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February 22, 2011

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

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

Dear Ms. Johnson,

This letter is submitted on behalf of The Home Depot, Inc. ("The Home Depot," "the Company," or "We") in response to the notice of proposed rulemaking published by the Federal Reserve Board ("Board") in the Federal Register on December 28, 2010. *Debit Card Interchange Fees and Routing*, 75 Fed. Reg. 81,722 (proposed Dec. 28, 2010) ("NPRM").

The Home Depot would like to thank the Board for addressing this important issue, and also express the Company's appreciation to the Board for dedicating substantial resources to your thorough data collections efforts, rigorous analysis, and detailed NPRM. The Home Depot believes the proposed regulations set forth in the NPRM are aligned both with the statutory mandate of the Durbin Amendment and the Board's own role in ensuring stability in the U.S. payments system. Most importantly, as discussed further below, this effort by the Board already is having a positive impact in the marketplace.

This letter is intended to respond to the Board's request for comment and to provide you with detailed information regarding how the proposed regulations will affect us and our customers.

The Home Depot Overview

The Home Depot is the world's largest home improvement specialty retailer, employing more than 300,000 associates. The Company has over 2,200 retail stores in all 50 states, the District of Columbia, Puerto Rico, U.S. Virgin Islands, Guam, 10 Canadian provinces, Mexico, and China. In fiscal year 2010, The Home Depot had sales of $68.0 billion and consolidated net earnings of $3.3 billion. Our stock is traded on the New York Stock Exchange (NYSE: HD) and is included in the Dow Jones industrial average and Standard & Poor's 500 index. We constantly strive to improve our customer service and offer every day values in our stores.

Why We Care About the Durbin Amendment and the NPRM

The Home Depot is proud to offer consumers outstanding customer service and products at everyday low prices. Unfortunately, interchange fees hinder our ability to provide even more value to our customers.

These excessive fees have grown to become our third-highest operating cost, only behind occupancy and wages. The Home Depot is willing to pay fair prices set by competitive market forces for goods and services. Unlike every other cost, however, interchange fees appear to be immune to the normal pressures of a competitive market. To the contrary, they appear to be set collectively by the banks within each network, so that we cannot negotiate lower rates with any of them individually even with our significant volume. Further, networks like Visa and MasterCard have such dominant market shares of the debit card market that, as a practical matter, we cannot refuse to accept their cards. Whether this should be described as a "broken market" or "market failure," interchange fees are clearly not subject to competitive market pressures. The Home Depot strongly supports the Durbin Amendment and the NPRM because they begin to address this significant issue. We believe that the proposed regulation of debit card interchange fees, rules, and routing is appropriate given the long-standing absence of competitive market dynamics that has resulted in abusive pricing by the networks and issuing banks.

Lack of transparency into interchange fees for consumers is also a problem with the current debit card system. Banks and networks have designed debit card rules to bar consumers from understanding the true costs of this payment method.[1] This means consumers don't get the price signals that would allow them to make informed, economically rational decisions. If our customers knew that their choice to use a debit card under the current system unnecessarily increases our costs of doing business and ultimately our prices for all of our customers – including our customers who don't even have debit cards – they would likely consider using another payment method that didn't have such high fees associated with it. Banks threaten that they will impose new banking fees on their customers if the interchange fees decrease. Even if true, moving from hidden subsidies to transparent fees – where the person making the purchasing decision is aware of the fees associated with such decision – will lead to increased efficiency because if costs are transparent, consumers can vote with their wallets.[2]

In short, these market failures and lack of transparency barring consumers from getting price signals are the reason the Company supports the Durbin Amendment and related

[1] Transparency has been prohibited by network rules such as the anti-surcharging and anti-discrimination rules as well as the Visa rule against discounting if it is not applied to "comparable cards."

[2] In addition to being consistent with standard microeconomics, this analysis also is supported by analogy to more applied economic theories like Tiebout competition and the Coase theorem. The core principle of Tiebout competition that preference revelation and aggregation should drive economic decision-making clearly supports increased transparency in this case. The Coase theorem similarly underscores that the highest and best use of resources is most likely when there is, among other things, perfect information available to market participants. If the prices of more costly payment methods were to go up relative to debit card transactions, that actually would represent a <u>more efficient</u> U.S. payments system.

regulations. The banks and debit networks have been arguing publicly that they are entitled to the supra-competitive fees resulting from their market power and collective price setting. They are wrong. Merchants like The Home Depot should pay them only the competitive market price for debit card fees. The amount of these fees above the competitive market level can then be given back to our customers—through lower prices and/or enhanced customer service.

With regard to transparency, we do want to take this opportunity to highlight that, in our opinion, merely having the ability to discount for other tenders such as cash and check is insufficient alone to provide transparency for two primary reasons: 1) it doesn't allow discount differentiation by network, so each network under the discount model is enticed to be the HIGHEST priced network of all of the networks[3]; and 2) it is not economically practical for any retailer with a higher cash or check penetration to discount for those tenders given the cost of the discount on the EXISTING sales on cash and check that would need to be funded prior to any shifting of sales to those tenders from more costly tenders. For example, for The Home Depot to fund a 2% discount on our cash and check sales, it would cost us over $200 million for that discount on existing sales before any shifting occurred. We could then never practically convert enough sales to cash or check to make up this cost. Our only option to recover this cost of discounting would be to perpetuate the absurdity of the exising model and take prices UP further on ALL products to continue to support the higher interchange fees.

How a Broken Market Permits a PIN Rate Increase of 57% In Past 6 Years

As an example of the broken market currently facing merchants, the rate (not transaction volume) paid by The Home Depot for one major network's PIN debit transactions on a typical ticket value has increased more than 57% during the past six years. Perhaps aware that they are under scrutiny, however, this network increased its nominal ad valorem interchange rate only 11% during that period which allows them to argue that their "rate" has remained essentially unchanged over this period. To allow them to accomplish excessive ad valorem price increases while increasing their published "rate" much less, this major network imposed massive per transaction interchange fee and interchange cap increases of 150% and 110%, respectively. The network also increased the switch fee, which the Company includes in its calculation of the effective rate, by 40%. All of these fees are components of the effective cost of a debit transaction and, therefore, are considered as part of the Company's analysis of interchange costs.

These fee increases highlight two things. First, banks and networks have many levers to impact debit fees, and focusing on only one aspect of their typically complex (perhaps intentionally so) fee and cost structures can be misleading. Second, these fees do not reflect a competitive marketplace because they bear no relationship to cost. This type of conduct by the banks and networks can exist only when there is market power or collusion – no business in a competitive market could get away with this type of price increases unrelated to costs.

[3] The Durbin Amendment goes beyond mere discounting, of course, by requiring rules prohibiting network exclusivity and permitting merchants to choose network routing.

How Banks and Networks Could Have Reduced Fraud Long Ago

As detailed in the Merchants Payment Coalition ("MPC") submissions to the Board, for years, banks and networks have promoted signature debit and suppressed PIN debit despite the fact that PIN debit is both lower cost and more secure. With respect to the cost differential, The Home Depot pays approximately 0.5% of sales more for signature debit transactions than PIN transactions. With respect to fraud, The Home Depot has virtually no fraud associated with PIN debit transactions, but has fraud equal to 0.03% of the Company's sales using signature debit. Broader industry data identified by the MPC and others indicate that The Home Depot's experiences are typical. Simply by switching from signature to PIN transactions, therefore, banks and networks long ago could have reduced fraud and costs at the same time. Instead, they opted to pocket the profits, which they will continue to do in the event of any delay in implementation.

Networks and banks also could have reduced U.S. debit fraud rates dramatically if they had deployed the same technology here that they have been using overseas for years. Because they failed to do so, we have been falling behind as a country and become a primary target of fraudsters. *Counterfeit Fraud Migration*, European Payments Council (June 29-30, 2010) at 5-7.

Responding to these missed opportunities, the Durbin Amendment and final regulations issued by the Board should drive the industry toward the most efficient and most secure tender. As discussed next, the keys are to limit the banks' ability to pass on these (and other) unnecessary costs to merchants and consumers, and to force networks to compete.

Why We Prefer Alternative 1 for Regulating Interchange Fees

We believe Alternative 1 should be implemented with respect to the regulation of interchange fees. The fact that fees between that alternative's safe harbor (currently proposed to be 7¢) and the cap (currently proposed to be 12¢) would be based upon the authorization, clearance, and settlement costs of individual issuers is consistent with the Durbin Amendment's directive to base the interchange fee on <u>each</u> issuer's costs. Alternative 2 ignores that statutory provision completely.

The Company also believes the lower safe harbor in Alternative 1 is more appropriate for several reasons:

- The Home Depot agrees with the observations made in the comments submitted today by the MPC that this lower safe harbor is preferable because it is closer to the mean costs and that the estimate of these mean costs based upon issuer survey responses likely reflects an upward bias.[4]
- While banks and networks argue that lowering debit fees will harm the debit system, international experience with this type of reform has proven them wrong. As reported by the MPC, seven of the eight countries with the <u>highest debit usage</u>

[4] The Home Depot supports the MPC's NPRM comments in their entirety.

utilize an at-par pricing model. Canada, for example, combines this at-par pricing system and higher per capita debit usage with higher merchant acceptance and much lower fraud rates than the United States. Importantly, the Canadian system operates under a cost recovery model, and the effective per-transaction switch fee that The Home Depot pays is LESS THAN 1¢. That is some of the strongest empirical evidence of the true cost of running a network.

- The Home Depot believes the proposed safe harbor and cap levels are too high because they reflect costs from a less than fully competitive marketplace where they are passed on to merchants and consumers. Subject to the discipline of increased competition and accountability under true market positions, these very same businesses should be expected to manage their costs much more effectively. This suggests the safe harbor should be set even lower than the current average cost level and the cap level should be similarly reduced.
- Counter to bank and credit union arguments, lower interchange fees encourage banks and networks to utilize lower cost authorization technologies, which will create an even more efficient U.S. payments system by removing excess costs. As discussed in the previous section, because this move from signature to PIN (or a newer technology) will reduce fraud, as well, it will further benefit the payments system and its participants.

Why We Prefer Alternative B for Regulating Network Exclusivity

We believe Alternative B ultimately should be implemented with respect to the prohibitions on network exclusivity. Unlike the other alternative, Alternative B satisfies the statutory requirement that every transaction has at least two network routing options. Giving merchants meaningful routing options for each authorization method that the issuing bank chooses to enable on a debit card is important for both signature and PIN because only one or the other of those methods is feasible for many merchants and transactions (e.g., many small merchants, in particular, accept only signature debit currently due to technical limitations). Alternative B should ensure network competition with respect to every transaction.

If there is a need to defer implementation for a short while due to alleged complications associated with enabling two signature networks on the same debit card, however, we believe there should be interim regulations to engender at least some network competition. While we believe Alternative A is clearly inferior as a proposal and would not create the necessary network competition in the long run, we agree with the MPC that this may be an acceptable interim solution (along with capping network fees at their current levels) until Alternative B can be fully implemented.

How The Home Depot Views Alternative Payment Providers

Over the past decade, alternative payment providers such as PayPal have become participants in the debit industry. Analogous to acquirers, these alternative payment providers enable online merchants to offer their customers a range of payments methods that otherwise would be unavailable to those merchants. The PayPal business model, for example, is based on trying to steer their users to select the lowest cost tender types to load their PayPal accounts – highlighting the type of transparency and competition that the debit industry needs.

These providers charge merchants fees based upon the services provided, and The Home Depot has found those fees are competitive with the fees charged by the traditional merchant acquiring banks. Like merchants, these alternative payment providers actually pay debit interchange fees when a merchant's customer pays with a debit card.

The Home Depot does not believe these alternative payment providers such as PayPal should be considered payment networks for purposes of the Durbin Amendment and the NPRM because they merely facilitate the use of a variety of payment options for the merchants' customers. This view would change, however, if these providers start acting as agents for banks to exercise market power or collude on prices.

A Sign of Things to Come?

Despite the fact that the Board has not yet finalized the NPRM, The Board's efforts already are having a positive impact. The Home Depot already has been approached by some debit networks offering discounts below the 7¢ and 12¢ thresholds in order to ensure transaction volume after the final regulations are implemented. We believe this is a clear indication that the proposed safe harbor of 7¢ is not set too low. Based upon this early anecdotal evidence, it appears the Board's regulations should work exactly as intended, with different competitors poised to bid down the cost of debit transactions.

How The Home Depot Will Deploy Savings Resulting from the Durbin Amendment

Our customers and employees will not be surprised that The Home Depot will deploy savings resulting from the Durbin Amendment in one or more of the following ways:

- Lower prices - The Home Depot operates under an "Everyday Low Price" model which means that we strive to have the lowest prices in the marketplace. The expected decreases in debit card fees resulting from the Durbin Amendment would allow us to lower them even more. Because interchange fees are the Company's third highest operating expense, any significant decrease in rates would have a meaningful impact.
- Increase customer service - There are many ways the Company would be able to increase customer service, including investing in technology to enhance customer service and putting additional associates on the floor to assist our customers directly.
- Extend payment terms for customers - Especially during the challenging economic times of the past several years, the Company is mindful of our customers' needs for financial flexibility. Savings from the Durbin Amendment would allow The Home Depot to provide additional and more generous payment options.

With regard to lower prices, The Home Depot believes that it is important to note the experience from other countries that have imposed similar regulation, particularly, Australia. The Reserve Bank of Australia concluded from their review of the reform in that country that "the Board's judgment remains that the bulk of these savings have been, or will eventually be, passed through into savings to consumers."[5]

The Home Depot is proud of its ability to generate profits for our shareholders, and having existed in a vigorously competitive marketplace throughout its corporate history the Company knows that providing value to our customers is the best way to continue doing so.

Conclusion

The Home Depot commends the Board on its work to date implementing the Durbin Amendment. We are optimistic that the Board's final regulations will address the current market failures and lack of transparency By injecting the necessary competition into this marketplace for the first time in decades, these regulations should produce substantial cost savings, increased security, and a more efficient U.S. payments system that will ultimately benefit consumers.

The Home Depot thinks debit card banks and networks should be subject to true competitive market forces and that is what the proposed regulations support. One way or another, the Company will use any resulting reduction in excessive debit card fees to benefit our customers.

The Home Depot thanks you for the opportunity to provide these comments and applauds your balanced and thorough efforts in this significant task.

Sincerely,

Dwaine Kimmet
Treasurer and Vice President, The Home Depot Financial Services

[5] Reserve Bank of Australia, *Reform of Australia's Payments System: Conclusions of the 2007/08 Review*, September 2008, page 23.