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FEBRUARY 22, 2011

BY EMAIL

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

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

Dear Ms. Johnson,

The National Association of Convenience Stores ("NACS") respectfully submits the following comments and proposal in response to the notice of proposed rulemaking published by the Federal Reserve Board ("Board") in the Federal Register on December 28, 2010. *Debit Card Interchange Fees and Routing*, 75 Fed. Reg. 81,722 (proposed Dec. 28, 2010) ("NPRM").

NACS is an international trade association representing the convenience store industry. The industry as a whole includes about 145,000 stores in the United States, sells nearly 80 percent of the gasoline in the nation, and employs about 1.7 million workers. It is truly an industry for small businesses; more than 60 percent of convenience stores are owned by one-store operators.

NACS is also a founding member of the Merchants Payments Coalition ("MPC") and fully supports the comment letter being submitted by the MPC today. These comments are intended to augment the MPC submission and NACS considers those comments to be fully incorporated herein by reference. NACS is highly appreciative of the Federal Reserve Board's efforts in drafting, and gathering comments on, the NPRM. NACS believes the NPRM is a good start to the regulatory proceeding mandated by Section 920 of the Electronic Fund Transfer Act ("Section 920").

Payment card cost, with interchange as the largest component, represents the single largest operating expense in our industry behind payroll expense, and is forecast to have cost the industry $8.9 billion in 2010. Of all card payment types, signature debit card products are the single fastest growing tender type within our industry and now comprise more than 50% of the industry's Visa and MasterCard interchange expense. PIN debit volumes have stagnated within the industry due in part to the use of incentives by issuers to steer consumers to less secure signature debit transactions with historically higher interchange rates.[1] This has been part of the dynamic behind an 8.1 percent annual growth rate for debit interchange between 2007 and 2010 in this industry.

Ultimately, the escalating cost of debit and other cards borne by retailers are paid by consumers through higher prices. A report by the Hispanic Institute[2] found that over 97% of the cost of payment cards is

1 The effective interchange rate of PIN debit exceeded signature debit in 2009.
2 Effraim Berkovich, PhD, "Cross-subsidization of Consumers in the Payment Card Market", Hispanic Institute, November 2009.

passed on to consumers – whether they pay with cards or cash - translating into over 3 cents per every gallon of fuel sold in the U.S. Interchange is effectively a regressive national sales "tax" levied on all consumers through price fixing.

NACS believes that Section 920 provides the most equitable method of addressing the market failure for debit interchange. The following highlights the most significant comments of the convenience and petroleum industry:

- With respect to debit interchange transaction fees, NACS unreservedly believes Alternative 1 to be the best combination of reduced regulatory burden, clarity and increased efficiency. While NACS believes the proposed safe harbor is overly generous given the Federal Reserve's own data and other countries' debit systems (many of which operate without interchange), this option represents real progress toward an improved system.

  The safe harbor and cap should apply to every transaction. For example, no issuer should be able to exceed the cap on any transaction even if the issuer keeps average fees below the cap.

- With respect to fraud and fraud mitigation costs, NACS supports comments submitted by the Merchants Payments Coalition[3] advocating for a performance standard for determining qualified fraud prevention expenses. The baseline for such a standard should be the fraud levels experienced on PIN debit transactions which are far lower than those for signature debit.

- With respect to debit card restrictions, NACS unreservedly recommends the adoption of Alternative B by the Board as the only suitable solution to establishing competition between card networks on every transaction. Alternative A would have limited effect; it would not create competition for the majority of transactions and it would not satisfy the language or intent of the Durbin Amendment. Further, the minimal cost and technical requirements of implementing Alternative B should be recognized and an accelerated implementation deadline should be adopted.

Once again, NACS appreciates the opportunity to comment and the Federal Reserve's efforts to address this issue. We look forward to the Fed's continued diligence and expeditious implementation of this rule.

Sincerely,

Hank Armour

Henry O. Armour
President and CEO

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3 Letter to Ms. Louise Roseman of the Board of Governors of the Federal Reserve System dated January 20, 2011 (RE: No.R-1404(Debit Card Interchange).

1 A Separate Safe Harbor and Cap is the Best Proposal for Interchange

1.1 Alternative 1 clearly offers the best opportunity to increase competition and efficiency

Given the cost data reported by issuers to the Federal Reserve Board (FRB), Alternative 1's 7 cent safe harbor provides more than enough revenue to adequately cover authorization, clearance and settlement (ACS) costs, and provides an unnecessarily high rate of return for issuers. The starting point for this analysis ought to be the cost savings that issuers receive every time a debit card is used. The debit transaction is cheaper for the issuer to handle and process than a check transaction or a withdrawal of cash by visiting a teller. This was the driving reason for financial institutions to create the debit payment system in the late 1970's in the first place. This fact, combined with the cost analysis performed by the FRB, demonstrates that no interchange is necessary to support the debit system. That conclusion is bolstered by experience around the world. For example:

- In Australia, the weighted average issuer interchange for all debit is *negative* 2 to 3 cents (AUD). Prior to reforms by the Reserve Bank of Australia, issuers actually paid a negative interchange of 20 cents on PIN debit transactions and could still justify this cost against the cost of over the counter transactions.[1]
- In Canada, New Zealand and The Netherlands PIN debit transactions have always been performed *at par* – in recognition of its cost advantage to alternative bank transactions.

In all, seven of the eight nations in the world with the highest per capita debit usage have net interchange of zero or negative amounts. Debit thrives in those nations. This experience demonstrates that alternative 1 proposed by the FRB (including a 7 cent safe harbor and 12 cent cap) is the best option proposed and, if anything, should be reduced to a level at or below the 4 cent per transaction cost that issuers reported to the FRB. Allowing any additional interchange would reduce the incentives for issuers to operate more efficiently.[2]

Alternative 1 also promotes adoption of PIN debit and its inherent benefits over the severely flawed signature debit product. In fact, based on the FRB's own data on cost differentials between the two debit products, issuers could maximize profits by simply steering customers to PIN debit while complying with the Rule at the safe harbor rate.

1.2 Alternative 2 will not promote cost efficiencies or competition

Alternative 2 will not promote the letter and spirit of the Durbin Amendment's objectives, but instead will result in an unjustifiably high – by the FRB's own analysis and examples of other debit market pricing – transaction "market" price, without providing financial incentives for increasing system efficiency.

[1] See Comments filed with the Federal Reserve Board by TransAction Resources February 22, 2011.
[2] Indeed, the primary impact of Australia's debit reforms has been increases in bank efficiency – not increased revenues in other areas.

1.3 Allowable costs under the proposed rule

The proposed definition of allowable costs is consistent with the law. The costs that issuers have argued should be included in the analysis simply do not make sense when scrutinized. The comparison to the paper check system is telling. Exchange fees on checks (the equivalent of interchange) were prohibited by the FRB in the early part of the last century. This change helped the checking system thrive as an efficient way for people to make purchases. Debit cards were an innovation to save banks the money it costs to process paper checks. Every time someone uses a debit card, the bank makes money because the use of that card is cheaper for the bank than it would be for that consumer to use a check or go to a teller to withdraw cash. That is true even if there are no swipe fees and no consumer fees associated with use of the card.

The Financial Services Roundtable sent to Congressional offices a list of additional costs it believes should be included in the FRB's analysis. The Roundtable wrote, "The proposal does not take into account funding costs, overdraft losses, billing and collection, customer service, data processing, protection of customer data and fraud losses that relate to supporting debit services – nor does it take into account the investment and development costs borne by financial institutions to create these electronic payment networks."

Why shouldn't funding costs be included in the FRB's analysis? Because those aren't debit costs. Debit cards are used when people want to access their own money. While that is money customers have given the banks to hold for them, it is still the customers' money. The banks should not be able to claim a cost for letting people get their own money.

Why shouldn't overdraft losses be included? Because banks make money on overdrafts. The fees banks charge for overdrafts are so high that this is a profit center for banks, not a cost. In 2009, banks made $38.5 billion in overdraft fees and more than $20 billion of that was from debit overdrafts alone. The banks simply cannot credibly claim that a profit center is a cost, allowing them to double-dip and charge both consumers and merchants for overdrafts.

Why shouldn't billing and collection costs be included? Because these aren't debit costs. Consumers accessing their own money aren't billed and nothing needs to be collected. There are costs like these for credit cards, but credit interchange isn't touched by the FRB's rule.

Why shouldn't customer service costs be included? Because these aren't costs of debit, these are costs of having customers. If banks want to have customers who give them money, then they need to provide some service to those customers. The money the banks get on deposit allows the banks to make loans and earn money. The deposit accounts provide multiple revenue streams for banks as noted by TCF Chief Executive Bill Cooper when he said last year, "There are a lot of revenues associated with retail banking. There's the checking fees, there's the debit card fees, et cetera. There's a lot of revenues, plus the margin we collect from the money that we bring in from checking accounts and so forth."[3] There is no reason for banks to charge merchants for what every other business provides as a consequence of having customers without charging a third party for it.

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[3] William Cooper, Comments, TCF National Bank Financial Earnings Conference Call, Transcript, Oct. 12, 2010, at 16.

Why doesn't the FRB rule take data processing costs into account? Well, as a matter of fact, it does. The costs of processing data through the system, checking that sufficient funds are in an account, and transferring those funds are precisely the costs contemplated and used by the FRB in coming up with its rule.

Why didn't the FRB include the protection of customer data and fraud losses in its analysis? Fraud losses weren't included because paying banks for having fraud losses creates a perverse incentive for banks to allow fraud-prone systems to proliferate. In fact, that is why "signature" debit – which is seven times more prone to fraud than PIN debit – has been able to grow even though it is far worse for consumers and the economy to have more fraud. Rather than compounding these problems, the law and the rule properly provide for ways that interchange can be adjusted when banks make expenditures that prevent fraud. This may include expenditures to protect data – which the Roundtable complains about without noting that this may be contemplated by the fraud prevention provisions in the rule.

The Roundtable also conveniently ignores that merchants spend billions of dollars on fraud prevention and data protection for the debit and credit systems. Just one subset of these expenditures by merchants (those necessary to comply with the network's PCI requirements) are estimated to be $10 billion to date.[4] Many of these expenditures are necessary because banks have pushed signature debit transactions which are far more fraud-prone than PIN debit transactions. Given that banks are already pushing higher fraud prevention costs onto merchants through their behavior, the FRB should cast a skeptical eye on bank attempts to recover their own, similar costs.

The magnitude of these costs may be surprising to people not familiar with how the payments system works. An average convenience store, for example, loses $930 each year to chargebacks and 86 percent of those chargebacks are in the category of "fraud" chargebacks. That means the store, not the bank, is picking up the tab for fraud. An average store also pays $9,200 each year to secure the payments system and protect data. That amounts to $1.3 billion for the industry as a whole – or 25 percent of the entire industry's pre-tax profits. The size of those numbers should make clear that merchants are more than paying their own share for fraud and data security and should not be paying more to subsidize the banks.

The card industry likes to claim that debit cards give merchants a payment guarantee. That is simply false. A merchant can do everything right to ensure a transaction is properly authorized and still be stuck with the loss if the transaction turns out to be fraud. That was made clear by testimony of Gus Prentzas, a New York florist, at a February 17, 2011 hearing before the House Financial Institutions Subcommittee, as well as by a letter entered into the record of that hearing from the owner of the Catch Seafood Tavern in New York. The letter explains how the banks refused to give him the money for five transactions amounting to $78. The claim was that they were duplicate transactions. After fighting his way through a lengthy dispute resolution process, the owner established that the transactions were legitimate and simply a case of the same cardholder ordering the same round of drinks more than once – a common occurrence in his establishment. He managed to win his dispute, but was charged a dispute resolution fee by the network of $15.50 per transaction. The fees came to $77.50 and he walked away from the abusive process with 50 cents for his efforts. Many merchants have simply given up challenging unfair decisions like this because the networks find other ways to discourage them from doing it – such as with this fee. His transactions weren't even fraudulent, but he lost the money anyway.

[4] Stephen Mott, "Industry Facts Concerning Debit Card Regulation Under Section 920," Oct. 27, 2010 at 28.

This happens with depressing frequency. The card industry comes up with any excuse it can to push fraud losses onto merchants. The FRB study found that 43 percent of the time on signature debit transactions merchants footed the bill for fraud. Other studies show merchants absorb more of the fraud losses than banks. In 2009, merchants suffered debit fraud losses of $689 million while bank issuers had debit fraud losses of $499 million.[5]

If you include credit cards and look at the numbers, merchants pay an even higher majority of fraud losses.[6] The card industry simply cannot legitimately maintain that it should be able to make merchants pay for fraud whenever it wants, not guarantee payment, *and* make merchants pay more interchange for fraud. As Mr. Prentzas said in his testimony, this is not only wrong, it is offensive. The real question is whether banks should be reducing swipe fees by the amount of fraud that merchants are forced to take.

Why shouldn't the costs to create the payment networks be included in the rule? There are many reasons for this. First, current network costs are borne by the networks – and their fees are not regulated by the Durbin Amendment or FRB rule. Second, any initial capital costs that were spent by banks to start the networks have been recovered many, many times over through decades of inflated interchange fees, technology efficiencies, and the huge investment gains the banks made when the major networks had initial public offerings of stock. The banks made investments and those investments paid off as Visa and MasterCard became very valuable. The banks should not be paid by merchants when they already made a killing off of these investments. Third, credit swipe fees are still vastly over-inflated and more than cover any and all costs that the banks might have put into the networks. There is simply no reason for banks to get debit swipe fees for investments that are borne by others, on which the banks have already recovered and for which the banks continue to receive an outsize revenue stream with huge profit margins.

In short, none of the costs that banks claim should be part of the FRB's analysis belong there. The costs of authorizing, clearing and settling transactions are more than banks receive on check transactions and additionally, the Fed has built in a substantial rate of return on these costs. The FRB's own survey of banks found that these costs amounted to 4 cents per transaction, but the FRB's rule allows for either 7 or 12 cents to be charged. That makes for average profit margins of 75 to 300 percent. Those are margins that no retailer would dare dream of making.

It should also be made clear that payments to networks are not allowable costs. Any other rule would incentivize circumvention of the rules through the card networks.

1.4 The safe harbor and cap should apply to every transaction

Every transaction should comply with the FRB's safe harbor and cap. Allowing issuers to comply based on average charges would be counterproductive and undercut the rule.

Allowing average cost compliance (at the issuer or network level) would foster an imbalance of price distribution, distort retail prices and be impossible to regulate for several reasons:

[5] Mott, "Industry Facts Concerning Debit Card Regulation Under Section 920," Oct. 27, 2010 at 25.
[6] Javelin Strategy and Research, *True Cost of Fraud Study*, Lexis Nexis (2009).

- The letter and spirit of the Durbin Amendment is that *all* debit transaction prices comply with the reasonable and proportional standard.

- Issuers do not have significantly different marginal costs by merchant. They do by authentication method but that is very different and the networks have used their centralized pricing power over time to discriminate among merchants to exploit their market power – not to recover differential costs. The Fed should not allow this use of market power to continue by allowing compliance by averaging rather than on a per transaction basis.

While NACS agrees with the proposed reporting requirements in "3(D) Disclosure to Payment Networks", NACS believes that issuer compliance must also be verifiable at the merchant level – not network or issuer levels – and that each merchant should, on a reasonable basis, be allowed to request a detailed statement of interchange charges from the network and/or individual issuers.

2 Fraud

2.1 Fraud prevention adjustment

NACS strongly supports the comments and recommendations expressed by the Merchants Payments Coalition (MPC) in its letter to the Board of Governors of the Federal Reserve System dated January 20, 2011 as an acceptable method of fostering fraud reduction and allocation of fraud costs. Any adjustment for fraud reduction should be based on a performance standard which is technology neutral. Any technology that meets the specified performance standard should be eligible (as long as it does not run afoul of other requirements such as through requiring investments by merchants).

Such a performance standard could be implemented on the same time schedule as the other aspects of the FRB's rule. If it cannot, however, that is not a sufficient reason to delay any other aspect of the rulemaking. While fraud is a significant societal as well as merchant cost, it is diminutive compared to total debit transactions accounting for only 0.075% of signature debit and 0.01% of PIN debit.[7]

Comments submitted to the FRB by FiTeq provide support for the NACS and MPC positions advocating for a performance standard. Innovations like FiTeq that demonstrably reduce fraud and save costs throughout the system (including merchant costs) should be incentivized by allowing a fraud adjustment for adopters of those systems – as long they reduce fraud below the levels achieved by PIN transactions today. Providing incentives for successful and efficient innovation is the right way to approach this aspect of the rule.

Longer term, NACS encourages the FRB to promote and/or sponsor open and transparent collaboration of all stakeholders in the card payments system to evaluate technologies and methods to greatly reduce fraud risk, with the idea that these stakeholders will jointly craft strategic "roadmap" for coordinated implementation of these technologies.

[7] Oliver Wyman/Pulse, *2010 Debit Issuer Study*

2.2 Merchants shoulder more than half of fraud costs already

As discussed above, the cost of fraud and fraud mitigation is subject to the same anti-competitive market forces as interchange. As with interchange, card issuers and brands leverage the same market power to transfer their costs of operations – in this case fraud – at will to the retailer.

Actual fraud costs are largely "charged back" to the defrauded retailer by the card issuer, inflating the actual cost of card acceptance and directly refuting the card brands' contention that the retailer receives a "guaranteed payment" in return for paying interchange. In fact, NACS research indicates that merchants assume 70 percent of payment card fraud costs through the chargeback system, which makes the actual cost of fraud borne by issuers diminutive and inconsequential. Included with this comment letter is a summary of a survey of NACS members that was submitted to the FRB prior to the date the NPRM was published. The NACS survey shows:

- Each convenience store suffers an average of $930 in chargebacks each year.
- That means $150 million in chargebacks for the convenience store industry as a whole each year.
- 86 percent of these chargebacks are categorized as fraud-related.
- Fraud chargebacks increased at a 19 percent rate per year from 2004 to 2008.
- This is in spite of huge convenience store expenditures to prevent fraud, for technology upgrades, and data security compliance. These expenditures total $9,200 per store each year -- $1.3 billion for the industry as a whole.

The cost of fraud between PIN and signature debit products offers a stark contrast in approaches to fraud by issuers. The 2010 Pulse Debit Report shows that fraud rates for signature debit – the type of debit transaction where authentication risk is on the retailer under card brand operating rules – had fraud rates of 0.075 percent of sales. Conversely, the Pulse data showed that PIN debit - where issuers largely hold authentication risk and implemented PIN authentication – was 0.01 percent of sales, or about 13% of signature debit. The dominant card networks push the higher risks of fraud associated with signature debit onto merchants.

2.3 Merchants shoulder most of the costs of fraud mitigation

The cost of fraud mitigation, as with actual fraud costs, is largely borne by the retailer. Retailers are required to invest in incremental system upgrades, bear the risk of breach, pay for additional validation processes and comply with PCI standards. When merchants are defrauded by virtue of gaps in the card system, the card brands and issuers penalize the merchants above and beyond the actual cost of the crime. All of these costs – over and above the cost of interchange – are paid by merchants in order to preserve the signature card systems and keep issuers from having to invest in technologies that dramatically reduce systemic risk. Issuers are not required to meet these same standards, which increases merchant costs, increases fraud, and keeps issuer fraud prevention costs lower than merchant costs. In brief, signature debit risk transference to the retailer comprises the main fraud risk reduction strategy of the card brands and issuers.

Merchants therefore support regulation that promotes restoration of the concept of the "guaranteed transaction" while reducing the societal risk of fraud. That would put incentives in the right place for issuers to actually reduce fraud. PIN debit offers an example of how this can be achieved while maximizing issuer returns under the Alternative 1 price model.

3 Limitation on Debit Card Routing Restrictions - Alternative B is the Only Viable Choice

NACS views network choice as critical to establishing competition in the debit card markets, with Alternative B offering the best environment to promote this objective.[8] Alternative A offers little improvement over the current state of affairs. Only those merchants with PIN capability (about 25 percent based on FRB data) would be able to benefit from Alternative A, while the majority of merchants would effectively have no routing choice for signature debit and thus see no improvement from the regulation.

There is no reason why Alternative B cannot be implemented in a relatively short period of time and with minimal costs to issuers. Visa and MasterCard already authorize each other's cards. Further, capture and settlement of another brand's card is a relatively simple process characterized by one EFT network executive as taking no more than three months to implement within the PIN debit markets. In the PIN debit market, this multi-routing capability was the de facto operating standard before network consolidation and exclusivity (in order to raise pricing) became the trend. Similarly, many large issuers, such as Citibank, support multiple card brands today and easily switch brands. They routinely are able to accomplish such switches within 6 months.

NACS also sees little impact on small issuers of full implementation of Alternative B, as efficient issuers have outsourced card operations to the myriad of providers (Jack Henry, Fiserve) who offer scale to even the smallest issuers. Further, these same third parties have already integrated operations with most, if not all, payment networks, further substantiating NACS belief that Alternative B can be quickly implemented.

[8] There is no reason to limit the non-exclusivity provisions of the Durbin Amendment to point-of-sale transactions. Some of the same dynamics are present in the ATM context and having competitive routing choice at ATMs would be beneficial. In short, more competition is a good thing in every context – including ATM routing. Such a reading is also consistent with the language of the law which is transaction-centric. That is, the Durbin Amendment requires multiple network routing options on every transaction. This is not limited by the way a card is authenticated, or by the location of the transaction or type of terminal used. The provision simply applies to all instances in which a person uses a debit card. Applying non-exclusivity to all forms of authentication and all places that a debit card is used (including at ATMs) is the only way to remain consistent with the language of the Durbin Amendment.

4 Prepaid General Purpose Cards

The exemption of prepaid general purpose cards from the legislation presents a significant risk that issuers will attempt to circumvent the law. It is expected that issuers will attempt to circumvent the Rule by creating "hybrid" products that meet the prepaid general purpose card definition. NACS proposes closing this risk of circumvention by defining exempt cards as those that are only reloadable through means other than an ACH, transfer or check drawn upon an asset account.

5 Emerging Payment Systems

New payment technologies should be subject to the FRB's non-exclusivity routing rules unless deployed exclusively on a limited, pilot basis. These payment technologies (which may include cell phones, biometrics and the like) are being developed to link to existing networks and should be able to meet the requirements of non-exclusivity without any issues.

6 Circumvention Through Rebates, Bonuses and In-kind Payments by Networks to Issuers

NACS views payments from networks to issuers as presenting a significant risk to circumvention of the Rule. Therefore, any and all monetary payments, consideration or in-kind services from the payment network to an issuer should be viewed as a circumvention of the Rule.