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RE: Docket ID FFIEC-2014-0001
(Federal Reserve Board Docket No. R-1510)

The National Retail Federation welcomes the opportunity to submit the following comments with respect to Debit Card Interchange Fees and Routing pursuant to the opportunity to comment under the Economic Growth and Regulatory Paperwork Reduction Act.

By way of background, NRF is the world's largest retail trade association, representing discount and department stores, home goods and specialty stores, Main Street merchants, grocers, wholesalers, chain restaurants and Internet retailers from the United States and more than 45 countries. Retail is the nation's largest private sector employer, supporting one in four U.S. jobs – 42 million working Americans. Contributing $2.6 trillion to annual GDP, retail is a daily barometer for the nation's economy. NRF was very much involved with the adoption of the law that resulted in Regulation II. Virtually all of our members accept debit cards and thus are subject to the effects. We believe that our perspective will be helpful to the Board in assessing the effects of the rule.

Congress mandated the rule's adoption in part because there was little evidence of meaningful competition by issuers in the delivery of debit card services. For decades much of the issuers' prices for credit and debit services had been collectively established within the issuer-member trade associations. The high "default" price to merchants of plastic payment products was reflective of the issuers' collective market power.

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In the second half of the 2000's the issuer trade associations were officially "spun off" from their issuer members, but the practice of default pricing continued. In short, the issuers' prices for most debit card services were effectively fixed for them by the two dominant networks, and other opportunities for cost savings for merchants (and their customers) via competitive routing were undermined by the same two dominant networks' cartel-like behavior. Issuers' simply "took" and charged the default price regardless of their actual costs. The result was escalating increases in debit pricing within various sectors of the merchant community and decreasing opportunities for other potentially competitive network services.

The law sought to address this in two ways. With respect to network services, it did so by ensuring that merchants would have at least two alternatives for routing each transaction as it was finally presented at the point of sale. With respect to debit card pricing, it did so by:

> a.) providing an incentive for larger issuers to independently compete outside the cartels for merchant acceptance of their cards; or
> b.) in the event large issuers chose not to compete, by setting standards essentially ensuring that the price for their services was reasonable and proportional to their incremental cost.

In the latter case, the lower the price cap set by the Board's standards above actual cost for basic debit card services, the greater the likelihood that individual issuers would exit the cartel and compete to offer sufficiently innovative products or services outside the cap as to potentially allow them to earn greater revenue. Of course, true competition among such unrestrained debit card services would act as an upper bound on how much extra revenue could be earned. The combination of prices constrained by a truly competitive market and those constrained in the non-competitive standards-set market would both foster some innovation while keeping overall costs at a more reasonable and proportionate level.

REASONABLE AND PROPORTIONAL STANDARDS

Regulation II has worked moderately well. On average, the established cost of providing debit card services among affected issuers is less five cents per transaction. Prior to the regulation's adoption, the cost to merchants (and ultimately in part their customers) for an average transaction was 45 cents per transaction. The regulation reduced this figure to 24 cents. Most merchants and consumers have realized the benefits of these savings. One prominent study estimated that approximately two-thirds of the savings is passed on to shopping public and one-third is retained by merchants for investment and return to shareholders. In most cases, 24 cents per transaction represents a significant savings over the prior non-competitive pricing. However, it is still *substantially* higher than issuers' incremental costs.

This has had three effects. First, savings more proportionate to those of a truly competitive market have not been realized under the Reg. II standards with respect to issuers who remain under the cartel's collective pricing umbrella. The margins afforded such issuers are much too high. By way of comparison, due to more restrictive margins in the retail industry and elsewhere, the average net profit for retail varies from slightly over one percent for the grocery sector to slightly under four percent for high-end specialty luxury stores.

Second, by establishing so high a ceiling, and so great a profit potential for those operating within the cartel, the regulation undermines the incentive for issuers to abandon it in order to engage in the risks and rewards associated the innovative products and services envisioned by the law. The extremely comfortable return provided issuers under current Reg. II standards makes risk-taking less rewarding.

And third, the high 21 cent-and-up ceiling has become a *de facto* floor in virtually every instance. There have been serious real world consequences.

Once tens of millions of consumers have been trained to expect to use a particular form of payment, it is extraordinarily difficult (if not impossible) to subsequently remove that form of payment from merchant establishments. Many retail transactions, especially small ticket price transactions, are quick in and out affairs. Checkout time spent on payment, or on tender type discussions, that upset consumers' expectations seriously impedes the profitability of the enterprise. (As a hypothetical, imagine entering a quick serve hamburger restaurant with cash and being told at checkout that the establishment no longer accepts bills; that it only accepts coins. The conversation time and disruption would be enormous.) The same is true for credit and debit cards.

For many years small ticket merchants did not accept credit or debit cards. That was understood by consumers. They were not accepted because the total transaction time was slightly longer than that for cash. More important, the cost of the transaction was far more than most small ticket merchants could afford in light of their narrow margins. Consequently, consumers expected to, and did, pay with cash.

In order to overcome merchant objections, the cartel payment networks offered merchants who specialized in small ticket products a special default issuer price. It was significantly lower than the standard debit card pricing in recognition of the deleterious effects of plastic transactions on small ticket product pricing and merchant profitability. Given the actual cost of transactions, as demonstrated by the Board's own research, the high single digit amounts then charged merchants was reasonable and proportional to the issuers' costs, and it was not so high as to have the negative effects mentioned above. Consequently the transactions came to be accepted at such merchants and consumers were trained to expect the ability to use another form of tender, debit, at point of sale.

Commentary surrounding the adoption of Reg. II, and the activity of one major debit card network in the immediate aftermath, suggested that such differential pricing would continue to the mutual benefit of issuers, merchants, networks, and consumers. However, shortly thereafter in response to inverse competition among the networks (i.e. the major card networks compete to maximize the amount of revenue they can extract from merchants and consumers to deliver to the issuing banks), the commentary and expectations were confounded. The Reg. II ceiling was converted by both the major networks into a default issuer floor for small ticket purchases. In light of the one-third versus two-thirds pass-through discussed above, ***all*** consumers of small ticket goods and services were injured.

For the reasons set forth, despite some successes achieved by Reg. II, the standards caps merit review and likely downward adjustment.

NETWORK SERVICES
As to network services, the law allows merchants, the buying parties who (along with their processors), have the greatest knowledge of the costs and benefits among competing network options, to route transactions over those networks that provide the greatest overall benefit when completing their transactions. Variables could include speed, cost, security, downtime, volume, cleanliness of transactions, and responsiveness, among other factors. Allowing this choice provides the opportunity for regional and other networks to outcompete the majors by investing in services that enhance these sometimes extremely technical variables.

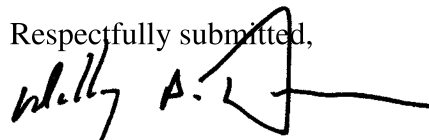
There recently has been an effort to subvert this provision of the law and transfer the choice of routing to a party who is not familiar with all of the factors involved in making an informed competitive choice. In reviewing its regulations the Board should take whatever steps are necessary to ensure that the intent of the legislation is preserved.

FRAUD COSTS
Finally, there has been a significant liability shift in conjunction with the multiyear transition to chip card transactions. The issuer fraud costs shifted onto merchants has been enormous. It appears that costs far beyond the claimed costs of counterfeit cards are being shifted by issuers onto merchants despite initial assurances by the major networks that such would not happen. Some mid-sized merchants already have seen issuer asserted counterfeit card costs rise from tens of thousands of dollars to over one million dollars, per month. If fraud costs anywhere near these amounts are being transferred from issuers to merchants, then the five basis point fraud allowance in the current standard may no longer have a legitimate basis.

Due to serious backlogs of hardware, network mandated certification resources, and scheduling (service station fuel pumps, for example, are not scheduled to be compliant until fall of 2017) these costs are likely to be shifted onto merchants for years to come. Indeed, the Canadian transition, involving a population of merchants a fraction the size of that in the U.S., took nearly ten years and included a delay. In light of this change, the current fraud allowance is ripe for revisiting by the Board.

CONCLUSION
Thank you for the opportunity to present these comments. In summary, Reg. II has worked moderately well in terms of laying the groundwork for enhanced competitive potential. Additional changes are necessary if that potential is to be realized. Should you have any questions please feel free to contact the undersigned at the above address.

Respectfully submitted,



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