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February 22, 2011

Via Email (regs.comments@federalreserve.gov)

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

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

Dear Ms. Johnson,

On behalf of RBS Citizens, National Association and Citizens Bank of Pennsylvania (the "Banks"), we welcome the opportunity to comment on the notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System (the "Board") entitled *Debit Card Interchange Fees and Routing* (the "Proposal").[1] By way of brief background, the RBS Citizens, National Association is a $114.46 billion asset national banking association located in Providence, Rhode Island and Citizens Bank of Pennsylvania is a $33.99 billion asset state savings bank located in Philadelphia, Pennsylvania. The Banks are the wholly-owned subsidiaries of Citizens Financial Group, Inc., a financial holding company registered with, and regulated by, the Board. Citizens Financial Group, Inc. is a U.S. subsidiary of The Royal Bank of Scotland Group PLC, Edinburgh, Scotland.

The Proposal represents the Board's initial foray into implementation of Section 1075 (the "Durbin Amendment") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[2] The Durbin Amendment adds Section 920, *Reasonable Fees and Rules for Payment Card Transactions*,[3] to the Electronic Funds Transfer Act ("EFTA").[4] Specifically, Section 920(a)(2) provides that "[t]he amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[5] Section 920 then directs the Board to "prescribe regulations . . . to establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and

1 Debit Card Interchange Fees and Routing; Proposed Rule, 75 Fed. Reg. 81,722 (Dec. 28, 2010) (to be codified at 12 C.F.R. pt. 235).
2 Pub. L. 11-203, 124 Stat. 1376 (2010).
3 15 U.S.C. § 1693*o*-2.
4 15 U.S.C. §§ 1693 *et seq.*
5 15 U.S.C. § 1693*o*-2(a).

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proportional to the cost incurred by the issuer with respect to the transaction." Notably, Section 920 only provides the Board with 9 months from the date of enactment of the Dodd-Frank Act's to issue implementing regulations – a relatively short time period to study, develop and promulgate a coherent policy on such a complex and intricate issue. We commend the Board for its information-gathering activities and public disclosure of related data and resources that have informed the Board's deliberative process with respect to the Proposal.

The Banks' specific comments are noted below; however, at the outset, we would like this letter to serve as an indication for our support of the comment letters prepared and filed by The Clearing House Association, The Financial Services Roundtable, Consumer Bankers' Association, American Bankers' Association, issuers and payment networks. Specifically, we believe these comments address the hastily deliberated and rushed nature in which the Durbin Amendment was incorporated into the Dodd-Frank Act. Consistent with the major themes presented in the trade association comments noted above, we strongly urge the Board to consider the following important public policy arguments:

- **Consumer and Merchant Benefit.** Consumers and merchants have benefitted from the development of the debit payment system which requires sizable investment to create and maintain. Interchange fees represent one manner in which issuing banks are reimbursed on the investments made in the system without a direct charge to consumers.

- **Wide-Use and Acceptance.** Merchant and consumer acceptance of electronic debit transactions as a payment method has grown over the past five years, while the use and acceptance of traditional checks has declined.

    - Consumers prefer the use of debit cards due to, among other reasons, the (i) convenience, ease and speed of use in multiple point-of-sale ("POS") environments; (ii) security features and reduced liability for fraudulent or unauthorized transactions; and (iii) level of control over the transaction.

    - Merchant acceptance of debit cards has increased due to several features, including: (i) guaranteed payments; (ii) next-day funds availability; (iii) a lower risk profile than checks; (iv) speed at the POS; and (v) a support infrastructure that is interoperable with other payment types.

- **Ongoing Investment Needed.** Additional and continued investment is necessary to keep pace with ever-changing technological advances and developments in order to ensure that the debit payment system provides for the most cutting-edge, state-of-the-art safeguards and protections for consumers and merchants – including fraud detection, prevention and mitigation initiatives. These investments are financed, in part, through interchange fees.

- **Market Driven Practices.** Interchange fees represent a negotiated term of agreements between business entities – the merchants and the networks – which reflects existing market realities triggered by consumer demand for merchant acceptance. Issuers are not involved in the price-setting, rather they bear most of the costs and risks as identified in the Board's survey analysis. A statutory attempt to disrupt the market equilibrium that

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has developed will, we believe, ultimately prove to be misguided and futile at best, and harmful to consumer protection, the scope and speed of the economic recovery and the safe and sound operation of financial institutions at worst.

- **The Statute Requires Only "Standards."** Recognizing that the Board perceives its flexibility under the Durbin Amendment as being fairly limited, nothing in the text of the statute suggests that Congress intended the Board to develop regulations that set interchange fees. The Board is directed to "establish standards" to assess whether an interchange fee is reasonable and proportionate to the costs of providing electronic debit transactions, not set fixed prices networks are permitted to charge and pass along to issuers in the form of interchange.

    - At a minimum in establishing "standards" for electronic debit card interchange, the Board must include consideration of all of the following costs: (i) network fees; (ii) fraud loss costs; (iii) claims and chargeback processing costs; (iv) servicing costs; (v) statement production costs; (vi) account set-up and card issuance; (vii) account-opening and regulatory compliance; and (viii) technology infrastructure.

- **Costs Not Covered.** A key misconception persists that the processing of checks by merchants is a low or no cost proposition. In reality, for check processing functionality on a level that roughly approximates the level of security and service provided in an electronic debit transaction (such as through the use of check verification and check guarantee services), the costs to merchants can more than double the costs of interchange fees. One industry average suggests that the discount rate paid by merchants – including all network costs and interchange fees – for PIN and signature transactions are 55 cents and 80 cents per transaction, respectively. The same analysis found that basic check handling costs for merchants equaled $1.00 per transaction and that check guarantee and verification services brought the total cost to $1.70 per transaction.

- **Take More Time.** The issues contained in the Durbin Amendment and addressed in the Proposal are complicated. The Board should take the opportunity to analyze the information received as comments to the Proposal and get further input through an additional round of rulemaking and public comment delaying the current proposed effective/implementation date.

    - An additional round of rulemaking and comments would also permit the Board coordinated the simultaneous release of a final rule on the Durbin Amendment to incorporate both the interchange fee standards and the fraud preemption adjustment.

Having endorsed and being supportive of general industry sentiments, the remainder of this letter addresses the Banks' comments on those portions of the Proposal where the Board has specifically asked a question or requested comment and the Banks have particular insights. We have also identified and discussed those issues that we believe the Board should consider and address prior to issuing a final rule. Part I of this letter provides a brief introduction of noncash payment methods and acceptance of debit cards versus checks due, at least in part, to the innovation and benefits the debit system has provided to customers and merchants alike. Part II addresses our responses to specific requests contained in the Proposal. This portion of the letter has been generally organized along four broad themes. These themes include the Board's (i) proposed alternatives for setting standards for interchange fees that are reasonable and proportionate to the costs incurred; (ii) proposed alternatives for establishing the fraud adjustment; (iii) proposed alternatives for network routing; and (iv) other, miscellaneous questions or requests for additional information. Part III of this letter concludes with a discussion of additional issues the Board should consider prior to adopting the final rule.

I. The Debit Payment System.

Acceptance of Debit Cards. Debit card transactions have become one of the most popular means for payment for the purchase of goods and services in the U.S. According to a summary of data compiled by the Board in a survey returned by 89 of 131 financial organizations with assets in excess of $10 billion, there were approximately 37.7 billion debit and prepaid debit card transactions in 2009 with a value of over $1.45 trillion – an average value of $38.58 per transaction.[6] The responding 89 issuers represented approximately 60 percent of total debit and prepaid card transactions in 2009 and had, on average, 174 million debit cards and 46 million prepaid cards outstanding during that year.[7]

According to another study released by the Board on December 8, 2010, "[e]lectronic payments (those made with cards and by ACH) now collectively exceed three-quarters of all noncash payments while payments by check are now less than one-quarter . . . ."[8] The study noted that the number of noncash payments made by debit card increased from 25.0 billion to 37.9 billion during the period from 2006 to 2009, representing a compound annual growth rate of 14.8 percent.[9] Comparatively, checks and credit card payments had compound growth (loss) rates of (7.2) percent and (0.2) percent, respectively, during the same period.[10] Although a number of factors contributed to these growth rates, the Board's study noted that the "increase in electronic payments and the decline of checks can be attributed to technological and financial innovations that influenced the payment instrument choices of consumers and businesses."[11]

As noted by many of the trade associations, payment networks and other interested stakeholders in comments to the Board, the investment necessary to create a secure and efficient infrastructure to support these technological and financial innovations was largely borne by banks and credit unions holding consumer asset accounts ("Accounts"). Debit cards and debit card transactions are also associated with popular products and services, such as free checking

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6 75 Fed. Reg. 81,722, 81,724-25.

7 *Id.* at 81,725.

8 Board of Governors of the Federal Reserve System, *The 2010 Federal Reserve Payments Study, Noncash Payment Trends in the United States: 2006 – 2009*, p. 4 (Dec. 8, 2010).

9 Noncash payments made through ACH increased from 14.6 billion to 19.1 billion during the same period, representing a compound growth rate of 9.3 percent. *Id.* Prepaid card payments increased from 3.3 billion in 2006 to 6.0 billion in 2009 – a 21.5 percent annual growth rate. *Id.*

10 *Id.*

11 *Id.*

and online or mobile banking access to consumer Accounts. These value-add propositions should be carefully considered as the Board adopts a final rule to implement the Durbin Amendment – the rule should not stifle innovation and efficiency in financial services and products to provide a windfall to merchants. Rather, it should follow the letter and spirit of the statute and establish standards for issuers to set interchange fees at an amount that is reasonable and proportionate to costs incurred in electronic debit transactions.

Check Acceptance and ACH Transactions. The Board is directed by the Durbin Amendment to "consider the functional similarity between electronic debit transactions and checks, which are required to clear at par . . . ."[12] Although there is perhaps a functional similarity between processing a payment through a traditional check – providing account holders access to funds in a demand deposit account at merchant POS – the distinctions are significant and obvious. Loosely analogous advancements in check transactions – remote capture and use of ACH transactions to provide quicker, more efficient payments on checks – have greatly increased. Indeed, as recently as 2007, the National Automated Clearing House Association ("NACHA") created a new Standard Entry Class Code for Back Office Conversion Entries which "establish[es] the legal framework and technical specifications to enable retailers and other merchants to accept checks for payment at the point of purchase and convert those checks to ACH debit entries during back office processing."[13] The use of ACH transactions to process checks in this manner (rather than the traditional method for processing through the Federal Reserve System at par) offers merchants and consumers the benefits of electronic processing, including timely notification of insufficient funds, with the structural safeguards provided by the NACHA system for processing payment transactions.

Increasing Regulatory Compliance Costs. An additional point that cannot be understated is that the impact of the Proposal cannot be viewed in a vacuum. Recent implementation of the Credit Card Accountability Responsibility and Disclosure Act of 2009 and amendments to the Board's Regulation E[14] regarding overdraft programs offered to consumers by Account-holding depository institutions have both had an impact on most debit card issuers. Before dismissing out of hand arguments that the impact of the Proposal could have on earnings and the safe and sound operation of a financial institution, the Board should carefully consider the cumulative impact of the Durbin Amendment in conjunction with these prior changes. As one study noted, up to "$25 billion in annual retail-transaction revenues – about 29 percent of total retail-transaction revenues – will be 'regulated away' from U.S. financial institutions as the new guidelines take effect."[15]

In a period of tepid economic recovery, slowly thawing credit markets and increasingly uncertain and complex regulatory compliance requirements, the impact of such a drastic reduction in revenues for issuers should be carefully considered. Issuers "active in the payments industry must rethink their business models and develop new value propositions . . . ."[16] Changes

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12 75 Fed. Reg. at 81,734.
13 NACHA, *2010 Operating Guidelines*, Section 1 – Development and Overview of the System, p. OG 4 (2010).
14 12 C.F.R. pt. 205.
15 Alenka Grealish et al., *Winning After the Storm: Global Payments 2011*, p. 5, The Boston Consulting Group (Feb. 2011).
16 *Id.*

in business models and the development of new value initiatives represent additional outlays and investments – both of which will further reduce the availability of credit in the market and impede economic recovery. The Proposal has far-reaching consequences which have not been fully studied or understood.

II. Responses to the Board's Specific Requests for Comment.

As noted above, the Banks appreciate the opportunity to provide comment and information specifically requested by the Board in the Proposal. We understand and appreciate that the Board is statutorily mandated to promulgate regulations implementing the Durbin Amendment and this process necessarily requires the exercise of the Board's best interpretive resources to divine the meaning of both the letter and spirit of the law. We also understand and appreciate that the Dodd-Frank Act provided the Board with little or no time to study the potential impact of the Durbin Amendment or the Proposal. Notwithstanding the foregoing, however, we generally believe that the Proposal represents a marked departure from traditional statutory interpretation techniques, prior Board interpretive precedent and the letter and spirit of the Durbin Amendment itself.

A. Establishing Standards for Setting Interchange Fees and Allowable Costs.

The Durbin Amendment requires the Board to establish standards for assessing whether interchange fees are reasonably and proportionately related to the costs of incurred in an electronic debit transaction.[17] Instead of establishing standards to be used to assess the correlation between interchange fees and costs, the Proposal presents two alternatives derived through a (i) tenuous analysis of the costs reported by 89 issuing financial institutions; (ii) an arbitrary assignment of certain expenses to be included in the "incremental" average variable costs for providing electronic debit transactions; and (iii) a complete disregard for fixed costs and investments allocable to the provision of electronic debit transactions on an incremental basis.

The first alternative provides for an "issuer-specific determination" that would allow any issuer to charge an interchange fee up to 7 cents per transaction (the "Safe Harbor") without determining whether such fee was reasonable and proportional to the costs of providing the service; however, for any amount charged over and beyond the Safe Harbor, the issuer must demonstrate that such fee represented an allowable cost and, in any event, is less than the 12 cent per transaction cap ("Alternative 1"). The second alternative places an industry-wide 12 cent per transaction cap on interchange fees ("Alternative 2"), presumably because any amount charged up to 12 cents per transaction is "reasonable and proportional" to the costs incurred by the issuer with respect to the electronic debit transaction. Indeed, this is likely the case, given that under either Alternative 1 or Alternative 2 issuers will be receiving interchange fees significantly below their per-transaction costs.

With respect to actual, incremental costs incurred by an issuer in an electronic debit transaction, an industry study provides that total average costs for issuers with more than $10 billion in assets are equal to 65 cents and 75 cents per transaction for PIN and signature debit

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[17] 15 U.S.C. § 1693*o*-2(a)(2) – (3).

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transactions, respectively.[18] Of this amount, 45 cents and 55 cents for PIN and signature, respectively, are incurred for the authorization, clearing, settlement, processing, fraud prevention and fraud loss associated with electronic debit transactions.[19] According to the analysis, all costs can be calculated as set forth in Table 1.

Table 1. Actual Costs Incurred by Issuers in Electronic Debit Transactions

Description of Cost[20]	PIN	Signature
Authorizing	$0.15	$0.20
Clearing and Settlement	0.10	0.10
Fraud and Fraud Prevention	0.05	0.07
Other Transaction Costs[21]	0.15	0.20
Subtotal	**$0.45**	**$0.55**
Administrative and Overhead	$0.20	$0.20
Total[22]	**$0.65**	**$0.75**

Specific Requests Regarding Alternatives 1 and 2.

1. The Board proposes to adopt only one of the alternatives and requests comment on each, as well as on any other alternatives that could be applied. (75 Fed. Reg. 81,736).

Before examining Alternative 1 and Alternative 2, it is critical that the Board focus on and consider several broader issues related to the Durbin Amendment. First, the legislation is bad policy and the Board's current interpretation is too extreme for the following reasons:

- The price fixing scheme contained in the Proposal is antithetical to the free-market system and inflicts significant unintended consequences on all participants in the payments system.

- The supposed beneficiaries of the legislation – consumers – will bear the brunt of the negative consequences of both the statute and the Proposal in the form of higher costs for financial services with no increase in savings from the merchants, as demonstrated in Australia and other markets in which similar legislation has been enacted.

18 Edgar, Dunn & Company, *MasterCard Worldwide: A Review of Issuer Electronic Debit Transaction Costs, Issuers Over $10 Billion in Assets*, p. 3 (Feb. 2011).

19 *Id.*

20 Additional discussions of what constitutes each of the costs listed in the table above is provided below in response number 5.

21 Does not include costs associated with rewards programs.

22 In the interest of full disclosure, the analysis provides that costs associated with reward programs averaged $0.03 and $0.10 for PIN and signature, respectively. However, we have not included these amounts in our discussion of those costs that are incurred by an issuer with respect to an electronic debit transaction.

- The Proposal puts regulators in the position of picking winners and losers rather than monitoring the environment for fair play and compliance.

However, if the legislation cannot be changed, the Board needs to leave as much room as possible under the law for competition and innovation to continue to flourish within the payments system. Components of the guidance do address the original intent of the Durbin Amendment as well as the concerns expressed by Board staff in the guidance and in other venues. These concerns include a lack of competition in electronic payments and a lack of visibility into true costs of payments.[23] The provisions contained in the Durbin Amendment and Proposal which address these concerns include:

- <u>Discounting for certain transaction types</u>: Reduces the negative impact that network price increase have by giving merchants power to incentivize consumers to select an alternative transaction type the merchant feels provides the best economics.

- <u>Network routing/exclusivity limitations</u>: Merchants already have total control over their network participation options; however, this component codifies that control and ensures that issuers cannot force merchants into a single transaction type or pricing structure.

- <u>Transaction minimums/maximums</u>: Permits merchants to set a floor or a cap for transaction values below or above which it is not economically beneficial to accept a card-based transaction.

In the long run, these three requirements provide an efficient market based completely on consumer choice. The merchant is indifferent to the choices since they will price each payment option to be on par with each other and competition for transaction volume will keep price in check. The consumer is indifferent because they can pay with a currency that makes most sense to them. Finally, issuers benefit from not being burdened by the inefficiencies of price fixing.

With respect to the particular alternatives presented by the Board, however, and for the reasons generally set forth above, the final rule should accurately reflect market costs for providing electronic debit interchange and set forth the standards for assessing whether an issuer's interchange fees are reasonable and proportionate with respect to those costs.

The Board is directed to include incremental costs associated with the authorization, clearance and settlement of, and which can be identified as specific to, a particular electronic debit transaction when setting the standards in the final rule. The average variable costs should serve only as a starting point for determining these allowable costs, rather than the end point from which to set a cap or Safe Harbor. As noted in the table above, the standard should recognize incremental costs that bear some reasonable resemblance to the actual costs incurred by issuers. The standard should, however, provide a description of the costs and allow an issuer to determine which of its costs meet the description. The onus should then be on the issuer to

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23 *See*, Schott Schuh, Oz Shy & Joanna Stavins, *Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations*, Public Policy Discussion Papers No. 10-03, Federal Reserve Bank of Boston, Consumer Payments Research Center (Aug. 31, 2010).

demonstrate that its costs comply with the standard and that the interchange fee is reasonable and proportionate to those costs.

In the event that the Board determines not to adopt the standards required by the Durbin Amendment and instead issues a final rule fixing prices for interchange fees, the Banks believe that an industry-average standard similar to Alternative 2 is preferable. The cap in Alternative 2 should be raised, however, to more closely reflect actual costs incurred by issuers with respect to an electronic debit transaction, as further adjusted to reflect the value of investments in fraud detection, prevention and mitigation. An industry-average cap would be preferable because it levels the playing field for all issuers and does not pick winners and losers in the market. Additionally, an industry-average cap leaves open the possibility that an issuer might one day obtain efficiency gains in their debit card program (*i.e.*, it provides an incentive for the issuer to continue to try to reduce costs below the 12 cent cap by allowing these gains to be retained by the issuer). Alternative 1 limits incentive for innovation and would likely have even more adverse effects on consumer utility, consumer access and fraud prevention investment.

*2. The proposed 12 cent cap does not differentiate between different types of electronic debit transactions (*e.g.*, signature-based, PIN-based, or prepaid). The Board does not propose to distinguish initially between the cap value for signature and PIN debit transactions, for either alternatives or to allow the safe harbor value to vary initially by authorization method, but requests comment on whether it should allow for such differences in the cap or safe harbor values.* (75 Fed. Reg. 81,737).

Given the acknowledged cost, acceptance and utility disparities between signature and PIN debit (all of which support higher interchange for signature debit), there should absolutely be differentiation between signature and PIN transaction interchange. As noted in the table above, authorization costs alone represent a 5 cents per transaction gap between the two types of electronic debit transactions. In the event that the Board adopts a cap for PIN, signature and prepaid transactions as presented in the Proposal, it should be higher than the proposed 12 cent per transaction cap and 7 cent per transaction safe harbor, with the standards recognizing the necessary differences in costs based on the differing methods.

3. In light of the higher reported prepaid card costs, the Board specifically requests comment on whether the Board should initially have separate standards for debit card transactions and prepaid card transactions, and what those different standards should be. (75 Fed. Reg. 81,738).

The Durbin Amendment directs the Board to set standards to allow interchange fees to be assessed to determine if they are reasonable and proportionate to the issuer's costs in providing the electronic debit transaction. The Board's recognition that costs associated with electronic debit transactions through a prepaid card are higher than other methods mandate that the standards should take this difference into account and that these transactions should be subject to standards that positively differentiate interchange rates to reflect a reasonable and proportionate relationship to the higher costs.

Costs that are borne by an issuer and allocable to several products and services related to Accounts backing traditional debit cards (such as know-your-customer account establishment procedures ("KYC"), technology infrastructure and branch overhead for example) are solely borne by the Accounts underlying prepaid cards. In many instances, these higher costs are required by federal regulations and which are often duplicated or required each time a new account opened which occurs more frequently than a traditional demand deposit account. Examples of such regulatory burdens required on an Account by Account basis for prepaid cards include compliance with the requirements of (i) the Office of Foreign Assets Control ("OFAC") and the specially designated nationals list ("SDN list") checks; (ii) the requirements of the Bank Secrecy Act and the Financial Crimes Enforcement Network's anti-money laundering requirements (collectively, "BSA/AML"); and (iii) the statements and disclosures required under Regulation E. Additionally, prepaid cards often represent a financial product and service available to higher-risk consumers typically underserved by financial institutions and, for this reason, represent higher costs for authorization, clearing and settlement. In addition, consumer expectations regarding the utility of a prepaid product, which is often defined by the parties in the payment chain with an interest in suppressing the interchange paid on the transaction, should not play into the effective revenues earned on reloadable prepaid debit card transactions.

4. The Board has identified two other potential methods for implementing the interchange fee standards and requests comment on whether either approach is appropriate and, if so, whether and how the standards should be adopted with respect to a permissible amount of variation from the benchmark for any given interchange transaction fee. The additional alternatives would permit an issuer to comply with the Durbin Amendment, (i) so long as it meets the interchange fee standard, on average, for all of its electronic debit transactions over a particular network during a specified period; or (ii) with respect to transactions received over a particular network as long as, on average, over a specified period, all covered issuers on that network meet the fee standard given the network's mix of transactions. (75 Fed. Reg. 81,738 – 39).

Neither of the above methods is appropriate or feasible due to operational, financial and administrative complications. For example, if an issuer (or network) determines that an approved interchange level has been exceeded during a period, the rule would be required to address:

- Whether the issuer would be required to hold a reserve to reimburse merchants charged interchange fees above the allowed amount during a period and the duration for which such a reserve would be held.
- The manner in which an issuer would have the option or ability to decline transactions or shut down merchant category codes to minimize risks.
- Standards for determining which party would be responsible to manage reimbursements.
- The allowable costs for managing reimbursements and on which party the costs would be levied.
- How the reimbursement would be monitored and validated.

- Whether these additional incremental costs be included as into the Board allowable interchange rate, which would itself present somewhat of a circular level of computations with respect to determining what the average allowable costs were during the period.

If a standard is defined, the Board should at a minimum permit the recovery of program costs as defined at an individual issuer level, with no cap. Annual or bi-annual certification of the program costs in a timeframe in advance of implementation defined by the networks would meet the requirement for periodic review and validation of the costs.

Specific Requests Regarding Allowed Costs.

5. The Board requests comment on whether it should allow recovery through interchange fees of other costs of a particular transaction beyond authorization, clearing, and settlement costs. The Board requests comment on what other costs of a particular transaction, including network fees paid by issuers for the processing of transactions, should be considered allowable costs. (75 Fed. Reg. 81,735).

Under the Statute, the Board is required to "distinguish between" the "incremental costs" and "other costs," and under the Proposal, the Board has limited an issuer's allowable costs to those costs that are attributable to the issuer's role in authorization, clearance and settlement of the transaction and that vary with the number of transactions sent to an issuer within a calendar year (variable costs). However, in defining those costs incurred in the authorization, clearance and settlement process, the Board has seemingly established the allowable cost definition by arbitrarily limiting the scope of activities contained within each of those broad categories of authorization, clearing and settlement conduct. Additional transaction-specific costs which should be incorporated, include:

- <u>Network fees</u>. This category of costs include network assessments, gateway fees (costs charged by processors to route transactions to additional networks) and any other costs associated with participation in a given payment network. Network fees represent 3 cents per PIN debit transaction and 12 cents per signature debit transaction.

- <u>Fraud loss costs</u>. Fraud losses are readily identifiable to a particular transaction and, in addition to investments for fraud detection, prevention and mitigation technology, averages 5 cents per transaction and 7 cents per transaction for PIN and signature, respectively.

- <u>Claims and chargeback processing costs</u>. Claims processing involves supporting the regulatory requirement (Regulation E) to receive, investigate and resolve cardholder disputes about transactions conducted on their account. Providing this service requires front-line and back-office staffing as well technology investment (interfaces to the payment networks, regulatory requirement for reporting/management information, etc.) to meet the regulatory requirement. Like most issuers, we have set a threshold below which it isn't economically feasible to pursue recovery of those transaction amounts and automatically reimburse our customers (our current threshold is $50). In the event the transaction value is above the threshold and our initial evaluation of the claim has determined that the claim is valid, we initiate chargeback procedures in which we re-present the transaction to the merchant through our network interfaces. This process can take up to 45 days to resolve and is one of our larger internal operational costs.

- Servicing costs. Account servicing often represents the first indicator to the issuer of potential fraud or misuse with respect to a given access device or transaction and service inquiries can be linked back to the specific transaction that generated them.

- Statement production costs. Settlement costs include the production of periodic physical or electronic statements for the consumer. The Board's Regulation E generally sets forth the required disclosures for debit transactions. Statements notify consumers of transactions on the underlying Account and often provide a consumer with the first level of notice of unauthorized or fraudulent transactions.

- Account set-up and card issuance. The expenses associated with physically producing a card or other access device, personalizing it and linking the card or device with an Account represent costs borne by the issuer, without which an electronic debit transaction could not take place.

- Account-opening and regulatory compliance. These costs include Account set-up, establishing parameters for confirming cardholder characteristics in an efficient, real-time fashion and to update neural or similar intelligent systems designed to match Account transaction data with consumer usage patterns. Account set-up costs include, among others, the costs associated with KYC procedures and compliance with other BSA/AML procedures, compliance with policies necessary to comply with OFAC and SDN list requirements and all Account opening disclosures required by Regulation E.

- Technology infrastructure. Technology infrastructure costs represent allocable, fixed costs that represent an incremental value-added increase to issuer expenses in connection with electronic debit transactions. Maintaining up-to-date, state-of-the-art technology increases efficiency, reduces all costs associated with authorization, settlement and clearing activities and ensures a more secure transacting environment for our customers as well as the merchants.

Additionally, changing statutory and regulatory mandates for issuers will continue to impose additional variable costs attributable to a particular electronic debit transaction. For example, mandating the use of multiple networks for processing electronic debit transactions necessarily increases the costs incurred by issuers with respect to the transaction. These incremental costs should necessarily be included in the Board's interchange calculation.

To be clear, each of the above categories of costs and expenses incurred by an issuer would move a particular debit card program closer to break-even on the program's run-rate costs. Recoupment of these costs does not, however, represent a reasonable return to the issuer of, or justify ongoing investment in, additional innovation or safe and soundness of the payment system. Capital investments by business are driven by the market to those opportunities representing the maximum or optimum rate of return on the investment. Recoupment of costs is not, by itself, a sufficient motivator to promote innovation and efficiency. Moreover, regulatory price-fixing eliminates incentives to innovate and encourages only cost-cutting initiatives necessary to establish actual costs and outlays below the mandated fee structure. The Board should necessarily consider a reasonable return on prudent, required capital investments when establishing standards for determining whether revenue generated by an issuer through interchange fees is reasonable and proportional to the costs of providing the debit transaction.

6. The Board also requests comment on any criteria that should be used to determine which other costs of a particular transaction should be allowable. (75 Fed. Reg. 81,735).

The Durbin Amendment provides that the Board should distinguish between "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular transaction" on the one hand, and "other costs incurred by an issuer which are not specific to a particular electronic debit transaction . . ."[24] on the other. This latter group of costs is to be excluded from the costs considered by the Board in establishing standards for determining whether an interchange fee is reasonable and proportional with respect to the costs incurred. Allowable costs should therefore include any costs that are directly attributable to a particular transaction. As noted above, the Proposal inexplicably ignores data demonstrating additional costs meeting this statutory standard.

7. The Board requests comment on whether it should limit allowable costs to include only the costs of authorizing a debit card transaction. (75 Fed. Reg. 81,735).

In proposing this course of action, the Board notes that "this option may be viewed as consistent with a comparison of the functional similarly of electronic debit transactions and check transactions."[25] The Board continues by noting that one of the "most prominent differences" between electronic debit and check transactions is the authorization process by which the Account is checked for available funds at the time of the transaction.[26] The Board continues by stating that clearing and settlement occurs for both checks and debit transactions, but that nothing in the check processing system analogous to an interchange fee to compensate the issuer for the cost of clearing and settling the transaction.[27]

For reasons set forth above, we believe that both consumers and merchants have shifted their payment preference away from check usage and acceptance and towards electronic payment products (whether by conversion to ACH under the NACHA guidelines or use of a debit card) to access funds in an Account. Unlike traditional check clearing processes which use the Federal Reserve System and therefore clear at par, issuing financial institutions developed the authorization, clearing and settlement process and infrastructure for electronic debit transactions. Though this process has evolved over time, and the fees associated with the process have varied, the market established the pricing for the use of electronic debit transactions at levels which permitted issuers to recover their costs, a reasonable return on investment and to cover their risk of loss on electronic payment transactions. Unlike check settlement where a merchant

[24] 15 U.S.C. § 1693*o*-2(a)(4)(B)(i) – (ii).
[25] 75 Fed. Reg. at 81,735.
[26] *Id.*
[27] *Id.*

potentially bears all risk of loss if a check is returned for insufficient funds in the Account (and where the merchant can charge a returned-item fee often up to $40 per item), an issuer is liable for a sizable portion of unauthorized or fraudulent transactions conducted through an access device such as a debit card, as well as all costs associated with receiving consumer claims, investigating those claims and pursuing recoveries, no matter the success rate.[28] There is, therefore, a significant difference in the clearing and settlement process between checks and debit cards.

Failure to consider clearing and settlement costs would force issuers to further reduce the value that consumers and merchants derive from debit card programs by limiting access, declining significantly more transactions, eliminating protections such as zero liability, drastically reducing investment levels and raising fees to banking customers. Failing to recognize the differences in costs for clearing and settlement, and therefore limiting and issuers ability to recover costs incurred in these processes, will increase risk associated with the transaction and reduce investment in innovation that will increase efficiency and safety and security of the payment system.

8. The Board requests comment on whether it should include fixed costs in the cost measurement, or alternatively, whether costs should be limited to the marginal cost of a transaction. If the latter, the Board requests comment on how the marginal cost for that transaction should be measured. (75 Fed. Reg. 81,736).

All costs associated with a debit card program and which are specific to a particular electronic debit transaction should be included within the Board's standards for allowable costs. In response number 5 above, we have identified examples of fixed costs such as card production, fraud losses, staffing expense, regulatory compliance costs (*e.g.*, statements and disclosures) and program management costs, which represent an incremental cost for an electronic debit transaction and without which the transaction would not be processed. One important distinction between costs to be included is the distinction between fixed and sunk costs (such as data centers and corporate overhead), with the later group being excluded from the category of allowable, recoverable costs because their expenditure is not sufficiently related to the processing of a debit card transaction. Fixed costs, however, are still necessary for, and allocable to, a particular transaction and are necessarily incurred to support a debit card program.

Absent the inclusion of fixed costs in the Board's final rule, marginal costs should be defined as the costs incurred to maintain a functioning and secure debit card and not limited solely to the average variable costs associated with authorizing, clearing and settling a debit card transaction. Additional information regarding those costs that we believe should be included in the Board's standards is provided in response number 5 above.

9. Proposed comment 3(c)-3-iv clarifies that proposed Section 235.3(c) sets forth an exhaustive list of allowable costs, and provides examples of costs that may not be included, such

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[28] *See, e.g.*, 12 C.F.R. § 205.6(b)(1) (limiting liability for consumers to $50 of the amount of an unauthorized transaction assuming timely notice has been given, additional loss borne by the financial institution holding the consumer's Account or issuing the access device).

RBS Citizens

as the costs of rewards programs. The Board requests comment on whether additional clarification of allowable costs is needed.

We believe that additional clarification should include expansion of allowable costs to enable recovery of costs, particularly those required by regulation (*e.g.*, data security and periodic statements and reporting), and sufficient margin to permit future innovation and maintenance of a secure payment system, as discussed above. Doing so will permit an issuer to operate in a safe and sound manner, increase security and efficiency of the network and comply with external standards such as the Payment Card Industry Data Security Standards ("PCI DSS"). Without recognition of the need for margin, investments in programs providing, for example, enhanced fraud prevention and more efficient and secure card management platforms would not be made.

Specific Requests Regarding Issuer Reporting.

As the Board notes, it is unclear whether networks will establish individualized interchange transaction fees. If a network does not establish individualized interchange transaction fees above the Safe Harbor, the Proposal states the Board's belief that it will not be necessary for an issuer to report its maximum allowable interchange transaction fee to networks through which it receives electronic debit transactions.[29]

10. The Board requests comment on whether this reporting requirement is necessary to enable networks to set issuer-specific interchange fees. Additionally, the Board specifically requests comment on whether prescribing a deadline for an issuer to report its maximum allowable interchange fee to a payment network by rule is necessary. If necessary, the Board requests comment on whether March 31 is an appropriate deadline or whether a different deadline is appropriate. (75 Fed. Reg. 81,740).

The Board proposes that an issuer report its maximum allowable interchange fee to each payment card network through which it processes transactions by March 31 of each year for the costs of the previous calendar year to ensure compliance with the standard beginning on October 1 of that same year.[30] In order to ensure issuers optimize their interchange revenue, periodic reporting (annually or biannually) is acceptable. There is no need to mandate by rule or Board action regarding the reporting date. The payment card networks in are in a better position to determine how much advance notice they need to meet an October 1 implementation date and provides more flexibility than a rule or action by a regulatory agency.

Specific Requests Regarding Prohibition on Circumvention or Evasion.

11. The Board also requests comment on all aspects of the proposed prohibition against circumvention or evasion, including whether the rule should provide any additional examples to illustrate the prohibition against circumvention or evasion of the interchange transaction fee restrictions.

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[29] *See* proposed comment 3(d)-1, 75 Fed. Reg. at 81,760; *see also* 75 Fed. Reg. at 81,739-40.

[30] *See* proposed comment 3(d)-1, 75 Fed. Reg. at 81,760; *see also* 75 Fed. Reg. at 81,740.

11.A. <u>Network Fees</u>. The Board requests comment on the proposed approach for handling increases in fees charged by the networks on merchants or acquirers coupled with decreases on charges to issuers, as well as on any other approaches that may be necessary and appropriate to address concerns about circumvention or evasion of the interchange fee standards. (75 Fed. Reg. 81,747).

We support the Board proposed approach such that, absent net compensation from the network to the issuer, increasing fees charged by networks on merchants or acquirers with concurrent decreases on charges networks impose on issuers does not qualify as circumvention or evasion of the Durbin Amendment or the Board's regulation by either the network or the issuer.

11.B. <u>Signing Bonuses</u>. Comment is requested regarding how the rule should address signing bonuses that a network may provide to attract new issuers or to retain existing issuers upon the execution of a new agreement between the network and the issuer. (75 Fed. Reg. 81,748).

The Board notes that signing bonuses "arguably do not circumvent or evade the interchange transaction fee restrictions because they do not serve to compensate issuers for electronic debit transactions that have been processed over the network."[31] The Proposal recognizes, however, that significant upfront payments and future, periodic "incentive payments" could inappropriately serve as offsets to the limits to interchange fees in violation of the requirements of the Durbin Amendment. We believe that the Board is correct in its position on the payment of signing bonuses and incentive payments from a network to an issuer. To the extent that these payments are not tied to electronic debit transactions processed over the network, these payments do not evidence circumvention or evasion of the limits on interchange fees.

Considered this way, the Board's role with respect to signing bonuses is similar to the role of the U.S. Department of Housing and Urban Development ("HUD") under the Real Estate Settlement Procedures Act ("RESPA") and its implementing regulations.[32] For example, HUD uses its general examination and review process, rather than explicit rulemaking, to ensure that RESPA's prohibition on referral fees or kickbacks for residential mortgage settlement services are upheld. This examination authority is particularly important with respect to business relationships established for purpose of skirting RESPA's prohibitions. Use of general enforcement authority to look through "sham" business relationships allows HUD to enforce and punish violations of RESPA without necessarily issuing explicit rulemakings attempting to describe every example of illicit conduct imaginable. Similarly, the Board is in a position to use its general examination and review authority to monitor relationships and ensure that the prohibitions of the Durbin Amendment are upheld, without the need to expressly detail each and every potential violation, such as inappropriate signing bonuses, by rulemaking.

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[31] 75 Fed. Reg. at 81,748.
[32] 12 U.S.C. §§ 2601 – 17; *see also* 24 C.F.R. Part 3500.

Specific Requests Regarding Reporting to the Board.

12. The Board is seeking comment on whether the reporting requirements in proposed Section 235.8 and whether the time frame for reporting is appropriate. (75 Fed. Reg. 81,753).

The Durbin Amendment authorizes the Board to collect necessary information from issuers and payment networks. The Board proposes that entities required to report during a given year submit the report to the Board by March 31 of that year. The timeframe poses no issues for us but we believe that a bi-annual, rather than annual, reporting period is sufficient to capture any changes in the operating environment.

B. Establishing an Appropriate Fraud Adjustment.

The Durbin Amendment provides that the "Board may allow for an adjustment to the fee amount received or charged by an issuer" if the adjustment is "reasonably necessary" to allow the issuer to recover costs incurred in preventing fraud in connection with electronic debit transaction and the issuer complies with fraud-related standards established by the Board.[33] Because the Board has proposed to develop a specific proposal for fraud-prevention adjustments at a later date, costs associated with such activities have been broken down above for comparison purposes. However, the Board should not implement a final rule on the Proposal without having in place standards for providing the reasonable fraud prevention adjustment provided for in the Durbin Amendment. Doing so risks potential system-wide decreases in fraud detection, prevention and mitigation expenditures, with a concomitant impact on fraud prevention effectiveness across the system.

Specific Requests Regarding Reporting to the Board.

13. Fraud-Prevention Adjustments. The Proposal requests comment on two general approaches to the fraud-prevention adjustment framework – a technology-specific approach a non-prescriptive approach – to designing the adjustment framework and requests comment on several questions related to these approaches. The Board requests comment in general on how to implement an adjustment to interchange fees for fraud-prevention costs. In particular, the Board is interested in input on the following questions:

13.A. Should the Board adopt technology-specific standards or non-prescriptive standards that an issuer must meet in order to be eligible to receive an adjustment to its interchange fee? What are the benefits and drawbacks of each approach? Are there other approaches to establishing the adjustment standards that the Board should consider? (75 Fed. Reg. 81,742).

While the technology-specific approach potentially provides economies of scale for participating issuers and lowers the administrative burden for regulatory agencies, the Board should not adopt the technology-specific approach for the following reasons:

33 15 U.S.C. § 1693*o*-2(a)(5)(A).

- There is no single solution or technological standard that works for all issuers. Additionally, adopting a single, technology-specific standard is antithetical to all fraud prevention and deterrence methodologies because it provides a single target for any would-be fraud perpetrators. A compromise of the prescribed technology would mean all issuers (and therefore consumers) would be open to attack.

- Setting technology-specific standards puts the Board in the position of picking winners and losers among the fraud prevention methods currently used by issuers and significantly limits the opportunity and incentive for innovation.

- Because one standard does not work for all issuers, a technology-specific standard further burdens those issuers whose capabilities or infrastructure make transitioning to the prescribed technology unsupportable due to the inability of the issuer to fully recoup the necessary investment through the fraud adjustment.

- A technology-specific standard ignores the risk and investment appetites of individual issuers and the fraud prevention needs a particular debit card product or service may have.

- There exists a potential incremental cost burden for processors, networks, acquirers and merchants, depending upon the technology selected.

The non-prescriptive approach enables issuers to determine their risk and investment appetite, the fraud prevention technology that best suits their transaction set and does not constitute an overt prohibition on innovation. In setting standards for the fraud adjustment, the Board should include the fully-loaded costs of fraud and fraud prevention, such as, costs associated with (i) chargeback transactions; (ii) claims processing; (iii) fraud losses; (iv) servicing; (v) staffing; (vi) technology investments necessary to ensure that a state-of-the-art system is in place to remain ahead of advances made by fraudsters; and (vii) 100 percent of the costs incurred through third party compromises. Historically, compromises in the system have occurred due to inadequate security at merchants and their service providers, not issuers or networks. However, issuers typically only recover between 20-30 percent of the total cost of the compromise (*e.g.*, fraud losses, staffing/servicing, card reissuance and card monitoring). These are event-specific costs that the issuer would not otherwise incur. An example of fraud losses incurred due to security breaches on merchant or merchant acquirer systems include the 2006 T J Maxx compromise of approximately 94 million cards representing around $200 million in fraud losses and incremental costs to the banks and issuers. Of this amount, only $64 million was reimbursed to, or otherwise recovered by, the issuers. Another example is the Heartland Payment Systems in 2008 which represented the compromise of approximately 130 million cards and $300 million in fraud losses and incremental costs to issuers of which $68 million was recovered or reimbursed.

13.B. If the Board adopts technology-specific standards, what technology or technologies should be required? What types of debit-card fraud would each technology be effective at substantially reducing? How should the Board assess the likely effectiveness of each fraud-prevention technology and its cost effectiveness? How could the standards be developed *to encourage innovation in future technologies that are not specifically mentioned?* (75 Fed. Reg. 81,742).

We oppose the implementation of a technology-specific standard for the reasons stated above in response number 13.A. Should the Board choose to adopt technology-specific standards, however, examples of appropriate technology platforms include neural real-time transaction scoring networks, chip and PIN, dynamic card verification value (CVV) and dynamic mag-stripe. Aside from neural networks, there are no other industry-standard technologies that are widely utilized or easily and cost-effectively implemented given the current state of industry infrastructure. Upgrading the technology is not feasible in an environment where there is no opportunity to recover the investment. Innovation from the current state of the art is unlikely without incentives and the freedom to determine which technology solution is best suited for each issuer.

13.C. If the Board adopts non-prescriptive standards, how should they be set? What type of framework should be used to determine whether a fraud-prevention activity of an issuer is effective at reducing fraud and is cost-effective? Should the fraud-prevention activities that would be subject to reimbursement in the adjustment include activities that are not specific to debit-card transactions (or to card transactions more broadly)? For example, should know-your-customer due diligence performed at account opening be subject to reimbursement under the adjustment? If so, why? Are there industry-standard definitions for the types of fraud-prevention and data-security activities that could be reimbursed through the adjustment? How should the standard differ for signature- and PIN-based debit card programs? (75 Fed. Reg. 81,742).

Of the two alternatives, the Board should establish the non-prescriptive standard for the reasons set forth above. The standard should be set based upon fully-loaded fraud and fraud-prevention costs at an industry level, not individual issuer level. This approach would permit issuers to work within their risk and investment appetites, innovate to maximize their opportunity to recover costs and pursue efficiency improvements.

Appropriate fraud-prevention and other regulatory-mandated activities that are not specific to the transaction should be reimbursable under the Board's standards. Examples of this include BSA/AML monitoring of Accounts and card transactions, KYC / OFAC / SDN list checks at Account opening, claims and chargeback processing costs and other costs identified above, including (i) network fees; (ii) fraud loss costs; (iii) claims and chargeback processing costs; (iv) servicing costs; (v) statement production costs; (vi) account set-up and card issuance; (vii) account-opening and regulatory compliance; and (viii) technology infrastructure. The rationale for including these costs is that they ensure a more secure payments environment – which benefits all parties in the transaction. Absent reimbursement for costs incurred for the activities required under applicable regulations, these issuers should be provided relief from these requirements and the standards should place appropriate requirements on the parties most able to mitigate or deter fraud, such as the merchant at the POS.

Given both the higher fraud costs and the greater acceptance and utility associated with signature debit, there should be a distinction between the fraud reimbursement for signature and

PIN debit transactions. Using information, such as the data provided to the Board in the issuer, network and merchant surveys, the full costs of fraud and fraud prevention should be accounted for and reimbursed to issuers through the standards for setting a fraud adjustment.

13.D. Should the Board consider adopting an adjustment for fraud-prevention costs for only PIN-based debit card transactions, but not signature-based debit card transactions, at least for an initial adjustment, particularly given the lower incidence of fraud and lower chargeback rate for PIN-debit transactions? To what extent would an adjustment applied to only PIN-based debit card transactions (1) satisfy the criteria set forth in the statute for establishing issuer fraud-prevention standards, and (2) give appropriate weight to the factors for consideration set forth in the statute? (75 Fed. Reg. 81,742).

The Board should not adopt a standard that results in a downward adjustment to allowed cost recovery in the fraud adjustment, regardless of whether PIN or signature debit transactions are involved. The current proposed rate already ignores significant costs and prohibits recovery of those costs. Any reduction from this already low level further burdens issuers and their ability to continue to offer a secure asset-based electronic POS payment alternative.

The majority of all fraud losses associated with debit transactions are the result of failures in systems in place at merchants and merchant acquirers. This fact is acknowledged by the Board in the Proposal, specifically with respect to signature debit transactions.[34] In some instances, federal regulations limit consumer liability for fraudulent or unauthorized transactions, with losses on such transactions borne primarily by the insured depository institution issuing the debit card or other access device or holding the underlying Account. Given these facts, the Board should ensure that its standards require that merchants, merchant acquirers and their service providers cover 100 percent of the losses they cause. Failure to do so would force issuers to significantly curtail cardholder access, limit the categories of merchants with which the consumer would be permitted to transact electronic debit payments with and decline transactions above a very low dollar threshold.

Providing an adjustment only for PIN fraud ignores the superior acceptance footprint, greater functionality, significantly larger purchase volume and higher fraud prevention costs tied to signature debit. Attempts to incentivize the payment industry to move to PIN by only adopting a fraud adjustment for PIN would cause banks and issuers to limit access to a large cross-section of merchant categories, decline far more signature debit transactions than is currently the case (approximately, 3.5 percent decline rate in the current environment) and force significant costs onto the merchant community to establish terminals for PIN. For reference, approximately 5.7 million of the 8 million merchants in the U.S. do not currently support PIN debit transactions. This course would also serve as a disincentive to continue existing or initiate new investment in improving signature debit fraud prevention capabilities by an individual issuer and on the industry level.

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[34] 75 Fed. Reg. at 81,741 ("Signature debit card transactions exhibit a higher fraud rate than that of PIN debit card transactions.").

13.E. Should the adjustment include only the costs of fraud-prevention activities that benefit merchants by, for example, reducing fraud losses that would be eligible for chargeback to the merchants? If not, why should merchants bear the cost of activities that do not directly benefit them? If the adjustment were limited in this manner, is there a risk that networks would change their rules to make more types of fraudulent transactions subject to chargeback? (75 Fed. Reg. 81,743).

Issuer investment in fraud prevention technology and innovations ensures that cardholders are confident and willing to use a debit card for their next purchase. Merchants receive as much, if not more, of a benefit as from electronic debit transactions as issuers do – given that an electronic debit transaction: (i) offers merchants a secure, guaranteed payment (unlike checks); (ii) provides next-day settlement (unlike checks); (iii) delivers a higher average ticket than checks or cash; (iv) enables greater efficiency at checkout versus checks or cash; and (v) provides our mutual customers a fast, convenient and safe method of transacting.

At the time issuers stop a transaction that appears to be fraudulent, it is unknown if it is an issue caused by the merchant, the cardholder or the issuer and therefore the distinction is impossible to make without investigating each transaction. For reference, in 2006 there were approximately $180.0 billion in charge-offs for merchants resulting from bad checks. In 2009, there was approximately $100.0 billion in bad-check charge-offs for merchants. During the same period from 2006 to 2009, transfers in payment acceptance from checks to debit resulted in about $80.0 billion in savings for merchants on bad-check charge-offs, while only costing these merchants $17.0 billion in total interchange fees (representing an incremental increase of approximately $5.0 billion from 2006).

13.F. To what extent, if at all, would issuers scale back their fraud-prevention and data-security activities if the cost of those activities were not reimbursed through an adjustment to the interchange fee? (75 Fed. Reg. 81,743).

Issuers are generally insured depository institutions or other financial institutions subject to the full panoply of consumer protection laws and regulations governing financial products and services. Examples of these laws include, among others, the disclosure requirements of the Truth in Savings Act and the EFTA, and the data security and privacy requirements of the Gramm-Leach-Bliley Act. As the holder of consumer Accounts and the custodian of protected personal financial information, issuers have data security requirements that extend beyond those associated with debit cards. These requirements will continue irrespective of whether an issuer would be permitted to recoup the costs expended through the establishment of the debit fraud adjustment.

However, there would also be little to no incentive to innovate in this area absent an ability to recoup the investment. In the current environment, the payment system is optimized to permit as many "good" transactions as possible to authorize (approximately, 96.5 percent approval rate) while accepting risk that some "bad" transactions will also authorize. Under the Proposal, issuers will maximize their efforts to prevent fraudulent transactions and decline significantly more transactions at the expense of a large number of good transactions that are currently authorized. This means significant disruption for consumers and merchants and a shift to less secure, more costly and less efficient forms of payment such as checks or cash.

13.G. How should allowable costs that would be recovered through an adjustment be measured? Do covered issuers' cost accounting systems track costs at a sufficiently detailed level to determine the costs associated with individual fraud-prevention or data-security activities? How would the Board determine the allowable costs for prospective investments in major new technologies? (75 Fed. Reg. 81,743).

The measure exists in the format of the Board's survey. All costs were provided in that survey and the Board simply has to include the full range of fraud and fraud prevention costs in the fraud prevention adjustment. Issuers' cost accounting systems track costs at a sufficient level of detail, with the exact level of detail varying by institution. The Board should be able to determine allowable fraud prevention costs in the same manner as other costs captured by the survey. Again, without an opportunity to recoup an investment in fraud prevention technology there will be little or no incentive to improve existing systems or engage in any innovation. Therefore, the board should set the reimbursement at a level that not only captures existing costs but also leaves room (through a reasonable margin) for investment in incremental improvements as well as major new technologies.

There are two ways in which to determine allowable costs for prospective investment. First, the standards should provide enough margin in the product that the free market drives innovation. Second, the Board can develop a process and forum whereby issuers can apply for and receive credit for prospective investments that can be shown to meet the purposes of the fraud prevention adjustment.

13.H. Should the Board adopt the same implementation approach for the adjustment that it adopts for the interchange fee standard, that is, either (1) an issuer-specific adjustment, with a safe harbor and cap, or (2) a cap? (75 Fed. Reg. 81,743).

The Board should define the fraud adjustment and reimbursement at an issuer-specific level without a cap, enabling each issuer to maintain its risk and investment appetites without undue interference from outside parties. Doing so also permits an issuer to match the level of innovation and technology necessary to meet the needs of the issuer's particular debit card products and services without increasing the likelihood that the issuer will implement systems that do not adequately provide the level of needed security.

*13.I. How frequently should the Board review and update, if necessary, the adjustment standards? (*75 Fed. Reg. 81,743).

Annually at most, bi-annually would be preferred.

13.J. Section 920 of the EFTA requires that, in setting the adjustment for fraud-prevention costs and the standards that an issuer must meet to be eligible to receive the adjustment, the Board should consider the fraud-prevention and data-security costs of each party to the transaction and the cost of fraudulent transactions absorbed by each party to the *transaction. How should the Board factor these considerations into its rule? How can the Board effectively measure fraud-prevention and data-security costs of the 8 million merchants that accept debit cards in the United States?* (75 Fed. Reg. 81,743).

This function is already fulfilled by Visa, MasterCard and other networks and the existing interchange system providing the pricing for issuers, acquirers and merchants. Merchants already factor the costs of fraud into the prices they charge consumers.

C. Network Routing.

14. The Board is requesting comment on two alternative approaches to implement the statute's required rules that prohibit network exclusivity. The first alternative would require a debit card to have at least two unaffiliated payment card networks available for processing an electronic debit transaction ("Alternative A"). The second alternative would require a debit card to have at least two unaffiliated payment card networks available for processing an electronic debit transaction for each method of authorization available to the cardholder ("Alternative B"). (75 Fed. Reg. 81,726).

Merchants already have and exercise freedom of choice in the networks they accept for card transactions, so the perception that they need federal protection from the networks and issuers is false. This is evidenced by (i) the widespread lack of acceptance of prominent networks such as American Express; (ii) Wal-Mart's very public dropping of MasterCard debit in 2003 after being unable to resolve a pricing dispute; and (iii) lack of MasterCard and Visa acceptance at major discount or big-box retailers. If at any time a merchant is not deriving value from a network participation agreement, they can drop acceptance. Given the multiple cards in consumers' wallets and the multiple networks carried on those cards, the merchants have considerable choice in the network over which a transaction is carried and exercise it through technology (prompting for PIN), staff training ("please enter your PIN") and network participation decisions ("I'm sorry, we don't accept that network").

Without a complete understanding of both the final interchange and fraud adjustment guidance, we cannot state a definitive preference for one Board proposed alternative over the other. Alternative A's implementation would have a lower impact to the industry than Alternative B, but would still inflict additional costs on issuers (*e.g.*, network fees, processing fees, gateway fees, legal costs and infrastructure costs to point to new networks) that have not been accounted for in the Board's survey or the Proposal with 12 cent cap. If forced to choose at this time and without clarity the issues of interchange fee and fraud prevention adjustment, Alternative A is the preferred approach.

However, we note that if the limitations on permissible interchange fees remain as suggested in Alternative 1 or Alternative 2 of the proposal, merchants should be indifferent to the networks in which a particular issuer participates. Fixing the price of interchange fees charged to merchants should render moot the merchant's interest in routing transactions over a particular network. We note that the network routing and exclusivity limitations appear to be somewhat redundant to, and potentially in conflict with, the interchange provisions, due to merchant indifference to network routing in a fixed-price scenario.

Against this backdrop, issuers would prefer to operate under the Board's proposed routing and exclusivity provisions rather than the interchange limits contained in the Proposal. In other words, issuer and network compliance with statutorily mandated prohibitions on network routing restrictions and exclusivity lessens the need for the Board to arbitrarily establish a fixed price standard for permissible interchange fees, such as those contained in Alternative 1 and Alternative 2. In the event that the Board continues with the Proposal and caps interchanges fees with a Safe Harbor that is the same for all networks and issuers with assets in excess of $10 billion, the Board should recognize merchant indifference and adopt Alternative A so as to not restrict issuer choice or stipulate network participation.

15. The Board requests comment on both proposed alternatives for implementing the prohibition on network exclusivity arrangements under EFTA Section 920(b)(1)(A). The Board requests comment on all aspects of implementing the proposed limitations on network exclusivity and merchant routing restrictions under Section 235.7, including the specific changes that will be required and the entities affected. The Board also requests comment on other, less burdensome alternatives that may be available to carry out the proposed restrictions under Section 235.7 to reduce the necessary cost and implementation time period. (75 Fed. Reg. 81,753).

Alternative A is less burdensome as it generally works within the industry infrastructure as it currently exists. Alternative B would require wholesale changes for issuers, processors, networks, acquirers and merchants to implement multiple brands for signature debit. The changes associated with Alternative B would effectively convert what heretofore has been a privately-developed and owned set of networks with unique values into an undifferentiated, government-controlled utility. A detailed description of these changes is provided to number 16, below.

16. Comment is requested on the cost and benefits of each alternative, including for issuers, merchants, cardholders, and the payments system overall. In particular, the Board requests comment on the cost of requiring multiple payment card networks for signature-based debit card transactions, and the time frame necessary to implement such a requirement. (75 Fed. Reg. 81,750).

The costs for Alternative A include incremental transaction processing costs, gateway costs, network fees, servicing costs (such as different claims and chargeback processes, different technologies and interfaces) and increased legal fees to negotiate network participation agreements – none of which were accounted for in the Proposal.

Alternative B's costs are significantly greater than Alternative A's as it would require not only the costs identified above, but also significant technology infrastructure investment for issuers, networks, processors, acquirers and merchants to enable multiple signature brands on a single card. In our opinion, a best-case scenario for major industry participants and providers to be ready is January 1, 2014.

17. The Board requests comment on the impact of the proposed approach to networks with limited geographic acceptance on the viability of regional payment card networks, and *whether other approaches may be appropriate, including, but not limited to, requiring that a particular debit card be accepted on at least two unaffiliated payment card networks (under either alternative) in States where cardholders generally use the card.* (75 Fed. Reg. 81,750).

17.A. If the Board permitted a regional network by itself to satisfy the requirement, what standard should be used for determining whether that network provides sufficient coverage for the issuer's cardholders' transactions? (75 Fed. Reg. 81,750).

Stand-alone regional networks should be acceptable options for regional banks and multiple regional networks should be sufficient for national banks so long as the network(s) cover states that contain a significant cardholder base, for example greater than 80 percent.

17.B. The Board also requests comment on the potential impact, and particularly the cost impact, on small issuers from adding multiple payment card networks in order to ensure that a debit card is accepted on a nationwide basis on at least two unaffiliated payment card networks. (75 Fed. Reg. 81,750).

See the first paragraph in response number 16 above.

18. Proposed Section 235.7(a) does not expressly prohibit debit card issuers from committing to a certain volume, percentage share, or dollar amount of transactions to be processed over a particular network. However, these volume, percentage share, or dollar amount commitments could only be given effect through issuer or payment card network priorities that direct how a particular debit card transaction should be routed by a merchant. As discussed below under proposed Section 235.7(b), these issuer or payment card network routing priorities would be prohibited by the proposed limitations on merchant routing restrictions. The Board requests comment on whether it is necessary to address volume, percentage share, or dollar amount requirements in the exclusivity provisions, and whether other types of arrangements should be addressed under the rule. (75 Fed. Reg. 81,751).

The Board should not address volume, percentage share or dollar amount requirements in its rule to implement the Durbin Amendment. Many of the Board's regulations govern the conduct and activities of financial institutions. Contractual provisions, terms and other agreements that are in conflict with the requirements of the Board's regulations are typically unenforceable, void or voidable and subject the violating party to regulatory enforcement actions. Similarly, where volume, percentage share or dollar amount requirements in contracts and agreements between issuers and networks violate the exclusivity provisions of the Durbin Amendment and the Board's rule, these provisions will be unenforceable and subject the issuer to regulatory criticism. This generality provides the Board with the greatest level of flexibility and enforcement of the network exclusivity provisions. Drafting specific rules and regulations to address these contract terms will limit the effectiveness and scope of the prohibitions to such contract terms.

19. The Board requests comment on whether 90 days provides sufficient time for issuers to negotiate new agreements and add connectivity with the additional networks in order to *comply with the rule, in the event that a previously unaffiliated network subsequently becomes affiliated .* (75 Fed. Reg. 81,751).

Given the number of banks that are required to negotiate or renegotiate network participation agreements under the new standards and the finite legal resources for networks and issuers, 90 days is not a sufficient amount of time to comply negotiate new agreements. Setting a 90 day standard will unfairly handicap issuers in negotiations with new networks which will know that the issuer has no choice but to comply with the requirements of the Durbin Amendment. Accordingly, at least one year should be the allotted timeframe for negotiating new agreements.

20. If Alternative B is adopted, the Board anticipates that significantly more time will be needed to enable issuers and networks to comply with the rule. The Board requests comment on a potential effective date of October 1, 2011, for the provisions under Section 235.7 if the Board were to adopt Alternative A under the network exclusivity provisions, or alternatively, an effective date of January 1, 2013 if Alternative B were adopted in the final rule. (75 Fed. Reg. 81,753).

Additional time to comply with the rule would be welcome, but as stated above, up to at least one year is necessary to negotiate network agreements under Alternative A and an effective date of January 1, 2014 if Alternative B is adopted.

D. Miscellaneous Issues.

21. <u>ATM Networks and Transactions</u>. The Board requests comment on the application of the proposed rule to ATM transactions and ATM networks. If ATM networks and ATM transactions are included within the scope of the rule, the Board requests comment on how to implement the network exclusivity provision. The Board also specifically requests comment on the effect of treating ATM transactions as "electronic debit transactions" under the rule on small issuers, as well as the cardholder benefit, if any, of such an approach. (75 Fed. Reg. 81,727).

As noted by the Board, the statute does not expressly include ATM transactions and networks within its scope. The Board should not read the definitions of "debit card," "electronic debit transaction," and "payment card network" to bring ATM transactions within the coverage of the rule. Nothing in the Durbin Amendment's passage suggests that ATM interchange fees or network-exclusivity prohibition and routing provisions should apply to ATM transactions and networks.

22. <u>Three-Party Systems</u>. The Board also requests comment on the appropriate application of the interchange fee standards to electronic debit transactions carried over three-party systems. The Board requests comment on the appropriate way to treat three-party networks and on any specific clarifications with respect to such fees that should be provided in the regulation. In addition, the Board requests comment on how the network exclusivity and routing provisions should be applied to three-party systems. The Board requests comment on all aspects of applying the proposed rule to three-party payment systems, including on any available *alternatives that could minimize the burden of compliance on such systems.* (75 Fed. Reg. 81,727 – 28).

Applying this rule to three-party systems would potentially require wholesale business model changes for the participants, including divestiture of the network components of their businesses, and would potentially cause a significant destruction of value for those enterprises, their shareholders and the payments industry. Had Congress had a full opportunity to discuss and understand the implications of the Durbin Amendment to electronic debit transactions in three-party systems prior to enactment, we believe that Congress would not have intended to cause such wholesale changes. It is precisely for situations like these that Congress left the rulemaking and implementation of the Durbin Amendment to the Board, which has more experience with the operation and regulation of payment systems and precisely why the Board should exclude three-party systems in its final rule.

23. <u>New and Emerging Payment Systems</u>. The Board requests comment on whether other non-traditional or emerging payment systems would be covered by the statutory definition of "payment card network." If such systems are not covered, the Board requests specific comment on how it should distinguish these payment systems from traditional debit card payment systems that are subject to the rule. (75 Fed. Reg. 81,733).

New payment systems such as mobile payments have been developed to operate on existing network pathways and should be defined in the same manner as an electronic debit transaction / general purpose reloadable ("GPR") card.

Other alternative payments methods, such as PayPal, accept debit and credit cards to fund the customer's accounts. Such a system's peer-to-peer environment is closed-loop and, barring a change to open-loop, should not be governed under this rule. However, the system's business-to-consumer environment is equivalent to a network, and to the extent it accesses the consumers' asset Account should be governed under this rule.

24. <u>Exemption for Small Issuers</u>. The Board requests comment on whether the rule should establish a consistent certification process and reporting period for an issuer to notify a payment card network and other parties that the issuer qualifies for the small issuer exemption. The Board also requests comment on whether it should permit payment card networks to develop their own processes for making this determination. (75 Fed. Reg. 81,743).

A consistent process would ensure that all issuers are working on the same basis and the same timeframe should apply.

25. <u>Exemption for Government-Administered Programs</u>. As with the small issuer exemption in Section 235.5(a), the Board requests comment on whether it should establish a certification process or whether it should permit payment card networks to develop their own processes. (75 Fed. Reg. 81,744).

The Board should establish standards so that all programs are consistently managed.

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25.A. If the Board is to establish a certification process, the Board requests comment on how to structure this process, including the time periods for reporting and what information may be needed to identify accounts to which the exemption applies. (75 Fed. Reg. 81,744).

The criteria are clearly defined, so application of those criteria should be straightforward. The reporting timeframe should be defined by the networks on an annual or bi-annual cycle, whichever is selected for the non-governmental programs.

26. Exemption for Certain Reloadable Prepaid Cards. The Board seeks comment on whether it should establish a certification process for the reloadable prepaid cards exemption or whether it should permit payment card networks to develop their own processes. The Board also requests comment on how it should structure the certification process if it were to establish a process, including the time periods for reporting and what information may be needed to identify accounts to which the exemption applies. (75 Fed. Reg. 81,745).

As stated in response to number 3 above, issuer intent and program structure – *i.e.*, where the card packaging clearly states that the product offered is "reloadable prepaid debit" – should define the interchange earned on the transaction, not ancillary marketing messages defined by merchants, resellers or other parties with an interest in suppressing the interchange paid on the transaction.

The current language puts the onus of defining the consumer expectation regarding a description or marketing of the GPR card to consumers on the reseller (merchants in most instances), eliminating issuer intent from the definition process. As proposed, issuers will have to bear additional costs to perform audits in order to ensure ethical treatment by merchants and other resellers of GPR products. These incremental costs should be included in the Board's calculation of allowable costs.

The reporting timeframe should be defined by the networks on an annual or bi-annual cycle, whichever is selected for the non-governmental programs.

III. Additional Issues for Board Consideration.

Comparing Debit to Checks. In addition to the information provided briefly in Part I above, we believe that consumer and merchant preference clearly favors debit over checks at merchant POS. While checks clear at par, merchants bear significant costs for check handling and acceptances that are understated or ignored in the Durbin Amendment and Board's Proposal.

Changes in Consumer Payments. In the U.S. for the years 2003 to 2008, the aggregate dollar value of check transactions decreased from $2.11 trillion to $1.61 trillion, or a decrease of $505.1 billion, and the total number of check transactions decreased from 27.6 billion to 19.9 billion, a decrease of 7.7 billion transactions. For the same period, the aggregate dollar value of debit card transactions increased from $583.0 billion to $1.33 trillion, an increase of $747.3 billion, and the number of debit card transactions increased from 16.1 billion to 34.0 billion, an increase of 17.9 billion.

Check and Debit Card Functionality and Costs. While checks clear at par, merchants bear significant costs for check handling and acceptance that are not reflected in the text of the Durbin Amendment and the Board's Proposal. To provide an accurate comparison of debit and check acceptance costs, similar functionality must be evaluated. Fraud prevention screening is applied to 100 percent of all debit card transactions, whereas only 33 percent of check transactions are covered by a check verification service. All debit card transactions (100 percent) carry a payment guarantee as compared to only 2.9 percent of check transactions. Every debit card transaction also provides a guarantee of next-day settlement. There is no comparable service or feature for check transactions.

With respect to costs incurred by merchants, the discount rate paid by merchants – including all network costs and debit card interchange fees – for PIN and signature transactions average 55 cents and 80 cents per transaction, respectively. Comparatively, merchants pay nearly $1.00 per transaction in basic check handling costs necessary to accomplish all the steps for processing the instrument. Check guarantee and verification services cost an *additional* 70 cents per transaction, meaning that for functionality and safeguards for checks that are roughly comparable with the services provided on a majority of debit card transactions, a merchant pays $1.70.

There are easily understood reasons why debit cards are the preferred payment method for consumer and merchants and why check usage is declining. For merchants, benefits of debit card transactions include ubiquitous ownership among U.S. consumers, low cost of acceptance, guaranteed payment, next-day funds availability, lower risk than checks or cash, higher average transaction size at POS than checks, speed at POS, acceptance choice across multiple networks, reliability, information and reporting, support infrastructure interoperable with other payment types (such as credit or prepaid) and the ability to route to the lowest-cost network. Consumers use debit cards due to the convenience of direct access to a Account without the risk of incurring further debt, ubiquitous acceptance, their choice over the transaction type, control, security, reduced liability for fraudulent or unauthorized activity, speed and ease of use, reliability, rewards and benefits such as purchase protection.

With respect to check transactions, benefits for merchants include the ability to convert processing to an electronic transaction, increased consumer choice and no interchange fees (but significant acceptance costs). Benefits for consumers include control over the instrument and payment method. On the downside for merchants, check transactions are declining by U.S. consumers, have a high cost of acceptance, lack a guaranteed payment (without incremental cost increases for a check guarantee service), higher risk of loss during processing, slower transaction times and lower average transaction value at POS. For consumers, the downsides of check use include declining merchant acceptance, less security, slower transaction speeds, lack of benefits or protection and absence of rewards.

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Conclusion.

RBS Citizens, National Association and Citizens Bank of Pennsylvania appreciate the opportunity to comment on this important rulemaking initiative. We look forward to continuing to work closely with the Board to implement an appropriate final rule.

Sincerely,

Martin Bischoff

Martin Bischoff
Vice Chairman, Consumer and Business Banking