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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. 20551-0001

***Via E-mail and U.S. Mail  
(regs.comments@federalreserve.gov)***

Re: ***Docket No. R-1404 (Debit Card Interchange Fees and Routing)  
RIN No. 7100 AD63***

Dear Ms. Johnson:

We appreciate the Federal Reserve Bank's ("FRB") invitation for comments about its proposed rules regarding debit card interchange fees and routing (the "proposed rules"). We have previously commented on behalf of merchants identified in our letters to you of October 15, 2010 and December 2, 2010.

The FRB's proposed rules are a positive and important reform for merchants. As we have written to you previously, certain of the card networks' point of sale rules governing merchant acceptance of payment cards restrain price competition among the networks or banks for merchants' preference (*i.e.*, surcharging or discounting) at the point of sale. Both economic theory and actual experience in other countries where some of these restraints have been removed demonstrate that interchange rates (credit and debit) will decline substantially for merchants who have the ability to steer cardholders to lower cost payment means by using the price mechanism (*i.e.*, surcharging or discounting) to favor or disfavor one payment card over another at the point of sale.

One form of steering involves surcharging, which is not addressed by the Durbin Amendment. Another form of steering involves price discounting, which is covered by the Amendment. The Durbin Amendment provides a mechanism for merchants to use price discounting to steer cardholders who would pay with a more expensive credit card to pay instead with a less expensive debit card. The FRB's proposed rules provide an economic basis for merchants to steer in this manner by setting forth a debit interchange cost standard that yields a demonstrably lower rate for a debit card transaction than a credit card transaction.

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As long as the networks and banks are able to use the networks' point of sale rules to insulate themselves from price competition for merchant preference, merchants and their customers will have to pay higher prices. The Durbin Amendment and the FRB's proposed rules are not a complete solution to this problem, but they are an important part of the solution.<sup>1</sup>

The FRB has gone to great lengths to give everyone who has a stake in the outcome of its rule-making procedures an opportunity to be heard. At this point, we think the FRB should finalize and adopt its proposed rules as scheduled so that all stakeholders have certainty about the "rules of the road" going forward and can plan accordingly.

The balance of this letter addresses eight specifically identified issues in the FRB's proposed rules.

**1. The Proposed Cost Alternatives**

As between Alternatives One and Two in Section 235.3, we think Alternative One is preferable provided that a merchant can get an issuer to charge less than 7 cents/transaction if the competitive situation allows. The data demonstrates that the cost to authorize, clear and settle a debit transaction is considerably less than 7 cents/transaction. If the 7 cents/transaction effectively sets the debit rate such that a merchant cannot harness price competition by using its ability to steer to incent an issuer to charge a lower rate, then Alternative One will not have done enough to allow merchant price discounting at the point of sale to move debit rates even lower for those merchants who have the ability to steer. To be clear, we read Alternative One not to set a 7 cent/transaction floor, but rather a ceiling below which a merchant can try to negotiate if it has the competitive leverage to do so.

**2. Per Transaction versus Average Transaction Cost Cap**

We do not believe that the FRB's proposed rule resolves whether to use a per transaction or an average transaction cost cap. We think the per transaction cost cap should be used to avoid a cross-subsidy.

Under an average transaction cost cap, an issuer or network could make up for losses on high-cost debit transactions by charging a higher cost for the low-cost debit transactions. In other words, the low-cost debit transaction interchange fee will be artificially higher to make up for the uncovered costs for the higher-cost debit transactions. This cross-

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<sup>1</sup> The solution will involve a suite of reforms arising from the Justice Department's enforcement action against Visa, MasterCard and American Express, private antitrust litigation against those networks (and potentially others), and the Durbin Amendment and the FRB's proposed rules.

subsidy is particularly likely to occur among merchants who handle a high volume of low-cost debit transactions.

To ensure compliance with the FRB's proposed rule and to prevent such a cross-subsidy from occurring, we suggest that the FRB require networks and issuers to produce a monthly report to the FRB and merchants setting forth the interchange fee charged on each debit transaction. This kind of transparency will enable the FRB to monitor compliance with, and give merchants more confidence that networks and issuers are implementing, the proposed rules.

### **3. Network's or Issuer's Costs?**

The FRB still appears to be considering whether the debit interchange rate should be based on network's costs or issuer's costs. As between the two, we think that issuers are in the best position to undertake efforts to reduce costs to authorize, clear and settle debit transactions because any savings from greater efficiency will directly benefit them. That is to say, if an issuer can become more efficient so that it is able to authorize, settle and clear a debit transaction at a cost less than the cap, then the issuer should have an incentive to do this and any excess can be competed away in competition between issuing banks for cardholders. Networks, in contrast with issuers, do not have an incentive to pass on any cost savings to merchants in the form of lower debit interchange rates because, under the cap system, any network savings on average processing costs will leave room under the cap for other issuers to obtain higher debit interchange rates for their transactions with the network still remaining under the cap.

### **4. Rewards**

We read the Staff's comments correctly to state that a network's or issuer's cost of rewards is not recognized as an allowable cost to include in calculating the average variable cost of the debit interchange rate. See FRB Staff Comments at 63 ("The Board does not view the costs of cardholder rewards programs as appropriate for consideration within the context of the statute.") Our letter to you of October 15, 2010 provides an economic analysis of why the cost of rewards should not be included in the computation of the debit interchange rate. By not expressly including rewards in the cost calculation, we believe that the FRB has taken an important step in avoiding the upward interchange spiral on debit cards when issuers charge merchants higher interchange fees to pay for more costly debit rewards cards.

### **5. The Threat of Network Circumvention of the Proposed Rule**

While the proposed rule would set the debit interchange rate at an average cost for authorizing, clearing and settling a debit transaction, it does not specifically regulate (or require the inclusion of) other network or issuer fees, including switch fees, transaction fees, membership dues and assessments. We think that this is an area that warrants careful scrutiny by the FRB because of the potential for a network to circumvent the proposed debit rule by, for

example, allocating to issuers a portion of a network's merchant membership dues or assessments to offset issuers' loss of revenue from interchange on debit cards. We suggest that the FRB carefully monitor the networks' operating rules for any changes that shift liability from issuers to merchants as a way to make up for lost income from interchange.

## **6. Routing**

The proposed rule would eliminate network exclusivity in routing debit transactions. The FRB's routing proposal offers two alternatives. One alternative calls for an issuer to offer at least one network for PIN debit and an unaffiliated payment card network for signature debit. The second alternative requires an issuer to offer at least two unaffiliated networks for PIN debit and two for Signature debit.

As between the two alternatives, we think the second is demonstrably better than the first because the second, unlike the first, offers merchants greater competition in the form of more routing options.<sup>2</sup> A further complication in the first proposal arises if a merchant does not accept debit cards that are "bugged" with at least one of the alternate routing networks. The solution, already contained in the second proposal, is for an issuer to offer at least two unaffiliated networks for both PIN and signature debit cards. The work to add an additional signature debit network to cards is not unreasonably burdensome or expensive. Today, card brands give networks, issuers, acquirers and merchants as little as 6 weeks lead time to make system changes for card acceptance. We can foresee no rational business basis to delay until July 2013 the addition of the signature debit network to cards.

## **7. Three- versus Four-Party System**

We read the FRB's proposed rules to cover both three- and four-party systems. This is sensible because of the economic reality of costs for authorizing, clearing and settling a debit transaction in a three- or four-party system; and because, from a merchant's perspective, the three- and four-party debit cards are fungible as payment devices but for the existence of point of sale anti-steering restraints imposed by networks who have or could launch a debit card product in the future, *e.g.*, Visa, MasterCard, American Express and Discover.

On a related note, a bank or company which is both an issuer and acquirer might try to allocate issuing costs to its acquiring side in order to charge those costs to merchants. We think that this would circumvent the FRB's proposed rule. We think the FRB could helpfully head off a future dispute on this point by clarifying that a three-party issuer or network cannot

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<sup>2</sup> A common theme running through this and the other letters that we have sent to you is that we favor any reform that enhances and makes more robust price competition among networks and banks for merchant preference at the point of sale. The more vigorous the competition, the better the chance that market forces will discipline networks and banks from charging supracompetitive debit card (and credit card) interchange rates.

allocate issuing costs to its acquiring side in order to charge those costs to merchants in circumvention of the proposed rules.

## **8. Fraud**

We do not believe that there is an economic rationale for merchants to pay for issuers' fraud prevention activity. Before allowing any debit interchange fee related to fraud prevention, we suggest that the FRB's rule should require an issuer to establish that a particular fraud prevention activity will reduce merchants' fraud costs and cannot be made specific to a merchant. If an issuer cannot establish the first condition, then there is no basis to charge merchants, and the issuers already have the proper incentive to incur fraud prevention expenses if the expected value of fraud reduction exceeds the cost of the activity. If, however, issuers can get merchants to pay for fraud prevention, then issuers will have an incentive to engage in inefficient fraud prevention activities. If a fraud prevention activity cannot be made merchant-specific, then issuers can contract with merchants for fraud prevention services when there is a net gain available (*i.e.*, the reduction in the merchants' fraud losses exceed the cost of the activity). The FRB's rule should require an issuer to demonstrate that these two conditions hold, and to determine the division of the gains between the issuers and the merchants, with any increased interchange certainly being capped by the level of the merchants' benefits.

## **Conclusion**

As noted earlier, we think the FRB's proposed rules represent a positive development for merchants and consumers. We urge the FRB to promulgate and implement the final rules on its current schedule.

Please let us know if you have any questions or would like to discuss any of the foregoing points.

Thank you in advance for considering our comments.

Respectfully,



William J. Blechman

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