National Retail Federation®
The Voice of Retail Worldwide

February 22, 2011

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

RE: Comments of the National Retail Federation in Docket No. R–1404 / RIN No. 7100 AD63 (Debit Card Interchange Fees and Routing)

The National Retail Federation ("NRF") submits these comments pursuant to the Federal Reserve Board's ("the Board's") rulemaking with respect to the Debit Card Interchange proceeding, noticed in the Federal Register on December 28, 2010.

As the world's largest retail trade association, the National Retail Federation's global membership includes retailers of all sizes, formats and channels of distribution as well as chain restaurants and industry partners from the U.S. and more than 45 countries abroad. In the U.S., NRF represents the breadth and diversity of an industry with more than 1.6 million American companies that employ nearly 25 million workers and generated 2010 sales of $2.4 trillion. NRF also is a founding member of the Merchants Payments Coalition ("MPC"), whose comments are being filed contemporaneously with these; NRF is a contributor to those comments, and as such fully endorses and supports them. Given NRF's long involvement in payment issues, and its position as the umbrella association for the retail industry, NRF files these supplemental comments in order to provide a broader perspective for the Board.

As was noted, NRF's members operate not only in the United States but in other nations as well, and thus have familiarity with the debit card operations outside our borders. That knowledge has helped inform these views.

The Board has undertaken this rulemaking at the direction of Congress as set forth in the Dodd-Frank Wall Street Reform Act signed by the President on July 21, 2010. In refining and finalizing the rule it may be helpful to consider some of the factors that led Congress to adopt these provisions. The National Retail Federation, along with other retail, consumer and financial institutions played a significant role in informing the deliberations that preceded adoption of the applicable language ("the Durbin amendment") in the Dodd-Frank legislation.

Liberty Place
325 7th Street NW, Suite 1100
Washington, DC 20004
800.NRF.HOW2 (800.673.4692)
202.783.7971 fax 202.737.2849
www.nrf.com

The existence of interchange fees on debit transactions, and the ability of the two dominant networks to impose them, has been the subject of considerable debate. But it is useful to consider why these fees have engendered such a heated response.

Origins and Success of Debit Cards

It is helpful to recognize that what we call debit cards (also called "check cards" or "plastic checks") were originally known as ATM cards. They allowed a bank customer to withdraw money from his or her deposit account. Regional networks (such as Most, Pulse, Honor or Shazam) served as the "pipes" between the Automated Teller Machine and the vault in the customer's bank. The cards revolutionized banking. Customers could withdraw funds day or night: obtain cash when they needed it.

On a practical level, this advance also increased the options for accessing deposit accounts: consumers could use checks, withdrawal slips or ATM cards. As a result of ATMs' convenience, consumers did not need to withdraw large sums of the money every payday, because funds were more readily available between paydays. Correspondingly, financial institutions did not have the same immediate cash demands. The cards allowed the consumer to essentially write a check for cash at the time they needed it, rather than all at once.

It is useful to consider the context within which this was occurring. As the Board is aware, for nearly a century cash and checks passed at face value (i.e. at-par). In laymen's terms, "a dollar was a dollar" and so was a paper check, because the Federal Reserve eliminated so-called "exchange fees" in 1916.

Since then until the current day, a consumer or a business can present a $100 dollar check to a bank and receive $100 cash in return. That cash can be deposited in yet another bank and the bearer of a check drawn on it will also receive one hundred dollars. The intrinsic underlying value of the currency is maintained. There is no diminution in value.

Prior to that time, the value of checks was subject to reduction. The amount of reduction extracted by what were then called exchange fees was uncertain. The fees acted as friction on the free flow of transactions and related commerce. Viewed from the perspective of parties engaged in a business transaction, competitive margins cannot be fully and efficiently minimized if the value of the payment for the transactions is subject to post-purchase diminution. Accordingly, Congress and the Board moved the nation toward at-par presentment of checks so that checks' value became similar to that of currency.

Policymakers knew that the handling of paper checks was not costless; but they also knew that if everyone involved in the system absorbed his or her own costs, the system ultimately would become more efficient. For example, at one time each paper check cost banks about 45 cents to handle. However policymakers knew that if banks had to absorb that cost, they would have an incentive to reduce the cost of paper check handling – and they did.

Similarly, consumers paid for checking accounts or received free checking if they met certain criteria. Banks advertised, and consumers shopped for accounts, and competition among banks kept their costs down.

Merchants too had costs for handling checks. They might have paid five cents to their bank for each check they deposited – regardless of its face amount. However, because some merchants were depositing thousands of checking items, they had an incentive to shop for a bank that charged less, perhaps as little as two cents per item. Merchants took other steps to control paper check costs. For example, to reduce fraud costs associated with checks, merchants might pay for a check guarantee, or delay shipping merchandise until after a check had cleared.

A little over a generation ago, the regional ATM networks (i.e. "the pipes that connected the banks to the automated teller machines) had a brilliant insight. They realized that if they could convince merchants to put PIN pads in their establishments (similar to the PIN pads on ATMs), they could connect the merchant and its banks to their customers' banks through the same networks. If broadly implemented, there would be less need for customers to carry cash, and an even lesser need for checks. The plastic ATM cards would act like a durable and improved paper check.

For starters, these electronic checks would be very cheap to process. This was a significant advantage for the banks. Consequently, to encourage acceptance of the cards at as many locations as possible, the banks made their ATM cards operational over as many regional networks as practicable (at the time indicated by various trademarks or "bugs" on the front and backs of the cards), so that there would never be a region of the country where a plastic check transaction could not take place. Once a shopper entered her verifying PIN at the store's check out counter, the merchant would route the transaction over whichever of the available networks was best for that merchant.

It is notable that the system continued to operate like a check – even though it was in many ways much improved. Each party continued to absorb its own costs. Transactions essentially cleared at face value, just as did the paper checks the new cards were attempting to replace. A $100 plastic check transaction resulted in $100 cash to the merchant, which the merchant could deposit and later write a $100 paper check against if he wished; and that check was also worth $100 cash. Most significantly, everyone benefited.

1. By offering this service to the banks, the ATM networks were able to save the banks approximately 30 cents on every replaced check transaction. Since the banks were handling millions of checks, that was a *very* significant savings.

2. Because the networks interacted with the consumers' accounts in real time, consumers had near instantaneous access to their account balances. Unlike paper checks, the new plastic checks could be used nationwide; wherever a merchant with a PIN pad was available. This was a significant advance beyond paper checks.

3. Merchants no longer had to bundle their paper checks. They could avoid the two to five cent fee for bundling; and, they no longer had to purchase a check guarantee service. The network intrinsically verified the balance of the consumer's account before approving the transfer. If the funds in the account were insufficient, the transaction was declined. For those transactions approved, the payment guarantee was an inherent byproduct.

Merchants began installing PIN pads in their stores. Indeed, the banks and networks were so excited about this change, were so anxious for merchants to adopt the new technology, that in some cases they began paying merchants approximately five cents per transaction to encourage them to install PIN pads and route the transactions over their networks. For banks, merchants and consumers this was a "win-win-win."

Distortions

Into this nearly Pareto optimal environment came the dominant credit card networks.

Two networks, established as trade associations of banks, controlled most of the credit card market through a combination of restrictive, anticompetitive rules and largely fixed prices. The rules, among which were the "Honor All Cards" and "Non-Discrimination" rules, required merchants who accepted a card from one bank, to accept similarly labeled cards from all other banks, regardless of those banks' location, size, or financial soundness.

The card associations also distributed to their member banks a fee schedule to be assessed against merchants whenever a card was used in a merchant location. Even though there were thousands of competitive banks, each bank charged virtually every merchant exactly the same fee for any merchant/credit card combination. No one merchant was large enough to negotiate against the combined insistence of thousands of banks on a set price. In short, such unyielding and consistent behavior by supposed "competitors" had the earmarks of nationwide price-fixing in the credit card market. That continues to this day. According to the Nilson Report (and other published data), the collective fees extracted from U.S. merchants and their customers for credit card interchange are close to thirty billion dollars a year in fact.

Just as PIN debit was beginning to blossom, one or more of the networks essentially decided that if they could a) convince their member banks to issue debit cards (accessed with a signature rather than a PIN) that were virtually indistinguishable from ubiquitous credit cards; b) convince consumers to not to tell merchants that the new cards were debit cards; c) convince them as well to forego the safer PIN and instead push the "credit" button (so as to route the transaction through the credit card companies' signature-based networks) even though it actually was a debit transaction; that the networks could use their "Honor All Cards" rules to force merchants to accept the transactions as if they were governed by the credit card contracts. The pay-off for the banks was that the merchant was forced by the card company rules to pay a high credit card interchange fees for what previously had been an at-par plastic check transaction. Since this was not transparent (cards generally were not marked as "debit") merchants only learned long after the fact, if then, that they had been charged high credit card fees for debit transactions.

Even had the fees and nature of the cards been transparent, there was little that merchants could do to protect themselves from these high fees or their customers from the escalating prices the cards engendered. As a result of other card company rules, merchants were not allowed to separate or apply the higher fee only on those who chose to use the new, not-at-par cards. As a result of vigorous retail competition, profit margins in the retail and restaurant sectors are

extremely narrow. The only practical option allowed merchants under the credit card company rules is to raise the price of goods and services to all customers in an effort to cover higher fees.

The results have been dramatic. Over the past several years, merchants have seen the cost of formerly "costless" debit transactions rise from zero to nearly $20 billion a year. These fees have increased the price of everything our customers purchase, and dampened merchant profitability as well (e.g. merchants now must pay interchange fees even on the sales taxes we are forced to collect and turn over to the states). Rather than lowering prices and making markets more efficient as processing costs decline, the card companies compete for card issuing banks by continually raising the amount of interchange merchants, and indirectly their customers, must pay the issuer. In the process, they were effectively eliminating the at-par model under which has been Congressional and Federal Reserve policy for nearly 100 years.

This lack of transparency and inverse competition in the credit and debit markets resulted in the numerous hearings in the House, in the Senate, before the Judiciary, Energy and Commerce and Financial Services committees over the past few years. Those actions culminated in the overwhelming Senate vote in favor of the Durbin amendment, and its refinement and retention by the House and Senate conferees in the final Dodd-Frank Act. If fully and properly implemented by the Board, it will begin to return transparency and true competition to this mal-functioning sector. What would that consist of? In essence, three things: a return to the transparent at-par model, a return to free market competition and sufficient oversight to preserve the first two.

The Return of Face Value Transactions

As was noted, plastic checks ("debit cards") are no more a "product" than are paper checks, ATM cards or withdrawal slips. They all are access devices. Indeed, they are no more a "product" than is a retailer's front door. They are integral aspects of everyday business. Front doors are the method by which customers enter stores with tender and leave with merchandise. The ability to retrieve funds from deposit accounts is an essential element of consumer banking, and, indeed is an inducement to customers to entrust their funds to banks in the first instance. Regardless of whether it occurs via a piece of paper or plastic, by assuring the customer that she can readily retrieve the value of her deposited funds, the institution encourages her and others to choose the bank as a place of safe-keeping, facilitating the institution's need to have funds available to lend.

Were it to become apparent that every dollar a customer withdrew to spend were diminished by the very act of withdrawing it (which is what happens, *sub rosa*, when the institution imposes a price raising fee on every transaction undertaken using a plastic check) the incentive to be banked would be similarly reduced. Merchants are aware of this price-fixing activity, but, because the fees are partially hidden and certainly not subject to competition, merchants respond in a less than efficient manner: the ultimate price of all goods and services paid for with plastic checks is adversely affected, just as occurred in the days of exchange fees.

Faced with collectively fixed prices, the Durbin amendment offers two options designed to recreate the market dynamics that delivered at-par debit. It gives each large bank the option of

choosing to unilaterally place any transparent price on debit cards it believes a true market will bear. In that event, so long as it is not done collectively, the Durbin amendment does not apply. These banks, many of which rival or exceed the size of the Discover network, will need to convince merchants that their fees are sufficiently reasonable that the merchant should agree to pay them and accept the banks' cards in its stores (just as merchants make a decision today whether to stock a particular designer's offerings). In each case, the bank's card will be widely accepted if the price is right; a free market result. Over time, in the absence of market power, competition will restrain fees.

Alternatively, if a large bank does not wish to compete unilaterally, but rather seeks to link its operations, collectively, with other large banks, the Durbin amendment does apply. It requires that the bank adhere to a Board developed "reasonable and proportional" standard, which the statute effectively requires be sufficiently close to at-par presentment as to cause the larger banks to weigh the advantages and disadvantages of choosing not to compete in order to remain in the existing cartels.

In light of the fact that the cartel rules severely restrict normal competitive behaviors, and that many nations operate robust debit card programs with no interchange whatsoever, the Board can achieve either of two positive goals with one standard. By electing a close-to-at-par standard, consistent with the reasonable and proportional costs of authorization, collection and settlement of electronic transactions, the Board either returns debit cards to a semblance of the true face value access device role they and checks played prior to the dominant networks' appropriation, or it encourages them to compete in the unfettered market where competitive forces will encourage similar results.

Setting too high a floor, whether through a safe harbor or otherwise, will blunt movement toward competition. For this reason, NRF supports Alternative 1, and strongly urges the Board to move the safe harbor toward a level that more accurately reflects the actual costs reflected in the Board's own study and those delivered in conjunction with the Merchants Payments Coalition filing.

Network Competition

As discussed above, it is the collective power of the networks that has allowed them to fix rules and prices such that formerly efficient new processes, such as PIN debit, became disadvantaged in favor of expensive, fraud-prone signature debit products. Products that ironically attempt to justify their higher fees in part on the fact that they are more subject to fraud.[1]

---

[1] In essence, a debit card is a plastic check. Every child, when opening his or her first checking account is cautioned in two respects: 1. Always balance the checkbook so that the available funds are known; and, 2. Never sign the checks in advance, lest someone find the checkbook and use the signed checks to deplete the account. Signature debit violates both these rules.

Unlike PIN debit, which accomplishes an immediate transfer of funds, and thus presents an accurate, current balance to the cardholder, signature debit has historically "batched" transaction information making the stated balances in all accounts less reliable. Second, because it is a requirement that cardholders sign the backs of their signature debit cards in order to make them valid, a misplaced or lost card actually carries a signature exemplar for a thief to forge in an attempt to empty the customer's deposit account. Instead of adopting the faster, safer PIN debit cards, many banks force their customers to put up with this inconvenience and the fraud potential of signature debit, in order to extract its extra high interchange fees from merchants and their customers. And as noted, the claim for such fees is justified, in part, to cover the higher risk of fraud. In this case, bad money absolutely drives out the good.

The market power of the networks has allowed them to command supra-competitive fees. These fees apparently have been used, in part, to further bolster their market dominance.

As was mentioned, when ATM cards were first converted into debit cards, the banks placed several network options on the cards in order to facilitate broad acceptance and use. This had the additional salutary and procompetitive effect, of providing merchants and their processors with the opportunity of selecting whichever network (i.e. the pipe to the customer's account) provided the best combination of pricing and efficient service. Competition among the networks for retailer volume caused them to raise their quality, even when the underlying transactions were at-par.

However, in recent years, the dominant networks have begun to incent the largest banks to eliminate the competitive PIN debit networks from their cards. In the case of the signature networks, no competition was ever allowed. As time goes on, only the most expensive networks remain. To make matters worse, in some of the few cases where competitive options exist, rules prohibited merchants from choosing the more desirable option. The Durbin amendment provides the opportunity to reintroduce competition. The Board should carefully follow the statute and maximize that effect.

The NPRM provides that competition can be accomplished by offering at least one unaffiliated network of each type on a debit card (e.g. a signature network and an unaffiliated PIN network) or at least two of each type (e.g. two signature networks and two PIN networks, if the card offered both options). NRF strongly supports the latter: Option B in the NPRM.

This not only accords with the goal of fostering competition, it also more closely adheres to statutory and practical usage. Competition cannot constrain prices and create efficiencies if it is unavailable. The statute states that *every* transaction shall have a competitive option. Having two PIN networks from which the merchant can choose satisfies that goal when a card is presented to a PIN enabled merchant. However, if a signature-enabled card is presented to a signature-enabled merchant, the absence of a second signature option deprives the merchant of a competitive option for every transaction. Suggesting that an unaffiliated PIN provides a competitive substitute for every signature transaction (NPRM Option A) is not sufficient. It is not evident that the PIN debit option would be of value to a florist who received a signature debit card order over the telephone. Unless that florist has the option to route that transaction over a competing signature network, she will be forced to pay the fees of the only proffered network. Every transaction means every transaction. Merchants must have the freedom to choose and to route if the premises underlying the amendment are to be realized.

Effective Oversight

Markets, especially newly emerging markets, are often fragile. This market has been dominated and distorted for more than a generation. The existence of inverse, upward competition in the face of rapidly declining prices is just one indication. The statute calls upon the Board to take steps to ensure that the dominant players do not use their existing power to circumvent the purposes of the statute or the intent of the Board's guidelines. Actively monitoring progress, and probing evidence of activity contrary to increased transparency and

competition, will be essential. The extent to which major market players choose to engage in continued cartelized behavior, rather than engaging in unilateral competition, may in itself be evidence that anticompetitive practices continue. It likely will be necessary for the Board to "fence-in" certain actions and practices until the fledging market becomes robust. The Board should be particularly sensitive to the manipulation of network fees, rule changes or other inducements, as a basis for circumvention.

Conclusion

The Durbin amendment to Dodd-Frank was grounded in a notorious market failure. A failure exploited by the largest and most efficient financial institutions and networks to create a situation such that the citizens of the country who pioneered cost savings improvements in payment systems, now pay billions of dollars more for access to those same accounts than when older, manual, far less efficient processes were the norm.

The Staff of the Federal Reserve Board has done an extraordinarily thorough job of identifying, considering and refining the many issues associated with these rules. Many of their structures and options, supported in this and in our Merchants Payments Coalition comments, are solid. In NRF's view, the NPRM's only serious shortcoming is its failure to carry the principles through to the extent necessary to achieve true market correction in a realm long lacking transparency and legitimate competition.

History has shown that in adopting at-par presentment for checks, Congress and the Board got it right. A century later, Congress has provided the Board with the opportunity to "get it right again" by renewing the principles embedded in the Board's "at-par checking rules": when every party bears its own costs, the free market will force all parties to strive to minimize their costs, and every party will have the potential to win.

Respectfully submitted,

Mallory B. Duncan
Senior Vice President, General Counsel