Board of Governors of the Federal Reserve System

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Comments Re: Docket R-1748, RIN 7100-AG15

Dear Board of Governors of the Federal Reserve System Members,

In the years immediately after the "Durbin Amendment" was adopted, staff and the Board undoubtedly heard considerable debate, representations and misrepresentations as to its purposes and effects. Based on experienced gleaned from the debate surrounding Dodd Frank's passage, such comments likely also were conveyed both in formal presentations and in informal asides. Given the nature of the Feds historic mission at the time, overwhelmingly comments within the Fed came from the financial services industry.

This is not surprising. The Federal Reserve interacts with financial institutions on a regular basis across a broad spectrum of issues. Both by opportunity and inclination it naturally focuses on issues raised by the subjects of its regulation. The opportunities for interaction with financial services executives are many; with senior retail executives

relatively few. Consequently, insights into the operations of these two sectors are not the same. In addition, there have been personnel changes over the past decade. So a general discussion of what led to the enactment of Durbin Amendment may be beneficial and could help inform the Board's current decision-making. That is the basis for these comments.

The history of national debit card transactions is inextricably linked with that of bank issued national credit cards. General purpose credit cards were, developed in part, as an extension of the travel and entertainment charge card business. Rather than carrying cash and checks, executives and others, typically with expense accounts, could carry a Travel & Entertainment card, such as a Diners Club.

These cards facilitated transactions especially at high end lodging and dining establishments. They were accepted at relatively few places and full payment of charges were due at the end of the month. Establishments who accepted the cards were charged a substantial fee when they were used. This was reflected, in part, in the establishments' higher pricing. However, because then businessmen's entertainment venues tended to be in higher price point locations, and partially because expense account holders were often spending "other people's money," the heightened price of expense account venues was all of a piece.

Traditional retail establishments, green grocers, butchers, dairies, had long offered customer accounts, entered into a ledger, that were due in full at the end of the month. "Put it on my account" was a common refrain in such establishments.

Historically, the cost of those retail account systems was not high. Small town merchants were accustomed to receiving payment from their best customers at month's end, typically just over two weeks away, or in some cases (such as in farming towns) somewhat more sporadically, such as after a harvest. The cost of maintaining ledger accounts was low and customers, not wishing to become crosswise with the relatively small number of local merchants, tended to pay as agreed.

Over time, as towns grew, some retail establishments, especially those with multiple outlets, introduce plastic propietary "charge cards" that substituted for the hand written ledgers. Having a SEARS card made shopping even more convenient. Travel and Entertainment cards built on this tradition.

The modern general purpose credit card initially was an effort to expand on the propensity of these executive level expense account holders to spend freely. Bank of America led the charge with BankAmericard.

Bank of America sought to entice higher spending, presumably higher income / lower credit risk individuals into carrying its bank card. It featured a revolving line of

credit to support larger charges. The bank's goal, of course, was to get cardholders to use its card at a broader array of merchants in lieu of cash. Since a card network requires both card holders and card acceptors, Bank of America attempted to encourage an expanded range of merchants to accept the card and its fees by emphasizing the relative affluence and potential spending characteristics of its burgeoning cardholder base. Credit cards issued by banks potentially collect two sets of fees: a so-called "merchant discount" (in fact what is "discounted" is the amount of money the merchant receives for a sale - e.g. $97 for a $100 transaction) and the potential for a finance charge on any unpaid balance left outstanding by the cardholder.

Within their niche, BankAmericard proved popular. The prospect of attracting affluent shoppers who could qualify for the cards was a draw for some merchants; but the high fees were problematic for the majority. (Most retail merchants operate on a very narrow net margin - typically between 1 and 3% after taxes – a substantial number of transactions bearing a comparably sized fee would decimate profitability. They can't make it up on volume.)

Nevertheless, there were sufficient number of higher margin merchants willing to take the cards, perhaps in hopes of attracting the loyalty, favorable word of mouth, and other non-credit card spending of affluent customers so as to make BankAmericard a success.

However, Bank of America's efforts to aggressive expand its brand outside if its California base eventually ran afoul of then limitations on interstate banking. Bank of America invited other banks to jointly form the "Visa" brand to surmount that hurdle.

The "Visa" brand was a joint venture of banks located in various states. It was styled as an association with bank members. But, like all associations, it took direction from and operated at the behest of its members - - in this case, the governing banks. The larger banks took the most active role in fashioning their venture's operations. Some bank members attempted to get customers to sign up for the cards that were to be issued (issuing banks). Some bank members attempted to entice (acquire) merchants into accepting the issued cards. Collectively, the member banks adopted, under the umbrella of the Visa brand, a series of rules and fees by which they sought to bind themselves and others. They were rules under which they, and all who interacted with the closed system, operated.

For issuing banks, there was a need to adopt an agreed upon card numbering system; requirements that cards be consistently branded - along with the issuing bank's name, with a standard Visa logo; and, importantly, that there be a set fee schedule for fixing the amounts merchants were required to pay issuing banks, calculated against the total price of a transaction, when a card was used: the interchange fee. This non-negotiable fee, when added to the smaller negotiated fees merchants paid acquiring banks to represent them as their agents to the closed system, plus the fees paid directly to the

association for coordinating the network, collectively became known as the "merchant discount," again, the amount by which merchants' revenues were "discounted" for the benefit of the member banks and associated expenses.

Since banks of all sizes and locations potentially could issue the similarly branded cards, the banks adopted a rule designed to ensure that their out of state cards or the cards of lesser known banks could not be rejected by merchants at point-of-sale, as had been the case with out-of-state checks from unknown banks. To ensure that the cards of one bank were not disfavored against another, the banks collectively adopted a rule requiring accepting merchants to Honor All Banks' cards carrying their association's brand mark: VISA.

Each bank vouched for its own cardholders and competed against other intrastate banks for customers by setting its own credit terms. If it were to become a national, uniform multi-bank brand, as its founders intended, every banks' rule-encumbered cards had to have an equal chance of acceptance regardless of the bank that issued it. From the merchants' perspective, the banks wanted the cards to be perceived as uniform and fungible as they were advertised to be. Thus the rule mandating merchants to honor all banks' branded cards was ironclad – and was officially christened the Honor All Cards rule. Over time, the abuse of mandates and ambiguities embedded in the system from near its inception became the source of the market distortions that led to litigation and to the Durbin Amendment provisions, that now again, are before the Board.

II

Just as Bank of America helped assemble banks to create Visa, in the mid-1960s other banks helped establish a similar association of banks to create MasterCharge. Those banks groups adopted largely comparable rules and requirements. Over time, several banks joined both associations so that they could issue whichever of the two brands customers preferred. However, with the effective duplication of their major rules and operation the two groups largely became, from retailers' perspective, essentially indistinguishable. The banks arranged for their associations to assess, and on nearly the same schedule reassess, roughly comparable interchange fees. They adopted similarly confining rules, requirements and technologies. Minor differences existed, but in those days, like low end Buicks versus high end Oldsmobiles, the differences were more of form than substance. That continues to this day. Both bankcard brands grew to become dominant credit forces in the United States. But there were higher aspirations. As Visa's former CEO declared, "We are the future of money."

A challenge to that hegemony emerged with the growth of ATM networks. Among other things the developers of automatic teller machines demonstrated to banks that for a modest fee it was possible to offer customers access to cash after banking hours and reduce customers' need to engage with tellers during banking hours. This both

increased customer convenience and reduced bank costs – a win-win. That is a hallmark of a functioning market.

By further organizing ATMs into networks, customers were no longer tied to the ATM affixed to the side of the bank's building. The bank-issued ATM card could be used by customers to withdraw funds from any automatic teller machine hosted by the affiliated network. The new cards were an astounding success.

ATM network owners soon realized that an even greater utility was available. If retailers could be incented to modify their point-of-sale registers to except ATM cards, customers would be able to access the funds in their deposit accounts instantaneously from inside the store. This would have a number of benefits. Among them fewer customers would choose to write paper checks, because they could process the transaction in a less cumbersome and faster manner (plus, thanks to ATM cards' 24 hour use, more easily ascertain their exact account balance).

Since funds were immediately verified and withdrawn, just as they were with ATMs outside of banking hours, merchants were assured of payment at all times and avoided hassles associated with bad checks. For banks the expansion of card acceptance by retailers not only increased customer usage of the bank's product (potentially enhancing loyalty) but also reduced the number of paper checks banks needed to subject to very expensive processing.

At the time paper checks were transported physically back to the bank, before being delivered, canceled and returned to customers along with their monthly statements. The cost to the bank of a remote ATM transaction was pennies as opposed to the typical 40+ cents for processing a paper check. Consequently a few ATM network owners could charge banks far less and still offer retailers a few cents "rebate" on every transaction to help defray the cost of point-of-sale terminal installation and maintenance, and incidentally, expand the ATM network's reach. The original "win-win" of bank mounted ATMs was expanded into a "win-win-win" for customers, retailers and banks. A competitive market-enhancing debit card network was born.

Debit card growth was steady but some banks saw a clouded future for their network. With the bank leaders' support Visa introduced its own debit card, "Visa Check."

Unlike the ATM networks' efficient, secure PIN-based debit cards, Visa Check ran on antiquated ***signature*** card networks. Not being PIN-protected they were much more susceptible to fraud.

Signature verification had arisen as an outgrowth of the old "put it on my account" system. In the early days it worked sufficiently well. Early credit card penetration was limited – they were typically to local "high profile" citizens in the community. In those days, card-carrying customers, and in some cases even their signatures, we're recognized

by local merchants. Long distance travel was not as ubiquitous as it has since become, and within local communities signature comparisons between a receipt and the back of a card (combined with voluminous distributed listings of fraudulent and dishonored card numbers) provided a modicum of protection. However, by the last decades of the 20th century, travel and the proliferation of cards was rendering signature verification a virtually meaningless form of protection. Other, marginally effective security measures gradually were added. [The perceived risk of accepting credit cards was slightly assuaged by the claim that sales might lift because customers ostensibly were borrowing to spend money they did not yet have; as opposed to debit spending of money already in the bank.] Nevertheless, the signature check card was forced into the debit card market and its penetration grew despite its abundant flaws.

Rather than being a net zero cost to retailers as were the PIN-debit cards, the banks' Visa Check branded cards assessed interchange fees (aka – "Swipe Fees"), even though they drew upon supposedly risk-free deposited funds, at the same high cost as did the banks' credit cards. As a result merchants did not receive $100 (or in a few cases even a penny or two more than one hundred dollars) for a $100 debit transaction; but rather, roughly $98 and change for the less secure Check Card transaction. Given retailers narrow net margins, expanded penetration of these expensive, fraud-prone cards ineluctably drove consumer retail prices ever higher.

Economics suggests the properly functioning markets do not deliver inferior goods in ever increasing quantities at ever increasing costs, absent a failure. The abuse of the banks' collective market power and founding Rules precipitated the failures here.

III

Although security experts (and, initially, even executives within the now rebranded MasterCard) had expressed dismay that customers' precious depository accounts could be hacked with a stolen card and a signature, that is what the banks controlling Visa Check allowed to be rolled out.

The banks' check cards were branded to look almost identical to Visa branded credit cards. Essentially indistinguishable from credit cards in a busy retail environment, Visa check grew rapidly. Based on the ATM experience, many merchants were aware that here-to-fore fiercely competitive debit card transactions had a reputation for being faster, more secure and less expensive to process than credit transactions. Many sought to encourage debit card use. They would have refused the banks' expensive Check Cards had they noticed them and had a choice. The banks, working through their association, sought to ensure they had neither.

As the courts determined, the bank associations by this point had market power in the credit card market. This meant they could raise prices without significant loss of market share. They used that market share to force the inferior debit cards on unsuspecting merchants. By making the cards facially similar to credit cards, the casual acceptor could not easily tell they were NOT credit cards. For those who are savvy enough to discover they were being overcharged for undesired signature debit transactions, the financial industry response was "you have no choice."

They interpreted the so-called honor all cards rule, adopted to prevent discrimination against smaller and out of state banks, to claim that retailers could not refuse a card *product* that carried the branded logo. If a retailer refused to accept Visa debit cards, they would be in violation of the Rule and be barred from accepting any of the banks' Visa branded credit cards. Since they had market power in the credit card market, the threat to a merchant of having their credit card acceptance terminated in retaliation for refusal to accept a smaller number of debit transactions was an untenable option. Consequently, whether merchants were aware of the bait-and-switch or not, Check Card transaction volumes grew.

Using a ruse such as a reinterpreted honor all cards rule to tie expensive, unwanted products to a more desired product, in which the seller has market power in the latter product, is a classic example of antitrust illegality. The banks had market power in their Visa branded cards and they used it to derail competition. Like Ma Bell tying use of its

desired monopoly telephone lines to the rental of its phones or Xerox requiring users of its market dominating copiers to only buy Xerox brand copy paper, effectively attempting to establish an Honor All Products rule from a position of market power is antithetical to functioning markets. The bank associations were sued, and *eventually* settled by agreeing to partially untie their products. However, by running out the very long (expensive and slow) antitrust litigation clock, they emerged with their fraud-prone debit cards themselves having a powerful position in the market.

The bank controlled association did acquire a safer PIN-based debit network, Interlink, and ultimately offered it as a possible additional ATM option on Check Cards. They also began charging merchants a high interchange fee for Interlink transactions. The effect was to entice other banks to make high cost Interlink the preferred, and only, ATM option on the by now widely prevalent Check Cards (subsequently rebranded as Visa debit). When banks eliminated the other competitive PIN-debit networks from their cards, it deprived existing PIN-debit networks fewer places to offer and merchants to accept the lower cost – win-win-win - cards. Instead, most of the prospective "wins" were redirected from consumers, who faced escalating merchandise prices due to the higher swipe fees; from retailers, who make fewer sales at higher prices; and instead given to the banks. Furthermore, the genuinely competitive PIN-debit networks began to lose market share. Had it been fully effectuated, the lion's share of credit card transactions would be processed over the expensive, antiquated credit card rails, as would the lion's share of expensive signature debit transactions; and a large portion of those transactions that

weren't processed over the former two would have passed over the high priced Visa controlled Interlink PIN-debit network: the future of money.

IV

Congress recognized that the disingenuous abuse of secretive, ambiguous "rules" by dominant players, coupled with the unintended benefits of protracted litigation (financed, in part, by fees assessed against the victims) could undermine the proper functioning of a market. So long as the underlying flaws remain in place, the seemingly endlessly malleable honor all cards rule, and market power, a market-perfecting competitive option cannot emerge.

In Dodd Frank, Congress adopted the Durbin Amendment to, among other things, reverse the spread of abuse and the potential destruction of a robust debit card market. It focused on banks because it is they who decide how transactions, and access to their customers' deposit accounts, are to be structured.

One critical prong of the amendment was aimed at preserving some competition by ensuring that *Every* bank facilitated debit transaction could be routed over at least two

competitive debit networks (preferably more of course). One goal was to hinder the ability of dominant players to engage in the "redefined product game" so as to foreclose merchants' ability to have access to a competitive option for processing each and every debit transactions presented at point of sale. Congress was aware of the history of dominance. If banks are allowed to accept what are essentially "bribes" to undermine merchant routing choice; or if some dominant players were allowed to rebrand a different style or mode of debit transaction as "new" and thereby ultimately allow Banks to avoid providing merchants competitive routing, then bad actors will leverage their position in debit just as they have in credit. Thus, Congress defined debit transactions both very broadly, and from the merchants' point of view, to foreclose the dominant networks expected efforts to get banks to circumvent the law.

A second critical prong was directed at the continuing non-competitive pricing of debit transactions. For the largest banks, Congress directed that at most, debit fees be capped at a level reasonable and proportionate to the banks' actual costs.

Again, this is an effort to provide a substitute for competition in a failed market where the players refuse to compete. In a functioning market, as overwhelmingly is the case in retail, competition drives a rationally tight connection between marginal costs and market price. However, as has been seen, left to its own devices the dominant banks use their networks, their power and rules to repeatedly raise prices even as technology and efficiencies drive their costs relentlessly downward. In a properly functioning market all

participants benefit from the savings that efficiencies deliver. As Congress recognized, this is not such a market.

Nearly a decade ago the Board and staff initially and properly determined that a cap of between seven and eleven cents was reasonable and proportional to the *then* higher existing costs. In the tenor of those turbulent times that Board ultimately gave banks a cap figure more than double what it had so carefully and properly calculated. Today, the underlying costs have dropped dramatically. While it unfortunately appears some at the Fed may be attempting to avoid addressing the elephant in the room, it is long past time to correct the errors of the past.

As we noted above, the Board then was intimately familiar with financial institutions' processes and complaints, but had far less knowledge of the real world effects on merchant operations. In the intervening years retailers and other merchants have attempted to partially redress this imbalance. It is difficult to match the financial institutions' access. Nevertheless, Board staff has experience firsthand the lengths to which the issuing banks and their card networks (strategically refashioned in the wake of litigation as separate entities, but, as 15 years' experience has now shown, essentially still doing the bidding of their stock owning banks) continue to operate in the same manner. Together the banks and their former associations repeatedly attempt to evade the clear wording and intentions of the Fed and of Dodd Frank.

Corrective adjustments by the Board and the Federal Trade Commission will always be needed when actors stray, but those nudges cannot address the problem Congress sought to remedy unless these two primary underpinnings of the Durbin Amendment, full routing competition – whether in store, online, in-app, by token, mobile device or otherwise - and genuinely reasonable and proportional debit ceilings are vigorously effectuated.

In closing, thank you for considering these comments. I hope this history will help demonstrate the importance of the Fed moving soon to restore at least a true semblance of competition.

Respectfully submitted,

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Washington, D.C.