interchange fees, hinder a financial institution's ability to provide its customers with the convenience of debit cards in a cost effective manner.**

The information gathered from the Federal Reserve's survey of issuers, networks and acquirers indicates that if the Federal Reserve's proposal to cap interchange fees at \$.12 per debit card transaction is adopted, (i) income generated for issuers by debit card interchange fees will be significantly reduced and (ii) a number of issuers will not be able to recoup their costs for debit card transactions through interchange fees.<sup>4</sup> The Federal Reserve posited that some of the institutions that suffered a decrease in income from debit card interchange fees and/or could no longer recoup their debit card transaction costs through debit card interchange fees might become more efficient.

A cap of \$.12 per transaction, however, will likely not permit Citi, given its relatively modest volume of debit card transactions, to maintain its debit card business, as it currently exists, as a profitable endeavor in a systemically responsible manner. In anticipation of implementation of the Proposed Rule, therefore, Citi has started assessing how it will need to change its business model. A business of this nature requires significant expenditures to ensure that it is both being operated in a safe and sound manner and is effectively serving the needs of customers.

To compensate for lost income from interchange fees, we expect that the industry is likely to consider numerous modifications to its programs, many of which will, ultimately, lead to higher costs or fewer choices for the consumer. Potential modifications include, among other things, introducing checking account fees in certain situations, limiting the size of debit transactions, eliminating reward programs associated with debit cards, limiting access to debit cards in higher risk situations, and eliminating some of the zero-liability fraud protection currently provided to consumers.

**II. The Federal Reserve should exercise discretion as permitted under the Interchange Amendment and broadly define costs. The plain meaning of "reasonable and proportional" should be applied.**

EFTA Section 920(a)(2) requires that the interchange fee charged or received by an issuer with respect to a debit card transaction be "reasonable and proportional" with respect to the issuer's costs for the transaction. The definition of costs is not limited in any way other than by the fact that the costs must be related to a debit card transaction. EFTA Section 920(a)(4)(B) provides guidance for the Federal Reserve in adopting the regulations required by the Interchange

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<sup>4</sup> Based on issuers' annual aggregate receipt of debit interchange fees of \$16.2 billion (75 Fed. Reg. at 81,725) and the Proposed Rule's contemplated reduction of such fees from an average of \$.44 per transaction to \$.12 per transaction, issuers would lose approximately \$11.8 billion in annual revenues. 75 Fed. Reg. at 81,735-36.

Amendment. This section expressly mentions two categories of costs. The first category -- incremental costs for authorization, clearance and settlement of specific transactions -- must be considered; the second category -- costs which are not specific to a particular transaction -- cannot be considered. EFTA Section 920(a)(4)(B) is silent on a crucial third category of costs that are encompassed in EFTA Section 920(a)(2) -- costs which are specific to debit card transactions but are not related to authorization, clearance and settlement. The Federal Reserve, therefore, has full discretion to include this third category of costs in the costs used to calculate a reasonable and proportional debit card interchange fee.<sup>5</sup> Nevertheless, the Federal Reserve has chosen to exclude this third category of costs. We believe it is permissible, appropriate and, ultimately, necessary for this third category of costs to be included to calculate an interchange fee that is genuinely "reasonable and proportional" to costs incurred by an issuer with respect to a debit card transaction.

Accordingly, contrary to what is contained in the Proposed Rule, we believe that the Federal Reserve should, and is permitted to, include in the calculation of costs upon which the interchange fee would be based, all costs (both variable and fixed) incurred by an issuer that are related to a debit card transaction. These allowable costs should include, at a minimum: (i) variable processing costs; (ii) transaction network fees; (iii) the costs for addressing cardholder inquiries and resolving cardholder disputes; (iv) the costs of processing charge-backs; (v) fraud losses; (vi) the cost for providing cardholder protections such as zero fraud liability and traveler's insurance; (vii) the cost of billing and collection; (viii) data processing costs; (ix) the cost of issuing replacement debit cards; and (x) fraud prevention costs. These costs are all incurred by an issuer and are either directly, or on an allocable basis, attributable to a particular debit card transaction. In addition, most, if not all, of these costs, as more particularly described in the Consortium Letter, are incurred with respect to the authorization, clearance and settlement of debit card transactions, the category of costs that are expressly supposed to be considered pursuant to the Interchange Amendment.<sup>6</sup> Although the incurrence or loss of any single debit card transaction may not eliminate or increase some of these costs, the overall volume of an issuer's debit card transactions, including volume on peak shopping days such as the Friday and Monday following Thanksgiving, determine how much must be spent on these items.

Finally, we believe that the use of the term "reasonable and proportional", as opposed to "equal to" or "a fraction of", suggests that Congress intended that the interchange fee not only cover all allowable costs, but also provide a reasonable return for the issuer in connection with a debit card transaction. The staff of the Federal Reserve acknowledged

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<sup>5</sup> The Federal Reserve acknowledged they had discretion in Memorandum in Support of Defendants' Motion to Dismiss Plaintiff's Claim Upon Which Relief Can be Granted and for Lack of Subject Matter Jurisdiction and Defendants' Response in Opposition to Plaintiff's Motion for a Preliminary Injunction ("Reply Brief"), *TCF National Bank v. Bernanke, et al.*, No. 10 civ. 04149 (LLP) (D.S.D. February 18, 2011) (dkt. No. 64). "Contrary to Plaintiff's assertion, the Board can consider factors other than the authorization, clearance, or settlement ("ACS") costs that are specific to a particular electronic debit transaction." Reply Brief at 2.

<sup>6</sup> 15 U.S.C. § 1693o-2(a)(4)(B)(i).

that terms such as “reasonable and proportional” have been interpreted as allowing for a profit. In response to a question by Governor Tarullo with respect to the appropriateness of a safe harbor, the staff stated that, “Reasonable and proportional doesn’t mean, is different than equal to or less than cost. And reasonable and proportional has been in other contexts read to include some profit. So we’re not required by that language to disallow all profit that might come along.”<sup>7</sup>

### **III. Government price controls are not required by the Interchange Amendment.**

We believe that the use of a cap is not required by, or consistent with, the Interchange Amendment.<sup>8</sup> The Interchange Amendment requires that the Federal Reserve prescribe regulations “to establish standards for assessing” whether an interchange fee is reasonable and proportional to the cost of a transaction.<sup>9</sup> As stated above, the Interchange Amendment also sets forth requirements on what costs must be considered and what costs may not be considered. Selecting and setting a fixed cap in advance for all covered issuers is contrary to the concept of establishing a system to assess whether a fee is reasonable and proportional to costs. Each issuer should have the opportunity to maintain data to prove its allowable costs and, by applying a formula or standards set by the Federal Reserve, to document that the fees that it receives are reasonable and proportional. As stated above, we believe that any formula or standards provided by the Federal Reserve should provide for an acceptable profit.<sup>10</sup>

Although the Interchange Amendment requires that the Federal Reserve determine what costs should be allowable costs and requires that the Federal Reserve set standards to assure that interchange fees are reasonable and proportional to those costs, it neither authorizes nor requires the Federal Reserve to assess the reasonableness of, or try to control, the costs themselves. The market should be allowed to function freely and control costs as appropriate.

### **IV. Debit card transactions are fundamentally different than checks in ways that benefit merchants.**

EFTA Section 920(a)(4)(A) requires that the Federal Reserve, in adopting its rule, consider the functional similarity between electronic debit transactions and checking transactions. Based on the commentary and the Proposed Rule, it appears that the

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<sup>7</sup>Open Meeting Transcript at 45.

<sup>8</sup> The Federal Reserve acknowledged that they are not required to set a specific rate. “In addition, the statute’s requirement that the Board “establish standards” for assessing debit interchange fees does not obligate the Board to set a specific rate for debit interchange fees.” Reply Brief at 2.

<sup>9</sup> 15 U.S.C. § 1693o-2 (a)(3)(A).

<sup>10</sup> We have no objection to providing a “safe harbor” within the regulations for administrative simplicity, provided that the “safe harbor” is a reasonable number so that it will be meaningful.

Federal Reserve did not consider some important differences between debit card transactions and checks. Debit card transactions are processed faster and in a more secure manner than checks. Unlike when a check is used to make a payment, merchants are provided with immediate payment when a debit card is used. In addition, in transactions where the card is physically presented or used, merchants are guaranteed payment. The issuer suffers the loss in the event there are no (or insufficient) funds or the account is non-existent. In contrast, checks may be returned for insufficient funds or a non-existent account, in which case, unless the merchant has paid a check guarantee fee, the merchant will suffer the loss. Finally, merchants incur additional administrative costs in handling, securing, reconciling and depositing checks that they do not incur with debit card transactions. Debit cards, therefore, provide significant benefits for merchants that checks do not.

The market, which permits each merchant to accept whatever payment method it chooses and each consumer to select among permitted payment methods, has proven that debit cards are not the functional equivalent of checks. The significant increase in the acceptance and use of debit cards<sup>11</sup>, coupled with the decrease in the acceptance and use of checks, indicates that debit cards are, in fact, viewed as superior to checks as a means of payment.

We note that the Federal Reserve's unnecessarily narrow definition of costs, as discussed in Section II, will create a significant disincentive against continued innovation in the debit payment field. Financial institutions are unlikely to continue to invest in maintaining and improving the debit payment system if they will not be able to recoup their investment costs.

**V. The exclusivity provisions should be interpreted narrowly and in accordance with their plain meaning.**

The Interchange Amendment requires the Federal Reserve to adopt regulations that prohibit an issuer and a network from entering into any arrangement whereby all transactions with a debit card would have to be processed over a single network or affiliated group of networks.<sup>12</sup> The Federal Reserve has proposed and has requested comments on two alternatives for implementing this provision. Alternative A requires that each debit card have at least two unaffiliated authorized networks through which debit card transactions can be processed. In other words, a debit card would only need to have two unaffiliated networks enabled on it in all events and could satisfy this requirement by having one network for PIN authorizations and an unaffiliated network for signature authorizations. Alternative B, on the other hand, requires that each debit card have a minimum of two unaffiliated networks over which debit transactions can be processed for each type of authorization permitted by the card. This would require a

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<sup>11</sup> The 2010 Federal Reserve Payments Study. Federal Reserve System, December 8, 2010, at 4.

<sup>12</sup> 15 U.S.C. § 1693o-2 (b)

debit card that permits both PIN and signature authorizations to have two unaffiliated networks enabled for each method of authorization.

We strongly support implementation of Alternative A. This alternative, as noted by the Federal Reserve in its comments, satisfies the requirements of the Interchange Amendment<sup>13</sup>; is much less disruptive to the debit card payment system; and, importantly, preserves the ability of the consumer to maintain some control over the network being used. The Federal Reserve in its comments acknowledged that the choice is an important one for consumers in that different networks might provide different benefits for the consumer.<sup>14</sup>

**VI. ATM transactions should not be subject to the Interchange Amendment or the rule promulgated thereunder.**

We agree with the commentary that the Interchange Amendment does not expressly include ATM transactions.<sup>15</sup> Given the magnitude and disruptive nature of the changes to be implemented by the Interchange Amendment, we believe that its scope should not be expanded beyond its plain language.

In addition, the Interchange Amendment is focused on regulating debit card fees paid to an issuer. Although fees may be charged when debit cards are used at ATMs, the fees collected from those transactions are generally paid by, as opposed to being paid to, an issuer.

**VII. An adjustment for fraud prevention should allow for maximum flexibility for financial institutions and should be implemented simultaneously with any limit on interchange fees.**

We strongly support an approach for fraud prevention adjustments that will not require governmental approval or setting of specific technology. We also believe that an allowance for fraud protection expenses must be implemented simultaneously with the imposition of any restrictions on debit card interchange fees. This approach is essential so that innovation with respect to fraud prevention is not inhibited. Over the last decade, the payments system arena has been dynamic with a steady flow of new and innovative processes developed by financial institutions in an effort to maintain the safety, convenience and efficiency of the debit payment infrastructure. As noted above, debit card payments provide merchants with important benefits over checks. These benefits

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<sup>13</sup> "Nothing in EFTA Section 920(b)(1)(A) specifically requires that there must be two unaffiliated payment networks available to the merchant once the method of debit card authorization has been determined." 75 Fed. Reg. at 81749.

<sup>14</sup> "From the cardholder perspective, however, requiring multiple payment card networks could have adverse effects. In particular, such a requirement could limit the cardholder's ability to obtain certain card benefits." *Id.* at 81748.

<sup>15</sup> *Id.* at 81727.

are possible, largely, because of the significant investments that financial institutions have made. Institutions will be discouraged from investing in new and advanced technology, or even maintaining existing technology, for preventing fraud in this complex market if they will not be able to recoup their costs.

**VIII. The definition of debit card needs to be clarified to avoid impacting credit transactions.**

The Federal Reserve needs to clarify the definition of debit card to explicitly exclude any card or other payment code or device issued or approved for use through a payment card network to access or obtain payment from a credit account.

In the absence of such a clarification by the Federal Reserve, there is the potential that a transaction involving a credit account might be interpreted to be an electronic debit transaction subject to Section 920 of the EFTA because the consumer has elected to repay the credit account by accessing a consumer asset account. Provided the purchase transaction is paid by the credit account, the card cannot be deemed to be a debit device by virtue of how it is repaid. In the In re Visa Check/MasterMoney Antitrust Litigation, US District Court, Eastern District of New York, CV-96-5238, the Special Master, in a decision adopted by Judge John Gleeson on February 14, 2011, concluded that a consumer credit program with similar features was not a debit card program under the terms of the MasterCard Settlement Agreement in that class action.

**IX. If the Proposed Rule is implemented without additional study and review, there are likely to be unintended consequences.**

We are concerned that the Federal Reserve may not have had sufficient time to collect all of the relevant data and thoroughly analyze and consider all aspects of the marketplace and the Proposed Rule because of the extremely tight time frame under which the Federal Reserve is required to adopt a final rule.<sup>16</sup> This increases the likelihood that there will be unintended consequences if the Proposed Rule is enacted as proposed. The Federal Reserve staff has conceded that the impact on consumers, the debit card market and the competitive landscape for issuers is not fully known.<sup>17</sup>

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<sup>16</sup> The Federal Reserve sent its survey to 131 issuers with assets of \$10B or more. Out of those 131 issuers, only 89 responded. We believe that the relatively low response rate was due, in part, to the complexity of the survey and the short response time required. No issuers with less than \$10B in assets were surveyed. 75 Fed. Reg. at 81724-81725.

<sup>17</sup> When asked by Vice-Chair Yellin about the impact on consumers, the staff responded that the result is difficult to predict and that any savings that might be passed on by a merchant could be offset by increased fees imposed by issuers. (Open Meeting Transcript at 25-26). When asked by Vice-Chair Yellin about the impact on the market, the staff responded, "on the whole, we don't know what the outcome will be in the market." (*Id.* at 29). In response to a question by Governor Warsh with respect to the impact of setting prices, the staff response was, "it is really somewhat difficult to tell how this will change ultimately the competitive landscape going forward." (*Id.* at 33-34). And, finally, when asked by Governor Duke what the impact will be on small institutions and government programs, the staff response was, "So with regard to the small issuers, we really don't know what the net effect will be, because it depends on actions to be taken by the networks and the merchants and we can't predict those actions."

We also note that Section 904 of the EFTA expressly requires that with respect to any proposed regulation promulgated under the EFTA, the Federal Reserve consider certain matters, including the costs and benefits to financial institutions, consumers and other users of electronic fund transfers; and the impact on competition among large and small institutions.<sup>18</sup> There is no indication in the Proposed Rule or the commentary that these matters were, in fact, considered.

We understand that some answers may be unobtainable until a final rule is adopted. At this time, however, we believe that provided that Congress does not act to postpone the deadline for adopting a final rule, the Federal Reserve should adopt a rule that is consistent with the Interchange Amendment, but will have a less drastic impact on the current debit card payment system than the Proposed Rule. The Federal Reserve can then take the time to conduct additional analyses to try and obtain answers to the very important questions posed by the Governors.

#### **X. Conclusion**

On behalf of Citi, I thank you for the opportunity to comment on this significant Proposed Rule. We can see how much time and effort went into developing it. We hope, however, that the Federal Reserve will consider all of the issues raised in this letter, the Joint Trades Letter and the Consortium Letter and revise the Proposed Rule to address our concerns.

If you have questions on any aspects of this letter, please call Rhona Landau at (212) 559-1864 or me at (212) 559-2938.

Sincerely,



Carl V. Howard  
Deputy General Counsel

cc: Rhona Landau  
Viola Spain

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(*Id.* at 34). “[G]overnment cards are not exempt from the exclusivity and routing provisions...And it is possible that...the issuers of the government cards would no longer be able to cover their costs strictly through interchange fees and they might, therefore, need to recover some costs from the agencies themselves increasing the costs of administering the programs.” (*Id.* at 38).

<sup>18</sup> 15 U.S.C. § 1693b(a)(2)-(3).