CBA | CONSUMER BANKERS ASSOCIATION

February 22, 2011

Via Electronic Mail

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

RE: Docket No. R-1404; RIN No. 7100 AD63

Dear Ms. Johnson:

This comment letter is submitted by the Consumer Bankers Association ("CBA") in response to the proposed rule on debit card interchange fees and routing ("Proposal") published by the Board of Governors of the Federal Reserve System ("Board"). *See* 75 Fed. Reg. 81722 (Dec. 28, 2011). The Proposal would adopt a new Regulation II and related Official Staff Commentary to implement the provisions of Section 920 of the Electronic Funds Transfer Act ("EFTA"), which was enacted by the so-called "Durbin Amendment" contained in Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

CBA is the only national financial trade group focused exclusively on retail banking and personal financial services – banking services geared toward consumers and small businesses. As the recognized voice on retail banking issues, CBA provides leadership, education, research, and federal representation on retail banking issues. CBA members include most of the nation's largest bank holding companies as well as regional and super-community banks that collectively hold two-thirds of the industry's total assets.

CBA appreciates the opportunity to share its views on the Proposal with the Board. At the outset, CBA recognizes that Congress imposed an extremely difficult task on the Board to implement a statute with virtually no legislative history in an unreasonably short time period. Rate making efforts by other federal agencies in similarly complex areas can take years to complete properly. Further, CBA appreciates the efforts of the Board to get out a proposal on the key interchange limits quickly and thereby allow for important review and comment by the industry on these extremely important provisions.

As a backdrop for its comments in this letter, CBA notes that it strongly opposes Section 920 insofar as it indicates that any rate-making is necessary or appropriate with respect to interchange fees received by debit card issuers. The debit card market is extremely competitive at the card issuer, merchant bank and card network levels. Section 920's governmental intrusion into the setting of interchange fees is wholly unwarranted and, like other government intrusion into properly functioning markets, will have undesirable and unintended consequences. However, Section 920 requires the Board to adopt regulations to implement the statute and it is important that the Board do so without causing undue disruption to the debit card marketplace.

EXECUTIVE SUMMARY

This letter comments extensively on the provisions of the Proposal relating to limitations on interchange fees received by debit card issuers. It also discusses briefly several points regarding the fraud-prevention adjustment to interchange fees, the prohibition on circumvention or evasion of the interchange fee limits, and the exclusivity and routing provisions. Given the length of this letter, a topical outline of the Discussion with page references is attached as Exhibit A.

Limitations on Interchange Fees

The Durbin Amendment requires that interchange fees be reasonable and proportional to the costs incurred by the issuer with respect to debit card transactions. Although the Proposal restates this general rule, it effectively (and impermissibly) re-writes the statutory standard by excluding (or imposing inappropriate limitations on) many types of costs that should be allowed, and prohibiting any reasonable profit on allowable costs. This fundamental problem is caused or compounded by many particular factors, including that the Proposal ***improperly***:

- Fails to follow Congress's direction that interchange fees should cover the cost of debit card transactions incurred by issuers and from which merchants derive substantial benefits;

- Deviates from a century of federal law across many different industries on "cost of service" rate-making that is well considered and provides not only protections to those paying regulated fees, but also provides appropriate incentives to maintain competition, product availability and innovation;

- Limits allowable costs in debit card transactions by comparison to check transactions, without an adequate basis in the statute, even though debit card transactions are substantially different from checks in many ways, including that, for no extra cost to merchants, authorized debit card transactions provide a payment guarantee;

- Concludes that the only allowable costs of debit card transactions are authorization, clearance, and settlement ("ACS") costs, without any reason other than that Congress required the Board to consider such costs at an absolute minimum;

- Limits allowable costs to those that vary with the number of debit card transactions (referred to as "average variable costs"), when the ordinary meaning of the statute is that issuers are guaranteed to be able to recover all costs allocable to debit transactions (referred to in economic literature and the statute itself as "incremental" costs);

- Attempts to justify failing to include the full cost of debit card transactions in allowable costs on the basis that issuers could recoup lost revenue from consumers, when such a transfer of fees from merchants to consumers is not consistent with the statute and would be ill-advised;

- Attempts to impose a hard cap on interchange fees, when the statute permits all issuers to receive fees that are reasonable and proportional to their own costs and where imposing a one-size-fits-all cap on a very wide variety of products, issuers and circumstances is likely to lead to unintended and harmful effects on consumers, competition and the debit card market generally; and

- Fails to comply with basic protections of the Administrative Procedures Act ("APA"), which require regulatory action to be based on (among other things) an adequate factual record and full consideration of the impact of the regulation on consumers, the availability and cost of debit cards, competition in the marketplace and other relevant factors.

For the reasons described more fully below in this letter, CBA urges the Board to expand the scope of permissible fees under section 920, in order to reflect the true costs incurred by the issuer with respect to debit card transactions, and to permit a reasonable rate of return. CBA opposes the imposition of a cap as fundamentally inconsistent with allowing issuers to charge fees that are reasonable and proportional to costs. In order to facilitate compliance, however, we urge the Board to adopt a realistic safe harbor that would permit issuers to save on administrative expenses associated with the rule.

Clearly, the Board requires more time to properly implement the provisions of Section 920 and fully consider appropriate cost data and complete the fraud prevention guidelines. The industry also needs more than the three months allotted to begin compliance. Therefore, we strongly urge the Board to delay the rule and provide the industry with interim guidance to permit issuers to receive interchange at current market levels, pending further analysis.

Fraud Adjustment to Interchange Fees

The prompt adoption of an appropriate fraud adjustment is critical, especially if the framework for interchange fees is not broadened substantially. Issuers have appropriate incentives and the proper expertise to develop fraud prevention methodologies. In contrast, the Board is not well suited for determining approved technologies. As a result, the technology-specific approach described in the Proposal clearly should not be adopted to the exclusion of the non-prescriptive approach.

Circumvention or Evasion of Fee Restrictions

The Proposal correctly avoids regulation of networks fees. Efforts to circumvent or evade interchange fee limits must, by their very nature, be considered on a case-by-case basis in consideration of all of the relevant facts and circumstances. There has not been an adequate basis established for demonstrating a circumvention or evasion of fee limits merely because an issuer receives "net compensation" and so a *per se* prohibition should not be adopted for that circumstance.

Exclusivity and Routing Provisions

Nothing in Section 920 requires issuers to include a minimum number of authorization methods on its debit cards. To the extent that the Board determines to impose such a minimum, signature debit cards should only be required to have an unaffiliated PIN authorization method and not an unaffiliated signature authorization method. The terms of the statute do not require two unaffiliated signature authorization methods, and such duality would be extremely expensive, time consuming and difficult to implement. In contrast, the addition of an unaffiliated PIN authorization method is much more easily implemented.

DISCUSSION

I. Section 235.3: Reasonable and Proportional Interchange Fees

A. The Proposal Impermissibly Narrows a Clear and Unambiguous Standard In the Statute for Permissible Interchange Fees

1. Section 920(a)(2) Provides Interchange Fees Shall Be Reasonable And Proportional to Debit Card Transaction Costs

The starting point for any regulatory implementation of a statute must be the language of the statute of itself. Congress set forth a clear and unambiguous standard for measuring the permissibility of interchange fees in Section 920(a)(2): "the interchange transaction fee . . . shall be reasonable and proportional to the cost incurred by the issuer with respect to the [debit card] transaction." Congress further emphasized this clear standard in Section 920(a)(3), where it required the Board to adopt regulations regarding "whether the amount of any interchange transaction fee . . . is reasonable and proportional to the cost incurred by the issuer with respect to the transaction." In each case, the statutory requirement is expressly tied to the costs of the transaction.

The meaning of the "costs of a debit card transaction" is straightforward. They simply are the costs that an issuer incurs in providing the various services which enable the consumer to use the debit card in purchase transactions. Under well developed economic theories, these include a full range of operational and capital costs that a company incurs to provide a service. Moreover, Congress allowed issuers to receive interchange fees that are "reasonable and proportional" to these costs. Any interpretation of Section 920 that allows issuers to recover only the costs of providing debit card services essentially reads out of the statute the "reasonable and proportional" language and limits issuers to simply recovering the costs of debit card transactions. As discussed more fully below in Section I.B., federal rate-making statutes are commonly interpreted to allow regulated industries to charge fees that cover not only costs of providing the service, but also a reasonable rate of return. This approach is necessary to avoid Constitutional limitations (such as limits on governmental "takings") and for sound policy reasons of creating economic incentives for availability of, and innovation with respect to, the service. Section 920(a)(2) thus sets forth the uncomplicated requirement that interchange fees should not be excessive and defines excessive as more than the cost of providing the debit card service and a reasonable profit.

The Proposal correctly recognizes in proposed Section 235.3(a) that interchange fees must be reasonable and proportional to the transaction costs of debit card transactions, and there is no limitation with respect to such costs in the general statement of the rule in subsection (a). The Proposal then changes the standard through an unreasonably narrow interpretation of "allowable costs" in proposed Section 235.3(c). In so doing, it alters the clear and unambiguous language of Section 920.

Moreover, the Proposal effectively reads the requirement of "reasonable and proportional" out of the statute by requiring interchange fees to be based solely on the allowable costs and by not allowing any profit.[1] The appropriate reading of the phrase "reasonable and proportional," as used in Section 920(a)(2), is that interchange fees must be "reasonably proportional" to the costs of debit card transactions. In other words, a service provider is entitled to receive not only the allowable costs of providing the service, but a reasonable profit (*i.e.* the fees must be "reasonably proportional" to the cost of providing the service) in order to provide appropriate incentives for market participants to provide the service. (*See* discussion in Section I.B. regarding purpose of allowing service providers to receive profit over cost in other federal rate-making schemes.) Indeed, if Congress intended debit card issuers to merely receive interchange fees equal to the cost of providing debit card services, it would have merely required that the fees not exceed the cost of providing debit card transactions.

Read correctly, Section 920 includes a broad range of costs. Generally, such costs should include all reasonable costs of providing debit card services, including the costs of issuing debit cards and providing statements and customer service with respect to debit card transactions. They also include the substantial capital and operational costs incurred to provide transaction authorization and settlement guarantees, including the development and maintenance of software and processes to prevent unauthorized debit card transactions and fraud losses. The costs of debit card transactions also include fixed costs that issuers reasonably incur in providing debit card services. They do not include, however, issuer costs that are not attributable to debit card transactions, such as the portion of issuer costs with respect to the deposit account accessed by the debit card that are not reasonably allocated to debit card transactions.

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[1] The Proposal appears to rely on the "reasonable and proportional" language in concluding that interchange fees do not need to be set specifically for individual transactions or issuers. However, the United States Supreme Court has recognized the appropriateness of a general rate applicable to individual transactions in other federal rate-making contexts without resort to similar statutory language. *See* Section I.B. Further, CBA strongly disagrees with the Proposal to the extent it interprets the "reasonable and proportional" language as permitting the imposition of a cap that restricts an issuer from receiving interchange that is based on the issuer's own costs. *See* Section I.H.

Notwithstanding the plain language of Section 920, the Proposal effectively limits interchange fees to covering only a very narrow set of costs which primarily relate to data processing and communications charges. Such limitations on allowable costs are inconsistent with the provisions of Section 920.

2. Section 920(a)(4) Does Not Limit Allowable Costs in Setting Interchange Fees to ACS Costs

The structure of Section 920 is instructive in correctly understanding the requirements of the statute. Congress set forth a standard for evaluating permissible interchange fees in Section 920(a)(2), required the Board to implement that standard through regulations adopted under Section 920(a)(3), and provided the Board with limited guidance to consider in adopting regulations in Section 920(a)(4). The Proposal loses track of the statutory standard in Section 920(a)(2) and fashions a new one by adopting a mix-match of concepts from Section 920(a)(4). The result sets interchange rates on the basis of ACS costs, then limits them further by incorrectly analogizing them to check transactions.

Section 920(a)(4)(B) requires the Board to distinguish between the incremental cost incurred by the issuer for the role of the issuer in the ACS of a transaction (which must be included in the allowable costs) and other costs which are not specific to a particular debit card transaction (which cannot be included in allowable costs). However, the statutory language in Section 920(a)(4)(B) does not mean that allowable costs should be limited to ACS costs. If Congress intended issuers to be limited to ACS costs, it would have used that as the standard (rather than all costs of the debit card transaction). The Proposal offers no reasonable basis for departing from the language of the statutory standard.

The Proposal does not offer support for any construction of the standard in Section 920(a)(2) that limits it to those costs that Congress required to be included. The Proposal contains no analysis of whether the inclusion in the costs of debit card transactions of any costs other than ACS costs would be consistent with the purposes of Section 920 or desirable from a policy standpoint in light of the likely consequences. The Proposal simply concludes, without any explanation, that the direction in Section 920(a)(4)(A) to consider similarities between check and debit card transactions supports the conclusion that allowable costs should be limited to ACS costs. *See* 75 Fed. Reg. at 81735. However, nothing in Section 920(a)(4)(A) relates to ACS costs; rather, as described more fully below in Section I.C., this provision simply mandates consideration of similarities between check and debit card transactions in connection with establishing regulations under 920(a)(3) regarding the cost of <u>debit card transactions</u> (not ACS costs).[2]

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[2] As described more fully below in Section I.C., the plain meaning of Section 920(a)(4)(A) is that the Board must consider the differences in check and debit card transaction costs in determining whether interchange fees are reasonable and proportional to debit card transaction costs. Contrary to the suggestion in the Proposal, *see* 75 Fed. Reg. at 81735, there simply is no basis for concluding that this provision either limits debit card transaction costs to ACS costs, or limits debit card transactions costs by the costs in check transactions when those transactions are dissimilar.

3. The Proposal Does Not Provide Any Rational Basis For Narrowing The Standard Set Forth in Section 920(a)(2)

As noted above, the Proposal failed to engage in the required analysis regarding the implications of the interpretation it has proposed. The leading treatise on administrative law describes the need for federal agencies to have an adequate basis for their rule-making as follows:

> To have any reasonable prospect of obtaining judicial affirmance of a major rule, an agency must set forth the basis and purpose of the rule in a detailed statement, often several hundred pages long, in which the agency refers to the evidentiary basis for all factual predicates, explains its method of reasoning from the factual predicates to the expected effects of the rule, [and] relates the factual predicates and expected effects of the rule to each of the statutory goals or purposes the agency is required to further or to consider . . . .

Pierce, Administrative Law Treatise (5th ed.) § 7.4 at p. 593 (citations omitted). The Proposal fails to satisfy any of these requirements, let alone all of them.

Further, Section 904 of the EFTA sets forth additional requirements that guide the Board's adoption of regulations under the EFTA, including under Section 920. In particular, this provision requires that: (i) the Board take into account, and allow for, the continuing evolution of debit card services and the technology utilized in providing such services; (ii) the Board prepare an analysis of economic impact in which it considers the cost and benefits to financial institutions, consumers and other users of debit card services, including the effects upon competition among large and small banks providing debit card services and the availability of debit card services to different classes of consumers, particularly low income consumers; and (iii) the Board demonstrate, to the extent practicable, that the consumer protections of the proposed regulations outweigh the compliance costs imposed on consumers and financial institutions.[3]

The Board has collected certain data on debit card transaction costs. However, it does not provide any meaningful data, let alone analyze any such data, in connection with the critical decision to limit debit card transaction costs to ACS costs. The Proposal is devoid of any data or analysis on fundamental questions that must be considered in a rule-making having the major impact of this Proposal. For example, the Proposal contains no data or analysis on factual predicates and considerations that underlie the Board's conclusions, including how the extremely narrow cost standard in the Proposal would impact the availability or cost of debit cards to consumers, the general use of debit cards in relationship to other payment methods, and market competition among issuers and/or payment card networks. There is no attempt to comply with the directions of Section 904, nor does the Proposal indicate the statutory goals or purposes of

[3] Section 1084 of the Dodd Frank Act transferred general regulatory authority under the EFTA from the Board to the newly created Bureau of Consumer Financial Protection. However, regardless of which agency is generally authorized to interpret the EFTA, Section 920 is part of the EFTA and Section 904 continues to dictate considerations that must be taken into account in adopting implementing regulations.

Section 920 that the regulation is intended to implement or explain how the Board's interpretation furthers them.

Further, an appropriate consideration of these factors leads to the inescapable conclusion that the Board should permit interchange fees based on all debit card transactions costs, rather than limit allowable expenses to ACS costs. The plain purpose of Section 920, which is apparent from the statutory language, is to limit interchange fees from being excessive in relation to the debit card transaction costs. The implicit assumption in the Proposal that interchange fees should be reasonably related to the costs of check transactions, or that the consequences of such a limitation are desirable, is wrong. The purpose of Section 920 is not simply to reduce costs (and increase profits) of merchants; rather it is to prevent excessive interchange fees by requiring such fees to be reasonably proportional to the costs of debit card transactions.[4]

As reflected in general cost of service rate-making authorities, refusing to allow service providers to recover the cost of providing their service and a reasonable profit is likely to decrease the availability or functionality of the service as the provider redeploys business capital into profitable business lines. *See* Section I.B. To the extent that issuers can choose to continue to offer debit card services, the issuers will be required to increase consumer prices, with the attendant reallocation of costs from merchants to consumers, including low- and moderate-income consumers who can least afford higher prices. The Board has not provided sufficient data or analysis regarding this impact of the Proposal.

The Proposal will also have anti-competitive effects on issuers, especially smaller debit card issuers and new entrants into the marketplace, which undoubtedly will be harmed more than larger or more established participants because they typically need more interchange revenue to cover the costs of their debit card business. The extraordinarily low levels of interchange fees allowed by the Proposal will drive many issuers from the market, hampering competition and leading to decreased product and service innovation. The fact that Section 920 provides an exemption for issuers with less than $10 billion does not suggest that small issuers will not be adversely affected because (i) there is no assurance that networks will institute (or maintain) dual rate structures to permit small issuers to receive higher interchange, and (ii) even if small issuers are allowed by network rules to receive higher interchange, we are concerned that merchants will discriminate against acceptance of cards issued by such small issuers to reduce costs (such as through steering practices, including promoting the acceptance of only cards issued by recognized large issuers which receive lower interchange fees). These consequences should be avoided. In any event, they must be considered fully before adopting a Proposal that significantly reduces current fee levels set in a fully competitive market.

[4] The Proposal will not even benefit merchants generally, but only large merchants at the expense of smaller merchants. Nothing in Section 920 requires merchant banks to reduce fees paid by merchants to reflect lower interchange fees. Thus, this savings in lower interchange fees is likely to benefit only those large merchants with sufficient leverage to negotiate lower debit card processing fees, while smaller merchants with less leverage will pay higher processing fees and subsidize the costs of larger merchants.

B. The Proposal Departs From Extensive Jurisprudence Under Federal Rate-Making Statutes Without Good Reason

As noted above, rate-making with respect to interchange fees is not necessary or desirable. However, to the extent that the Board has been required by Congress to engage in such an effort, the unreasonably narrow interpretation of allowable costs in proposed Section 235.3(c) is unsupportable because it is contrary to a substantial body of federal law regarding rate-making in other industries. Congress must be presumed to have been acting with this substantial body of existing law in mind. Moreover, industry participants, federal agencies, and courts have considered comparable issues as those presented in the current rule-making by the Board. Especially given the extremely accelerated time frame for adopting regulations under Section 920, and the absence of prior Board experience in setting rates for bank products and services, the Proposal should have attended more closely to federal rate-making law in other industries, rather than rushing into a completely untested and novel approach to rate-making likely to adversely affect consumers and the debit card industry generally.

In many industries in which Congress has determined to impose rate regulation, it has done so by requiring that the fees for services be "just and reasonable."[5] The courts (including the United States Supreme Court) and federal regulatory agencies generally have implemented these types of requirements by employing a "cost of service" analysis. As the name suggests, this involves a frequently complicated analysis of the costs incurred by a company in providing the service, and allows the company to charge fees that are sufficient to cover such costs and a reasonable profit.[6] Even where agencies use "price cap" and other, less usual rate-setting processes, they design those rate levels to enable the service provider to recover the full range of economic costs associated with the provision of the regulated service. In all of these contexts, the interpretation of "just and reasonable" rate regulation has been shaped significantly by Constitutional protections against impermissible "takings" that result when regulated companies are not allowed to charge adequate fees for the services they provide.[7] These time-tested cost of service principles both protect against excessive fees for services and provide appropriate incentives for companies to provide services and invest in the maintenance and development of infrastructure to improve the service for the benefit of consumers.[8] Given the well-established basis of cost of service regulation in other industries, Congress must be assumed to have intended that the Board would implement this standard to not only protect against interchange fees that are not reasonably proportional to the cost of providing debit card transactions, but also provide appropriate incentives for debit card issuers to support and innovate for the benefit of consumers and merchants alike.

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[5] *See, e.g.*, Federal Power Act of 1920, 16 U.S.C. § 791 *et seq.* (§ 824(d)); Communications Act of 1934, 49 U.S.C. § app. 1 *et seq.* (§ app. 1(5)(a)); Natural Gas Act of 1938, 15 U.S.C. § 717 *et seq.* (§ 717(c))

[6] *See, generally, Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 483-85 (2002) (describing history of federal rate-making).

[7] *Id.* at 481.

[8] This standard also allows agencies the flexibility to use industry-wide data for setting fee levels and does not require that fees charged by particular service providers be set only with respect to the costs of that particular provider. *See Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

The Board attempts to distinguish this substantial body of federal rate making authority in a few brief sentences in a footnote to the Proposal, noting two arguable differences: (i) debit card issuers, unlike public utilities, are not required to make their services available to the public, and (ii) debit card issuers have an additional source of revenue (*i.e.* fees charged to consumers) while public utilities do not. This attempt to distinguish persuasive and well-considered rate-making authorities fails to recognize the overwhelming similarities in statutory language and purpose of regulation. Moreover, the basis on which it attempts to distinguish these important and time-tested precedents is unpersuasive.

First, the Proposal incorrectly assumes that Congress has imposed cost of service rate-making only in connection with public utilities. The "just and reasonable" standard finds its origins in rate regulation of railroad and other shipping rates. And, such standards have been applied to rate-making for gas production.[9] The application of common limitations on rate-regulation across different regulated industries is appropriate, of course, since the same constitutional protections that have shaped the standards apply to all companies providing goods or services subject to rate regulation, including debit card issuers.

Second, even to the extent that the usual application of rate regulation focuses on public utilities, that would be a reason to adopt a *less* onerous, rather than a *more* onerous, form of regulation here. The reason that rate regulation applies to a natural monopoly such as a utility is that market failure presents risks of excessive profits. Where, as for debit card services, there is competition and clearly no natural monopoly, there is no economic or policy reason for imposing fee regulation that does not enable service providers to recover their costs of service (plus a reasonable rate of return) and that treats issuers far more harshly than any public utility.

More broadly, Congress plainly chose to focus on fees that cover costs rather than on whether issuers must provide services (as with respect to public utilities). Congress chose in Section 920 to impose a regime of fee regulation based on the recovery of costs of providing a service (here, debit card transactions), just as it has in other contexts. This is entirely understandable: creating appropriate economic incentives for debit card issuers to provide debit card services is an important policy consideration in regulating interchange fees, just as interpretations under "just and reasonable" requirements recognize the importance of creating economic incentives for providers of services in other rate-making contexts. Debit cards play an extremely important part in supporting retail sales and the economy, surpassing checks as the most common method of third-party payments from demand deposit accounts. Debit card transactions provide many advantages over other payment methods both to consumers (including limited liability for unauthorized use and billing error rights) and to merchants (including faster and more payment transactions, and guaranteed payment). Indeed, there are some types of transactions, such as renting an automobile or making a hotel reservation, for which a consumer simply cannot use a check.

The fact that issuers can shift some of the costs onto consumers also is an inadequate basis to fail to follow traditional cost of service rate-making principals or the statute's cost-

[9] *See, e.g. id.*

recovery language. Other regulated industries may be able to shift costs of providing services in other directions. For example, this may occur if a provider of a service with regulated prices is able to shift the cost of that service to users of an unregulated service.

From a policy standpoint, debit card issuers should not receive interchange at levels below the cost of debit card transactions merely because those costs could potentially be shifted to consumers. Congress undoubtedly did not intend that issuers raise prices charged to consumers for debit card services so that certain merchants could reduce the price they pay for accepting debit cards. Nothing in the statute or regulation requires that merchants pass along any reduction in interchange to consumers, and the Board offers no data or analysis on which to conclude that consumers will actually recognize such benefits. This unwarranted fee shift from merchants to consumers is especially wrong with respect to low- and moderate-income consumers who can least afford price increases for banking services. And, with respect to the lower income consumers, many of them may be particularly reliant on debit cards covered by the interchange regulation because they do not have credit cards.[10]

Regardless of how the Board proceeds, it needs to make a reasonable effort to evaluate the size of the likely cost increases for consumers, the ability of consumers (especially low- and moderate-income consumers) to pay increased costs, the extent to which debit cards will not be available or related functionality will be limited, and whether such consequences are consistent with the purposes to be implemented in Section 920. Indeed, apart from limitations under the APA, it would be bad policy to implement regulatory changes of the dramatic nature involved in the Proposal if the consequence was to severely limit the ability of consumers to obtain debit card services because interchange fees do not cover an appropriate share of the cost of service.

Further, to the extent that the Proposal attempts to set a balance in a payment card network between the interests of acquirers (and merchants) and those of issuers (and consumers) by regulating interchange fees paid between the parties, the Board needs to gather data and analyze how its implementation of Section 920 may impact that balance, which it has yet to do. It is well established that operation of a debit card network involves a careful balance of the interests of issuers (in making debit cards attractive for consumer use) and acquirers (in creating appropriate incentives for merchants to accept cards). These two sets of interests are interrelated in that a network must have adequate participation of both cardholders and merchants to be successful.[11] Card networks have the proper incentives and expertise to balance these interests and nothing requires merchants to accept debit cards. However, if contrary to the statutory direction that interchange should cover the costs of debit card transactions, the Board determines it will establish a different balance, it should do so only with full consideration of the relevant data and the likely consequences of the dramatic change in current interchange fee levels, or risk

[10] This cost shift to consumers also would be especially inappropriate in the case of gift cards and similar products which are standalone product offerings. Providing a debit card and separate deposit account may share common costs that may be covered by fees received from both services. However, a gift card is a standalone product and any increase in consumer fees must be imposed only on that product. As a result, absent special consideration in the final rule, the shift of costs from merchants to consumers in connection with such standalone products may prevent them from being viable, especially in lower dollar denominations.

[11] *See, e.g., NaBanco v. Visa USA*, 596 F.Supp. 1231, 1260 (S.D. Fla. 1984).

unintended and harmful consequences to consumers, merchants, issuing banks and card networks.

C. The Proposal Improperly Applies The Statutory Requirement to Consider Check Transactions As a Limitation on Interchange Fees

The Board's determination to limit allowable costs in Section 235.6(b) relies heavily on Section 920(a)(4)(A), which requires the Board, in prescribing regulations, to consider the functional similarity between debit card transactions and checks, which are required within the Federal Reserve bank system to clear at par. Again, the Proposal deviates from the express statutory language in Section 920(a)(2) and fails to implement the congressional intent behind this provision. The Proposal fails to provide any data or analysis on the implications of this unwarranted limitation on allowable costs. Moreover, as discussed below, Section 920(a)(4)(A) compels the conclusion that the Proposal's interpretation of "allowable costs" is impermissibly narrow.

To start with, the statute directs the Board to "consider" the similarities between two payment methods (checks and debit card transactions) in setting interchange limitations.[12] Given that this language appears in a statute requiring interchange fees to be reasonable and proportional to the costs of debit card transactions, the plain meaning of this language is that the Board should compare the cost of providing check services in determining the cost of providing debit card services. The Proposal at least implicitly acknowledges the requirements of Section 920(a)(4)(A) by noting several important differences between check and debit card transactions. However, the Proposal then improperly fails to take into account how those differences result in higher costs of providing the debit transaction services or to take those higher costs into account in setting interchange fee limits. Instead, the Proposal concludes that interchange fees should be reasonable and proportional to ACS costs, rather than all debit card transaction costs: "[g]iven the statute's mandate to consider the functional similarities between debit transactions and check transactions, the Board proposes that allowable costs be limited to those that the statute specifically allows to be considered, and not be expanded to include additional costs that a payor's bank in a check transaction would not recoup through fees from the payee's bank." 75 Fed. Reg. at 81735.

We believe that the Proposal is wrong when it indicates that the statute "allows" ACS costs to be included; in fact, Section 920 "requires" such costs to be included. Similarly, the statement that the Proposal declines to "expand" the standard for permissible costs beyond ACS costs misconstrues Section 920. The standard for permissible interchange fees, set forth in Section 920(a)(2), is reasonable and proportional to the cost of debit card transactions; it is not reasonable and proportional to ACS costs. The whole purpose of Section 920 is to establish a process for compensating issuers that is entirely different from the scheme used for compensating the payor's bank in a check transaction. The Proposal improperly: (i) changes the standard to reasonable and proportional to ACS costs from reasonable and proportional to the

[12] Under commonly accepted principles of administrative law, when Congress directs an agency to "consider" a factor, the agency is not required to give any special weight to it, but rather must reach an express and reasoned conclusion about the matter. *See, e.g.*, *Time Warner Entertainment Co. v. FCC*, 56 F.3d 151, 175 (D.C. Cir. 1995).

cost of debit card transactions; and (ii) limits allowable costs by a comparison to check transactions, without considering the fundamentally different nature of check and debit card transactions and consequent differences in costs.

The Proposal should not limit allowable costs based on comparison to costs in check transactions. Section 920(a)(4) does not provide that interchange must be limited to an amount that is reasonable and proportional to the costs of check transactions. If Congress had intended such a limitation, it would have said so rather than directing the Board to merely "consider" check transactions in regulating interchange for debit card transactions. The statutory standard in Section 920(a) is reasonable and proportional to debit card transaction costs. Thus, the Board should consider the relative differences in the costs of providing check and debit card services and take such cost differences into account in setting interchange fee limits on the basis of debit card transaction costs.

It is instructive to consider the substantial differences in the real world economics to merchants depending on whether they accept a check or debit card. When merchants accept a check, and attempt to approximate the payment guarantee that debit cards provide, the check guarantee fees they pay can be 1% of the transaction amount or more. This payment guarantee is one of the most fundamental and important differences between checks and debit cards, yet it is not included by the Board in its cost analysis of debit card transactions. If interchange fee limits prohibit issuers from recovering costs of providing settlement guarantees, the anomalous result would be that merchants would receive payment guarantees in debit card transactions for free while paying market rates for check guarantees.

Limiting allowable costs in proposed Section 235.3(c) to the types of costs incurred in check transactions is not only inconsistent with the statute, but also is bad policy. There are two likely consequences if interchange fees do not cover the costs of debit card transactions: these costs may be passed on to consumers through higher prices on debit card transactions and/or issuers may avoid incurring such costs by not providing payment guarantees on debit card transactions. Both results should be avoided. As recognized by the considerations that Section 904 of the EFTA requires the Board to take into account, the more appropriate goal is to promote the development of debit cards and other electronic payments, which is consistent with the trend among virtually all businesses to encourage the use of debit cards as the superior payment method.

Finally, it bears noting that Section 920(a)(4)(A)'s recognition that checks clear at par is very different from any indication that there are not costs incurred by banks providing checking services. Clearing at par merely means that the initial settlement of a check cleared by a bank for its customer involves payment by the bank to the customer of the face amount of the check. It is an entirely different question whether the bank incurs costs (whether ACS or otherwise) in connection with providing check clearing services. Similarly, the fact that a bank clearing a check does not pay fees to the bank on which the check is drawn does not mean that merchants do not (and should not) pay for check clearing services: virtually all banks charge fees to their business customers for processing checks deposited by the customer. Nothing in Section 920(a)(4)(A) suggests that Congress intended that debit card transaction services be provided for less than cost, nor would such a result make any sense from an economic or other policy standpoint. This provision, by its express terms, simply requires the Board to consider the costs of providing check services (not which party pays them) in determining interchange fees that are reasonable and proportional to the costs of providing debit card services.

D. Even If the Board Limits Allowable Costs to ACS Costs, The Proposal Fails to Properly Define ACS Costs

Assuming that the Board limits allowable costs to ACS costs, the Board should not limit allowable costs to a subset of ACS costs. As discussed above in Sections I.A. through I.C., the statute clearly requires interchange to be set in relation to the costs of debit card transactions and there is no basis in the statute (nor any reasonable policy reason) for limiting allowable costs in debit card transactions to only a subset of ACS costs.

The failure to recognize the full costs of providing debit card transactions is reflected in the unnecessarily narrow definition of ACS costs that are allowable under proposed Section 235.3(c). As a general matter, the expense items included in the Proposal under Section 235.3(c) are limited to relatively minor data processing and communication costs. The Proposal approaches the cost of debit card transactions as if such transactions involve nothing more than electronic checks with the same cost of service involved in paper check transactions. That plainly is wrong, and is expressly recognized by the Board in the Proposal's extensive detailing of many fundamental differences between check and debit card transactions, including guaranteed settlement on debit card transactions in contrast to the risk of settlement involved in check transactions. The Proposal should not limit allowable costs to ACS costs, but that limitation is made exponentially worse by reading a requirement to "consider" check transaction as a limitation on permissible ACS costs.

The Board further raises the possibility of "limiting the allowable costs to include only those costs associated with the process of *authorizing* a debit card transaction, because this option may be viewed as consistent with a comparison of the functional similarity of electronic debit card transactions and check transactions." *See* 75 Fed. Reg. at 81735. CBA strongly opposes this suggestion. Section 920(a)(4) expressly and unambiguously requires that allowable costs include not only authorization costs, but also clearance and settlement costs; the Board does not have regulatory authority to disregard Congress's statutory direction that clearance costs and settlement costs must also be included. Nor is the suggestion internally consistent. Indeed, authorization costs, which are incurred solely in debit card transactions, have absolutely no similarity to check transactions, yet the Board also proposes to ignore all other types of costs because they are not incurred in check transactions.

E. The Proposal Improperly Defines "Incremental Costs" To Be "Average Variable Costs"

Section 920(a)(4)(B) requires that allowable costs include the incremental ACS costs for a particular debit card transaction and exclude "other costs" (*i.e.* non-ACS costs) that are not specific to a particular transaction. Based on the Board's interpretation of "incremental costs," proposed Section 235.3(c)(1) would only include ACS costs to the extent that such costs "vary with the number of transactions sent to the issuer." The Proposal refers to these costs as "average variable costs." As described above, the Proposal should not adopt incremental ACS costs, addressed as a consideration in Section 920(a)(4), as the standard for determining allowable costs for purposes of the governing, broader standard of Section 920(a)(2). However, even if incremental ACS costs were the correct standard, "incremental costs" should be construed as much broader than "average variable costs."

The Proposal fails to follow the statute's plain and ordinary meaning. In considering Section 920(a)(4), the Board declined to construe "incremental costs" according to what it acknowledges is the standard generally used by regulatory economists: the costs saved by a service provider if the provider did not provide the service (or, alternatively, the incremental costs required to provide the service). In the context of a debit card transaction, this would be the costs incurred by a bank that provides debit card services that would be saved if the bank had instead provided deposit accounts without the debit card access. It would include, for example, the incremental costs saved by such an issuer in not providing customer service in connection with the debit card transactions. It also would include costs saved by the bank in not having to comply with the requirements of the EFTA applicable to the debit card transactions, such as costs associated with statement requirements, resolution of billing errors and limitations on liability for unauthorized use of debit cards that do not apply to check transactions. And, it would include the extensive capital costs and ongoing systems engineering expenses associated with acquiring the capability to perform and report debit card transactions.

Policy considerations also weigh heavily against the Board's statutory construction. Congress could not have intended the consequences that follow from the Board's "average variable cost" requirement. The Proposal, as written, will exclude a substantial portion of ACS costs, because it effectively precludes including any fixed costs, even though such costs are undoubtedly costs of providing debit card transactions. There is nothing to suggest that Congress intended that issuers not be able to recover substantial fixed costs that are incurred to provide debit card services that benefit merchants, especially when recovery of such costs is entirely consistent with interchange fees that are not excessive under any reasonable measure. Such an interpretation also hinders recovery of millions, if not billions, of dollars that issuers have expended in building debit card systems and will decrease the likelihood that issuers will make similar future investments.

To the extent the Board appears to rely for its interpretation on the phrase "particular transaction," the phrase does not support the Board's conclusion. All of Section 920 is written in terms of particular issuers and particular transactions. For example, the critical language in Section 920(a)(2) setting forth the standard for permissible interchange fees refers to fees that are reasonable and proportional "to the cost incurred by the issuer with respect to the transaction" (emphasis added). As noted above, the Board has interpreted Section 920(a)(2) as not requiring consideration with respect to a particular issuer, let alone a particular transaction. It would be inconsistent for the Board to interpret "incremental costs" to compel examination of particular transactions only in the context of Section 920(a)(4)(B). Any transaction fee allocates costs to a specific transaction, and the reference to "the particular transaction" does not resolve the question of which costs are specific to that transaction.

Further, the factors in Section 920(a)(4)(B) that the Board must consider in applying the general, benchmark standard in Section 920(a)(2) cannot be read to override and narrow the standard itself. Rather than interpreting Section 920(a)(4)(B) as conflicting with the standard in Section 920(a)(2) by narrowing all "costs of debit card transactions" to only average variable costs, Section 920(a)(4)(B) must be read as subordinate to and consistent with the standard in Section 920(a)(2). Indeed, a broader definition of "incremental costs," extending to the full range of costs that economists commonly recognize as falling within that term, would reconcile the two provisions. References to the "incremental costs" of "particular transactions" in Section 920(a)(4)(B)(i) and to "costs which are not specific to a particular transaction" in Section 920(a)(4)(B)(ii) are better read simply to recognize that interchange fees are imposed with respect to particular debit card transactions and, in the case of Section 920(a)(4)(B)(ii), to exclude those costs that are not specific to an issuer providing debit card transactions (*i.e.* those not related to providing such services).[13] Indeed, as the Board recognized, it would not be workable to adopt a rule that the fee charged for each specific debit card transaction recover only the costs connected with that particular transaction.

This view that Section 920(a)(4)(B) provides for recovery of a much broader range of costs through "per transaction" fees is entirely consistent with traditional concepts of federal rate-making law. For example, in most industries, depreciation of fixed assets used to provide a service are recognized as a major component of the cost of providing the service and are allocated to particular transactions. Such depreciation costs are properly considered a cost that is specific to a "particular transaction" because the occurrence of each particular transactions (or provision of the service) results in this depreciation of the assets – just as the issuer's debit-related plant depreciates as the issuer completes particular debit card transactions. Similarly, other fixed costs incurred in providing a service are properly considered to be specific costs of particular transactions to the extent that the service provider incurs such costs to provide the particular transactions. Again, the issuer's fixed costs supporting debit transactions are spread across and enable a series of particular transactions, and each increment of depreciation of those assets is specific to a particular transaction.

Nor does the Proposal reflect the necessary consideration of the issues required by administrative law. The Proposal offers no data or related analysis on the implications of the Board's interpretation of the term "incremental cost" or the relative impact of more ordinary interpretations of the statute. For example, the Proposal does not explain how refusing to allow issuers to recover fixed costs of debit card transactions through interchange will impact the availability of debit card services or the willingness of issuers to invest in fixed costs to maintain and improve the level of such services. The APA, as well as EFTA § 904, requires that the Board consider fully these and other implications of the extraordinarily important interpretations it is making, in light of the policies and purposes of Section 920.

Finally, it bears emphasis that clause (ii) of Section 920(a)(4)(B) is the only provision that even resembles any type of limitation on allowable costs. Clause (i) guarantees that certain

[13] Section 920(a)(4)(B)(ii) does not, however, exclude non-ACS costs that an issuer incurs with respect to providing debit card services merely because they are common to providing the related deposit account. Indeed, such common costs (if properly allocated) are specific costs of particular debit card transactions.

costs are included in the cost of a debit card transaction, and thus does not limit the costs of debit card transactions under Section 920(a)(2). Section 920(a)(4)(B)(ii) only applies to "other costs" besides ACS costs. Thus, to the extent that the Proposal limits allowable costs to ACS costs (and the current Proposal permits recovery of no other types of costs), Section 920(a)(4)(B)(ii) is not, by its express terms, relevant.

F. The Regulatory Definition of ACS in the Proposal Is Inconsistent with the Express Language of Section 920

The regulatory definition of ACS costs, apart from the average variable cost limitation, is not consistent with the statute insofar as proposed Section 235.3(c) and the related Commentary exclude many costs that fall within the common meaning of "authorization, clearance, and settlement" of debit card transactions. This is attributable both to the failure of the Proposal to recognize the proper meaning of "authorization" and "clearance and settlement" in the context of debit card transactions, and to limiting ACS costs by comparison to check transactions. When the appropriate meaning is ascribed to these terms, ACS costs of debit card transactions should be recognized to be an expansive set of costs.

Authorization of a debit card transaction involves not only the communication of the authorization decision but also the costs incurred by the issuer to be able to provide the authorization. Moreover, as recognized by the Board, authorization of a debit card transaction involves the issuer's guarantee that the transaction will be settled. Similarly, clearance and settlement is a process that begins when an issuer receives a debit card transaction and sends the funds to the merchant's bank and continues through any dispute of that settlement by the cardholder and the issuer's chargeback of the transaction (or reversal of conditional settlement). As described below, with these concepts in mind, there are several broad categories of costs that should be included in allowable costs, even if the costs of debit card transactions are limited to ACS costs.

First, the costs of providing monthly statements (to the extent allocable to debit card transactions) is within the ordinary meaning of clearing and settlement costs. A necessary part of settlement of a debit card transaction is not only the initial transfer of funds between the issuer and network, but also providing disclosures required under the EFTA regarding such settlements on monthly statements. The EFTA also requires issuers to provide consumers with rights to assert billing errors, and settlement of a particular transaction is not complete until such consumer rights and the issuer's right to charge back (or reverse initial settlement) has ended.[14] Similarly, customer service costs related to an issuer answering questions about transactions and requesting credits for improper postings are likewise properly included in the ACS costs of a debit card transaction, but improperly excluded by the Proposal.

The requirement in Section 920 that the Board consider the similarities between check and debit card transactions further supports the conclusion that such statementing and customer service costs be included in allowable ACS costs. The requirements that consumers receive monthly statements and resolve billing errors are imposed under the EFTA with respect to debit

[14] *See, e.g., In re Twenty-Four Hour Nautilus*, 81 B.R. 71 (D. Colo. 1987).

card transactions, and are not required with respect to checks. These costs, while not incurred in check transactions are incurred in debit card transactions, and thus under Congress' direction that the Board consider the cost differences between check and debit card transactions, should be included in setting interchange for debit card transactions.

Second, the Proposal does not properly recognize the nature of the costs incurred in the authorization of debit card transactions. Proposed Comment 3(c)-2.i provides that authorization activities include data processing, voice authorization inquiries and referral inquiries, but that separate activities with the primary purpose of fraud-prevention are not included in authorization services. The Proposal excludes many authorization costs for debit card transactions without any reasonable basis. The very nature of an authorization, as recognized by the Proposal, is that it constitutes the guarantee of payment to the merchant. The costs incurred by issuers in being able to provide such settlement guarantees, such as the cost of sophisticated systems to detect unauthorized use or other types of fraud must necessarily be included. Indeed, fraud prevention costs related to debit card transactions should be included as authorization costs because denial of authorization is the means by which transaction fraud is prevented. Despite the clear connection between fraud prevention costs and authorization systems, as with many other key interpretive issues, the Proposal offers no reasonable basis for limiting authorization costs to merely communicating the authorization approval or denial.[15]

Third, the Proposal improperly fails to include fraud losses in allowable costs under Section 235.3(c). The Proposal focuses too narrowly on simple administrative costs of clearance and settlement of debit card transactions, and does not take into account fraud losses that are inherently part of the settlement process and, in fact, one of the largest settlement costs. Fraud losses occur when an issuer settles a debit card transaction through the network but is not able to charge the consumer's deposit account or recover the settlement funds from the merchant under applicable chargeback procedures (which the Proposal appropriately recognized are allowable expenses). Further, the EFTA imposes limitations on consumer liability for fraud losses in debit card transactions that are not applicable in check transactions. The additional costs associated with this difference must be considered by the Board in setting allowable costs under the direction of Section 920(a)(4). The Proposal also improperly excludes network processing fees from allowable costs; such costs clearly are ACS costs because they cover the cost of the network authorization system, and they should not be excluded merely because they are paid to a third party.

G. The Interchange Amounts Proposed By the Board Are Grossly Lower Than Any Reasonable Estimate of ACS for Debit Card Transactions

The Board has proposed a safe harbor and/or cap on interchange fees of between seven and twelve cents per transaction, regardless of the transaction amount. These amounts are significantly below levels that should be established under a proper implementation of the

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[15] Many fraud prevention costs are required to be included in allowable costs under Section 920(a)(4)(B) because they are part of the "authorization" costs of debit card transactions. As discussed below, to the extent that certain fraud prevention costs are not authorization costs, the Board should act promptly to permit issuers to recover such costs through a separate fraud adjustment to the interchange fee.

statute. A primary cause of these proposed improper fee amounts is the failure of the Proposal to properly implement the Section 920(a)(2) standard and the allowable cost framework.

Wholly apart from the standard used to determine a reasonable and proportional interchange fee, we have concerns about the data collection process on which the Proposal is based. Cost data was not collected from small issuers and, as noted above in Section I.A.3., such issuers are likely to be subject to the same interchange fee limits with which large issuers must comply—as a practical if not legal matter. Such data about small issuer cost should be collected and incorporated into any average costs being determined to avoid such small issuers (which tend to have higher costs) being placed at a competitive disadvantage to larger issuers which have already reported their data.

In addition, the short time provided to the Board and the limited time for issuers to respond may have resulted in confusion and misunderstanding by survey respondents. A review of the accuracy of the Board's data collection efforts should be undertaken before finalizing the Proposal, and the data collection process going forward would be enhanced greatly by an improved and common understanding of the information being sought in light of the purposes for which it is going to be used.

The lack of transparency with respect to the underlying data collected by the Board's staff is also a cause for concern. The Proposal notes some high-level statistics on costs in support of its conclusion to set interchange at an unreasonably low level of seven to twelve cents. However, further consideration of the relevant data is needed to consider the appropriate conclusions to be drawn from it. For example, the Proposal recognizes that there is a wide-range of cost data submitted by industry participants, but offers only an insufficient explanation of the Proposal's one-size-fits-all approach. Notwithstanding that the Board presumably has collected significant data from a variety of industry participants, the Proposal does not adequately disclose the relevant data or provide sufficient analysis on the important issues of whether different interchange rates are appropriate or desirable for different types of transactions or issuers.

In sum, the pricing decision in the Proposal will affect billions of dollars in interchange fees annually, and the data and the analysis of it should be subject to thorough review and comment by the industry participants whose businesses are going to be dramatically impacted by the fee limits that are being set on the basis of it. Thus, the Board, consistent with maintaining confidentiality of competitive information, should provide access to all relevant data so that interested parties can validate the Board's analysis and conclusions and assist in developing an appropriate implementation of Section 920 to accommodate the legitimate interests of all participants in debit card transactions.

H. Section 920 Does Not Permit The Board to Adopt a Cap on Interchange Fees, Although a Safe Harbor Should Be Implemented

The Proposal sets forth two alternatives for determining the level of allowable interchange fees. Under Alternative 1, an issuer would be able to charge an interchange fee at the level of a safe-harbor amount without calculating its allowable costs or the issuer could receive its actual allowable costs up to a specified cap. Under Alternative 2, the Board would use information about issuer costs to determine a cap on the interchange fees that all issuers could charge, regardless of the actual costs of specific issuers.

CBA opposes both Alternative 1 and Alternative 2 to the extent that they involve a cap on the interchange fee that an issuer can receive. A cap is fundamentally inconsistent with Section 920 because it prevents an issuer from receiving interchange fees that are reasonable and proportional to the issuer's allowable costs. The Proposal expressly recognizes that some issuers will not be able to recover their allowable costs, since its allowable costs will exceed the cap, but nonetheless concludes that such a result is permissible. This is inconsistent with the statute because it denies the issuer not only the right to recover its allowable costs, but also a reasonable profit. Such confiscatory pricing regulation raises significant issues regarding unconstitutional government takings. Since a cap does not always permit an issuer to recover its costs, it effectively regulates *costs* of issuers; in contrast, Section 920 only authorizes the regulation of interchange *fees* received by issuers.

The Board appears to base its determination that Section 920 permits rate caps on its view that "reasonable and proportional" imposes a "reasonableness" requirement that is independent and separate from "proportional" and that this provides the basis for requiring interchange fees to be "reasonable." As noted above in Section I.A.1., CBA disagrees with this interpretation and believes that the phrase should be interpreted to mean "reasonably proportional." However, even if it were correct, an interchange fee that does not allow an issuer to recover its reasonably incurred costs, plus a profit, would not be "reasonable."

The Proposal indicates that a cap is desirable from a policy standpoint to encourage issuers to provide efficient services. However, there are better ways to address potentially excessive allowable costs that are consistent with the statutory mandate of Section 920. To the extent that an issuer incurs unreasonable costs, the rate-making process can address that problem on an issuer-specific basis by limiting the costs to reasonable levels. As the Board has noted, there are many different types of debit card programs and an issuer may have different ways of providing services that are reasonable for that issuer, but maybe not for another. For example, certain cost levels may be appropriate for gift cards that are not appropriate for debit cards. Similarly, certain costs may be appropriate for a new entrant into the debit card market or a smaller issuer, that are not appropriate for an established or large issuer. The Board should not adopt a one-size-fits-all approach in which a single rate cap is used to measure the reasonableness of a wide variety of issuer cost structures and situations. Such an approach is likely to lead to unintended consequences in reducing competition among issuers and availability of debt card services, none of which the Proposal even notes or attempts to evaluate.

However, CBA supports the concept of a safe-harbor under Alternative 1 (even though CBA also believes very strongly that 7 cents per transaction is far too low). A safe-harbor provides substantial administrative savings to many issuers (especially smaller issuers) by not requiring the issuer to incur the time and cost of setting its own level of interchange fees. It also is consistent with the construct of Section 920 because, since it is only a safe harbor, it permits the issuer to recover all of its allowable costs and a reasonable profit if the issuer wants to undertake the time and expense to do so. An issuer would not have that option with a cap. A safe harbor, rather than a cap, is especially important because the wide variety of debit card programs and cost structures in the industry means that there are many issuers that potentially will want to individually consider their own costs in setting interchange fees.

I. The Board Should Delay Implementation of the Limits on Interchange Fees and Provide Interim Guidance

Congress imposed onerous obligations on the Board to implement Section 920. While the Board and the staff have attempted to respond to the challenge, further work is needed by the Board to implement the limits on interchange fees in Section 920(a). The Board needs to redefine the standards in the Proposal to better reflect the cost of debit card transactions as required under Section 920(a)(2). In addition, although the Board has collected valuable information in its industry surveys to date, there is further work needed to ensure that the data and conclusions based on it are sufficiently reliable to implement an extraordinary change of the magnitude envisioned by the Proposal. Among other things, the Board needs to collect data on small issuers and factor that data into its analysis of appropriate interchange fees. The Board also needs further data and analysis of the implications of its implementation of Section 920(a) to appropriately consider its impact on consumers, merchants, issuers and card networks. As a result of the foregoing, CBA strongly urges the Board to delay implementation of the interchange fee limits until these actions can be taken.

However, CBA also urges the Board to take action to provide the industry with interim guidance while its further work is proceeding. In particular, CBA believes that it would be appropriate for issuers to receive interchange at current market levels, pending further analysis and regulatory action by the Board.

II. Section 235.4: Fraud Prevention Adjustment

Section 920(a)(5) authorizes the Board to provide an adjustment to the interchange fee amount received by an issuer for costs incurred by the issuer to prevent fraud involving the issuer's debit card transactions. The Board should exercise this authority promptly and in a manner that will promote fraud prevention efforts by issuers to the benefit of consumers, merchants, issuers and card networks. If the Board limits the ability of issuers to recover costs of preventing fraud, issuers will likely reduce debit card authorizations and card utility to prevent fraud losses for which the issuer is required to bear responsibility under the EFTA, and/or increase consumer prices to cover fraud losses or fraud prevention efforts. Debit card fraud also harms consumers, even if they have limited liability for the actual card charges, since they are required to spend valuable time obtaining refunds for fraudulent charges and to have their cards re-issued after fraud incidents. Merchants also will be worse off if the Proposal does not appropriately support fraud prevention efforts by issuers because merchants typically bear substantial liability for fraud losses through the chargeback process. Finally, card networks and the debit card industry generally are harmed by debit card fraud to the extent that debit card fraud causes consumers to have less confidence in the debit card system and use other forms of payment in lieu of debit cards.

In light of the overwhelming importance of minimizing debit card fraud, it is important for the Board to act promptly to implement a fraud adjustment that recognizes the importance of issuers investing in and maintaining the highest quality fraud prevention systems. The Board should redouble its efforts with respect to the fraud adjustment and make every attempt to complete that work so that the fraud adjustment is in place at the same time that the general limits on interchange fees are imposed. As described above, many fraud prevention costs are properly included in debit card transaction costs. However, to the extent that the Proposal does not take such costs into account under proposed Section 235.3, it is imperative to allow issuers to cover these costs through interchange as soon as possible. Indeed, especially if the extraordinarily narrow interpretation of debit card transaction costs in the Proposal is adopted (which CBA believes would be a serious mistake), consumers are likely to be substantially harmed by fewer debit card authorizations and/or higher debit card fees if the fraud adjustment is not implemented quickly and appropriately. For example, issuers may be compelled to manage fraud risk by limiting the dollar amount of authorized transactions or restricting authorizations for transactions over the internet or phone.

The Board has requested comment on two approaches to implementing the fraud adjustment: a technology specific approach and a non-prescriptive approach. The Proposal indicates that the technology specific approach would allow issuers to recover costs incurred for implementing major innovations that would likely result in substantial reductions in fraud losses. The Board would undertake to indentify "paradigm shifting technology(ies)" to reduce debit card fraud and the issuer would be allowed to recover some or all of the costs associated with implementing the new technology, possibly up to a cap. Under the non-prescriptive approach, the Board would establish a more general standard that an issuer must meet to be eligible for a fraud adjustment. Issuers would be required to take steps reasonably necessary to maintain an effective fraud-prevention program but not prescribe specific technologies that must be employed as part of the program.

CBA strongly opposes a technology-specific approach as outlined in the Proposal if it is the exclusive approach or otherwise limits issuers from following the non-prescriptive approach. As noted in the Proposal, issuers have strong economic incentives to implement the most effective fraud prevention methods since issuers bear a substantial portion of the fraud losses and otherwise have competitive advantages over competitors if their debit card products are involved in fewer fraudulent transactions. Issuers also are in the best position to identify and develop those fraud prevention methodologies that are most likely to be effective because of their superior knowledge of debit card transaction processes. In contrast, governmental agencies generally are not only ill-suited to determine the relative merits of different fraud prevention measures, but also poorly equipped to assist in the implementation of evolving technologies. For example, any process by which such measures would be specifically approved will likely be cumbersome and inefficient. Fraud prevention needs to be a quickly implemented process in which issuers respond to the latest efforts by thieves, not a slow process that is implemented by regulation. A process involving public notice and comment on a regulation that approves specific fraud prevention technologies also is problematic to the extent it signals fraudsters the efforts that industry is taking to prevent debit card fraud. Thus, although a technology-specific approach might supplement a robust non-prescriptive approach, it should not be adopted as the exclusive method or if it will limit the alternative method.

The fraud adjustment should apply to both signature and PIN debit cards. Signature debit card transactions are prevalent with many merchants that have not invested in POS technology to accept PIN debit cards. Moreover, most debit card transactions involving internet sales are signature debit card transactions. There is nothing in Section 920 that suggests that a fraud adjustment is not appropriate for all debit card transactions, and it would be improper for the Board to leave out a substantial portion of the debit cards from the fraud adjustment. To the extent that there is a higher incidence of fraud in signature debit cards, that indicates that fraud prevention is needed more with respect to signature debit card transactions. Further, the policy reasons supporting a fraud adjustment apply equally to signature and PIN debit cards. Finally, providing a fraud adjustment only for PIN debit cards would establish an improper regulatory preference for PIN debit cards over signature debit cards. Nothing in Section 920 provides the Board with authority to prefer one type of debit card over another, and doing so would not be in the interests of consumers, merchants or issuers.

Finally, the fraud prevention adjustment should not be limited to only costs of activities that benefit merchants. It is not feasible to directly allocate specific fraud prevention efforts to particular fraud losses and whether the consumer, merchant or issuer bears the financial loss for the particular loss. More generally, all fraud prevention benefits consumers, merchants and issuers by creating a more efficient and reliable debit card system. Consumers benefit from reduced fraud, not only because of less liability for fraud losses, but also through lower costs of service and fewer problems with using debit cards. Similarly, merchants benefit from reduced fraud through increased (and faster) sales when consumers have confidence in the debit card product as well as through reduced liability for chargebacks of fraudulent transactions. In sum, reducing fraud benefits all of the participants in debit card transactions. It thus will not be possible (and is ill-advised) to attempt to quantify specific portions of the benefit from particular fraud prevention efforts to particular participants.

III. Section 235.6: Prohibition on Circumvention or Evasion

Section 920(a)(8) authorizes the Board to prescribe rules to ensure that network fees are not used to compensate an issuer with respect to a debit card transaction, or to circumvent the limitations on interchange fees imposed under Section 920(a). In addition, Section 920(a)(1) provides the Board with authority to prevent circumvention or evasion of Section 920(a). The Proposal properly recognizes that Section 920 does not regulate network fees (*see* 75 Fed. Reg. at 81747), and CBA strongly supports the Proposal insofar as it does not seek to set or establish the level of network fees that a network may seek to impose on network participants. Instead, the Proposal should not impact network fees or other financial arrangements between network participants unless such fees or arrangements are used to circumvent or evade the limitations on interchange fees imposed under Section 920(a).

Proposed Comment 6-1 also is correct to recognize that any finding of circumvention or evasion of the interchange fee limits of 235.3 will depend on the relevant facts or circumstances. The Proposal notes many complexities of the pricing considerations involved in network participation which arise from different fee structures, discounts and incentives with respect to both processing debit card transactions as well as other services network participants receive from or provide to a network. The complexity of these arrangements prevents a one-size-fits-all approach with hard and fast rules, and demands that any attempt to evade or circumvent the limits of Section 235.3 be addressed on a case-by-case basis depending on all of the relevant facts and circumstances. For this reason, the Proposal properly determined to refrain from categorically declaring that an increase in network fees charged to acquirers coupled with a decrease in network fees charged to issuers would necessarily constitute an evasion or circumvention of the limitation on interchange fees. *See* 75 Fed. Reg. at 81747.

Similarly, the Board should refrain from a *per se* rule of evasion or circumvention in proposed Section 235.6 merely because an issuer receives "net compensation" from a network. As noted above, circumvention or evasion is by its very nature something that must be evaluated on a case-by-case basis and is not subject to a *per se* rule. Moreover, the Proposal does not provide an adequate basis for the conclusion that the payment of "net compensation" to an issuer will in all (or even a significant number of) instances constitute an evasion or circumvention of proposed Section 235.3. For example, the Proposal contains neither data nor analysis on circumstances in which issuers have received "net compensation" from a network and whether such payments are appropriate. In the absence of such a predicate analysis, absolutely prohibiting "net compensation" is not appropriate as there cannot be an adequate basis to conclude that such arrangements will necessarily (or even likely to) involve evasion or circumvention of the interchange fee limits.

IV. Section 235.7: Limits on Payment Card Restrictions (Exclusivity and Routing)

At the outset, CBA notes its strong opposition to the policy reflected in the Proposal that issuers are required to enable multiple networks on their debit cards. From a policy standpoint, the Proposal should not require an issuer to do business with multiple unaffiliated networks as a condition to being able to issue debit cards. The Proposal thus should not limit the ability of issuers to determine the networks with which they want to do business. Indeed, the Proposal incorrectly presumes that all networks provide indistinguishable and generic services, whereas in fact issuers take into account many legitimate business considerations in choosing the card network or networks in which it wants to issue debit cards.

The express provisions of Section 920 do not require an issuer to take an affirmative step of enabling multiple authorization methods on its cards. Rather, Section 920 indicates that networks and issuers cannot *restrict*, through any agent, processor or member of a network, the number of payment card networks on which a debit card transaction can be processed to fewer than two unaffiliated payment card networks. If Congress had intended to affirmatively require debit cards to be enabled on multiple networks, and not allow issuers to make that choice, it would have said so directly, and not merely limited the imposition of restrictions.

The Proposal assumes that Section 920 imposes a requirement for a debit card to be enabled in multiple networks and sets forth two alternative approaches for implementing the requirement. Alternative A would require a debit card to have at least two unaffiliated payment card networks available for processing transactions, while Alternative B would require a debit card to have at least two unaffiliated payment card networks available for each method of authorization. CBA strongly supports Alternative A, and strongly opposes Alternative B, for several reasons.

To start with, as recognized by the Board, nothing in Section 920 requires (or even suggests) that there must be multiple networks for each authorization method as would be required by Alternative B. Requiring a debit card to be enabled on multiple signature networks will impose extraordinary changes in debit card formats, and existing authorization and settlement processes, which would be extremely costly and time consuming to implement. Such extraordinary burdens, and intrusions into the freedom to choose the networks with which an issuer wants to do business, should not be placed on the debit card industry when not required by the statute.

Further, Alternative A appropriately implements the provisions of Section 920 on exclusivity. Signature debit cards have never been enabled on multiple networks, while the functionality of PIN debit cards has permitted (from an operational standpoint) additional networks to be added without the same level of complexity involved in multiple signature authorization capability.

Finally, the Proposal should recognize the important interests of consumers in choosing the manner in which they pay merchants and not place the interests of certain merchants in lower interchange (and higher profits) above such consumer interests. Consumers have the right to decide whether to pay a merchant with cash, a credit card or a debit card. And, if the consumer wants to pay with a signature debit card, the consumer should not be forced into using an alternative signature debit card network that may not provide the benefits the consumer wants, merely to reduce merchant costs.

Indeed, consumers have important interests in deciding the network on which a signature card transaction is made because many consumer benefits of using a signature card payment are determined at the network level. For example, benefits such as zero liability for unauthorized use or travel insurance are many times provided at the network level and a consumer would not receive these benefits if the consumer's choice to use a particular signature card network can be overridden by a merchant who is motivated solely by reducing the costs of card acceptance.

The faulty premise underlying Section 920's direction for multiple network authorization and for allowing merchants to route transactions over enabled networks is that all networks are interchangeable and none provides any benefit to the consumer over another. Nothing could be farther from the truth. Besides competition at the issuer level, there is intense competition at the card network level and card networks have strong incentives to improve the functionality of their networks and card products to attract and retain market share. By allowing merchants rather than consumers to choose the network on which payments are made, based on the lowest cost alternative to the merchant, card networks will have little incentive to improve the network because they will have no reason to believe that consumers will ever see the benefits that they develop. The end result will be a self-fulfilling prophecy where the Proposal will ensure that debit card networks become a least-cost service for merchants at the expense of competition and innovation that benefits consumers.

Finally, special consideration needs to be provided in applying the exclusivity and routing requirements to prepaid, gift and other specialty cards that traditionally have been enabled only on signature authorization networks. Adding an unaffiliated PIN network authorization to such cards is not practical because the nature of such cards is that they do not include PIN functionality. As noted above, Section 920 limits the ability of networks and issuers to impose restrictions on cards participating in multiple networks, but does not affirmatively require all covered cards to participate in multiple networks. Thus, even if the Board determines to impose such an affirmative requirement on traditional debit card products, it is not required to do so for specialty cards that are by design only participate in signature authorization systems (or it should adopt an exemption for such cards). At a minimum, appropriate transition rules will be needed for such specialty cards to recognize that issuers do not have necessary customer relationship information to issue substitute or replacement cards that are enabled on multiple networks, and to allow additional time to implement the addition of PIN authorization methods to cards that previously only had signature authorization methods..

* * *

CBA appreciates the opportunity to provide our comments to the Board. Please feel free to contact us, or Jim Huizinga at Sidley Austin LLP, who assisted in preparing this letter, to assist in responding to your inquiries.

Sincerely,

Richard Hunt
President

cc: Steven Zeisel, CBA
David Pommerehn, CBA
Jeff Bloch, CBA
Jim Huizinga, Sidley Austin LLP

EXHIBIT A

Topical Outline of Discussion

I. Section 235.3: Reasonable and Proportional Interchange Fees (page 4)

A. The Proposal Impermissibly Narrows a Clear and Unambiguous Standard In the Statute for Permissible Interchange Fees (page 4)

1. Section 920(a)(2) Provides Interchange Fees Shall Be Reasonable And Proportional to Debit Card Transaction Costs (page 4)

2. Section 920(a)(4) Does Not Limit Allowable Costs in Setting Interchange Fees to ACS Costs (page 6)

3. The Proposal Does Not Provide Any Rational Basis For Narrowing The Standard Set Forth in Section 920(a)(2) (page 7)

B. The Proposal Departs From Extensive Jurisprudence Under Federal Rate-Making Statutes Without Good Reason (page 9)

C. The Proposal Improperly Applies The Statutory Requirement to Consider Check Transactions As a Limitation on Interchange Fees (page 13)

D. Even If the Board Limits Allowable Costs to ACS Costs, The Proposal Fails to Properly Define ACS Costs (page 15)

E. The Proposal Improperly Defines "Incremental Costs" To Be "Average Variable Costs" (page 16)

F. The Regulatory Definition of ACS in the Proposal Is Inconsistent with the Express Language of Section 920 (page 18)

G. The Interchange Amounts Proposed By the Board Are Grossly Lower Than Any Reasonable Estimate of ACS for Debit Card Transactions (page 20)

H. Section 920 Does Not Permit The Board to Adopt a Cap on Interchange Fees (page 21)

I. The Board Should Delay Implementation of the Limits on Interchange Fees and Provide Interim Guidance (page 22)

II. Section 235.4: Fraud Prevention Adjustment (page 23)

III. Section 235.6: Prohibition on Circumvention or Evasion (page 25)

IV. Section 235.7: Limits on Payment Card Restrictions (Exclusivity and Routing) (page 26)