FOOD MARKETING INSTITUTE

February 21, 2011

Submitted Electronically

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

Re: Debit Card Interchange Fees and Routing [Regulation II; Docket No. R–1404]

Dear Ms. Johnson

The Food Marketing Institute (FMI) appreciates the opportunity to respond to the Federal Reserve Board of Governors proposed rule on debit card interchange fees and network routing.[1] Debit card fees have increased exponentially for FMI's member companies over the past decade, and we appreciate the opportunity to provide our feedback on this proposed rule. We appreciate the thoughtful considerations that have been taken into account in the proposed rule and look forward to working with the Federal Reserve Board as this rule is finalized.

FMI is the national trade association that conducts programs in public affairs, food safety, research, education and industry relations on behalf of its 1,500 member companies – food retailers and wholesalers – in the United States and around the world. FMI's members in the United States operate approximately 26,000 retail food stores and 14,000 pharmacies. Their combined annual sales volume of $680 billion represents three-quarters of all retail food store sales in the United States. FMI's retail membership is composed of large multi-store chains, regional firms, and independent supermarkets. Our international membership includes 200 companies from more than 50 countries. FMI's associate members include the supplier partners of its retail and wholesale members.

We will comment on reasonable and proportional interchange transaction fees and enforcement, limitations on payment card routing restrictions, prohibition on circumvention, fraud prevention adjustment, and exempt and non-exempt products.

[1] 75 Fed. Reg. 81722 (December 28, 2010).

2345 Crystal Drive, Suite 800 • Arlington, VA 22202-4801 • T 202.452.8444 • F 202.429.4519 • fmi@fmi.org • www.fmi.org

Section 235.3 - Reasonable and Proportional Interchange Transaction Fees

FMI strongly prefers the structure of proposed Alternative 1 that calls for a 7 cent safe harbor with a 12 cent cap. We do not believe Alternative 2, which moves closer to setting a single rate, is consistent with the intent of the legislation.

Overall, we would encourage the Federal Reserve to move even closer to the check system as the rule is finalized since the legislation specifically instructs the Fed to take into account the similarities between debit cards and checks. We do not think that costs beyond authorization, clearance and settlement should be considered based on the statute, especially since the Federal Reserve notes that including authorization costs only would be more consistent with a comparison of the functional similarity of electronic debit transactions and check transactions.

In the check market fees do not vary based on the transaction amount so we are pleased Alternative 1 does not call for different interchange fees based on the transaction amount despite the safe harbor and cap levels being relatively high for low dollar transactions. Additionally, we are pleased the Board has chosen not to differentiate between signature and PIN debit transactions, which we will discuss in greater detail under Section 235.4.

While our preference is for the debit card interchange fee structure to move closer to the check system, we are supportive of proposed structure in Alternative 1, and would just encourage the Federal Reserve to consider moving closer to the 4 cent weighted average of interchange fees as a safe harbor value. For the nation's largest banks, interchange fee levels of 7 to 12 cents will likely continue to be extremely profitable, and under the proposed fee structure in Alternative 1, banks could still receive costs above the safe harbor maximum if they were able to demonstrate their actual costs exceeded the safe harbor.

We recognize that each payment card network could set interchange fees at or below the safe harbor, but we are unconvinced that there will be market incentives for networks to set fees below the 7 cent safe harbor. Interchange fee revenue flows to card issuing banks, and the card networks use interchange fees to incentivize their bank customers to issue their cards. The way the debit card fee interchange market works likely will not vary based on this section of the proposed rule other than it will bring the rates closer to the reasonable and proportional costs of authorizing, clearing, and settling a debit card transaction. As such, we believe is unlikely that networks will set interchange fees below the maximum allowable level.

To that end, the most critical piece of this section is enforcement. If a network establishes interchange fees on a per-issuer basis and the issuer is responsible for reporting its maximum allowable interchange fees to the network it is critical that there be some supervisory oversight of that process since networks compete for issuer business. It is also important that there is appropriate oversight over which financial institutions are exempt from the rules regarding reasonable and proportional debit card transaction fees. We do not believe this process can be managed solely by the networks.

Lastly, we were pleased that the Federal Reserve payments staff recognized that savings from reductions in interchange fees are likely to benefit consumers due to the low margins and intense price competition in the retail and grocery industries.

Section 235.7 - Limitations on Payment Card Routing Restrictions

FMI strongly prefers proposed Alternative B that calls for two unaffiliated networks for each type of authorization method – signature, PIN, or other – because more choice will lead to greater competition in the market.

The current market has stifled innovation because there are extreme market barriers to entry for networks. We do not believe that requiring unaffiliated payment card networks on a debit card for each method of authorization would limit the development and innovation of new authorization methods in the long-term. Rather, removing those barriers to entry would help provide competition between current networks to innovate and would allow for entrepreneurs to enter a market that has been largely closed off for many years, especially as the market trends toward new and innovative payment devices such as mobile phones.

Additionally, we believe it is clear that the Congressional intent was for the type of solution presented in Alternative B. In a statement for the Congressional Record (156 Cong. Rec. S5926 (2010)), Senator Richard Durbin (D-IL), author of the amendment, stated:

> "Paragraph (b)(1) directs the Federal Reserve Board to prescribe regulations providing that issuers and card networks shall not restrict the number of networks on which an electronic debit transaction may be processed to just one network, or to multiple networks that are all affiliated with each other. It further directs the Board to issue regulations providing that issuers and card networks shall not restrict a person who accepts debit cards from directing the routing of electronic debit transactions for processing over any network that may process the transactions. **This paragraph is intended to enable each and every electronic debit transaction--no matter whether that transaction is authorized by a signature, PIN, or otherwise--to be run over at least two unaffiliated networks, and the Board's regulations should ensure that networks or issuers do not try to evade the intent of this amendment by having cards that may run on only two unaffiliated networks where one of those networks is limited and cannot be used for many types of transactions**."

There are many merchant environments that may only support one type of debit authorization method, which means under Alternative A, those merchants will have no routing choice if only one network is on a card for each type of authorization method. As the Board notes, only about 2 million of the 8 million merchant locations in the United States that accept debit cards have the ability to accept PIN so not requiring two unaffiliated signature debit networks on a single card will leave 6 million merchants potentially with no transaction routing choice. In the supermarket industry, in addition to our brick and mortar retail stores, many of our member companies offer customers the ability to make purchases online. While we believe PIN transactions will be more common for Internet purchases in the near future, having two signature debit options is important for the current online marketplace. Additionally, according to the *Nilson Report* (Issue 947, April 2010), signature debit accounted for 59.8% of debit product market share among the top 50 issuers, and Visa cards alone accounted for 78.4% of signature-based purchase volume while MasterCard cards contributed the remaining 21.6% so we have extreme concerns about lack of competition in the signature debit card space.

We also believe it is important for debit cards to contain multiple PIN debit networks in order to foster a more competitive market. Prior to the increased number of exclusive arrangements between card networks and issuers, the PIN debit market was extremely robust so we strongly encourage the Federal Reserve to require at a minimum two network options for each PIN transaction. In the supermarket industry, PIN debit is accepted in most brick and mortar retail locations. However, FMI estimates that well over 50% of PIN debit transactions run over a single PIN debit network, and that network increased costs roughly 35% to the smallest grocery stores in April 2010.

We believe competition between networks is critical for a couple of reasons. First, under both proposed alternatives regarding reasonable and proportional transaction fees, networks retain the right to set interchange fees. In order for those fees to be subject to market forces, there must be competition between networks, which can be achieved by merchants having multiple network routing options. With signature debit accounting for almost 60% of the debit product market share among the top 50 issuers and with one company controlling over 75% of the signature market, it is imperative that at least two signature options be available on each card in order for any network to be able to compete with such extensive market share.

Second, multiple network options are critical to help facilitate competition in network fees. The amount a merchant pays on a single debit transaction includes processing fees and network fees in addition to the amount merchants pay in interchange. Merchant network fees include assessment fees, switch fees, access fees, and security fees. One example of a security fee that Visa charges is an account verification fee. This costs $0.025. And, these fees are all take-it-or-leave-it. The access fees for example increased tremendously in 2009 – over 250% by both the Visa and MasterCard networks. MasterCard increased their rate in April only to have Visa follow suite in July. The Visa fee increased from $0.005 to $0.0195 while the MasterCard fee increased from $0.005 to $0.0185. These network fees are not directly impacted by changes to interchange transaction fees. However, adoption of Alternative B would likely create a more competitive market for network fees.

We are sensitive to concerns raised by small issuers, but we do not believe cards would need to be re-issued under either alternative. Currently, cards in the marketplace support multiple PIN debit networks. While those PIN debit networks may not be enabled for a point-of-sale purchase, it is not difficult for them to be enabled for such a transaction. In order to add a network to a card, the network has to include a financial institutions card number in their BIN files list. This process requires information already available on a card and should not lead to card re-issuance. We believe the process is similar for enabling a card to run on multiple signature debit networks, and the processes for signature debit should be made synonymous with those for PIN.

As noted above, we do not anticipate major re-programming of systems or necessary re-issuance of cards under Alternative B so we believe an effective date could be 6 to 9 months from the issuance of the finalized rule. That 6 to 9 month timeframe is consistent with what networks expect from merchants when changes are made.

Section 235.6 - Prohibition on Circumvention or Evasion

Overall, we support a broad and dynamic circumvention rule, which has substantial consequences if violated. Below are a few areas of specific concern to our industry.

As noted in our comments on Section 235.4, we are concerned networks could shift the majority of fraud prevention costs onto merchants. We have seen this before when networks have mandated merchant compliance with technologies such as Triple Data Encryption Standards (Triple DES), without demonstrating a clear need for this technology. The onus of equipment and programming upgrades fell to the merchants in this example. Many of our member companies have fuel operations, and any changes that require new payments equipment or technology on fuel dispensers are extremely expensive. In the current market, networks still have the ability to mandate these technology changes.

We are also concerned about networks shifting some issuer fees to merchants and acquirers. This is another reason we believe Alternative B, as it pertains to network routing and merchant choice, is of particular importance because networks that are forced to compete will be less likely to be able to shift issuer costs to merchants. As previously noted, we saw a huge, arbitrary network fee increase of over 250% in 2009.

Lastly, we are concerned about new decoupled debit partnership where a large non-exempt bank could partner with a small financial institution exempt from the interchange transaction fee portion of the proposed rule so that the small financial institution is the issuer, and thus both banks are able to get the interchange fee revenue at the small bank fee levels.

Section 235.4 – Fraud Prevention Adjustment

The Food Marketing Institute and our member companies are supportive of the fraud adjustment approach presented by the Merchants Payments Coalition in the letter dated January 20, 2011.[2]

We applaud the Board for recognizing that a major technology shift in the United States may be necessary to significantly reduce fraud in the payments card system. However, we do believe the first step in such a shift involves incentivizing technologies that are more secure than PIN debit technology. We believe that it is critical, however, not to prescribe a specific technology and support efforts by the Board to ensure that any approach provides flexibility in responding to emerging and changing fraud risks.

Most importantly, we encourage the Federal Reserve to move forward with other sections of the rulemaking regardless of when a fraud adjustment rule is finalized. Under the current system, the Board found that merchants bear 43% of all fraud losses, including up to 76% of card-not-present signature transactions so the overall cost of fraud is relatively evenly spread out between issuers and merchants. Additionally, merchants receive no payment guarantee when a customer uses a debit card because the card network reserves the right to reverse the payment due to a processing error or fraud. This is called a chargeback[3] and leaves the merchant out the money and the merchandise.

Under the current interchange fee system where all issuers receive the same centrally-set fee revenue from a network regardless of the amount of fraud in the system there are limited incentives for networks and card issuers to invest in more secure technology and fraud prevention efforts. If these costs were not reimbursed, or not fully reimbursed, through an adjustment to interchange fee revenue, issuers and networks would likely have economic incentives to invest in more secure products and reduce fraud in the system in order to decrease their fraud mitigation costs.

Another major problem in the current payment card system is the high usage and fraud prone nature of the signature debit card product, since it can be used in a card-present environment without requiring the cardholder to input a second level of user identification, such as a PIN, to access the account(s) on the card. According the Federal Reserve's 2010 Payments study, these

[2] http://www.federalreserve.gov/SECRS/2011/February/20110203/R-1404/R-1404_012011_61804_561400767649_1.pdf
[3] http://usa.visa.com/merchants/operations/chargebacks_dispute_resolution/index.html

less secure signature transactions account for 62% of all debit transactions while PIN accounts for 38%.

Lastly, merchants invest millions of dollars to prevent fraud in order to protect their brand and their customers, and to meet Payment Card Industry Data Security Standards (PCI DSS). According to the 2007/2008 Food Marketing Institute Annual Financial Review found: "Annual spending on data security and PCI compliance in 2007 is highly dependent on company size. Independents spent anywhere from $3,000 to $10,000, whereas chain companies easily spend $1,000,000 and up." For some of the largest companies, PCI compliance costs are estimated in the tens of millions. Costs associated with PCI compliance include technology upgrades, hardware and software maintenance, maintaining new segment firewalls, point-of-sale card reader replacements, personnel training, and external assessors. All of these costs can be considered fraud prevention activities.

Exempt and Non-exempt Products:

Under this section we will address exempt government-issued benefit cards, as well as products we believe are not exempt, such as health care related debit card accounts and mobile phone debit transactions.

Exempt Products:

First, we understand the need for a short-term exemption of government-issued benefit cards where there are pre-existing contract arrangements between state or federal governments and a financial institution. However, it is important to note that these cards are negatively impacting merchants across the United States because they carry high interchange rates, and we do not believe these cards should be exempt in the long-term.

The statute does require a study of the fees associated with government-issued benefit cards. It is important to note that without access to the BIN tables that contain identification numbers for these cards, merchants will have a limited ability to specifically identify them and provide any cost information for the study.

Lastly, we support the exemption for Electronic Benefit Transfer (EBT) cards used to administer both the Supplemental Nutrition Assistance Program (SNAP/formerly food stamps) and the Women's, Infants, and Children (WIC) program. Based on current statute, however, no interchange fees can currently be collected on either type of EBT transaction.

Non-exempt Products:

We do not believe that Flexible Savings Account (FSA), Health Savings Account (HSA), and Health Reimbursement Arrangement (HRA) debit card accounts would be covered under the exemptions for prepaid cards. We strongly support the Board's proposed comment (5(c)-3.ii) that "a card is not marketed as a gift card or gift certificate if it is promoted as a substitute for traveler's checks or cash for personal use, or <u>promoted as a means of paying for a consumer's health-related expenses.</u>"

FMI's retail membership has over 14,000 in-store pharmacies. We understand that health-related FSA, HSA and HRA accounts require complicated substantiation technology to validate the eligibility of transactions, but merchants are largely responsible for the extensive time and resources that went into making this technology a reality. Merchants played an integral role in point-of-sale programming and software development in order to support this real-time substantiation technology. Overall, we believe FSA and HSA debit card products are not covered under the definition of exempt products.

Additionally, we believe mobile phones and other payment code devices are covered in the definition of a "payment card network" and do not believe that mobile phone debit transactions, including those that are authorized, cleared and settled through a third party intermediary should be exempt from the rule. We believe that exempting these products from the rule would slow the rates at which merchants agree to accept the technology and would have a negative impact on innovation in the mobile marketplace.

Thank you again for the opportunity to provide comments on the Board's interchange transaction fee and routing proposed rule. We look forward to working with you as you finalize the rule. We are confident that as the proposed rule is finalized and implemented, it will have a positive impact on the grocery industry and ultimately our customers.

Sincerely,

Jennifer Hatcher

Jennifer Hatcher
Senior Vice President, Government Relations