

**Meeting between Federal Reserve Staff and  
Representatives from Commerce Bancshares, Inc. and Commerce Bank, N.A.  
October 26, 2010**

**Participants:** James Bullard and Jane Anne Batjer (Federal Reserve Bank of St. Louis)

David W. Kemper and Charles G. Kim (Commerce Bancshares, Inc.); and  
Carl P. Bradbury (Commerce Bank, N.A.)

**Summary:** Staff from the Federal Reserve Bank of St. Louis met with representatives from Commerce Bancshares, Inc. and Commerce Bank to discuss the debit interchange fee provisions in the Dodd-Frank Act and the rulemaking associated with those provisions. The representatives from Commerce Bancshares, Inc. and Commerce Bank expressed views reflected in the attached presentation materials.

*ask listen solve*

## Impact of the Durbin Amendment on Commerce Bank and the Banking Industry

David W. Kemper, Chairman, President and CEO  
Charles G. Kim, Executive Vice President and CFO  
Carl P. Bradbury, Sr. Vice President

October 26, 2010



**Commerce Bancshares, Inc.**

# OUR CENTRAL CONCERN REGARDING THE DURBIN AMENDMENT

- The Durbin amendment requires the Federal Reserve to regulate interchange for some Banks.
- We fear the Fed is instructed to set interchange at a rate that covers only a fraction of the costs of our debit card program, including only the costs of authorization, clearing, settlement, and perhaps some fraud prevention cost.
- The cost of running a debit card portfolio is far greater than these basic transaction costs.
- Debit Cards are now a fundamental part of retail banking. We must offer debit cards if we are to meet our customers' needs.
- We ask that interchange be set taking appropriate costs and a return on capital into account.

## Failure to do this will:

- Threaten the future of the payment system in the U.S
- Further damage the fragile profitability of the entire banking system
  - Potential cost to Commerce \$44 million (18% of 2009 pre-tax income)
- Place Commerce Bank and peer banks at an extreme competitive disadvantage



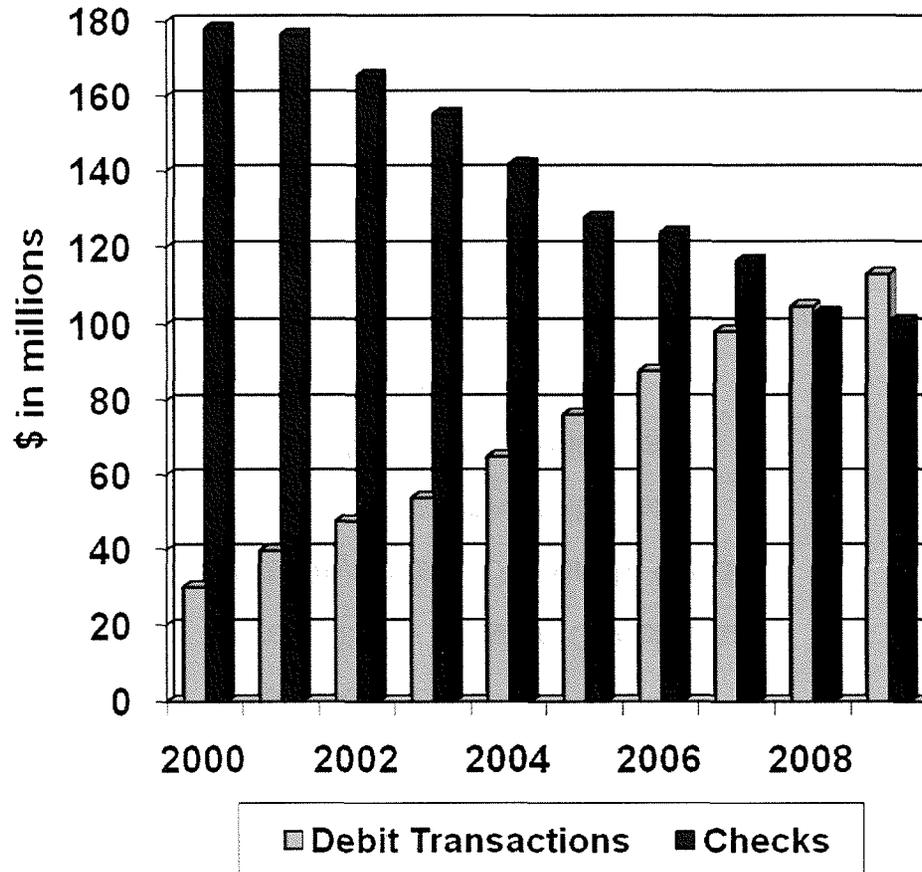
## CONSUMER DEMAND PLUS CAPITAL INVESTMENTS HAVE CREATED A GROWING PRODUCT – FUTURE INVESTMENT IS AT RISK

1978	ATM Cards – “Connection 24”
1985	Special Connections “combination” debit & credit card
1994	Visa Check Card
1994	Zero Liability for Visa Check Card
1995	Fort Hays State University Card
1996	Wichita State University card
1997	Kansas State University Card
1998	Kansas University Card
1999	Standard / Gold / Platinum distinctions
2000	Business Check Card
2003	Payroll Card
2004	Gift Card
2005	Pittsburg State University Card
2009	Instant Issue Debit Cards
2010	Remote PIN selection
2011	General Purpose Re-loadable Card?



# CHECKING ACCOUNTS HAVE BECOME DEBIT ACCOUNTS

Commerce Bank Debit and Check transaction volumes



- Debit cards are now so fundamental to checking accounts that we must offer them to attract new customers.
- Over 92% of Commerce Bank's new checking customers choose to take a debit card when they open a checking account.
- The Debit Card is now the primary access mechanism for checking accounts.
  - Debit access to checking accounts eclipsed checks in 2008.
  - Check usage is declining 6% annually while Debit usage is growing 16%.
- We have invested heavily in Instant Issue technology and continue to invest in customer friendly, debit-specific technology to meet our customers' checking account access needs.



# DEBIT'S REMARKABLE SUCCESS AND GROWTH IS A REFLECTION OF IT'S MANY BENEFITS TO CONSUMERS AND MERCHANTS

## Benefits to the Consumer

- Worldwide, 24 Hour Access to Funds
- Consumer Protection: Disputes
- Zero Liability Protection: Fraud
- Faster Checkout
- Safer than Cash
- Enables E-Commerce
- More Acceptable than Checks
- Monthly Record of Transactions

## Benefits to the Merchant

- Guaranteed Payment
- Faster Checkout
- Fewer Unpaid Checks\*
- Lower Check Guarantee Expense
- Less Cash to Handle
  - Reduced employee error
  - Reduced employee theft
  - Smaller robbery losses
- Enables E-Commerce
- Greater "Convenience" Sales

\*2007 Federal Reserve estimated 153,000,000 checks were returned unpaid totaling \$182.5 billion. From "A Survey of Depository Institutions" for the 2007 Federal Reserve Payments Study. Released March, 2008. Pages 40, 41.



**Commerce Bancshares, Inc.**

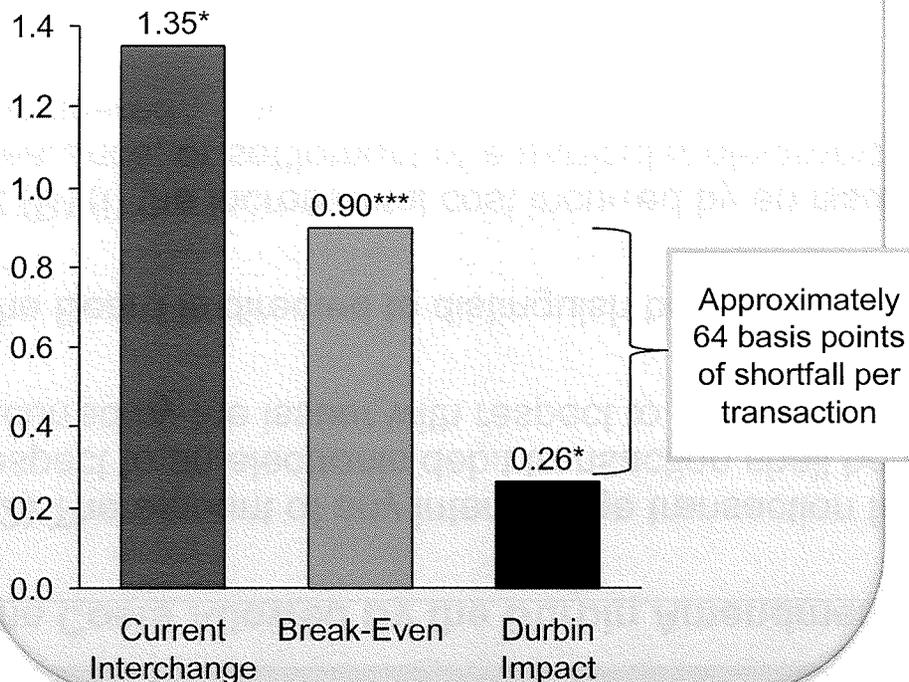
## A SUMMARY OF THE DURBIN AMENDMENT

- **Debit interchange will be regulated by the Fed** to ensure that it is “reasonable and proportional” to the cost incurred by the issuer. This language will not apply to issuers with less than \$10 billion in assets or to re-loadable prepaid programs or debit and prepaid cards issued for government programs.
- **Issuers may not restrict the number of payment card networks on a debit card to one.** In addition, they may not restrict multiple networks to networks owned by the same company.
- Subject to issuer participation in the networks available, issuers shall not inhibit the routing of debit transactions. That is, the **merchants will determine how transactions will be routed.** That is, a merchant may choose to send a transaction for authorization and settlement via network A or network B.
- Retailers may impose **minimum purchase amounts on credit Card purchases.** The minimum purchase amounts may differ by merchants but they may not exceed \$10. **Maximum purchase amounts** may be applied by federal agencies or institutions of higher education.
- **Merchants may offer discounts for use of cash,** check, debit, credit, or prepaid payments. They may not differentiate by issuer or card network.



# REGULATED INTERCHANGE COULD RESULT IN A \$44 MILLION REDUCTION IN COMMERCE BANK REVENUE

## Durbin Amendment Encourages Fed to Set Interchange Below the Issuers' Break-Even



If interchange is set below break-even, issuers over \$10 billion in assets will be forced to choose between:

1. Losing money on every transaction
2. No longer issuing debit cards
3. Imposing fees to make up the un-reimbursed expenses and loss of profit.

- While option three may appear the most likely, the creation of new fees would automatically put us at a price-based competitive disadvantage. 99.4% of our competitors are not bound by the amendment and would not have to impose fees.
- Our own experience has shown that the imposition of fees has a negative impact on new account openings and product usage.
- Merchants are not required to pass the interchange savings on to the consumer. The Australian experience suggests they won't.\*\*

\*Interchange estimates from TCF Complaint.

\*\*Reserve Bank of Australia Payments System Board, Reform of Australia's Payments System: Preliminary Conclusions of the 2007/2008 Review, Page 23.

\*\*\*An approximate number. For example, does not include expense such as branch depreciation or all allocated salaries.



# INCREMENTAL VERSUS REAL COSTS

## The Costs Allowed By the Durbin Amendment

“(2) The amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.”

The Board is directed to distinguish between –

“2 (B) (i) the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which cost shall be considered...; and

“2 (B) (ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction, which costs shall not be considered...”

The Board may allow for an adjustment to interchange for Fraud Prevention costs providing –

“5 (A) (i) such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transaction involving that issuer;...”



## THE AMENDMENT ALLOWS THAT THESE COSTS MAY BE REIMBURSED

- The incremental cost of authorization
- The incremental cost of clearance
- The incremental cost of settlement
- Perhaps the cost of preventing fraud



# THE REAL COST OF DEBIT – A PARTIAL LIST

## **Card Compliance Support**

- Staff (facility, work station, salary/benefits) for Card Risk Group, IT Risk, IT Info Security, Compliance, Legal, and Audit Departments.
- Periodic statement expense to comply with Regulation E.

## **Cardholder Dispute Management**

- Administration of Card Network Operating Rules and Regulation E – Loss Mitigation
- Staff (facility, work station, salary/incentive)
- Training Tools and Expense
- Card Network Tools and Aids
- Ticket Retrieval Expense
- Chargeback and Goodwill Losses
- Cardholder Notification (Letters, postage, etc.)
- Re-presentation Handling

## **Card and PIN Production & Delivery**

- Card Stock and Inventory Management
- Other Collateral (Carrier, envelope, PIN mailers)
- Card and PIN Personalization and Mail Sort/Prep
- Postage and Expedited Delivery Expense
- Cost of Processing Returned Mail
- Instant Issuance – Hardware/Software development and maintenance, auditing procedures and controls, printer transfer film and print ribbon.

## **Customer Service**

- IVR Development and Maintenance and various Telephony
- Online Banking Development and Maintenance
- Branch Banking Platform Development and Maintenance
- Staff (facility, work station, salary/incentive)
- Training Tools and Expense
- Data connections, middleware and interfaces to core systems
- Scheduling and Call Monitoring Tools
- Graphical User Interface and Scripting Tools

## **New Account Origination Expense**

- Acquisition Marketing
- Staff (facility, work station, salary/incentive)
- Branch Platform
- Know Your Customer Tool
- On-boarding software application
- Data line, middleware, and various interfaces
- In-house systems (CICS, CPU, Disk Space, etc.)

## **Non-sufficient Funds Handling**

- Staff (facility, work station, salary/benefits) for review and notification of NSF items.
- NSF related customer service
- Reporting of Charged Off Accounts to ChexSystems
- Collection Expense
- Charged Off Losses Not Recovered
- Recovery Expense

## **Data Security**

- Firewalls
- Host Security Modules
- Encryption Software
- Anti-phishing Software
- Security Testing

## **Card Program Support**

- Storage, Monitoring, Analyzing and Reporting of Card Data.
- Debit Program Management, Staff, Analysts (facility, work station, salary/benefits)
- Hardware and Software Development and Maintenance
- Database development and support, Disk Space, etc.
- Administration of contractual relationship and service levels with the card networks and processors.

## **Research and Development**

- IT Developers and Business Staff (facility, work station, salary/benefits)
- Capital or incremental expense related to product, project, or enhancement.

## **Card Marketing and Rewards**

- Advertising creative, direct mail pieces, and postage.
- Partner revenue share, rewards maintenance, and redemption expense.
- Marketing and Business Staff (facility, work station, salary/benefits)

See appendix for additional explanation



**Commerce Bancshares, Inc.**

## WE SEEK A SUSTAINABLE AND FAIR BUSINESS MODEL

- We believe the Durbin Amendment was passed into law without adequate study and that it holds the potential to greatly damage the U.S. payments system.
- We ask that the Federal Reserve, in concert with the Government Accountability Office, study the interchange question and recommend a fair interchange rate to Congress.
- We ask that the Fed take all of the costs of running a debit card program into account when recommending an interchange rate, not just the incremental costs of authorization, clearance, and settlement.
- We ask that the Fed recommend an interchange rate that allows us to make a reasonable return on our capital. We wish nothing more than to compete on an equal footing with the other financial institutions in the U.S.
- In short, we ask for a business model that does not make us choose between:
  - Losing money on every transaction
  - No longer issuing debit cards
  - Imposing consumer fees to make up for un-reimbursed debit expenses.



# APPENDIX



## **ADDITIONAL CONCERNS: NETWORK EXCLUSIVITY AND TRANSACTION ROUTING**

### **The Network Exclusivity Provision**

- Appears to require issuers to participate in more than one network
- Creating a debit card that simultaneously participates in both the Visa and MasterCard networks would be an unrealistic undertaking for the U.S. payments system
- Mandating that issuers add non-affiliated PIN-based networks will have at least two effects:
  - It will cause us to reissue our entire card base without the possibility of reimbursement.
  - It will force us to do business with a network that we have avoided for business reasons.

### **The Transaction Routing Provision**

- Allows merchants to choose how a transaction is routed
- Promotes the growth of lowest cost networks
- Does not address data security concerns that may have limited the success of these networks in the first place



## ADDITIONAL EXPLANATION RE: THE REAL COST OF A DEBIT PROGRAM

**Data Security** – Infrastructure necessary to support the enterprise is shared across lines of business. For example: hardware such as firewalls and Host Security Modules, software for encryption and anti-phishing, professional fees for establishing best practices and for conducting security penetration testing.

**New Account Origination Expense** – Acquisition marketing, facilities expense, FSR work stations, salary and incentive for sales interaction, entry into branch platform, tools for evaluating customer's identity (KYC) and business rules for establishing new account, the data line, middleware and interfaces used to pass data to establish accounts on system of record and various other support systems (processor, in-house card system, customer reference file), All of the tools/systems mentioned require hardware and software maintenance and development. We are assessed account on file fees from third party vendors, and incur in-house mainframe systems expense in the form of CICS Transactions, CPU minutes, disk space, tape mounts, etc.

**Card and PIN Production & Delivery** – Expense associated with managing card stock inventory and other collateral (the card carrier, envelope, PIN mailers, inserts, etc.), the personalization of the physical card, the affixing of the card onto the card carrier, PIN generation, PIN mailer personalization, mail preparation (pre-sort and zip sort), postage, expedited delivery expense, and the cost of processing returned mail. We have an additional cost structure associated with instant issuance that includes hardware and software development and maintenance, separate card stock inventory procedures and controls, printer transfer film and ribbon, and performing periodic audits.



## ADDITIONAL EXPLANATION RE: THE REAL COST OF A DEBIT PROGRAM

**Customer Service** – Infrastructure associated with multiple service channels is shared across lines of business, including the integrated voice response unit (IVR), online banking platform, and branch banking platform. This server based infrastructure accesses information from various systems using data connections, middleware and interfaces to perform customer inquiries. There is hardware and software development and maintenance expense associated with each channel. The expense associated with the full service options include the agents' facility, work station, salary, and training expense, scheduling and call monitoring tools, telephony, and various customer service graphical user interface tools.

**Cardholder Dispute Management** – Expense associated with the handling of a cardholder disputes, the administration of Card Network Operating Rules and Reg. E related to disputes and chargebacks, and providing excellent customer service while maintaining acceptable levels of loss. This expense takes the form of staff (facility, work station, and salary), training, card network tools and aids, ticket retrieval, chargeback and goodwill losses, and re-presentment handling.

**Card Compliance Support** – Expense related to compliance with Reg. E, contractual relationships with our customers and vendors, and industry specific standards. Includes staff (facility, work station, salary) associated with this function including members of our Card Risk Group, IT Risk, IT Information Security, Compliance, Legal, and Audit Departments. In addition, there is expense associated with generating and mailing periodic statements in order to remain compliant with Reg. E.



## ADDITIONAL EXPLANATION RE: THE REAL COST OF A DEBIT PROGRAM

**Card Program Support** – Expense associated with storing, monitoring, analyzing and reporting card authorization and transaction data and product performance in order to improve cardholder access to their funds during processing and/or resolve problems to reduce outages. This expense would take the form of staff analysts (facility, work stations, salary), hardware and software development and maintenance for the various tools used, database development and support, disk space, etc. There is also administrative expense incurred for the on-going management of the relationship with the card networks and processors, and establishment and monitoring various Service Level Agreements and contractual commitments.

**Research & Development** – Costs related to the development of the debit product, whether it be a launch of a new product/process or the incremental improvement of an existing product/process. Expense includes any capital or incremental expense related to the product, project, or enhancement; plus any staff (facility, work station, salary) necessary to complete the project (product developers, business analysts, corporate finance analysts, IT developers, project managers, and other subject matter experts).

**Card Marketing & Rewards** – Expense associated with various campaigns and programs to acquire new accounts, activate existing accounts/cards, and promote on-going usage of the card product. The expense associated with this takes the form of advertising creative, direct mail pieces and postage, partner revenue sharing, and third party rewards and redemption expense.

