INDEPENDENT COMMUNITY
BANKERS of AMERICA

Submitted via email --regs.comments@federalreserve.gov

February 22, 2011

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

Re: Docket R-1404, Regulation II, Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

The Independent Community Bankers of America ("ICBA") offers the following comments on the Board of Governors of the Board System (Board) proposed rulemaking – Regulation II, Debit Card Interchange Fees and Routing -- to implement Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] Section 1075 amends the Electronic Fund Transfer Act (EFTA).[2]

I. Executive Summary

The Durbin Amendment (EFTA Section 920) purports to shelter community banks from the adverse effects of the price controls it requires for debit card interchange. A detailed analysis of the proposed Regulation II, however, illustrates that the regulation, if implemented as proposed, will have a devastating effect on community banks. ICBA recognizes the basic problem that the Board confronts: it is difficult (if not impossible) to design a regulation that lowers interchange fees to the

[1] Debit Card Interchange Fees and Routing, 75 *Federal Register* 81,722 (proposed December 28, 2010).
[2] A Table of Contents for this letter is attached as Appendix B.

cost of a particular transaction plus a reasonable rate of return; permits merchants to control routing of transactions; and insulates community banks from the resulting price setting.

The proposed regulation takes the approach of aggressively pursuing two of those goals (price cuts and routing control) to the entire exclusion of the third (insulating community banks). Nothing in the statute compels or supports an approach that will have such a devastating effect on community banks. Accordingly, ICBA urges the Board to withhold its approval from the proposed regulation and take the steps outlined below.

ICBA has signed a separate comment letter presented on behalf of the banking industry as a whole and signed by nine national financial services trade associations and we support the recommendations in the comment letter.

The purpose of this submission is to explain the unique perspective of community banks and provide recommendations based solely on that perspective. Specifically, ICBA urges the Board to:

- Gather data about the costs incurred by banks of all sizes and establish standards that make it feasible for banks of all sizes to collect fees that are reasonable and proportional to their costs and allow a reasonable profit.
- Examine the impact of the rule on consumers, small businesses, community banks, and the "underbanked," as well as the likely adverse effect of the rule on competition and innovation. Even if the statute compels adoption of severe price cuts, the Board should emphasize for the record the breadth and severity of the ensuing adverse economic consequences, as required by EFTA § 904(a)(2).
- Take realistic steps to shelter community banks from the price cuts, including appropriate incentives (or requirements) for networks, acquirers,

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and merchants to permit community banks to collect interchange fees adequate to cover all their costs plus a reasonable profit and compete effectively with large banks.

- Limit the multi-network requirement to two networks per card. Nothing in the statute compels a four-network requirement. A four-network requirement will have a particularly debilitating effect on community banks.
- Withhold approval of the pricing rules until the Board is in a position to promulgate adjustments for fraud. Destabilization of the industry's aggressive anti-fraud efforts will impose needless cost on the industry, merchants, cardholders, and society at large.

Our presentation proceeds in several steps.

- Sections II and III introduce the role of community banks in the American economy and their stake in the proposed regulation.
- Section IV provides a detailed empirical description of the debit card marketplace, emphasizing the importance of debit card revenues to community banks and the strong economies of scale in average variable costs of debit card processing. These economies of scale mean that smaller banks (most of which use third-party processors rather than operating internal processing units) have higher costs solely because of their size, without regard to their situational or internal operating efficiency.
- Section V documents the specific harms that the proposed regulation will impose on community banks. Whether networks adopt separate market-rate schedules for community banks or not, community banks will bear the brunt of the proposed price controls.
    - First, it is likely that at least some of the networks will not immediately adopt separate schedules. If they do not, the price controls will apply directly to community banks and, given their relatively greater dependence on debit card revenues, destabilize

them more severely than the large banks at which they are aimed.

- Even if the networks do adopt separate price schedules (as some eventually are likely to do, if only to palliate Congressional sentiment), they are likely to do so at prices far below existing market levels (so the separate schedules will only mitigate – not remove – the harm of the price controls).
- Moreover, because the statute leaves merchants free to discriminate against consumers who carry higher-interchange debit cards, the right of community banks to issue cards with interchange rates that reflect operating costs and provide a reasonable profit is not likely to lead to their common use or acceptance in the marketplace.

- Section VI follows with an analysis of the likely effects of the Board proposals on the economy at large, especially consumer welfare.
  - Basic principles of economics, together with data drawn from current community bank operations, demonstrate that implementation of the proposed regulation will have an important and immediate adverse impact on consumer welfare. Highly visible increases in banking fees and reduced services that will drive marginal customers out of the mainstream marketplace will far outweigh any cost savings passed through to consumer purchasers from those few very large merchants likely to receive cost savings from their acquirers.
  - More generally, by setting a price cap that is far below debit card costs incurred by all card issuers, the regulation conflicts with the statutory requirement to set a "proportional" price. The end result, we show, will be to drive consumers away from the relatively efficient use of debit cards and toward the use of payment products that are, from an efficiency perspective, considerably less desirable.
- Section VII explains that the regulatory flexibility analysis offered with the regulation is fatally flawed by its failure to acknowledge the stark impacts the regulation will impose on community banks and the limited likelihood that

the statute will benefit small merchants. At a minimum, the Board should reassess the regulation informed by a thorough assessment of those costs and benefits.

- Section VIII responds to the Board's request for input related to fraud. We urge the Board not to freeze innovation by adopting any technology-specific standards. Rather, recognizing the need for continued innovation in fraud prevention, the Board should adopt a flexible proposal that permits the industry to continue innovating to limit the socially devastating losses from fraud.
- Finally, Section IX concludes with the details of ICBA's recommendations. An Appendix specifies ICBA's responses to the explicit questions posed by the Board in the proposed rule.

II. Community Banks in the United States Economy

ICBA represents community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers these banks serve. With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold over $1.2 trillion in assets, $960 billion in deposits and $750 billion in loans to consumers, small businesses and the agricultural community. The mean asset level among our members is $265 million; the median is $132 million. We respectfully suggest that the role of community banks in the banking industry makes their perspective on the proposed Regulation II uniquely valuable to the Board.

Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. Community banks are prolific small business lenders. Thus, although community banks with less than $10 billion in assets represent only 21.5 percent of bank industry assets, they have made 58.3

percent of the small business loans currently outstanding from banks.[3] In contrast, banks with more than $100 billion in assets, the nation's largest financial firms, make only 25.4 percent of small business loans.

As a decentralized source of capital and lending, community banks play a vital role in the stability and growth of each of the fifty states. This wide dispersion of our nation's assets and investments helps preserve the safety, soundness, fairness, and stability of our entire financial system. Regulatory intervention that destabilizes community banks threatens the network of deposit and lending services those banks provide – which extends not only to the largest metropolitan areas, but throughout all areas of the country.

III. The Stake of the ICBA

Although EFTA § 920(a)(6) exempts most community banks from the proposed debit card interchange regulation, ICBA remains deeply concerned about the regulation for two reasons: the likelihood that community banks nevertheless will face the drastic rate cuts the proposed regulation contemplates; and their direct exposure to the costs of the multi-network regulation (from which community banks have no statutory exemption). Both of these concerns arise from the implications of the rule for customers of community banks.

On the first point, it is not yet clear when any of the major debit card networks will adopt dual interchange fee schedules, or clear that they ever would allow community bank members to receive market-based interchange fees while their larger bank members are forced to accept artificially-set rates reduced by 80 percent or more. As noted in the staff's oral comments when presenting the proposed regulation to the Board, neither the statute nor the regulation requires the networks to create separate schedules for community banks.

[3] The statistics in this paragraph are based on September 30, 2010 Call Report data.

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There are good reasons to expect that at least some of the networks will not promptly adopt separate rate schedules for community banks, and those that do, will adopt schedules inadequate to permit community banks to recover the costs of the services that they provide and earn a reasonable profit, and that in any event merchants and acquirers will discriminate against community bank cards that bear higher interchange rates than cards of larger banks. Thus, ICBA regards it as farfetched to believe that community banks will surmount those obstacles and actually succeed in receiving fees four to five times as high as their larger peers.

On the second point, the interaction of the pricing rules with the routing control rules (authorized by EFTA § 920(b)) underscores the plight of community banks. Because community banks are not exempt from the latter rules, merchants will have strong incentives to use those rules to prevent routing of transactions on any network that permits community banks to continue receiving existing market-based interchange fees. Similarly, although EFTA § 920(b)(2) prohibits merchants from discriminating on the basis of issuer or network, it does not prohibit merchants from discriminating on the basis of price. In the end, it seems likely that merchants will provide monetary or other incentives to encourage their customers not to use debit cards issued by community banks. Moreover, even apart from those problems, the difficulties of compliance with those rules will be especially burdensome for the relatively small institutions that are members of ICBA (half of its members have assets of less than $132 million).

The implications of the interaction of these §s of the proposal for the customers of community banks are significant. The loss of interchange revenue under the proposed rules will be significant enough for community banks that they will have to undertake unfortunate and unpopular offsetting actions, regardless of the expectations and intent of the Congress when it passed the relevant sections of the Dodd-Frank Act last year.

In sum, ICBA presents these comments to ensure that the Board proceeds with awareness of the devastating costs that the proposed regulation will impose on community banks and their customers, costs that are sharply in tension with the statute's explicit intention to shelter community banks from the adverse effects of imposing price controls on debit card services.

IV. Background

Community banks provide a menu of important financial services in their local communities, chief among them, monetary services through deposits (a medium of exchange and store of value), and credit services important for local commerce (small business and consumer loans). At the center of both of these critical services is the demand deposit account (DDA). Because DDAs are the accounts to and from which monetary transfers are made, the provision of DDAs is one of the two core functions of community banks. In addition to their role as the vehicle for transfers and payments, DDAs are the source, when banks act as intermediaries, of much of the funds for the other core community bank: lending to consumers, small businesses, and governments.

Increasingly in recent years, the monetary services of community banks, as for larger banks, have involved electronic forms of monetary transfer, including ACH, ATM, and debit card transfers for consumers, businesses, and governments. Notably, those electronic transfers do not involve intermediate activating steps using paper debit orders (checks). Community banks are able to engage in these kinds of electronic activities competitively, without individually undertaking the massive electronic infrastructure investments such activities entail, by relying upon servicing organizations that provide the necessary electronic processing for a fee. This is not to say that community banks benefit fully from the scale of economies available to larger banking organizations with largely internal processing capabilities. Rather, community banks compete with their larger brethren in electronic deposit markets by matching them on deposit product pricing, without installing the full complement of processing equipment that would be necessary to operate at large-bank deposit levels at minimum cost.

Although third-party or outside processing is still more costly on a unit basis for community banks than the large-scale internal processing typical of larger organizations, the community bank strategy has proven itself feasible in the marketplace. Debit interchange revenue has been crucial to the competitive balance, because it provides community banks sufficient revenue to cover their internal and external costs along with a reasonable profit margin. Without revenue at or near the market level, community banks would have to make significant changes in their product pricing if they wish to continue to provide these popular, useful, and important financial services.

Evidence suggests that debit card interchange revenue under the prices the Board has proposed will no longer be sufficient for community banks to maintain these popular, useful, and important financial services without significant product pricing changes. Thus, the result of reduced interchange will be higher consumer and business deposit account pricing for community bank consumer and commercial customers.

Unfortunately, it does not follow that this significant change will be matched with lower prices for consumers and businesses at large merchant outlets, the main beneficiaries of lower interchange. Among other things, lower interchange might not benefit retail purchasers because it will not be significant enough on individual transactions to warrant alterations either in merchant pricing or purchaser behavior.

Evidence from Australia, which underwent similar interchange reduction, suggests that this is just what is likely to happen domestically. Years later, there is

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no evidence whatsoever of a reduction in consumer prices, even though the regulator that imposed the price controls has followed the situation closely. There is, however, undeniable evidence of immediate and salient increases in the prices consumers pay for banking products and a reduction in the banking services they receive. This is just the wrong approach to encourage competition for financial services or innovations in the payments system.

V. The Risk for Community Banks

Despite the statutory emphasis on sheltering small institutions from the adverse effects of centralized price fixing (EFTA § 920(a)(6)), community banks will suffer devastating disruption of their existing businesses under any plausible scenario. The inevitable effect of the proposed regulation will be to increase the incentives toward industry consolidation (already exacerbated by other provisions of Dodd-Frank that favor large issuers). Discussion in this section proceeds in three steps.

- Market dynamics make it unlikely that small bank issuers of debit cards will benefit from separate interchange schedules that will permit them to recover their costs and earn a reasonable profit.
- Interchange controls established by proposed Regulation II will have a devastating effect on community banks.
- Proposed multi-network rules will severely impact community banks.

A. Small Bank Issuers Do Not Expect Price Schedules That Permit Them To Recover Their Costs and Earn a Reasonable Profit

It is an unfortunate aspect of the deadline imposed by EFTA § 920(a)(8)(C) that the Board must implement regulations before it can be sure how the various networks will respond to the issuer-level price controls that the Board has proposed. Also, the different circumstances of different networks make disparate

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responses likely, especially for the PIN networks. But in no plausible scenario can community banks expect to receive interchange fees that will cover their operating costs, much less afford a reasonable profit. The accuracy of our expectation is underscored by the Government's concession in their brief in defense of the statute (in *TCF v. Bernanke*). The Government defends the constitutionality of the statute by arguing that "exempt banks will likely receive lower interchange fee income." Memorandum in Support of Defendants' Motion to Dismiss at 40, TCF National Bank v. Bernanke, No 4:10-cv-04149-LLP (D.S.D.) [hereinafter *TCF Brief*].

To be sure, networks may feel the need to comply with Congressional intent by adopting separate interchange schedules. But this does not solve the problem of community banks for three reasons:

- There is little or no incentive, punitive or otherwise, for networks to adopt separate schedules immediately.
- Even if the networks had a strong incentive to adopt schedules promptly, the acknowledged technical complexity likely would delay implementation well past the effective date of the rule.
- And the reality of network competition, combined with the large merchants' omnipotent power to route transactions as they please, means that any schedules networks do offer are unlikely to set prices at which community banks can recover their costs and earn a reasonable profit.

Economics suggests that the dominant strategy for Visa and MasterCard will be to compete for signature-debit transaction volume. The interchange on big-bank signature transactions would be fixed by the regulation at 12 cents or lower. But substantial increases above that 12 cent ceiling by either network for small-bank cards gives merchants an incentive to refuse (or discriminate against) the entire network's cards: for example, if one network sets 50 cents as the small-bank interchange fee and the other network sets interchange at 25 cents, merchants might decline to accept (or discriminate against) the cards with the higher interchange. Although the networks traditionally have been able to prohibit discrimination by merchants, the recent antitrust settlement[4] expressly authorizes merchants to discriminate against high-cost cards in a number of ways. Among other things, merchants now have free rein to express a preference for particular types of cards through sequencing payment choices or providing information to consumers. So, for example, it would be perfectly legal for merchants, without refusing to accept one brand or the other, to design terminals to encourage consumers to use cards from their "preferred" brand or to dissuade the use of cards from a higher-cost brand.

Moreover, since the antitrust settlement in the referenced case, merchants are free to refuse all debit cards from either of the major networks; indeed, Wal-Mart already has exercised this option when it became dissatisfied with MasterCard's pricing. The differential prices necessary to permit small banks to recover their costs and a reasonable profit are much higher than anything the industry previously has experienced. Accordingly, we think it is realistic to expect the largest merchants to refuse cards from a network that attempts to establish such a price schedule.

Finally, merchant processors are likely to respond to the combination of the federal validation of discrimination and the new routing provisions of EFTA § 920 by developing and offering to merchants more sophisticated methods for identifying high-cost transactions than hitherto have been available. It is safe to say that we have not yet seen the most effective devices for transaction routing technology companies can devise. Again, the basic problem is that the price differentials between what Regulation II proposes and what is necessary for community banks to recover their costs and earn a reasonable profit are so high that the return to devising effective devices for discrimination against high-cost cards easily should justify substantial investment in such devices. Again, the importance of these new

[4] United States v. American Express Company, No. CV10-4496 (E.D.N.Y.)

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rules is evident from the Government's arguments in *TCF v. Bernanke*, in which they rely heavily on the likelihood that these routing rules will minimize any price differential community banks might attempt to preserve. *TCF Brief* 40-41.

The possibility that merchants would decline to accept (or discriminate against) Visa cards in response to a relatively high-cost schedule for community banks would give Visa's big bank members an incentive to switch their cards to MasterCard (with its hypothetically lower small-bank price schedule). Importantly, as this example demonstrates, because the big banks can switch their cards from one network to another in response to higher-interchange small-bank schedules (and most big banks can or do issue both card brands), and because merchants have the leverage of refusing (or discriminating against) *all* cards of a particular network (not just those of the small banks), Visa's and MasterCard's need to protect their share of big-bank signature transactions will force them to compete downward on price for the small-bank cards.

In the current marketplace, which balances market forces without outside intervention by government, the balance between a pressure toward high interchange fees (to make cards attractive to large issuers) and low interchange fees (to make cards attractive to large merchants) produces fees that are relatively stable. But in a marketplace with fixed prices for large banks, the competition for their business will make the interchange revenue for the supposedly insulated community banks move only in one direction – downward. The equilibrium outcome, we believe, would be a separate schedule for small-bank cards (to palliate Congress) with a price only slightly above the regulatory level for big banks. Such a price will be below the costs of providing debit card services for most if not all community banks.

A similar, though slightly more complex dynamic, will drive PIN network strategies. In some parts of the country (for example, large metropolitan areas on the coasts), several PIN networks have substantial merchant networks that compete against each other for issuance. In those areas, one network might be motivated to become the network of choice for community banks. This network might adopt a relatively high-interchange schedule, and most or all local community banks might issue their cards on that network.

But again it is unlikely that market pressures would leave such a schedule unaltered. Given the ready presence of competing PIN networks, and the availability of signature networks on all cards, it will be easy for merchants to refuse or otherwise discriminate against cards issued on such a network. Again, the proposed Regulation II explicitly recognizes the likelihood that acquirers will assist merchants in establishing systems for that kind of network discrimination. The inevitable equilibrium outcome in the face of such a response is a lowering of the interchange on any separate small-bank schedule to the point that it is no longer economically worthwhile for acquirers and merchants to discriminate against the network. Again, at that point the interchange is likely to be well below the cost that community banks incur in providing debit card services.

The final dynamic relates to areas of the country in which only one PIN network is competitive. In areas of the country in which one or a small number of networks have competitive merchant and issuing operations, the network will face little or no incentive to adopt a separate small-bank schedule with substantially higher interchange. It will face opposition from both large banks and merchants. As with the Visa and MasterCard scenario described previously, merchants could respond under this circumstance by encouraging customers to route transactions over the signature networks (which are unlikely to have prices much above twelve cents as discussed above). Big banks, which would provide the majority of transactions on such a network, in any case will oppose that result as well, and thus provide additional pressure against such a strategy. In the face of the combined opposition of merchants and their largest acquirers, it is unlikely that any PIN network would choose that strategy.

In sum, it is difficult to envision a competitive outcome in which any network maintains over the long run a schedule that permits community banks to collect interchange fees adequate to cover the costs of providing debit card services and earn a reasonable profit. That result, we submit, is directly inconsistent with the intention of Congress in adopting Section 1075 of the Dodd-Frank Act as written, and thus, by itself, is sufficient grounds to withhold approval from the proposed Regulation II.

B. The Proposed Price Controls Will Undermine the Financial Health of Community Banks

Given the explicit recognition in the drafting of Section 920 that community banks should not be subjected to interchange limitations, it would seem self-apparent that the Board should think twice before setting price controls on interchange that in practice will disrupt not only the profitability and capital-raising ability of community banks but also the pricing of important banking services for customers.

The first point is the simplest: because debit card programs provide an important component of the revenue of community banks, the interchange rate reduction of approximately 80 percent will sharply impact operating income. A survey of ICBA members conducted to gauge their interchange revenue and debit card program costs suggests that most community banks will lose revenue equal to more than 10 percent of net operating income; for some it will be more than half of net operating income.[5] Coming on the heels of reductions in income from overdrafts due to amendments to Regulation E (Electronic Fund Transfers)[6] and

[5] ICBA Debit Card Costs and Revenue Data Collection conducted, February 1-8, 2011, from among ICBA members.

[6] Regulation E (Electronic Fund Transfers) Rule limits the ability of a financial institution to assess an overdraft fee for paying ATM and one-time debit card transactions that overdraw a consumer's account, unless the

guidance issued by the Federal Deposit Insurance Corporation[7], the pressure is profound. If community banks are to remain profitable and meet regulatory capital requirements consistent with continued health and ability to expand, they will be forced either to identify other sources of revenues (new or increased customer fees) or to change the scope of their operations in important ways (service and staff reductions). The likelihood that they will be driven toward riskier operating strategies is certainly relevant.

Second, demonstrated economies of scale in debit card processing mean that interchange revenue loss is more significant for community banks. From the Board's cost survey of the largest banks, we know that the volume-weighted average variable costs of authorization, clearance and settlement of debit card transactions is about 4 cents. This means that for the very largest banks the cost is less than 4 cents. For community banks, however, the average variable costs of authorization, clearance, and settlement exceed 12 cents. We emphasize that this has nothing to do with the care or lack of care in the design of the debit card programs of individual banks. Rather, the data collected by the Board cost study demonstrate the inexorable role of economies of scale in debit card operations that extend to the community banking end of the bank size continuum. Removing the necessary revenue to cover these costs and provide a reasonable rate of return threatens serious disruptions for community banks; at the same time, large banks that benefit from the economies of scale are much less threatened by such a rule.

Moreover, because large banks are more likely to be diversified beyond their core banking operations for consumers and small businesses (through insurance, capital market operations, securities trading, and the like), they may well feel less need, especially in the short run, to respond to interchange controls by imposing sharp fee increases on consumers. Notwithstanding those options, some of the

consumer affirmatively consents, or opts in, to the institution's payment of overdrafts for these transactions. 74 *Federal Register* 59,033, November 17, 2009.

[7] Federal Deposit Insurance Corporation Financial Institution Letter (FIL-81-2010), Overdraft Payment Supervisory Guidance, November 24, 2010.

largest banks have already announced sharp DDA and/or debit card fee increases in anticipation of significant decreases in debit card interchange. Community banks, in contrast, will have little choice but to impose those increases on the relatively compact product lines they offer. Again, the inevitable effect – notwithstanding the favorable treatment required by EFTA § 920(a)(6) – is an unfavorable impact upon community banks and their customers.

C. The Four-Network Alternative Will Exacerbate the Harm to Community Banks

Because Section 920(b)(1) does not exempt small issuers, community banks are directly exposed to the adverse consequences of the multi-network rules required by Section 920(b)(1) and the proposed regulation. ICBA notes that the proposed Regulation II fails to take into consideration the special difficulties that the four-mark alternative will impose on community banks.

As the Board staff explained when they presented the proposed rule, the market for debit card issuance has gravitated toward a product that includes two processing capabilities (marks) on each card – a single signature mark (usually either MasterCard or Visa) and a single PIN-based mark (NYCE, PULSE, STAR Network, Accel/Exchange, Shazam, NetWorks, etc.). Because most community bank cards have a PIN mark from a network that is not affiliated with either Visa or MasterCard, the two-mark alternative would not cause any substantial disruption to community banks, aside from the significant adverse competitive consequences discussed above. A shift to a four-mark rule, however, would impose substantial additional costs. Notably, those costs would likely be much more onerous for community banks than for large banks. Thus, adoption of this alternative would exacerbate the adverse competitive effects community banks will suffer from the other aspects of the proposed regulation.

Importantly, a four-mark rule would substantially change the negotiating dynamics of putting a new network relationship in place. In the existing milieu, governed by market forces, any single community bank that wants to provide its customers the same functionality as large banks (a single card with signature and PIN capabilities) is likely to form relationships with either Visa or MasterCard and with one of the PIN-based networks. In this milieu, the ability of the community bank to pick among available alternatives gives it some negotiating power, which limits the ability of the much larger networks to set unilateral "take-it-or-leave-it" terms on which they will contract.

In a four-mark world, by contrast, all community banks would be obligated to contract with *both* Visa *and* MasterCard. In that milieu, community banks would have no negotiating power at all, because both Visa and MasterCard would know that any community bank that failed to accept the terms offered by Visa and MasterCard could no longer issue signature debit cards; under these conditions, as a practical matter, the bank would be forced to withdraw entirely from the debit card market. For large banks, this is less of an issue, because they bring to the table a sufficient number of transactions to make it costly for Visa or MasterCard to treat them harshly. In addition, their ability to move their credit card operations from one of the large networks to the other would be a powerful protection. Smaller financial institutions, of course, have no such leverage. The effect of the four-network rule in the signature space would result in transforming the existing duopoly into a two-headed monopoly. In this case, at least, such a direct worsening of the competitive landscape cannot be blamed on the Board's congressional mandate.

It also is important to recognize the substantial costs of establishing new network relationships. As a practical matter, the contract with the new network is likely to require community banks to reissue the covered cards as networks likely will not agree to process transactions on cards that do not bear the network's mark. And, it is not likely that cards could be processed on multiple signature networks without revisions to the existing card-numbering system which would require reissuance of all debit cards and innumerable new network and processing configurations. For community banks that do not generate large amounts of debit transactions, increased issuance costs and a doubling of membership costs will impose a cognizable increase on the average total cost of each debit card transaction for community banks. As with each of the other aspects of the new milieu discussed, this operates inevitably to give large banks a regulation-induced, cost-based competitive advantage over small banks.

VI. Analysis of the Impact of Proposed Regulation II

We turn now to a specific discussion of the proposed Regulation II. We first discuss specific problems with the proposal for a 12 cent cap on interchange revenue. We then discuss likely responses by community banks. We close by discussing ways to improve the rulemaking process.

A. The Cap Improperly Fails to Allow Even the Most Efficient Small Banks to Recover Debit-Card Transaction Costs and Earn a Profit

The most salient aspect of the proposal is that it would cap interchange revenue for card issuing banks at a maximum of 12 cents per transaction, with mechanics depending upon the alternative chosen (safe harbor or not). The proposal for a 12 cent cap rests on a cost survey of certain variable processing costs for authorization, clearing, and settlement at the largest banks.

The proposed pricing has two basic flaws: failure to recognize the economies of scale in processing, and an unduly jaundiced perspective on the types of costs to include. When those two flaws are combined with the relatively heavy reliance of community banks on interchange revenues, the result is a program that seems almost intentionally designed to put community banks at a competitive

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disadvantage.

1. The Importance of Interchange Revenue to Community Banks

On the first point, the evidence shows that the burden of the proposal will fall more heavily on community banks than on larger banks. For instance, a Wall Street estimate of the revenue impact of the proposed rule on the largest banks suggests an earnings decline ranging from less than 1 percent for Citicorp up to a bit over six percent for Bank of America and PNC.[8] By comparison, results of an ICBA survey of member community bank costs shows that about half of community bank respondents expect an earnings impact *near twice the upper end of this range or more* (11 percent or more).[9]

The reason for the difference between the largest and the smaller banks is that the consumer and small business demand deposit product is a larger share of the operations of community banks than it is of the larger institutions. For instance, processor FIS suggests that debit interchange is about 16percent of industry DDA revenues. [10]

By contrast, ICBA survey results reveal debit interchange revenue equal to more than 20 percent of demand deposit account revenue for more than half (55 percent) of responding community banks.[11] This means that for community banks the same cap on interchange revenue produces a larger change in net income. Simply put, the accounts that the regulation adversely affects are disproportionately more common for community banks. In general, the need to recover those costs suggests a shift away from retail and branch operations toward wholesale funding; few would regard such a shift as a positive trend in banking regulatory affairs.

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[8] Bernstein Research, "Large Cap Banks: Fed's Draft Debit Rules Could Impact Banks More Than Expected," New York: Sanford Bernstein, Dec. 17, 2010.
[9] ICBA Debit Card Costs and Revenue Data Collection conducted February 1- 8, 2011.
[10] David Mendoza & David Eldred, *Beyond Free Checking*, FIS 2010 Client Conference.
[11] ICBA Debit Card Costs and Revenue Data Collection conducted February 1- 8, 2011.

2. Processing Costs Are Higher for Community Banks Due to Reliance on External Processors

Greater dependence on consumer and small business accounts is not the only difficulty. As indicated, the price caps in proposed Regulation II (12 cents per transaction) are based upon a survey of authorization, processing, and settlement costs of large banks, most of which do their own internal processing. Even among this universe of institutions, the proposal self-consciously places many institutions in a loss position: the proposal suggests that 20 percent of the largest banks would not even recover their authorization, processing, and settlement costs under the 12-cent cap.

Moreover, the data strongly suggest profound and ineradicable economies of scale in processing, so that the cost of processing declines steadily with increased transaction volume, with little relation to the vigor or laxity of the individual bank's focus on efficient spending. At the smallest end of the spectrum, community banks that use outside processors experience processing costs substantially higher than those for the smallest of the banks surveyed by the Board.

Direct discussions with community banks and their processors and the ICBA survey provided some information on costs of debit card systems for community banks. Survey results show that the variable costs of authorization, clearance, and settlement, including necessary switch fees, equal or exceed 15 cents per transaction for three-fifths (60 percent) of respondents.[12] These average variable processing costs are, by themselves, above the interchange revenue caps proposed in the draft Regulation II. And, if the final rule also requires debit cards to have the capability for processing through as many as four separate networks, the small volumes community banks are likely to have on the additional networks makes it almost certain that the unit processing prices will be even higher than those that exist in the current market-based regime. In sum, few, if any, community banks will

[12] ICBA Debit Card Costs and Revenue Data Collection conducted February 1 – 8, 2011.

be able to recover even their core processing costs if they are subjected to the price caps proposed in Regulation II.

3. The Board Must Recognize All Allowable Debit Card Costs

Furthermore, the Board's calculations on which the cap is based ignore many of the incremental and highly inelastic costs of the debit card product, all of which economically and logically are incremental costs of individual transactions. These costs include such things as card production, issuance, maintenance, and renewal (all necessary for any transactions to take place); customer support centers for investigation and resolution of disputes and possible errors (required by the EFTA) and customer inquiries; network fees; data processing; billing and collection; fraud prevention costs and fraud losses; and depreciation and amortization of associated processing infrastructure including ATMs and other equipment (some of which is necessary even with third party processors). These items, all of which are essential for an institution to remain in this business, add substantially to the costs of each transaction. About half (49 percent) of ICBA survey respondents reported total costs of at least 25 cents per transaction, *excluding* any management allocations, NSF losses due to payment guarantee, or costs of rewards programs.[13] A situation in which prices are cut so far below the basic costs of providing the product necessarily will require drastic measures for offsetting and overcoming the looming debit card product losses.

B. The Proposed Rule Will Drive Increased Costs for Consumers and Small Businesses

ICBA surveyed its members in January 2011 to discern how they plan to respond to the likely interchange reductions. This more recent survey extended an earlier and similar effort that we undertook in May 2010. In both cases, the survey results indicate a strong expectation that the proposed regulation will drive increased charges for checking account holders.

[13] ICBA Debit Card Costs and Revenue Data Collection conducted February 1 – 8, 2011.

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In May 2010,[14] more than three quarters of respondents indicated they would consider imposing annual or monthly fees on checking accounts. In January 2011,[15] 73 percent of respondents expected to consider imposing annual or monthly fees to debit cardholders:

- 93 percent said they would be required to charge customers for services that currently are offered for free;
- 61 percent said they will consider imposing monthly fees for all checking account customers;
- 50 percent said they would consider imposing a per transaction charge for debit cards;
- 44 percent said they would consider eliminating debit rewards programs; and
- nearly 20 percent said they will have to eliminate jobs or halt plans to open new bank branches.

That these community banks would even consider raising prices on or eliminating these popular services, potentially disturbing or even angering many customers, suggests the seriousness of the financial difficulties that the proposed debit interchange fee regulations put community banks in.

Notably, the changes will fall particularly severely on the "underbanked," whose accounts are generally the least profitable. Thus, in January 2011,

- 38 percent also said they would consider closing higher-risk checking accounts;
- 46 percent said they would consider reducing rates on deposit accounts;
- 42 percent said they would consider strengthening debit card qualification standards;

[14] ICBA Debit Card Interchange Survey generated 1,048 responses from among ICBA's 5,000 members.
[15] ICBA Mitigating Lost Interchange Revenue Survey conducted from January 19- February 8, 2011, generated 1,190 responses from among ICBA's 5,000 members.

- 37 percent said they would consider eliminating surcharge-free ATM programs; and
- 33 percent said they would consider raising rates on consumer and/or small business loans.

Each of these changes exacerbates the problem of the "unbanked" and "underbanked" sectors of the population, making these problems even more difficult to mitigate.

None of these outcomes is consistent with mainstream economic policy in this country, and all would be a direct result of an unfortunate legislative and regulatory attempt to save large merchant firms a few cents per debit card transaction. Compared to these relatively swift and certain costs to consumers, the countervailing benefits to retailers are obscure.

Consumers and businesses (which for community banks means small businesses), can expect to pay the full decrease in interchange through higher bank pricing. In the increasingly competitive environment of community banking, the local institutions cannot merely draw upon some reservoir of noncompetitive profitability to offset revenue disruptions of this magnitude. The electronic technologies themselves have increased competition as community banks increasingly face competition from remote institutions and non-banks as well as increasingly aggressive local ones, including non-taxed credit unions. Because the availability of interchange revenues has been a major factor in the sustained low-cost DDAs of the last few decades, the loss of those revenues surely will drive DDA prices back up again. More broadly, the pricing shifts will encourage a trend away from relying on DDAs as a source of funding in favor of greater reliance upon riskier wholesale funding.

C. The Board's Process to Date is Deeply Flawed

So where did the Board go wrong? In ICBA's view, the process to date suffers from three general problems: a failure to exercise the broad discretion that the Dodd-Frank Act gives the Board; a failure to apply the Board's traditional scrutiny to the economics of the situation; and a failure to examine the link between the posited market failure and the proposed remedy.

We recognize that the Board has plunged forward on a thankless task consistent with its reputation and responsibilities. ICBA does not fault the effort or the good-faith nature of the attempt, but we do question the outcome and expect it would have been different if the statutory deadline had permitted a more reasonable time for consideration of the restructuring of the pricing and product design of such a complex industry. In that spirit, we offer what we hope are constructive suggestions about where the Board should go from this point.

1. The Board Has Broad Discretion, and It Should Use It

The central problem in the process to date is the failure of the Board to take advantage of the broad discretion the Dodd-Frank Act affords it to design a regulation that effectuates Congressional intent to protect community banks from the government-set interchange price controls. In drafting the proposed Regulation II, it appears that the Board believes it has substantial areas of discretion in implementing the underlying legislation.

- Discussion at the Board meeting when the proposal was approved for comment shows that the Board believes it has substantial discretion concerning the definition of "incremental cost" used in the statute.
- Additional Board discussion of the choice of average variable cost of authorization, clearance and settlement for "incremental cost" further suggests the agency's belief in its discretion over definitions.

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- A proposal that adopts "safe harbors" and "caps" for defining "reasonable and proportional" interchange fees, even though the statute makes no mention of either safe harbors or caps and suggests only adopting "standards."
- A proposal potentially requiring that debit cards be enabled for processing through up to four networks, although the statute does not suggest such a requirement.
- An interchange cap proposal based upon a cost survey of only the largest banks and which would allow at least some of them to receive a multiple of their average variable costs for authorization, clearance and settlement of debit card transactions while relegating community banks to a loss, despite statutory wording specifying that community banks should be exempt.

Absent from the proposal is any consideration of how to realize the statutory goal to protect community banks from the interchange controls. It might be difficult for the Board to accommodate perfectly all of the goals of the statute, but the Board certainly has the discretion – if not the obligation – to consider how it might design standards for assessing whether interchange rates are reasonable and proportional to costs and multi-network rules so as to limit the harm to community banks and their customers.

The importance of that discretion is underscored in the Government's arguments in *TCF v. Bernanke*, in which the Government defends the constitutionality of Section 1075 of the Dodd-Frank Act by arguing both that the statute gives the Board discretion to consider a broader range of costs than it has considered and also that the statute gives the Board discretion to adopt a more flexible standard for assessing interchange fees than a fixed-price cap. *TCF Brief* at 2, 28.

Given the recognized room for discretion, we urge the Board to exercise its discretion to permit issuers to recapture not only reasonable levels of average variable costs as defined in the proposal, but also other incremental costs as well as a reasonable profit margin. Discretion is also called for to account for clear differences in the characteristics of debit cards and checks. The service card issuers provide to merchants for debit cards is much more complete. It includes an instantaneous shift of the risk of nonpayment to the issuer and an almost complete acceptance by the issuer of the risk of fraud. The statutory mandate to consider the functional similarities of debit cards to checks suggests that those qualities of the debit-card product warrant a higher fee to issuers than otherwise might be called for. Yet the proposal shows no recognition of these important distinguishing product features.

Finally, the mandate to establish prices that are "reasonable and proportional" to costs certainly does not bar the Board from taking into account the many variable costs excluded by the proposed regulation, such as customer support centers for investigation and resolution of disputes and possible errors (required by the EFTA) and customer inquiries; network fees; data processing; billing and collection; fraud prevention costs and fraud losses; and depreciation and amortization of associated processing infrastructure including ATMs and other equipment (some of which is necessary even with third party processors As noted in the industry comment letter, the appropriate response is to design a reasonable and proportionate assessment that accounts for the all-in costs of debit card operations and provides for a reasonable profit.

2. The Board Should Identify the Relevant Market Failure

As the Board recognized when it approved the proposal for comment, a sensible understanding of market failure is the foundation of any successful regulatory endeavor. In this case, the Board has not yet undertaken the important background work of investigating and identifying the relevant market failure necessitating extensive regulation. The cause of this problem is easy enough to see: the rulemaking schedule imposed by Congress left the Board little or no opportunity to evaluate either whether there was a market failure that required a remedy or what the implications might be of implementing a new regulatory regime. Yet the Board's own longstanding policy statements call for a careful consideration of competitive impact and the significance of market position for implementing any important operational changes to payment systems[16]. Given the Board's recognition of the systemic importance of stability in the payments system, we think it is incumbent on the Board to come to its own understanding of the likely market failure and its relation to any potential or proposed remedy. Indeed, Section 904 of the EFTA specifies that in developing regulations under the Act the Board must:

> prepare an analysis of economic impact which considers the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers, including the extent to which additional documentation, reports, records, or other paper work would be required, 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.

More broadly, the Board has not adequately assessed the impact of the proposed regulation on consumers or the public interest. No one can doubt that the pricing changes we have summarized above will affect consumer welfare directly. Limited discussion at the Board meeting suggesting the possibility that merchant pricing changes might balance the direct and salient effects on pricing changes of consumer and business deposit accounts is not adequate in the context of a government-mandated price reduction of the magnitude contemplated by proposed Regulation II. The possibility that the proposed Regulation II will directly and immediately raise costs for consumers is simply too serious to be ignored.

[16] Board of Governors of the Federal Reserve System, *The Board in the Payments System*, 76 *Federal Reserve Bulletin* 293, 1990.

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Moreover, the disruption of the debit-card system will slow the steady (and socially valuable) shift toward debit cards from alternate payment instruments that are less efficient (cash and checks) or that discourage financial main-streaming banking, both of which are contrary to the spirit of the Dodd-Frank Act. Ensuing deposit pricing changes also will price many consumers out of the deposit market and swell the ranks of the unbanked and underbanked. The Board's tradition of careful consideration of disruptive changes to the payments system counsels for direct attention to these possibilities.

3. The Proposed Remedy Does Not Fit the Posited Market Failure

Further, the Board should consider whether cost-based regulation is a sensible economic approach to enhancing competition in the market for debit cards. The Board's economists have recognized that cost-based pricing is not an appropriate remedy for any market failure that might exist.[17] In our view, this paper fairly summarizes the academic literature on socially optimal interchange fees. The academic studies emphasize the importance of relative elasticity of card acceptance by merchants as compared to card uptake and use by consumers as the important considerations for addressing any market concerns, not the costs of production in themselves.

But even considered from the basis of cost, the proposed remedy ignores that 20 percent of covered banks and almost all of the supposedly exempt banks will face regulated interchange revenue that does not cover even the average variable cost of authorization, clearance, and settlement (a number that is far below any reasonable estimate of the incremental costs of debit card operations). Thus, the proposal places small banks at a competitive disadvantage in securing DDA customers. This gives large banks an advantage directly inconsistent with the intentions evident in

[17] See Robin A. Praeger, Mark D. Manuszak, Elizabeth K. Kiser, and Ron Borzekowski, "Interchange Fees and Payment Card Networks: Economics, Industry Developments, and Policy Issues," Finance and Economics Discussion Series, 2009-23, 2009.

the statute. A thorough evaluation is the only appropriate response to the juxtaposition of those costs with Congress's perception that it had insulated community banks from the adverse effects of the interchange controls.

VII. Regulatory Flexibility Analysis

The Board has not undertaken a reasonably complete regulatory flexibility analysis. Federal law obligates the Board to conduct a regulatory flexibility analysis that specifically considers the likely effects of the regulation on small businesses. [18] As discussed above, the cost survey on which the Board based its proposed regulation did not consider community banks. The ICBA cost survey discussed above demonstrates that the impact of the proposal on community banks differs from its impact on the banks the Board surveyed.

The proposed regulation also is likely to have a disproportionate adverse effect on small businesses that depend on community banks for financial services. Finally, the regulation is likely to have an adverse effect on small merchants which are not likely to experience the same benefits from regulation of debit interchange as their larger brethren. All of these matters should be explored.

VIII. Fraud and Debit Cards

Payment card fraud losses in the United States historically have been much lower than in other countries. There are many reasons for this, including the more highly developed infrastructure for telephone communications in this country. But the fact remains that the existing market structure, the loss-allocation rules of the EFTA and a set of market relationships and contracts built on the card networks' liability-shifting rules, have been most effective in generating incentives to prevent fraud. In general, that framework leaves a substantial amount of the risk of loss on the issuers, giving them an incentive to invest heavily in fraud prevention and data

[18] 5 U.S.C. § 603; see EFTA § 904.

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security. Because there are many reasons to believe that this allocation of incentives is appropriate, the most serious mistake that the Board could make in this area would be to adopt a regulatory framework that substantially alters the existing incentives.[19] Among other things, this raises the likelihood that the networks will respond to the new cost structure by shifting to a different allocation of risks that is less effective in preventing fraud.

The recognition that the existing market-based outcomes are adequate to limit fraud losses, coupled with the statutory mandate that the Board adjust interchange to account for the costs of fraud preventing technology, suggests that the proper regulatory approach is to give a flexible credit for the costs of fraud-prevention activities at whatever level they might occur.

Following are answers to the questions that the Board posed in its request for comment:

1. The Board should adopt non-prescriptive fraud-prevention standards because technology-specific standards necessarily would limit incentives to develop new anti-fraud technologies. In substance, technology-specific standards would freeze the tools issuers use to prevent fraud, giving malefactors an opportunity to improve their technological skills at a time when issuers have slowed their efforts to develop more impenetrable barriers to fraud.
2. The Board should not adopt technology-specific standards.
3. The Board generally should assume, in accordance with basic principles of economics, that the expenditures of the type issuers customarily have made are cost-justified. To be sure, the shift from a market system for allocating prices to a system of central planning might well limit or remove incentives for issuers to spend effectively, but the appropriate response is not to penalize issuers for aggressive anti-fraud expenditures. A standard permitting reimbursement for "reasonable and appropriate" expenditures is consistent with the economics of the situation and the statutory mandate.

[19] Ronald J. Mann, *Making Sense of Payments Policy in the Information Age*, GEO. L.J. 633, 638-39 (2005).

4. An adjustment for PIN-based transactions but not signature-based transactions would unfairly discriminate between the two types of transactions. There is no basis in the statute for such a distinction. PIN-based and signature-based transactions are better suited for different contexts; PIN-based transactions are not useful in transactions where speed of the transaction is paramount (such as the rapidly broadening contexts in which signatures are waived for contactless – near-field communication or "NFC" – and other "small dollar" debit transactions). Thus, fraud concerns for the two types of transactions are distinct. A rule that reimburses fraud costs in one context but not the other essentially privileges one set of networks over the other. The cost justification on which the statute is premised should not be leveraged to stifle innovations that allow one set of market participants to compete effectively against the other.

5. The adjustments should include all the costs reasonably associated with the reduction of fraud. As a matter of social cost, it is preferable for the debit-card system to internalize the costs of fraud by preventing fraud. There is every reason to believe that a system forcing the issuers to bear unreimbursed costs of fraud prevention will result in a decline in the provision of fraud prevention, which would likely result in a rapid upturn in the rate of socially devastating activity such as identity theft. Nothing in the statute compels such a result and the Board should not seek it out.

6. If the Board denies issuers reimbursement for the costs of fraud prevention and data security, issuers will expend less on that activity than they do under the market-based rules that currently exist.

7. As discussed above, we believe the appropriate response is to permit recovery for "reasonable and appropriate" expenditures, subject to periodic audits such as through the normal bank examination process. The Board should be cautious to ensure that its regulation does not lessen the incentive to invest in major new technologies.

8. The Board should not adopt a cap, because a cap would be inconsistent

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with the incentive to invest in major new technologies.

9. The adjustment standards should be sufficiently general that they only rarely need review and update. In the unfortunate event that the Board adopts any approach that is not technology-neutral, we recommend frequent reviews to ensure that its regulatory standards do not stifle fraud prevention to the advantage of malefactors.

10. The Board should ensure that revenues from debit card transactions are available to offset the costs of expenditures on fraud-prevention technology. And so, fraud prevention adjustment should take the form of increases in allowable interchange revenue. Otherwise, issuers would be left with an incentive to forgo reasonable expenditures to prevent fraud.

IX. What the Board Should Do

As the Board reviews comments on proposed Regulation II, first and foremost it should reconsider the range of discretion it has exercised in this rulemaking. The Board's proposal and the Government's understanding of the statute both recognize the substantial regulatory discretion left to the Board by the Section 1075 of the Dodd-Frank Act; it should exercise this discretion to produce reasonable outcomes in a number of important areas.

As noted previously, ICBA supports the recommendations provided in the industry comment letter. We offer here specific recommendations from the perspective of community banks. An appendix also organizes our recommendations as answers to the additional specific questions posed in the proposed rulemaking.

First, the Board should not adopt the proposed interchange caps. On the contrary, at a bare minimum, the Board's establishment of a government-determined price cannot properly rest on assessment of the costs of a small number of the largest institutions. This merely centralizes the market in the large institutions and disadvantages community banks. In our view, no system makes sense if it caps what an institution can charge at an amount that is less than the costs that a well-run institution of that size would incur and does not provide for a reasonable profit. At the same time, as emphasized in the industry comment letter, we believe that a safe harbor at some level is appropriate for administrative convenience. It makes little sense, though, to set the safe harbor at a level far below the amount necessary for cost recovery by most institutions.

Second, the Board should not adopt a rule that is self-evidently unreasonable as a matter of economic planning. Thus, before adopting any rule, the Board should examine the impact that the proposed rule would have on all the major affected stakeholder groups: consumers, small businesses, community banks, and the "underbanked." More broadly, the Board should examine the likely effect of the proposed rule on competition, market structure, and innovation. A rule trending strongly toward market concentration and the weakening of community banks should not be adopted without an explicit acknowledgment of the likely outcomes.

The Board should, in addition, examine the likely effect on payments markets; a rule that drives traffic away from more efficient electronic payments is counterproductive. Even if the Board determines that the statute requires an imprudent rule that has an adverse effect on consumers, competition, or payments choices, it will be better as a matter of policy to adopt the rule with a direct explanation of the likely adverse outcomes Congress has forced upon the industry.

Third, the Board should find a way to ensure that the Congressional exemption for institutions with assets less than $10 billion has real meaning. This should involve some combination of requiring the networks to adopt tiered rate schedules (one for exempt institutions at existing market rates and another for regulated institutions), allowing them the time to undertake the necessary technical alterations to bring this about, requiring acquirers to adhere to the schedules, and preventing merchants from using routing control or multi-network rules to circumvent or evade those schedules.

Fourth, the Board should either require no more than two unaffiliated networks for debit cards or should provide an exemption for small banks. As we have explained above, a four-network rule would have an especially debilitating effect on community banks. Moreover, in determining which networks count as unaffiliated, the Board should not limit the rule to networks that operate throughout the United States; rather, the Board should accept major PIN networks that are unaffiliated with MasterCard and Visa even if they do not operate throughout all parts of the United States.

Fifth, the Board should not implement the pricing aspects of this rule before promulgating the fraud-prevention adjustments. As we explain above, protection of fraud-related innovation is central to the future of the payments sector in our economy.

* * * * *

If you would like further information, additional discussion, or have questions, please contact Viveca Y. Ware, senior vice president of regulatory policy, at viveca.ware@icba.org.

Thank you for the opportunity to comment on this significant proposed regulation.

Sincerely,

/s/

Karen M. Thomas
Senior Executive Vice President
Government Relations & Public Policy

Appendix A
ICBA Responses to Specific Requests for Comment

Pages 33, 35: Whether the Board should treat ATM transactions as electronic debit transactions: No. These do not involve an exchange of funds, and are so functionally different from debit card transactions that extension of the rule would be difficult, if not impractical.

Pages 33, 35: Whether the Board should extend the rule to three-party transactions: The problems of extending issuer-based price controls to a system in which the issuer, the network, and the acquirer are one entity are so complex that we do not think this is achievable. However, the Board should further evaluate whether the exclusion of such systems places four-party systems at a competitive disadvantage and take actions to correct this government-induced imbalance.

Page 55: Whether the proposed rule should extend to emerging systems (like PayPal): The problems of extending issuer-based price controls to systems with differing logistics raises difficult practical questions. However, the Board should further evaluate whether the exclusion of such systems places four-party systems at a competitive disadvantage and take actions to correct this government-induced balance.

Page 64: Whether the Board should permit recovery only of authorization costs: No.

Pages 67, 77: Whether either of the proposed mechanisms for setting prices is appropriate: Neither of the proposed mechanisms is appropriate. An appropriate mechanism would permit issuers to charge an interchange fee that permits them to recover their reasonable and appropriate costs of processing debit card transactions plus a reasonable profit.

Page 72: Whether the pricing mechanism should vary by authorization method: No. Any such variation would unfairly discriminate between PIN and signature networks.

Page 79: Whether additional clarification on allowable costs is appropriate: We believe that the existing description of allowable costs is fatally flawed.

Page 80: Whether issuers are obligated to report their maximum allowable interchange fees to networks that do not establish individualized schedules: We believe such a requirement would be pointless.

Page 93: How the Board should certify issuers as exempt: We defer to the Board on this question. As we note above, we doubt that exempt status has any practical significance.

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Page 118: Whether it is appropriate to treat regional payment card networks as disqualified for purposes of the unaffiliated network rules: As summarized above, that approach would have a particularly debilitating adverse effect on community banks. Any network that is generally accepted at merchants in the local area of the bank should be adequate for purposes of the multi-network rules. The cost impact of an alternate approach would be severe, especially for community banks.

Page 119: Whether additional guidance on the concept of networks with limited acceptance is necessary: No. The concept is adequately clear in the existing proposal.

Page 122: Whether requiring multiple unaffiliated networks on mobile devices would retard innovation: Yes. Such a requirement would inappropriately discriminate against rapid current innovation in the signature-debit sector.

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Appendix B
Table of Contents

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