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February 22, 2011

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

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

Dear Ms. Johnson:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the nation's federal credit unions, I am writing to express NAFCU's concerns with the Board of Governors of the Federal Reserve System's ("Board") proposed rule on debit card interchange fees. NAFCU is deeply concerned about the impact the proposed price caps will have on the entire financial services industry, including debit card issuers with less than $10 billion in assets. The proposed rule makes plain that the supposed small issuer exemption is illusory and will do little, if anything, to protect smaller issuers in the long term.

NAFCU strongly opposes the proposed rule and recommends the Board reconsider its determination to implement price caps for debit card interchange fees. Our concerns with the price caps, the fraud adjustment and the network exclusivity and routing provisions are explained in detail below. Additionally, nothing in the proposed rule indicates that the Board met its obligations under the Electronic Fund Transfer Act ("EFTA") to consult with other federal financial regulators, or to consider the impact of Board regulations on financial institutions, consumers and others who use debit cards.[1] Finally, the proposal completely ignores the small issuer exemption for institutions with less than $10 billion in assets.

I. Debit Interchange Fee Caps

NAFCU does not believe the Board has met its statutory obligation to establish reasonable standards for determining whether an interchange fee is "reasonable and proportional" as required by § 1075[2] of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] The Board's two proposed caps would greatly harm credit unions and significantly hamper their ability to provide low-cost alternative financial services. Accordingly, we do not support either of the two proposed alternative price caps.

Should the Board decide to finalize a rule with one of the two proposed alternative price caps for debit interchange, NAFCU would select the higher cap of twelve cents per transaction.

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[1] 15 U.S.C. § 1693b(a)(1)-(2) (2010).
[2] Codified as § 920 of the Electronic Funds Transfer Act.
[3] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

While the twelve cent cap is the less harmful of the two alternatives, in the strongest terms possible, we do not believe either the seven cent option or the twelve cent option are appropriate.

A. <u>The two Price Cap Alternatives</u>

The higher twelve cent alternative is preferable for two primary reasons. First, the flat twelve cent cap would be much easier to administer for issuers, the networks and the Board than the more complex alternative permitting an interchange fee between seven and twelve cents based on the issuer's costs. More importantly, the twelve cent fee would better - though still not accurately - reflect some of the actual costs of operating a debit card system.

The twelve cent cap, although it is undesirable and unreasonably low, better reflects the actual costs of debit card issuers. The statute prohibits certain costs from consideration and the Board chose not to consider other costs that were within its discretion to include. Specifically, § 920 directs the Board to consider the incremental costs involved in authorizing, clearing and settling a particular debit transaction, but directs the Board not to consider other costs, "which are not specific to a particular electronic debit transaction…."[4] These two buckets, however, do not represent the entire universe of costs associated with operating a debit card portfolio. The Board, considered and ultimately rejected including other allowable costs that, in its view, would be permitted under § 920(a).[5] Given that the statute prohibits consideration of some costs and the Board chose not to consider other costs that were permissible, the proposed interchange fees are, unquestionably, based on a relatively small percentage of the total costs required to operate a debit card portfolio. Consequently, the higher of the two alternative fees is clearly the more reasonable approach.

B. <u>Neither of the two Proposed Interchange Transaction Fees are Appropriate.</u>

Neither the seven cent fee, nor the 12 cent fee is appropriate, and neither fairly compensates issuers for the costs involved in processing debit card transactions. First, the Board should not have proposed a rule implementing price caps. Second, even if imposing a price cap is a reasonable interpretation of the statute, the Board's proposed fee is unreasonably low. Third, even the higher of the two proposed fees is so low that it raises constitutional issues under the Takings Clause of the Fifth Amendment.

1. <u>The Statute Does Not Require the Board to Implement Price Caps.</u>

Congress did not direct the Board to impose price caps for debit card interchange fees. The interchange amendment only requires the Board "to establish standards for assessing whether the amount of any interchange transaction fee…is reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[6] Nowhere does the statute require the Board to impose price caps. Indeed, requiring the Board only to establish standards for assessing

[4] § 920(a)(4)(B).
[5] Debit Card interchange Fees and Routing, 75 Fed. Reg. 81,722, 81,734-35 (proposed Dec. 28, 2010) (to be codified at 12 C.F.R. pt. 235).
[6] § 920(a)(3)(A).

interchange fees is distinctly different than directing the Board to impose hard price caps. Imposing hard price caps to meet the statutory requirement of establishing standards is not only unreasonable but also beyond the Board's authority.

The Board's proposal here is inconsistent with previous rules that interpret very similar terms. In 2009, Congress passed the Credit Card Accountability Responsibility and Disclosure Act (the "CARD Act")[7], directing the Board to "establish standards for assessing whether the amount of any" credit card penalty fee "is reasonable and proportional to the omission or violation to which the fee or charge relates."[8] The Board responded by implementing a safe harbor as required by the statute, but also created a flexible standard, authorizing credit card issuers to charge a higher fee based on the costs associated with the violation.[9] The CARD Act and § 920 of the EFTA employ virtually identical wording, yet the Board's CARD Act rule provides flexibility whereas the interchange proposal would affect a strict and unreasonably low cap on the fee in question.

The distinction between what Congress required and what the Board proposed is particularly confusing given that price caps are a tool used only sparingly by the U.S. Government. The Government imposed price caps on a number of goods during World War II, culminating in the Emergency Price Control Act of 1942. That legislation was "in the interest of the national defense and security and necessary to the effective prosecution of the present war,"[10] More recently, price caps were used to combat escalating energy prices. In 2001, the Federal Energy Regulatory Commission (FERC) imposed price caps, throughout several parts of the Western United States. FERC acted in order to minimize power outages that were affecting residents living in California.[11] Further, when imposing price caps, FERC had already determined "that the market structures and rules for wholesale sales of electric energy in California were seriously flawed and that these structures and rules…have caused, and continue to have the potential to cause, unjust and unreasonable rates for short-term energy under certain conditions."[12] Importantly, the statutory scheme provided FERC considerable authority to regulate rates.[13] The two examples above and the proposed debit interchange price caps could not be more disparate.

The Emergency Price Control Act was passed in order to ensure the Government could prosecute the Second World War. The Act also granted the administration wide latitude to stabilize prices, prevent speculation, profiteering, hoarding and manipulation and to protect individuals with limited income.[14] In the much more recent context of the energy shortage,

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[7] Pub. L. No. 11-24, 123 Stat. 1734 (2009).
[8] 15 U.S.C. § 1665d(b).
[9] Truth in Lending, 75 Fed. Reg. 37,526, 37,526-27 (June 29, 2010) (to be codified at 12 C.F.R. pt. 226).
[10] *Yakus v. U.S.*, 321 U.S. 414, 420 (1944) (quoting the purpose of the Act).
[11] *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services*, 95 FERC ¶ 61,115 (2001 (April 26 Order).
[12] *Id.*
[13] 16 U.S.C. § 824d et seq. (the statute (1) requires public utilities to provide regular rate schedules and contracts that may affect the rates; (2) provides FERC specific authority to approve rate changes and temporarily suspend rate changes at its discretion; and (3) authorizes FERC, in examining rates, to review whether utilities are efficiently using resources).
[14] *Yakus v. U.S.*, 321 U.S. at 420 (quoting the purposes of the Act).

FERC acted only after U.S. residents had already experienced power outages, a much more significant concern than merchants being unhappy with the price paid for accepting debit cards. Further, FERC had already determined that the market was not functioning. Finally, the statutory scheme provides FERC clear authority to closely oversee rates. Utilities are required to submit proposed rate increases to FERC. The Commission then has the authority to suspend operation of the proposed rate increases subject to a hearing where the Commission determines whether the higher rates are appropriate.[15]

Debit card interchange fees are not of the same significance as the national defense or access to electricity. The Board has not determined that the market is not functioning, and the statutory scheme provides the Board considerably less authority than FERC possesses in regards to regulating utility rates and prices. Certainly, these two examples are not dispositive of the issue. Nonetheless, national defense and ensuring access to an important public utility in a malfunctioning market are prototypical examples that arguably warrant using a tool as extreme as price caps. It does not follow that capping debit interchange fees is necessary in a market involving multiple networks, thousands of issuers and millions of U.S. consumers. Price caps are a tool seldom used because economists agree that they often do not work and, instead create new, unintended consequences.[16] Had Congress wished the Board to employ this extraordinary measure, it could - and presumably would - have clearly said as much. Given that the statute does not explicitly require price caps and that there are no extenuating circumstances that might warrant employing such a powerful tool, the Board should not implement the proposed debit card interchange fee cap.

2. <u>The Board's Cost Calculation is Unreasonably Low.</u>

Even if it is appropriate for the Board to set hard price caps, the cap should not have been set at a level so low that it fails to cover all of the costs associated with operating a debit card portfolio. First, the Board chose not to consider several legitimate costs associated with issuing debit cards. Then, after discounting several costs from the fee structure, the Board set the rate at a level that fails to compensate issuers even for the small number of costs the Board did include in the fee structure.

The Board, somewhat inexplicably, determined to consider only a very small range of costs in proposing the two potential interchange fees. To be clear, the Board did explain that in determining to include only costs associated with authorization, clearance and settlement, it examined the similarities and differences between debit cards and checks and chose not consider "costs that a payor's bank in a check transaction would not recoup through fees from the payee's bank."[17] However, the Board's rationale for allowable costs taken together with its cost

[15] 16 U.S.C. § 824d(d), (e).
[16] Hugh Rockoff, Price Controls, The Concise Encyclopedia of Economics, *available at* http://www.econlib.org/library/Enc/PriceControls.html (stating, "Despite the frequent use of price controls…economists are generally opposed to them, except perhaps for very brief periods during emergencies. In a survey published in 1992, 76.3 percent of the economists surveyed agreed with the statement: 'A ceiling on rents reduces the quality and quantity of housing available.' A further 16.6 percent agreed with qualifications, and only 6.5 percent disagreed. The results were similar when the economists were asked about general controls.").
[17] 75 Fed. Reg. at 81,735.

measurement, do not lead to a reasonable result. In examining the similarities and differences between checks and debit card transactions, the Board made virtually no mention of the benefits that debit cards provide merchants vis-à-vis checks - such as prompt, guaranteed payment - or the considerable capital invested by the networks and issuers to ensure the debit card system functions properly. The Board failed to include network switch fees, despite the fact that issuers are required to pay a switch fee on each debit transaction.[18] The Board also chose not to include other costs such as customer service costs.[19] Tellingly, the Board acknowledges that its cost measurement does not include fixed costs that are specific to debit card transactions.[20] It simply cannot be that a reasonable interchange fee is one which, by the Board's own estimation, does not include several of the costs *absolutely necessary* to operate a debit card program.

The problem created by the decision not to consider several permissible costs is compounded by the Board's interpretation of what constitutes a "reasonable and proportional" interchange fee. The Board interpreted "reasonable and proportional" to mean "equal to" the allowed costs. This interpretation ignores a bedrock principle of statutory construction; namely that each word matters.[21] Had Congress intended for the Board to set the interchange rate at a level "equal to" the costs, it could have easily used those words. While the phrase "reasonable and proportional" is clearly ambiguous, the Board's interpretation is not a reasonable reading of the term.

The Board's determination of allowable costs and its cost measurement result in allowable costs that are far below the actual per transaction cost. Further, the Board's interpretation of "reasonable and proportional" is itself unreasonable, and ignores fundamental rules of statutory construction. It simply is not reasonable to set the fee at a level that fails to adequately reflect actual costs and then, fails again, to compensate issuers for even the limited number of costs the Board did consider.

It is with the above thoughts in mind that NAFCU recommends that the Board allow recovery through interchange of other costs. Specifically, the following costs should be included by the Board in establishing standards for determining what constitutes a "reasonable and proportional" debit interchange fee.

- Network switch fees;
- Data security controls and procedures;
- Ongoing maintenance, monitoring, review and technical upgrades of card systems;
- Hardware;
- Software;
- Personnel;

[18] *Id.* at 81,735.
[19] *Id.*
[20] *Id.* at 81,736.
[21] *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) quoting *Duncan v. Walker*, 533 U. S. 167, 174 (2001) ("It is 'a cardinal principle of statutory construction' that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.'").

- Qualifying members for a card through ChexSystems or similar providers;
- Card issuance costs, such as producing, mailing and activating new debit cards;
- Creating a PIN number and mailing separate confirmation of the PIN;
- Bank Identification Number (BIN) management costs;
- Administrative and production activities related to processing transactions, including authorization, settlement and posting to cardholder accounts;
- Error resolution services;
- Insurance premiums;
- Insurance deductibles;
- Fraud and risk management tools; and
- Processing claims, including fraud and non-fraud disputes, chargebacks and copy retrieval requests.

To the extent that the Board determines any of the costs related to fraud should not be included in the fraud adjustment, NAFCU urges the Board to instead include those costs in the base interchange fee.

Including all or some of these costs in the debit card interchange fee will more accurately represent the actual cost incurred by issuers in processing debit card transactions. Further, most if not all of these costs arguably fall within the scope of costs which the Board, in the proposal, indicated would be permissible, but which it ultimately chose not to include.

3. The Proposed Cap is so Low that it risks violating the Takings Clause of the Fifth Amendment.

The Board's proposed price cap raises serious constitutional concerns under the Fifth Amendment's Takings Clause. The Fifth Amendment guarantees that no person will be deprived of property without due process.[22] The U.S. Supreme Court has interpreted the clause to protect private companies against price caps that do not guarantee a fair and reasonable return.[23] By the Board's own estimation the proposed debit card interchange rate of 12 cents fails to cover the allowed costs of twenty percent of covered issuers.[24] Further, the Board also acknowledged that the proposed rate fails to include all costs associated with processing debit card transactions.[25] On the face of the regulation, the more reasonable proposal still (1) fails to consider all of the costs associated with operating a debit card program; and (2) fails, even after ignoring several costs, to fairly compensate twenty percent of issuers for the cost of processing a transaction.

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[22] U.S. CONST. amend. V.

[23] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (holding that government imposed rates must be sufficient to provide "enough revenue not only for operating expenses but also for the capital costs of the business.").

[24] 75 Fed. Reg. at 81,737.

[25] *Id.* at 81,734 (stating, "After considering several options for the costs that may be taken into account in setting interchange transaction fees ('allowable costs') the Board" limited such costs "to those associated with authorization, clearing and settlement of a transaction." *Id.* at 81,736. The Board also acknowledged the rate does "*not* consider costs that are common to all debit card transactions and could never be attributed to any *particular* transaction (i.e., fixed costs), even if those costs are specific to debit card transactions as a whole." *Id. at 81,737.*) (emphasis in original).

Meanwhile, the lower of the two proposed rates would fail to cover the allowable costs, much less the actual costs, for a full fifty percent of debit card issuers.

The Board's reasoning is deficient for five different reasons. First, the differences between public utilities and debit card issuers, referenced by the Board, strengthen the argument that issuers are entitled to a fair and reasonable return. Second, the fair and reasonable return rule has been applied in cases that did not involve public utilities. Third, the Board ignores its obligation to avoid creating constitutional issues. Fourth the Board ignores precedent that a company cannot be forced to carry out part of its operation at a loss. Fifth, even absent the four above issues, the ultimate result of the proposal will be increased costs to consumers and thus there will be little, if any, actual benefit.

The Board seemingly dismissed the requirement for a fair and reasonable return, distinguishing that precedent because it applies, according to the Board, only to public utilities.[26] This distinction is all the more unusual, given that the statutory langue in *Hope Natural Gas*, which the Board discusses, requires a "just and reasonable" rate[27] that is very similar to the "reasonable and proportional" fee required by § 920. Nonetheless, the Board states the similarities between § 920 and the public utility cases are limited and that, consequently, the Court's precedent in *Hope Natural Gas* is of little significance in this context. Specifically, the Board distinguished public utilities from debit card issuers because the former are required to provide services while the latter are not, and because debit card issuers presumably have sources, besides interchange fees, which can be used to earn revenue and pay for the costs of operation.[28]

The distinction between public utilities and debit card issuers, however, actually supports the argument for a constitutionally guaranteed fair and reasonable return in this context. Transmitting and selling power is "affected with a public interest" and thus subject to robust federal oversight to protect that interest.[29] Given the importance of ensuring the nation has reliable, affordable access to energy, the government has a much more significant interest in regulating the market and ensuring power can be distributed even if the returns on the investment are extremely small. The debit card system is important, but certainly not as vital as the power grid. Accordingly, there is significantly less rationale for the government imposing price caps that fail to even cover the costs of operating the system. Further, the primary parties in the energy market are the companies that produce and distribute energy and the consumers who use it. By contrast, the primary parties affected by interchange fees are card issuers and the merchants, ranging from simple and small proprietorships to large and complex multinational companies, which pay the interchange fees. Certainly, the merchants that pay for the benefit of accepting debit cards do not require the same sort of protection - in the form of government price caps - as individual citizens that wish to have reliable, affordable access to power. In conclusion, the Board's distinction between public utilities and debit card issuers strengthens the argument that debit card issuers are entitled to a fair and reasonable return on their investment.

[26] *Id.* at 81,733, n. 44.
[27] 16 U.S.C. 824d(a).
[28] *See* n. 22.
[29] 16 U.S.C. § 824(a).

Next, the Board seems to indicate that the fair and reasonable return test is not applicable here because it has been applied only in the context of public utilities.[30] However, the test has been applied by the courts in several other contexts. Specifically, some version of the rule has been applied to railroads, insurance companies, and landlords.[31] Thus, the distinction made by the Board misses the point entirely. Regardless of whether debit card issuers are public utilities, they are still entitled to a fair and reasonable return. This seems particularly true given the similarities in the statutory language at issue here and in *Hope Natural Gas*.

Next, the Board should reconsider the interchange rate because it raises serious constitutional issues, which should be avoided if possible. This principle was articulated by the Supreme Court, when it ruled that "[w]hen the validity of an act of the Congress is drawn in question, and even if a serious doubt of constitutionality is raised, it is a cardinal principle that this Court will first ascertain whether a construction of the statute is fairly possible by which the question may be avoided."[32] The proposed rate cap does raise serious Constitutional issues as there is significant case law for the proposition that companies are constitutionally entitled to a return on their investment.[33] Further, the Board itself acknowledges that the proposed interchange fee rate does not include all costs associated with operating a debit card program and that the rate is not sufficient to cover costs for twenty percent of issuers, even when considering the relatively small number of "allowed costs."[34] Accordingly, the Board should revise its proposal to either eliminate the proposed price caps altogether or to set the interchange fee at a level that is not so low that it prohibits issuers from earning a return on their investment.

The Board, in stating that issuers may compensate for the decreased interchange revenue by charging more elsewhere ignores Supreme Court precedent to the contrary. In a case involving state rate-setting authority, the Court found that the state of North Dakota could not, "set apart a commodity or a special class of traffic and impose upon it any rate it pleases, provided only that the return for the entire intrastate business is adequate."[35] In much the same way, the Board cannot require debit card issuers to operate a debit card program at a loss simply because it is possible that issuers could make up that lost income in another line of business. Much more recently, the Sixth Circuit held the same, finding, "although the plaintiffs have other unregulated income streams, they are not required to subsidize their regulated services with income from…unregulated services."[36] It is simply not enough to say that debit card issuers may be able to recover their costs through charging other customers or by increasing revenue in other lines of business.

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[30] *See* n. 22.
[31] *B. & O.R. Co. v. United States*, 345 U.S. 146, 150 (1953) (finding "so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates…."); *New Jersey Ass'n of Health Plans v. Farmer*, 777 A.2d 385, 395 (N.J. Super. Ct. 2000) (finding a rate that does not provide a fair and reasonable return would raise serious constitutional issues.) (quoting *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 350 A.2d 1 (1975)); and *Morgan v. City of Chino*, 9 Cal. Rptr. 3d 784, 788-789 (Cal. Ct. App. 2004) (finding price controls may not "deprive investors of a fair return on their investment.").
[32] *Crowell v. Benson*, 285 U.S. 22, 62(1932) (favorably citing six other cases that stand for the same proposition).
[33] *See n. 22.*
[34] 75 Fed. Reg. at 81,737.
[35] *Northern Pacific Ry. Co. v. North Dakota*, 236 U.S. 585, 600 (1915).
[36] *Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 594 (6th Cir. 2001).

Finally, if institutions are forced to offset the losses on their debit card programs elsewhere, the most logical solution is to begin charging customers for checking accounts generally and for using debit cards specifically. Alternatively, issuers may reduce the service and overall support provided to debit card users. Proponents of debit card price caps have argued those increased costs would be offset by lower prices for consumer goods. However, the Government Accounting Office (GAO) reported that officials in Australia, which did cap interchange prices, stated there is no "conclusive evidence" that merchants' savings were passed on to consumers in the form of lower prices.[37] Consequently, the proposed rule is seemingly at odds with the intent of the Electronic Fund Transfer Act, which states its "primary objective" is the provision of individual consumer rights.[38] Instead, this rule will lead to consumers paying fees for a previously free service without any guarantee of a corresponding drop in prices.

In conclusion, the Board should reconsider its decision to implement price caps for debit card interchange fees. Price caps are not required by the statute and the Board's decision to implement price caps will create constitutional issues where none existed previously. If the Board is intent on implementing price caps, however, the fee should include all costs associated with operating debit card programs that are not explicitly prohibited by § 920. NAFCU opposes any price cap for debit card interchange fees, nonetheless, increasing the fee to more accurately reflect the true costs associated with operating a debit card program would, at the least, improve the proposed rule.

II. Fraud Adjustment

NAFCU is also concerned with the proposal as it relates to the fraud adjustment. NAFCU supports the non-prescriptive approach for the fraud adjustment. Moreover, the Board should implement a fraud adjustment when it approves its final rule on interchange fees. NAFCU understands that more research on this issue may be useful; nonetheless, it is imperative that issuers receive the fraud adjustment in tandem with any capped interchange fee.

A non-prescriptive approach is superior to a technology-specific approach. A prescriptive approach would stifle innovation in an area that *must* respond quickly and dynamically to new threats. Some basic anti-fraud technologies change little over time. Other technologies, however, are a result of a never-ending chess match pitting issuers, networks and consumers against increasingly sophisticated criminals. Many of the anti-fraud technologies in place today are a direct response to complex new criminal attempts to commit fraud. A prescriptive approach would discourage issuers, networks and third parties from developing sophisticated new technologies to combat fraud. Issuers obviously have an interest in any cost-effective anti-fraud technology; nonetheless a requirement that the Board formally approve any new technology would certainly factor into an issuer's calculus when determining whether to move forward. Moreover, third party vendors that currently develop anti-fraud programs but

[37] U.S. GOVERNMENT ACCOUNTING OFFICE, *Credit Cards: Rising Interchange Fees Have Increased Costs for Merchants, But Options for Reducing Fees Pose Challenges* (2009), *available at* http://www.gao.gov/new.items/dl045.pdf.
[38] 15 U.S.C. § 1693(b).

which lack issuers' vested interest in combating fraud may reasonably determine that their resources will be put to better use developing products that do not require government approval. The Board stated that it "would identify the paradigm shifting technology(ies) that would reduce debit card fraud in a cost effective manner" and approve an adjustment for those technologies.[39] However, a prescriptive approach would undoubtedly result in significantly fewer paradigm shifting technologies. Further, the proposal seemingly ignores other technologies that may not have as dramatic an impact but that still successfully combat fraud in a cost-effective manner.

If the Board ultimately chooses a non-prescriptive approach, NAFCU recommends the framework that it implements for examining anti-fraud measures be as flexible as possible for all of the reasons discussed above. If the Board adopts a rigid approach it will have a direct, negative impact on innovation in an area that demands constant change.

The Board should permit issuers to recoup the entire cost of any anti-fraud measures, rather than simply a percentage of the costs. As the Board indicated, issuers bear the majority of the costs associated with fraud losses.[40] However, direct fraud losses are only a small portion of the overall costs associated with combating fraud. First, issuers already spend a considerable amount of money on anti-fraud technology. Issuers pay insurance premiums to minimize out of pocket expenses when fraud occurs. Issuers devote a considerable amount of time and money towards responding to instances of fraud, including employee time dealing with the customer, processing claims, chargebacks and copy retrieval requests, and card and PIN reissuance costs. At least some of these costs appear not to be included in the Board's discussion of the fraud related losses borne by issuers and merchants.[41] These costs, however, are substantial. Moreover, the networks' liberal payment policy benefits merchants who are guaranteed payment in most cases where they follow network rules. Finally, given that the proposed interchange fee cap does not cover all allowable costs, let alone fixed costs, the fraud adjustment is the most logical avenue for ensuring issuers' have the ability to cover their fraud related costs.

The Board indicated it does not plan to implement a fraud adjustment at the same time that it finalizes its interchange fee rule.[42] This planned approach is unnecessary and also contrary to the clear direction of § 920 which instructs the Board to implement standards for assessing the interchange fee and the fraud adjustment within nine months after passage of the Dodd-Frank Act.[43] Accordingly, the Board should adopt a fraud adjustment fee if or when it adopts a final regulation implementing the "reasonable and proportional" requirement.

The Board may implement a fraud adjustment fee with the information it currently has at its disposal. The interchange survey was distributed to all issuers directly affected by the rule as well as networks and merchant acquirers.[44] The information included in the survey was, presumably, sufficient to guide the Board in setting an interchange fee cap. Consequently, it seems unusual that the Board does not have enough information to set the fraud adjustment.

[39] 75 Fed. Reg. at 81,742.
[40] *Id.* at 81,741.
[41] *Id.*
[42] *Id.* at 81,740.
[43] § 920(a)(3)(A), (a)(5)(B).
[44] 75 Fed. Reg. at 81,724.

While NAFCU understands the Board's desire to properly calculate the adjustment, there is nothing in the statute that prevents the Board from implementing an interim fraud adjustment fee that it can increase or decrease upon further study.

More importantly, the Board's decision to implement an interchange fee cap and the fraud adjustment independent of each other is in clear disregard of the statutory mandate, already discussed above, that both rates be finalized by the Board within nine months after passage of the Dodd-Frank Act. Under the familiar *Chevron* analysis, courts defer to agency interpretations of a statute provided (1) the statute is ambiguous or silent to the issue and (2) the agency's interpretation is reasonable.[45] Here, the Board's interpretation would not even satisfy the first prong of *Chevron*. The intent of Congress is not ambiguous. Quite the opposite, Congress could not have been any clearer in its instruction to the Board to set both an interchange fee rate and a fraud adjustment within nine months after passage of the Dodd-Frank Act. The subsection describing the fraud adjustment immediately follows the subsection dealing with the interchange fee itself and is every bit as detailed. Assuming Congress really did intend for the Board to implement price caps based on an admittedly small universe of total costs, it stands to reason that Congress, at the very least, intended for those caps to be implemented hand-in-hand with the fraud adjustment. Indeed, Congress thought the fraud adjustment was so important that it is the sole cost explicitly referenced in the entire amendment.

The Board acknowledges the proposed interchange fee does not consider several costs associated with processing debit card transactions. The Board also acknowledges that even within the smaller universe of "allowed costs" several issuers directly impacted by the rule will be unable to recoup their own costs on each transaction. Given the low interchange fee the Board proposed, the considerable information the Board already has regarding fraud costs, and Congress' clear directive to implement the interchange fee and fraud adjustment simultaneously, the Board should adopt a fraud adjustment fee at the same time that it adopts a final rule on the base interchange fee.

III. Network Exclusivity and Routing Restrictions

NAFCU is equally concerned with the routing and network exclusivity provisions which will affect all debit card issuers regardless of size. NAFCU supports Alternative A, which would require that debit cards have the capability to route transactions over two unaffiliated networks. This option is superior to Alternative B, requiring four unaffiliated networks, because of technical concerns and the cost that would be associated with Alternative B.

Alternative B is currently not technologically feasible. Under this alternative, debit cards must have the capability to process transactions over two unaffiliated signature networks and two unaffiliated personal identification number (PIN) networks. However, debit card transactions currently cannot be processed over multiple signature networks. Further, the Board acknowledged that it may be unfeasible to develop such technology in the "near term."[46] Alternative A is feasible, though still potentially costly. Further, nothing in the statute can be

[45] *Chevron U.S.A. v. NRDC*, 467 U.S. 837, 842–843.
[46] 75 Fed. Reg. at 81,749.

interpreted to require Alternative B. It would be unreasonable for the Board to mandate technology that does not yet exist. This is particularly true when nothing in the statute can be read as requiring such a mandate.

Alternative A will be significantly less costly. Understandably, the cost to the industry is not the Board's primary concern; nonetheless, mandating four unaffiliated networks on each debit card would be extremely costly. The Board itself said,

> "enabling multiple signature debit networks on a debit card could require the replacement or reprogramming of millions of merchant terminals as well as substantial changes to software and hardware for networks, issuers, acquirers, and processors in order to build the necessary systems capability to support multiple signature debit networks for a particular debit card transaction."[47]

While closely related to the feasibility concerns mentioned above, these sorts of wholesale changes to transaction routing will be extremely expensive for all parties involved. The capital costs required by the networks to build these systems will obviously be recouped by higher fees levied on issuers and others that use the system, which brings into question whether there will be any real benefit. Moreover, issuers will have significantly higher reoccurring expenses if they are required to provide debit cards capable of routing transactions over four networks, as opposed to one or two, as is often the case today. Issuers also have legitimate business reasons for limiting transactions to one or two networks, such as simplifying the processing system and consequently minimizing costs. Requiring debit cards to carry four networks will complicate the process and also add new costs. The Board should adopt Alternative A as Alternative B is currently not feasible and by the Board's own estimation would only be feasible at some future date and only at *considerable* expense.

IV. <u>The Board Failed to Meet its Obligations under EFTA.</u>

The Board did not satisfy its responsibilities under EFTA because it failed to consult with other federal financial regulators as required by the Act. Specifically, the EFTA states the Board "shall" consult with other federal financial regulators to ensure the continued evolution of the electronic banking system.[48] However, absolutely nothing in the proposed rule indicates the Board consulted with other agencies. Further, nothing on the Board's website disclosing meetings and communications regarding this rulemaking indicate any consultation with other regulators.[49] It is clear the Board did not carry out its statutory obligation to meet with other regulators regarding this rulemaking.

The Board failed to fully consider the economic impact, costs and benefits to financial institutions, and it also failed to consider the effect of the rule upon competition between small

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[47] *Id.*
[48] 15 U.S.C. § 1693b(a)(1).
[49] The Federal Reserve, Regulatory Reform Communications with the Public, *available at* http://www.federalreserve.gov/newsevents/reform_interchange.htm

and large financial institutions as required by EFTA.[50] There is no indication that the Board conducted any thorough economic analysis of the costs and benefits to financial institutions and consumers, despite the rule's direct and indirect impact on every single debit card issuer in the nation as well as every debit card issuer.

Moreover, the Board refused to consider the likely impact of the rule on smaller institutions and the competitive consequences, as required by the Act. The Board's inattention to smaller institutions is particularly troubling given that both the EFTA and the interchange amendment, through the small issuer carve-out,[51] explicitly single out smaller institutions for protection. The Board refused to consider the likely consequences of the price caps on smaller institutions and failed to meet with smaller issuers on that matter. However, at the December 16 Board meeting, Federal Reserve staff acknowledged that the price caps may ultimately trickle down to all institutions, regardless of whether they qualify for the small issuer exception. The proposed rule fails to account for, much less implement the small issuer carve-out, which Congress clearly included in order to protect smaller issuers from the statute's pricing provisions.

The EFTA clearly requires the Board to consult with other regulators on rules promulgated pursuant to the Act. The EFTA specifically directs the Board to consider the impact of its rules on smaller institutions and the interchange amendment also explicitly directs the Board to take steps to protect smaller issuer from the rule's most onerous provisions. The Board, however, failed to meet any of these duties. The Board should postpone finalizing this rule until after it has carried out its statutory duty to consult other agencies and until such time that it has fully assessed the impact of the rule on small issuers.

V. <u>Small Issuer Exemption</u>

Finally, the Board's determination not to consider, much less implement, the small issuer exemption will create a perverse result where the small issuers that were singled out for protection under the statute will instead suffer the greatest harm. The statute intended for the Board to regulate rates only for issuers with more than $10 billion in assets. The Board's proposed interchange fee rates are, in turn, based on survey results from eighty-nine of the nation's largest debit card issuers.[52] However, as the entire financial services industry predicted, there is an increasing likelihood that the capped rates will ultimately become the industry standard. Consequently, small issuers will likely receive the lower interchange rate, even though that rate is based on results from the nation's largest issuers which, presumably, have a much lower per transaction cost.

Throughout the rulemaking process, the Board refused to consider the costs for small issuers. The Board's issuer survey was sent only to the 131 institutions that had more than $10 billion in assets.[53] No corresponding survey was conducted for issuers with less than $10 billion in assets. It is beyond question that the Board's proposed interchange rates are based solely on

[50] 15 U.S.C. § 1693b(a)(2).
[51] § 920(a)(6).
[52] 75 Fed. Reg. at 81,724-725.
[53] *Id.*

the results it gathered from institutions with more than $10 billion in assets.[54] The Board's determination to ignore the costs of smaller institutions is unreasonable in light of the fact that the Board simultaneously chose not to take steps to implement the small issuer exemption.

As discussed above, § 920 explicitly includes an exemption for small issuers with less than $10 billion in assets.[55] The intent of the exception was to ensure that small issuers would receive the same interchange rate they currently receive even if the Board's rulemaking impacted interchange rates for issuers with more than $10 billion in assets. The rule contains an exemption for small issuers from the lower interchange rates; however, there is no assurance that the exception will actually protect small issuers. That is to say, the card networks that set interchange fee rates are free, under the proposed rule, to set the interchange rate for small issuers at the same level that the Board requires for large issuers, thereby eviscerating the exception. During the debate on the Durbin amendment, NAFCU stated that the small issuer exemption was unworkable and would provide no protection. Consequently, I understand that the Board itself had no real option other than to execute a very flawed and unworkable provision. Nonetheless, that reality is of little solace to the credit unions and other small institutions that will suffer at the hands of a provision intended to protect them.

The Board's decision not to consider small issuers' costs, and the lack of any practical method for enforcing the small issuer exception create a result at clear odds with the intent § 920. On the one hand, small issuers will likely ultimately receive the lower, capped interchange rate. On the other hand, that rate will be twice as difficult for small issuers to manage because the fee is based not on their own costs but on costs of larger, more complex institutions with better economies of scale. Thus, the small issuer exception, which singled out issuers with less than $10 billion for protection will, instead, place small issuers at a significant competitive disadvantage, compared to large issuers. However rational the Board's individual decisions might appear when viewed in isolation; taken together they generate a completely irrational result.

VI. Conclusion

First and foremost, the Board's proposed price caps are unreasonably low, fail to consider all of the costs associated with operating a debit card program and raise serious constitutional concerns. The Board should revise its proposal and eliminate the price caps altogether in favor of a more generalized standard for assessing whether fees are reasonable and proportional. Alternatively, the Board should, at the very least, reconsider the "allowable costs" in order to ensure the interchange fee rates more accurately reflect the actual costs involved in operating a debit card program. Regarding the fraud adjustment, NAFCU supports the non-prescriptive approach as the alternative will undoubtedly stifle innovation in an area that thrives on dynamic and creative responses to an ever-changing threat. NAFCU prefers the Board's proposal to require only two unaffiliated networks on debit cards, though neither of the two options is desirable. As required by the EFTA, the Board should consult with other federal regulators, more thoroughly consider the consequences of this rule on small debit card issuers, and revise

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[54] *Id.* at 81,724-726, 81,737-738
[55] § 920(a)(6).

the rule as necessary. Finally, the Board should reconsider the interchange fee as well as its decision to ignore the costs of small issuers when setting the fee. The logical consequence of the Board's rulemaking is a competitive disadvantage for small issuers, a result that Congress specifically sought to avoid.

NAFCU appreciates the opportunity to share our thoughts on the proposal. Should you have any questions or require additional information please call me or Carrie Hunt, NAFCU's General Counsel and Vice President of Regulatory Affairs at (703) 842-2234.

Sincerely,

Fred R. Becker, Jr.
President/CEO