Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

March 4, 2011

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

Subject: Docket No. R-1404: 12 CFR Part 235; Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

I am writing to convey comments of the Office of the Comptroller of the Currency on the Board's proposed Regulation II, which implements section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act concerning interchange transaction fees for electronic debit transactions.[1] The proposed rule has two main components. First, it implements the statutory prohibition on network exclusivity arrangements and merchant routing restrictions. Second, the proposal contains two alternative approaches, each of which sets maximum permissible debit card interchange fees for covered banks. The comments in this letter relate to the second component of the proposal.

Section 1075 clearly is designed to limit the types of costs that debit card issuers can recover through fees. Within that framework, however, we believe the proposal takes an unnecessarily narrow approach to recovery of costs that would be allowable under the law and that are recognized and indisputably part of conducting a debit card business. This has long-term safety and soundness consequences – for banks of all sizes – that are not compelled by the statute.

Background

Section 1075 of the Dodd-Frank Act added a new section 920 to the Electronic Fund Transfer Act[2] (EFTA), regarding debit card interchange transaction fees. Section 920(a)(3) of the amended EFTA requires the Board to prescribe regulations "to establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[3] The statute also directs the Board to

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010) (Dodd-Frank or the Dodd-Frank Act). The proposal was published at 75 Fed. Reg. 81722 (Dec. 28, 2010).
[2] 15 U.S.C. §§ 1693-1693r.
[3] 15 U.S.C. § 1693o-2(a)(3).

distinguish between the issuer's incremental cost to authorize, clear, and settle a particular transaction, which the Board must consider, and other costs that are not specific to a particular electronic debit transaction, which the Board may not consider.[4] The statute also permits, but does not require, the Board to allow for an adjustment to an interchange fee to account for an issuer's costs in preventing fraud, provided the issuer complies with standards established by the Board relating to fraud-prevention activities. In addition, the statute exempts from interchange fee regulation issuers that, together with their affiliates, have assets of less than $10 billion.

The statute was clearly designed to prevent the recovery of certain types of costs that are a part of the cost of doing a debit card business. Under Section 920(a)(2) "[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] In establishing standards for determining whether an interchange transaction fee is reasonable and proportional, section 920(a)(4) requires the Board to "consider the functional similarity between – (i) electronic debit transactions; and (ii) checking transactions . . . " and "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction."[6] The Board, however, may not consider "other costs incurred by an issuer which are not specific to a particular electronic debit transaction . . . ."[7]

Within the constraints of this statutory framework, we believe there is flexibility for the Board to consider alternative approaches that could enable debit card issuers to recover identifiable costs of conducting a debit card business. For example, the statute directs the Board to set "standards for assessing" whether a fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction; it does not say that the Board should set the allowable fee. . The statute also allows costs in addition to those related to authorization, clearance, and settlement (ACS) if those costs are specific to a particular electronic debit transaction.

In a brief filed recently in a case seeking to enjoin the enforcement of Section 1075 and a future regulation issued by the Board thereunder, the Board in fact *agreed with* both of these points:

> Under the statute, the Board can consider non-ACS costs that are specific to a particular electronic debit transaction. See 15 U.S.C. § 1693o-2(a)(4)(B)(ii). In addition, the statute's requirement that the Board "establish standards" for assessing debit interchange fees does not obligate the Board to set a specific rate for debit interchange fees. See 15 U.S.C. § 1693o-2(a)(3)(A).[8]

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[4] 15 U.S.C. § 1693o-2(a)(4)(B).
[5] 15 U.S.C. § 1693o-2(a)(2) (emphasis added).
[6] 15 U.S.C. § 1693o-2(a)(4).
[7] *Id.*
[8] *TCF National Bank v. Bernanke, et. al*, No. 4:10-cv-04149-LLP (D. S. D.), Memorandum in Support of Defendants' Motion to Dismiss Plaintiffs' Claims for Failure to State a Claim Upon Which Relief Can Be Granted and For Lack of Subject Matter Jurisdiction and Defendants' Response in Opposition to Plaintiffs' Motion for a Preliminary Injunction at 28 (filed Feb. 18, 2011) (Brief). The OCC is named as a defendant in this case and joined in the Brief.

These points are discussed in more detail below.

Establishing standards for reasonable and proportional interchange fees

Section 920 (a)(3) instructs the Board to "prescribe regulations . . . to establish standards for assessing whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction." As the Board acknowledges in the Brief, to which the OCC is also a party, "the statute's requirement that the Board 'establish standards' for assessing debit interchange fees does not obligate the Board to set a specific rate for debit interchange fees." Yet, the Board's proposal focuses solely on two options that involve setting specific fee caps per transaction: (1) an issuer-specific interchange fee with a safe harbor (initially set at 7¢ per transaction) and a cap (initially set at 12¢ per transaction); and (2) a cap (initially set at 12¢ per transaction) applicable to all covered issuers. These are rate caps that will result, by the Board's own estimates, in at least a 70% reduction of interchange revenue. The impact of a revenue reduction of this magnitude has not been studied, but it is clear that it will change how financial institutions, both large and small, will do business, with obvious negative impacts on their ability to recover their costs of operation and unpredictable collateral consequences for their customers. We therefore urge the Board to reconsider its rate-cap based approach in light of the flexibility it acknowledges it has to pursue other choices.

Allowable Costs

Even if the Board chooses to implement the statutory direction to "establish standards" through a rate-cap approach, we believe the Board has not given appropriate consideration to the costs that should be taken into account in calculating the allowable rate. We urge the Board to reconsider the following points:

The Board did not propose rates that are pegged to issuers' actual costs, stating that it would be difficult for issuers accurately to report those costs so that bank examiners checking for compliance with the proposal could compare costs to fees received. Yet, the proposed rule requires issuers to collect that data and report those costs to the Board on a regular basis. If the Board continues to view the statute as requiring the setting of rates, it seems reasonable to link such rates to the actual cost data the Board expects issuers to be able to collect and report.

We believe that the statute does not limit allowable costs only to those related to ACS, provided the other costs are specific to a particular electronic debit transaction. Under the language of the statute, the fee that a debit card issuer may charge must be reasonable and proportional to the cost incurred by the issuer with respect to a transaction (section 920(a)(2)), and the Board must establish standards for assessing whether such an interchange fee is reasonable and proportional to such cost (section 920(a)(3)). In prescribing regulations establishing those standards, the Board is required to "distinguish between" the "incremental cost" incurred by the issuer in "authorization, clearance, or settlement of a particular transaction," which are to be considered in

transaction, which are not to be considered (section 920(a)(4)(B)). This distinction and direction to consider particular types of costs is simply not drafted as an exclusive set of the recoverable costs described in section 920(a)(2). The Brief acknowledges that this flexibility exists. Yet, the proposal is premised on the position that the debit interchange fee may *only* reflect the incremental authorization, clearance, and settlement costs incurred in a specific debit card transaction. We therefore urge the Board to reconsider and expand the types of transaction-specific costs that are clearly identifiable as part of conducting a debit card business.[9]

In its proposal, the Board declined to consider such costs in light of the statute's direction to consider the functional similarities between debit card and check transactions, and the fact that these costs are not charged to merchants in check transactions. We respectfully suggest that the Board's approach did not fully consider this direction. Consideration of the similarities between check clearing and debit clearing necessarily includes recognition of where the two are *not similar*. For example, when a merchant swipes a customer's debit card, it is "approved" by the issuing bank and the merchant is guaranteed to receive payment ("good funds"). In contrast, a merchant who accepts a customer's check bears the risk that the check will bounce. Private guarantees for checks cost approximately 1% of the transaction value, while debit card issuers provide this service for free. The merchant benefit and issuer costs of the guarantee of good funds are factors appropriately within the scope of the statutory directive to compare debit card and check transactions.

The Board also has proposed to exclude any network switch fees as allowable costs, even though these are incremental costs required to authorize a transaction and therefore allowable under even the most narrow reading of the statute. The statute mandates that the Board consider inclusion of transaction-specific ACS costs, which would include switch fees, and we urge the Board to reconsider its exclusion of a type of cost that Congress clearly signaled an intent to allow.

Fraud Adjustment

Section 920(a)(5) allows the Board to increase the interchange fee to include "reasonably necessary… costs incurred by the issuer in preventing fraud in relation to electronic debit transactions." The Board currently is not proposing a specific increase in the fee as a fraud adjustment; rather, it is offering two general alternatives for comment. The first would allow issuers to recover costs for their current fraud-prevention efforts, while the second would only allow issuers to recover costs for major technological innovations.

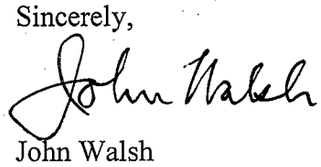
We are concerned that adopting the second alternative would make the Board the gatekeeper for determining which innovations are significant enough to be eligible for the adjustment. Moreover, adopting the second alternative could discourage issuers from engaging in incremental improvements to existing fraud prevention technologies. The OCC encourages national banks to develop technologies to prevent fraud across all product lines and to implement

[9] Such costs include transaction processing costs, transaction-based cardholder inquiries, transaction-based rewards programs or revenue-sharing, and non-sufficient funds handling.

improvements whenever feasible, whether they be product-specific or cut across multiple product lines. This is simply sound banking practice. Allowing cost recovery for only certain technologies, and only when applicable in merchant debit card transactions, runs counter to that fundamental goal.

We look forward to consulting with the Board as the final rule is developed.

Sincerely,



John Walsh
Acting Comptroller of the Currency