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Delivered Via Email: regs.comments@federalreserve.gov

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

RE: Proposed Rule on Debit Card Interchange Fees and Routing, Regulation II; Docket No. R-1404; RIN No. 7100-AD63

Dear Ms. Johnson:

Preamble

We were dismayed by the preliminary guidance that was given by the Federal Reserve Board on December 16, 2010. We believe that the Board's proposed rule must be fundamentally changed in order to avoid serious negative consequences for the consumer, the banking system and for the payment system overall. We respectfully suggest that a more practical approach to the rulemaking could result in an *improved* payment system that allows all parties to flourish harmoniously.

We have a number of pragmatic operational concerns regarding the proposed rule but our most fundamental concern is the substantial disconnect and deviation between the instructions given to the Board in the Durbin Amendment and the resulting proposed rule.

Governor Walsh said it best during the December 16, 2010, Federal Reserve Open Board Meeting: "So the statute – the first reading of the statute says that the Board shall establish standards for interchange fees. It doesn't say we should establish prices…can you take us through why the staff proposal has us in the price-setting business?"[1]

In fact the statute clearly instructs the Board to "establish standards for *assessing* whether the amount of any interchange transaction fee described in paragraph (2) is reasonable and proportional to the cost incurred by the issuer with respect to the transaction." We believe the Board has gone beyond what is required of it by law and if it continues down this path it will unintentionally cause harm even as it aims to do good.

1. YouTube video "Federal Reserve Open Board Meeting, December 16, 2010 @ 25 minutes, 32 seconds.

The proposed rule unnecessarily sets the interchange cap *below* our cost to provide debit card services to our customers. From a purely practical perspective, we find it hard to believe that the agency charged with regulating this product would force it underwater, so to speak. Under these circumstances, the consumer will be harmed by the fees that will result from the banks trying to break even on their debit card operations. This does not appear to ease the burden of the institutions you regulate or the consumers you aim to protect. It does, however, create an uneven playing field whereby those banks with great economies of scale will experience a smaller marginal loss. Those of us without their resources and negotiating power will be placed at a relative disadvantage by our own regulator.

Under your current proposal the loss of revenue will be so profound that innovation and investment will be stifled. The allowable interchange cap is below our variable costs, let alone our fixed costs, and provides no chance of recouping our total cost, much less making a profit. We believe that this situation cannot be good for any party in the payment system long-term and we are compelled to ask that you fundamentally reconsider your guidance and change your position.

We respectfully ask that, first and foremost, the Board do no harm to the payment system. You may achieve this by returning to the statute and responding with a literal reading of what is statutorily required. A strict reading would result in precisely what the statute requires: The Board would produce "standards for *assessing* whether the amount of any interchange transaction fee described in paragraph (2) is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."

Senator Durbin is on record stating that he did not intend to set prices. By creating standards for *assessing*, the Board will return to the specific meaning and intent of the statute.

Who We Are

Commerce Bancshares, Inc. ("CBI") is a regional bank holding company with one bank subsidiary, Commerce Bank, N.A. ("Commerce"), and total assets of $18.5 billion at December 31, 2010. Commerce is a full-service bank, with approximately 370 banking locations in Missouri, Illinois, Kansas, Oklahoma, and Colorado and credit card operations in Nebraska. A full line of banking services, including investment management and securities brokerage, is offered. CBI also has operating subsidiaries involved in mortgage banking, credit related insurance, and private equity activities.

Commerce is one of the smaller debit card issuers included under the debit interchange provisions of the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We are a highly regarded regional banking institution located in the Midwest, recognized for the safety, soundness and service we deliver to our community and customers. We believe that as one of the smallest issuers, we will be relegated to the worst possible competitive position under the proposed rules. We will be challenged to compete against banks that are exempt from regulation, and we will not be able to leverage volume discounts and economies of scale enjoyed by the big national issuers.

We appreciate this opportunity to comment on the rule proposed by the Board regarding debit card interchange fees and routing, as published in the Federal Register on December 28, 2010.

Unintended Consequences

We fear that the Board's narrow view of the costs used to determine the proposed interchange fees will produce the following unintended consequences:

1. Most significantly, the proposed debit card interchange fee structure will force issuers to operate their debit programs below cost and will provide little, if any, financial incentive for banks to emphasize the sale of debit cards to customers, despite the obvious societal benefits of debit cards.
2. Regulation II effectively and wrongfully places sole control of the payment system into the hands of retailers with no regard for consumer choice, security or impact on innovation.
3. The proposed fee structure will result in the consumer paying higher fees for banking services, and will limit consumer choice and satisfaction as banks struggle to break even on their debit card operations. This may have the effect of pushing low income consumers out of the banking system and they will pay substantially more for financial services.
4. Without any adjustment for fraud losses, the customer will experience more frequent declines as issuers attempt to reduce risk of loss not offset by revenue, and a major fraud incident could put an issuer (especially a smaller issuer) out of business.
5. Under the proposed rules, card networks are not obligated to maintain a separate debit interchange structure for exempt issuers, and marketplace pressures could eventually drive those issuers to a lower fee, thereby harming community banks.
6. The proposed interchange fee structure will result in a shift of consumer spending to other payment methods that are less efficient, less convenient and more costly for the merchant such as cash, checks or credit cards.
7. With the proposed interchange fee structure, the large merchants will be inclined to discontinue check acceptance as some have in Canada, further limiting consumer choice and prompting many consumers to seek products and services outside of the banking mainstream.
8. The proposed network provisions and the expected delay of the effective date for the fraud-prevention adjustment rules will result in an implementation that is out of sync, further complicating the issuers' understanding of their financial positions, and

compounding the consequences outlined above. We are being asked to fundamentally restructure our relationship with our customers, including product design and pricing, prior to having full guidance on our compensation.

9. Small businesses will lack the knowledge and sophistication to be able to take advantage of network routing enhancements and will not realize benefits afforded to large merchants.
10. The dramatic change to the issuers' debit card business model brought on by the proposed rules will put jobs at risk, and stifle innovation if card networks or issuers are unable to recoup their investments.

Our Comments In Response To The Board's Requests

§235.2 Definitions

The proposed definition of "debit card" places issuing banks in the uncomfortable position of deciding whether to bargain for a level playing field by supporting a more inclusive definition, while being philosophically opposed to the price setting that accompanies the proposed rules. We are concerned that the definition of "debit card" will reshape competition and harm the payment system if certain products or transactions are not included as part of the definition, but we believe price setting establishes a terrible precedent and is not an acceptable solution under any conditions. As proposed, the Regulation revises the debit card business model so dramatically that an expanded definition of "debit card" will surely stifle innovation in this area. For this reason, we ask the Board to narrow the definition of "debit card" so that the device itself is not classified as a debit card if it performs both debit and credit functionalities. In the case of dual-function cards, we assume debit transactions will qualify under the proposed definition of "debit card", while credit transactions will not, even if performed with the same card. If the Board is inclined to expand the definition of "debit card" to include ATM networks, three-party systems and/or emerging payment systems, we urge the Board to study the Regulation's effect on competition and innovation as part of the assessment process required by the statute prior to issuing the final rules. The consequences otherwise are unpredictable at best and profoundly negative at worst. We should not gamble the payment system on an unknown outcome.

§235.3 Reasonable and proportional interchange transaction fees

The proposed alternatives for setting debit interchange fees do not cover the costs of operating a debit card program, nor do they fairly compensate the issuer for the value received by the merchant. The Durbin Amendment calls for standards, which is not the same thing as a price cap or any other specific price parameters. The alternatives will effectively extinguish the viability of a product that is highly popular with customers, and will create unintended consequences that will harm the consumer, specifically, and the payment system, generally.

An interchange fee based on an extremely narrow view of issuers' expenses is clearly in conflict with the words "reasonable and proportional." The value that debit cards provide over checks, such as guaranteed payment and cost savings in the form of reduced collections expense, reduced per item deposit fees, reduced return item fees, etc., were not considered. A broader range of issuer expense should be included as "allowable costs."

The Board should expand its definition of allowable costs to include other costs specific to a transaction, but not necessarily related to authorization, clearance or settlement as permitted by the statute. We propose the inclusion of expenses (variable or fixed) associated with functions that are dedicated and essential to debit processing. In addition, we urge the Board to consider including an acceptable level of fraud loss when establishing standards for interchange fees.

Compensation for these costs is justifiable considering that merchants pay fees related to processing checks today. It is true that when checks clear they clear at par; however, it is not unusual for merchants to pay a per item fee of 5-10 cents when depositing checks, a fee of $1 per batch deposit, a $10-15 per item fee when the check is returned and not paid, a re-clear per item fee of $1-5 if an item is submitted a second time, plus any costs of collection efforts. None of this guarantees payment to the merchant. Additionally, many merchants pay an extra 1-2% transaction fee for a check guarantee service. If the check clears, it can take up to three days for the funds to be available for the merchant's use.

As a smaller issuer, we are concerned that larger issuers, because of their size and the number of their transactions, distorted the survey, which led the Board to propose cap and safe harbor amounts that are too low. If we endorse Alternative 1, we take on the regulatory burden of justifying anything above the safe harbor. We are also mindful that the card networks are not obligated to support issuer-specific interchange fees, and such a structure would be difficult for them to implement. Alternative 2 keeps us bound to a structure that is based on the costs of larger issuers, but is less burdensome for us and the industry to support. In either case, the largest merchants will negotiate downward and issuers will be even less able to make the investment that is necessary for the payment system to flourish.

We again urge the Board to further study the implications of the alternatives it has outlined in the proposed rule as part of the assessment process required by statute prior to issuing the final rules, and to consider removing the cap and broadening the definition of allowable costs to account for the value of the debit card payment system to merchants, such as swift, guaranteed payment.

§235.4 Fraud-prevention adjustment

We consider the proposed approaches for fraud prevention adjustments to be inadequate and potentially damaging to consumers and the constituents of the debit card payment system. The Board has not provided enough detail regarding the approaches in order for us to evaluate them and express an opinion. The proposed approaches are biased in favor of merchants, and assume that issuers will make additional investments in fraud prevention and innovation when there is no financial incentive to do so.

The timing of the implementation of the fraud adjustment is particularly problematic. Issuers will continue to incur expense for fraud prevention once the interchange rules become effective, but, without a final rule on adjustment for fraud prevention, the issuer's financial position becomes uncertain, and it is therefore difficult to introduce appropriate debit card fees to customers. It is also more likely that losses from any given fraud incident or event could be insurmountable for some issuers. We urge the Board to synchronize the adoption of rules for interchange fees and the adjustment for fraud prevention.

Questions 1-3. A technology-specific major innovation would likely require investment from card networks, issuers, issuer processors, acquiring banks, acquiring processors, and merchants. We question whether there would be sufficient funding allocated appropriately to the parties to undertake a major innovation. An adjustment for this type of innovation would have to be considerable to cover the cost of, for example, a migration to "chip and PIN".

The technology-specific approach raises the following questions and concerns:

- How is agreement to be reached on the selection of technology to deploy?
- Will large merchants use their ability to afford and implement new technology as a way to disadvantage local merchant competition? Even now, large merchants claim they are ready for "chip and PIN." Many thousands of small merchants are not.
- Is it the Board's expectation that the issuer would fund the other parties' expenses?
- If so, how could issuers be held accountable for implementation by other parties?
- How would the funding be distributed to the parties involved?
- How are the costs estimated for new technology? What happens if the adjustment does not cover actual expenses or the return on investment falls short of expectations?
- What is the role of the card networks?

If the Board adopts a non-prescriptive approach, its effect would depend on the standard used. If the standard calls for a significant reduction in losses, the result will be an increase in the decline rate of legitimate debit card transactions.

We ask the Board to consider the following factors when developing approaches to determine the fraud-prevention adjustment:

1. Compare merchant costs of debit card fraud to similar costs associated with other payment forms, such as stopped or returned unpaid checks, and the handling and theft of cash.
2. Consider that merchants receive swift, guaranteed payment for authorized debit card transactions and can protect themselves from chargebacks by following the card network rules.
3. Consider the reliability, popularity and security of debit cards compared to other forms of payment. Customers want legitimate transactions to be approved, and they want their personal and financial information protected.
4. Consider that issuers have the tools available today to manage to a lower fraud loss, and because issuers consider the risk of declining legitimate transactions and damaging customer relationships, issuers incur manageable levels of loss as a cost of doing business.
5. Consider that merchants desire an efficient means of processing payments. They also desire high card authorization approval rates so they can maximize the number of sales and efficiency at the point of sale.

Questions 4 - 6. Without adequate compensation from the merchant for fraud prevention and losses beyond what is charged to the customer in the form of fees, the most affordable ways to combat debit card fraud will be for the issuer to decline authorizations, adjust cardholder liability levels and/or redirect customers to other products. An adjustment for both PIN and signature purchases is required. Merchants receive numerous benefits when they accept debit cards, and the compensation we receive from them as a party to the transaction should take into account the risk of loss and the losses incurred by the issuers. In addition, there are also consumer regulatory protections in Regulation E that prevent us from recouping fraud loss from the consumer directly with no regard for the consumer's own negligence.

Question 7. We have the capability to track costs, and our expenses for fraud prevention and losses were determined and submitted as part of our survey response.

Question 8. As stated above, we question the appropriateness of the Board setting specific price parameters and have concerns about the unintended consequences of not being allowed to recoup our costs for fraud losses and fraud prevention. However, any fraud loss or fraud prevention adjustment should be included in the interchange fee standard.

Question 9. The Board should review and update the adjustment standards at least annually, but a major fraud incident should warrant a special review.

Question 10. Without regulatory authority over merchants, the Board will be unable to effectively measure costs as described in this question without assistance from card networks, acquiring banks and the merchant community.

§235.5 Exemptions

Small Issuers. The exemption for small issuers is completely arbitrary and politically motivated, devised to win support for the Durbin Amendment and fragment the banking industry's position. There was no Congressional analysis of whether the $10 billion asset-size exemption would avoid harm to community banks. The exemption may prove to be ineffective if, as we expect, market pressures force fees down for small issuers. They will certainly be negatively impacted by the rules that apply to them, such as the added expense associated with network exclusivity and routing. For this reason, we believe the Board should study the impact of this exemption further, prior to issuing final rules.

Prepaid Cards. The exemptions for government-administered and certain reloadable prepaid cards were also politically motivated to gain buy-in from state governments, special interest groups and consumer groups. There were no studies performed as a basis for the exemption, but, as a matter of principle, we do not disagree with an exemption that limits the negative effects of price setting.

Certification. The payment card networks are capable of creating their own certification process for the exemption of this product without need for government interference.

§235.6 Prohibition on circumvention or evasion

We have no objection to the circumvention and evasion language proposed, and we agree that signing bonuses 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.

§235.7 Limitation on payment card restrictions

We have outlined our concerns with the limitations in the proposed rule below, and urge the Board to further study its impact in conjunction with other provisions in the proposed rules as part of the assessment process required by statute, before adopting the final rule.

Unnecessary limitations. If the interchange fee for PIN and signature debit transactions is drastically reduced as proposed, the merchants' complaints about fees will be eliminated, and card networks will have little room to distinguish themselves based on the interchange fee they set. This will inhibit competition rather than encourage it as originally intended.

Limits on consumer choice. Consumers will lose current benefits and protections because merchants and card networks will control how their financial transactions are routed under the proposed rule. The final rule may prompt card networks to change cardholder benefits and protections for economic reasons, so issuers will be challenged to keep benefits and protections equal between unaffiliated card networks.

Undue burden on issuers. If an additional unaffiliated card network is required by the final rules, issuers should receive an adjustment to compensate them for the expense associated with adding and supporting that network. This should include, but not be limited to, expenses associated with implementation, on-going network connectivity and support, vendor relationship and contract management, third-party risk assessment, card system development and maintenance, card collateral, and settlement activities.

No level playing field. The proposed rule unfairly chooses clear winners and relegates others to a position of competitive disadvantage. Small merchants who lack the sophistication or knowledge to choose optimal routing will be at a competitive disadvantage if this rule is adopted. They could be sold merchant services featuring bundled pricing, not realizing there may be an opportunity for cost savings. Regional PIN networks will not meet the geographical requirements of the proposed rule and will lose business if they cannot expand. The proposed rule creates an incentive for large issuers to circumvent card networks by becoming a card network themselves with the ability to negotiate directly with merchants, putting smaller issuers at a disadvantage because they are unable to secure such an arrangement.

Effect on innovation. It is quite common in most industries for product developers to leverage existing infrastructure to introduce emerging technology when it makes sense. We have seen this happen with RFID (Radio-Frequency Identification) and mobile payments. The developers consider the value that the emerging technology delivers to the customer, and determine the most relevant and cost effective means of deploying it. For example, the value proposition associated with RFID is that of speed and convenience, which would clearly diminish if the merchant requires the customer to enter a PIN when using the RFID enabled device. If card networks and developers are required to implement their technology for each method (PIN and signature), it is possible they would be unable to justify deploying the technology and innovation would effectively be stifled.

Alternatives A and B. Alternative B calls for monumental change and investment to the card payment system without any real promise of improvement to the card payment system or benefit to society. Of the two alternatives, Alternative A is less harmful to the card payment system, and less onerous to implement.

Effective dates for alternatives. The effective dates for both alternatives are unreasonable. Under normal business conditions, the effective date for Alternative A might be achievable, but a bottleneck is certain to occur because the majority of issuers will be seeking an unaffiliated card network at the same time. It is our opinion that the effort associated with Alternative B will take well beyond the January 1, 2013 proposed effective date to implement, and would likely require phases. We urge the Board to eliminate Alternative B from consideration, and, if Alternative A is deemed necessary as part of the final rule, to extend the effective date by at least a year.

In conclusion, we contend that merchants receive value when they accept debit cards, and issuers should receive fair compensation from merchants in return. The proposed rule on interchange should be changed to set standards for assessing fees, permit banks to earn a reasonable profit, and not impose government price controls. By doing so, the payment system and all constituents will flourish in a free market environment.

Sincerely,

David W. Kemper
Chairman of the Board, President
and Chief Executive Officer
Commerce Bancshares, Inc.

Carl Bradbury
Director of Consumer Card Products
and Senior Vice President
Commerce Bank, N.A.