August 11, 2021

Ms. Ann E. Misback, Secretary
Email: regs.comments@federalreserve.gov
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20511

Re: Docket No. R-1748, RIN 7100-AG15 – Comments from Target on Debit Card Interchange Fees and Routing NPRM

Target appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System on the proposed rulemaking which would clarify the requirements of Regulation II and its Official Commentary with regard to debit transaction routing. We strongly support clarification of the regulation to confirm that technology may not be deployed to inhibit merchants' right to routing choice for all transactions, including e-commerce transactions. Non-compliance with regulatory requirements to date has resulted in increased merchant costs and effectively stifled alternatives to the large networks in this significant and growing segment of payment transactions.

Target is a general merchandise retailer with over 1900 stores in all 50 U.S. states and the District of Columbia. We employ more than 350,000 team members, from our Minneapolis headquarters to our distribution centers and stores. About 75% of the U.S. population lives within ten miles of a Target store. We serve millions of guests every year in our stores and digital channels, giving us both experience and perspective regarding the payments landscape.

In the ten years since implementation of the debit routing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Target has been able to avail itself of up to a dozen different networks to route debit transactions in our stores. However, despite the clear requirements of Regulation II, Target has struggled with the lack of competition in e-commerce routing.

"E-commerce" includes all transactions where payment is made online, whether the purchase is completed by shipment to the guest's home or in person such as by in-store order pickup, curbside, or same-day delivery. As consumer shopping patterns have evolved, 2019 marked the sixth consecutive year in which Target's e-commerce sales grew more than 25 percent, and digital sales

have increased at least 25 percent quarter-over-quarter in each of the past four years. In 2020 alone, our e-commerce sales increased 145 percent. Given the durability of consumer behavior as guests have become accustomed to shopping in the manner that is most convenient for them, and with approximately half of our guests paying by debit card, achieving competition in e-commerce debit routing is even more critical than it was ten years ago.

**Target supports routing choice in e-commerce**

Target strongly supports the Federal Reserve's proposal to clarify and reinforce the requirement that debit card issuers and networks enable merchant routing choice for all transactions, including e-commerce transactions. Our view is that the duty of debit card issuers and networks is clear in the existing regulation – merchant routing choice for e-commerce transactions was possible in 2011 when the regulation was implemented, and card network solutions have evolved substantially since then. And yet, while some smaller banks have complied with the regulation and enabled routing choice in e-commerce, many of the largest banks have simply ignored their obligation. Paradoxically, those large banks are highly capable and in the best position to enable routing choice in e-commerce. All of this leads us to the conclusion that the main issue has been the lack of enforcement of the existing regulation against large banks, who have been protecting their financial interests at the expense of merchants and in violation of the law for over a decade. We welcome the Federal Reserve's proposal, and view it as an important step toward enforcing the regulation. Providing this clarification signals that the Federal Reserve will not tolerate policies or practices that deny merchants' routing choice. We also agree with the Federal Reserve's analysis concluding that no new costs, burdens or impacts on small entities are created by the proposal, as it is simply clarifying obligations that already exist.

**Each transaction should offer routing choice without regard to the method of authentication**

Target encourages the Federal Reserve to clarify that issuers must enable at least two unaffiliated networks for each method of cardholder authentication if they cannot otherwise satisfy the dual-network requirement for each transaction. Issuers and networks have regarded the "one network per authentication method" loophole as a broad exception to the two-network requirement which they have exploited to undermine merchants' routing options. This is in fact the principal reason for the lack of routing choice in e-commerce to date.

The notion that routing choice can be represented by a single network for signature and a single network for PIN authentication harkens back to the market as it existed when Regulation II was enacted. At that time, most transactions were "card-present," there were two methods for authentication, and as long as a merchant had the technology to accept both signature and PIN authentication at point of sale, the merchant had two or more network choices for each debit transaction.

The market for debit card payments and the technology for payment processing have changed dramatically over the last ten years, including with respect to authentication. In fact, a signature is no longer required for "card present" transactions and the card networks acknowledge that

signatures never provided an effective, systematic means of authentication as constructed. Meanwhile, over 99% of the PIN debit transactions in our stores have more than one unaffiliated PIN network to choose from. Where PIN authentication is available, the regulation has achieved its objective and the merchant has true routing choice.

In e-commerce, PIN entry solutions were not widely adopted, so the unaffiliated networks have developed alternative authentication solutions. However, many issuers have deliberately chosen not to enable the PIN-less debit solutions offered by the alternate networks on their cards, leaving merchants with no choice but the global networks to process most e-commerce transactions. Without broad issuer enablement, PIN-less debit solutions are of limited value to merchants, thereby inhibiting merchants from undertaking the development required to accept PIN-less e-commerce transactions.

It should be so obvious as to go without saying that an issuer cannot meet its obligation to provide "at least two unaffiliated networks on which a debit transaction may be processed" by simply entering into an arrangement with two networks that *theoretically* could process transactions on the card. Merchants must *actually* be able to process transactions through *each* of the networks selected by the issuer. For that to happen, the issuer must fully enable the functionality of each network it selects. To read the requirement otherwise would permit issuers to defeat the intent of the statute by constraining the actual availability of alternative networks for merchant routing choice.

The global networks and their issuers have also relied on the authentication loophole to enable only one network for more recently developed means of authentication, such as biometrics, without enabling an alternative authentication method so that the merchant can choose a different network. For example, in device-based wallets like ApplePay, biometrics authenticate the cardholder to the device, and Visa and Mastercard can include that authentication in the message requesting authorization from the issuing bank. However, the second network on the card is not allowed to pass the biometric authentication message to the issuer. When the issuer does not receive authentication information from the second unaffiliated network, it evaluates the risk of the transaction as if there had been no authentication at all, which is untrue. In fact, sophisticated biometric authentication has occurred. An unauthenticated transaction is much more likely to be declined. As a result, merchants are effectively forced to route to the network that can communicate the authentication message to the issuer.

We believe the authentication information issuers receive in order to make a decision to approve or decline a transaction should not depend on which network the merchant chooses to process the transaction. The alternative network is enabled to access and transmit the account number and other transaction data. We are not aware of any technical limitation that would prevent the communication of the authentication information as well to any network otherwise enabled to process the transaction.

The authentication loophole even has the potential to erode existing merchant routing choice in the card-present environment. For example, merchants currently have the option to route low-

dollar card-present transactions to alternative networks without PIN authentication. Now that the global networks have eliminated their signature requirement, transactions that historically would have been "signature-authenticated" are processed with no authentication. If issuers are only required to provide one network per authentication method, an issuer could decide to enable only Visa or Mastercard to process card-present transactions with no authentication and to require PIN authentication for routing all card-present transactions to the alternative network.

Similarly, an issuer could enable only Visa or Mastercard to convey authentication verification in a contactless/touchless mobile transaction at point of sale while requiring a PIN to authenticate the transaction through the alternative network. The merchant is thereby required to demand physical interaction by the cardholder with the point of sale device to preserve its statutory right to routing choice. It should hardly need to be said that safety and security should be widely enabled, not deployed strategically as a differentiator between networks in order to quell competition and impede merchant choice.

**The Federal Reserve should substantially reduce the regulated rate and eliminate the additional fees.**

The current proposal does not address the debit interchange rate provisions of Regulation II. Target encourages the Board to take up this issue with a sense of urgency. The rate has not been adjusted since it was established in 2011, and there is ample data to support a reduction effective immediately. The most recent Federal Reserve biennial report[1] clearly illustrates that the base debit interchange fee standard needs at least to be halved to maintain the statutory requirement that the rate be reasonable and proportional to the issuer's transaction costs.

The 2019 report documents the continued trend in consistently declining actual costs for issuers. In the summer of 2020, based on the then-available eight years of Federal Reserve survey data, Target joined with more than 200 retailers and merchant trade associations to ask the Federal Reserve to reduce the base component of the regulated rate by at least 50 percent and eliminate the fraud component and fraud adjustment. Target does not consider the base component to be "reasonable" or "proportional" when it pays issuers almost over five times their aggregate allowable cost, over and above the separate value issuers receive from accounts and customer activity, including deposits. Nor is it "fair, proper or moderate" that the base component alone fully reimburses issuers' costs on over 99.4% of transactions, even for the least efficient institutions. The Federal Reserve should reset the base component of the cap to be not more than the original multiple of 2.7 times the average allowable costs. Based on the 2017 and 2019 issuer surveys, this would reduce the base component from $0.21 to about $0.10.

Target continues to believe that the Federal Reserve should also eliminate the 5bps ad valorem fraud component of the debit interchange fee. The most effective way to accomplish an overall reduction in fraud is to make sure all parties have an incentive to combat fraud. The ad valorem

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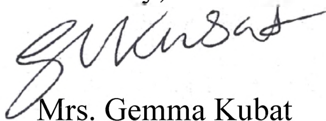
[1] Federal Reserve 2019 biennial report on Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions

component has proven antithetical to this objective. The Federal Reserve's theory was that issuers would have an incentive to reduce fraud losses even though they are reimbursed by a static ad valorem component. In fact, the incidence of fraud on covered transactions has more than doubled since the ad valorem component was implemented, rising from 3 basis points in 2011 to 7.8 basis points in 2019. Meanwhile, industry changes have significantly reduced the share of fraud losses borne by issuers, which has fallen from 60% in 2011 to 35% in 2019. Merchants are now incurring a greater proportion of the cost directly while also reimbursing issuers at an inflated rate. It is past time for the Federal Reserve to consider a different approach. The market has changed for both issuers and merchants. Fraud loss and fraud prevention are a shared burden in practice, and we submit that it is objectively unfair to require that merchants reimburse issuers for fraud losses.

Target also continues to believe that the Federal Reserve should eliminate the $0.01 per transaction fraud prevention adjustment. It is apparent from the data that neither the ad valorem component nor the fraud-prevention adjustment serves as an incentive for issuers to reduce fraud. Both are merely additional elements of the amount merchants are charged by covered issuers for electronic debit transactions. Merchants are spending an increasing amount on fraud prevention and data security while bearing the bulk of fraud losses. The fraud-prevention adjustment, like the ad valorem rate, is based on an outdated assessment of both fraud exposure and fraud prevention activity, and it too should be eliminated.

In closing, Target strongly supports the proposed rule and further encourages the Federal Reserve to take additional steps to lower the base interchange fee standard and eliminate additional fraud related fees. We are also hopeful that the Federal Reserve will vigorously enforce this regulation and bring or encourage actions, as warranted, against card networks and card issuers who attempt to circumvent their legal obligations with regard to debit routing competition. Thank you for consideration of our perspective and experience.

Sincerely,



Mrs. Gemma Kubat
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