Jodi Golinsky
Vice President &
Senior Regulatory Counsel

MasterCard International
Law Department
2000 **Purchase Street**
Purchase, NY 10577-2509

914 249-5978
Fax 914 249-3648
E-mail jodi_golinsky@mastercard.com
www.mastercard.com

MasterCard
International

Via Electronic Mail July 26, 2004

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

Re: Proposed Changes to the Policy Statement on Payments System Risk
Docket No. OP-1191

Dear Ms. Johnson:

Mastercard International Incorporated ("Mastercard") submits this comment letter in response to the request by the Board of Governors of the Federal Reserve System ("Board") for comment regarding proposed changes ("Proposal") to its Policy Statement on Payments System Risk ("Existing Policy"). Mastercard appreciates the opportunity to comment on the Proposal.

Background

Mastercard is an SEC registered private share corporation that is owned by more than 2,100 financial institutions throughout the world. These financial institutions are known as "principal members" and participate directly in the business of Mastercard. There are approximately 21,000 "affiliate member" financial institutions that participate in our business through principal members.

Mastercard manages a family of widely accepted payment card brands including Mastercard, Maestro, and Cirrus. We license our brands to our financial institution customers ("customers") for use in connection with their payment card programs. Mastercard itself does not issue payment cards nor does it contract with merchants to accept those cards. Instead, those functions are performed by our customers. The customers that issue payment cards bearing the Mastercard brands are referred to as "issuers." The customers that enter into contracts with merchants to accept MasterCard-branded cards are referred to as "acquirers." Mastercard provides the networks through which issuers and acquirers interact to complete payment transactions, and we set the rules regarding those transactions.

The primary payment services Mastercard provides to its customers are referred to as the authorization, clearing and settlement processes. The objective of these processes is to facilitate the movement of transaction data and funds among customers on a global basis in a timely and efficient manner.

Authorization is the process by which a transaction is approved by the issuer or, in certain circumstances, by Mastercard or others on behalf of the issuer in accordance with the issuer's instructions. The Mastercard authorization system is a worldwide network designed for near-instantaneous transmission of card data and authorization results among the participants in our systems. In a typical transaction, the merchant or acquirer request authorization for the transaction from the issuer, and authorization is granted or denied based on criteria established by the issuer. In many instances, Mastercard provides stand-in authorization, or authorization on behalf of the issuer, when the issuer is not signed onto our system or cannot be contacted within an established timeframe. Typically, our global data transport network routes the authorization requests and responses between issuers and acquirers in less than one-fifth of one second with a reliability rate of more than 99.7% and an availability rate in excess of 99.99%.

Mastercard transactions are generally "cleared" through our centralized processing system and the related information is typically routed among customers via our global data transport network. Clearing involves the movement of transaction data from the acquirer to Mastercard, where individual transactions are sorted and forwarded to the appropriate issuer for posting to the cardholder accounts. Data can be submitted **24** hours per day, 7 days per week, and there are multiple clearing cycles each day. Data transmission is provided on every U.S. banking business day to facilitate the customer settlement process.

Once transactions have been authorized and cleared, Mastercard provides services in connection with the "settlement" of the transaction—that is the exchange of funds among customers. Once clearing is complete, a daily reconciliation is provided to each customer, detailing the net amounts by clearing cycle and a final settlement position. The actual exchange of funds takes place between a clearing bank chosen by the customer and approved by Mastercard and one of Mastercard's settlement banks. If the customer is in a net debit position, its clearing bank transfers funds to Mastercard's settlement bank; the opposite occurs if the customer is in a net credit position.

We also operate the Mastercard debit switch, which supports processing for Cirrus and Maestro transactions. The switch transmits financial messages between acquirers and issuers, provides transaction and statistical reporting and performs clearing and settlement services between customers and other debit transaction processing networks. Unlike the authorization and clearing process described above, which involve the exchange of transaction data in two discreet messages (one for authorization and one for clearing), the debit switch generally operates as a "single message" system in which clearing occurs simultaneously with the initial authorization request.

A number of companies operate businesses similar to the Mastercard systems such as Visa, American Express, Discover/Novus, and JCB. We also encounter competition from businesses such as retail stores and gasoline companies that issue their own payment cards and from regional ATM/POS networks. Moreover, a number of transaction processors, such as First Data Corporation, are seeking to build networks that link issuers directly with point-of-sale devices for payment card transaction authorization and processing services. In fact, First Data Corporation now owns an ATM/POS network that processes more than 50% of PIN-based transactions in the U.S.

The management of risk within our systems is one of Mastercard's highest priorities, and Mastercard devotes considerable resources to ensuring that our risk management program is in line with international best practices. For many years, Mastercard has voluntarily used the Existing Policy as a guideline for structuring our own risk management framework. These efforts include the adoption of risk management principles designed to address the Lamfalussy minimum standards -- standards which are intended to apply only to systems far larger than Mastercard's. Moreover, when the Bank for International Settlements ("BIS") expanded the Lamfalussy standards and issued the "Core Principles For Systemically Important Payment Systems" ("Core Principles") in January of 2001, Mastercard elected to incorporate relevant portions of the Core Principles into our risk management framework as well.

The Proposal

The Proposal sets forth the Board's expectations regarding the management of risk in payments systems. The Proposal, like the Existing Policy, would apply to public- and private-sector payments systems that expect to settle a daily aggregate gross value of U.S. dollar-denominated transactions exceeding $5 billion on any day during the next 12 months. For those payment systems subject to the Proposal, the Board sets forth two categories of risk management expectations. The first category consists of the general risk management expectations for all payments systems subject to the Proposal. The Proposal states that "[w]hile there are a number of ways to structure a sound risk-management framework, all frameworks should perform certain functions:

- Clearly identify risks and set sound risk-management objectives
- Establish sound governance arrangements
- Establish clear and appropriate rules and procedures
- Employ the resources necessary to achieve the system's risk management objectives and implement effectively its rules and procedures."

The second category of risk management expectations is intended to apply to "systemically important" payments systems. Specifically, the Board expects systemically important payments systems to comply with the "detailed standards" set out in the Core Principles. Under the Proposal, the Core Principles would be adopted by the Board without modification.

The Proposal states that to determine whether a system is systemically important "the Board may consider, but will not be limited to," one or more of the following six factors:

- Whether the system has the potential to create significant liquidity disruptions or dislocations should it fail to perform or settle as expected.
- Whether the system has the potential to create large credit or liquidity exposures relative to participants' financial capacity.
- Whether the system settles a high proportion of large-value or interbank transactions.
- Whether the system settles transactions for critical financial markets.
- Whether the system provides settlement for other systems.
- Whether the system is the only system or one of a very few systems for settlement of a given financial instrument.

The Board explains that "[s]ystemically important systems are expected to meet specific risk-management standards because of their potential to cause major disruptions in the financial system."

Mastercard Comments

Mastercard fully supports the Board's goal of reducing risk in the payments systems by providing guidance for payments system risk management. We are concerned, however, that the Proposal could unintentionally create adverse consequences for smaller payments systems that have reached the $5 billion threshold but have not yet achieved the relative importance that would warrant application of the Board's risk management policies. In addition, we are concerned that the lack of clear guidance for determining whether a particular payments system is "systemically important" will create uncertainty and even confusion regarding risk management expectations for a wide variety of payments systems that, like Mastercard, clearly are not systemically important. These concerns, and our suggestions for addressing them, are discussed below.

Impact on Smaller Systems

As noted above, the Proposal would apply to public- and private-sector payments systems that expect to settle a daily aggregate gross value of U.S. dollar-denominated transactions exceeding $5 billion on any day during the next 12 months. Mastercard believes that defining the scope of the Proposal based on a clear dollar threshold is both helpful and appropriate. However, we believe that the $5 billion threshold is too low.

The $5 billion threshold was first established in January of 1999 and, according to the Board, was intended to provide a "general threshold for application of the policy in order to eliminate potential administrative burdens on those smaller systems that are not likely to pose systemic risks or other significant risk concerns.'' In our view, the *$5* billion threshold, when adopted, appropriately distinguished smaller systems from those that should be expected to manage risk in accordance with the Board's guidance. A number of factors have conspired, however, to decrease the relevance of that threshold. For example, general economic growth has increased volumes for many payments systems without affecting the relative importance of or risks associated with those systems. Similarly, increases in the prices of goods and services purchased using retail payment instruments also have increased payments system gross volumes without affecting their relative importance or risk. As a result of these and other factors, smaller payments systems may be experiencing volumes at or near the *$5* billion threshold without posing "systemic risks or other significant risk concerns,' that would warrant application of the Proposal. To address this issue, we recommend that the threshold for application of the Proposal be increased to account for economic and other factors that drive up gross volume without affecting relative importance. Based on our experience, we believe that a threshold of $10 billion would be appropriate. We also urge the Board to establish a process to adjust the threshold on an annual basis to reflect relevant economic and other factors.

The Determination of Systemic Importance

Under the Proposal, the Board retains the discretion to determine whether a payments system is systemically important and, as noted above, sets forth six factors that "the Board may consider, but will not be limited to," in making such determinations. Although the six factors clearly are relevant in determining systemic importance, they simply do not provide enough clarity for payments systems and their participants to determine whether a particular system will be deemed to be systemically important.

The Proposal's lack of clarity creates potential for a number of adverse consequences. First, it has the potential to create confusion among a payments system and its participants regarding how to build the appropriate risk management framework for that system. For example, because the Proposal's guidance regarding systemic importance is subjective, it is inevitable that some banks will be overly conservative and require that the payments system they participate in comply with the Core Principles in many circumstances where the Board intends a different result. Of course, such confusion can be resolved by seeking guidance from the Board, but doing so will be time consuming and unnecessarily occupy Board resources.

Second, the Proposal's lack of clarity will impede the ability of payments systems to plan for risk management changes that may be appropriate when their systems achieve systemic importance. In this regard, proper implementation of the Core Principles requires careful consideration and, in many cases, may involve significant financial and other resource commitments. Because the Proposal does not provide adequate guidance regarding when a payments system achieves systemic importance, however, payments systems will have limited ability to anticipate the timing of their designation as systemically important or to plan accordingly.

Third, the Proposal's lack of clarity is likely to have consequences for U.S.-based payments systems that operate globally. In particular, unless the Board establishes clear guidance on systemic importance under the Proposal, U.S. payments systems run the risk of being inappropriately deemed to be systemically important in other regions even though the Board, if given the opportunity, would reach a different conclusion. In view of the burdens involved in complying with the Core Principles, this could unnecessarily disadvantage such U.S. payments systems, particularly those that compete with systems that are not deemed systemically important and, therefore, have the ability to adopt more flexible and potentially more cost-effective approaches to risk management.

To a certain extent, these issues can be addressed by appropriately increasing the gross daily volume threshold for application of the Proposal to $10 billion. We believe it is important, however, that the Board also modify the Proposal to more clearly distinguish payments systems that are systemically important from those that are not. This can be achieved with a number of relatively modest changes.

The BIS has published guidance that is helpful in this area. Specifically, in the materials published by the BIS in connection with the issuance of the Core Principles, the BIS stated that "[t]he distinguishing feature of a systemically important payments system...is that it is capable of triggering disruptions or transmitting shocks across the financial system domestically or even internationally. Most countries have at least one such system."[1] This guidance contains an important clarification not yet included in the Proposal. The Proposal indicates that one of the indicia of systemic importance is "[w]hether the system has the potential to create significant liquidity disruptions or dislocations." The Proposal does not make it clear, however, that the type of liquidity disruptions or dislocations that are relevant are those that would trigger disruptions "across the financial system." **As** a result, the Proposal might mistakenly be read to suggest that a system is systemically important if it could create "significant liquidity disruptions" for a single participant. In order to address this issue, we urge the Board to modify the Proposal to incorporate the BIS guidance stating that "[t]he distinguishing feature of a systemically important payments system...is that it is capable of triggering disruptions or transmitting shocks across the financial system domestically or even internationally."

We also urge that the Board incorporate into the Proposal the guidance from the BIS report which states that "[i]t is likely that a system is of systemic importance if at least one of the following is true:

- It is the only payments system in a country, or the principal system in terms of the aggregate value of payments;
- It handles mainly payments of high individual value;
- It is used for the settlement of financial market transactions or for the settlement of other payments systems."[2]

[1] "Core Principles for Systemically Important Payment Systems," published by the BIS January 2001, at p. 14.
[2] ***Id.*** at p. 15.

This guidance would be helpful in better conveying the types of characteristics a systemically important system is likely to have.

We also urge the Board to provide appropriate guidance that can be used to distinguish retail payments systems from those that are systemically important. It would be particularly helpful if the Board were to set forth a list of indicia that suggest that a payments system is not systemically important. For example, when the Board adopted the Existing Policy, it made the following observation regarding large check, ACH and credit card settlement arrangements: "[s]ettlement obligations for individual participants are not of the same magnitude as in traditional large-value payments systems, and credit and liquidity exposures are typically diversified over large numbers of participants." This observation by the Board continues to be accurate and could be incorporated into the final Policy by making it clear that a payments system is unlikely to be systemically important if it does not involve large-value payments and its credit and liquidity exposures are diversified over large numbers of participants.

We urge the Board to identify other factors that indicate the absence of systemic importance as well. For example, it is unlikely that a payment system would be systemically important when it involves small dollar transactions, the large majority of which are authorized prior to settlement. We also urge the Board to modify the Proposal to recognize that where there are multiple payments systems that provide comparable services to participants, there is a decreased likelihood that any one of those systems is systemically important.

If the Board were to modify the Proposal to incorporate these and other factors as indicia of a lack of systemic importance, we believe that the Proposal would provide much needed clarity and certainty while preserving for the Board the flexibility to apply the Proposal where appropriate to a wide variety of systems.

Other Issues

MasterCard notes that the general expectations portion of the Proposal provides helpful guidance for structuring risk management programs and should be retained when the Proposal is adopted in final form. In addition, we urge the Board to retain the approach embodied in this portion of the Proposal, which provides guidance for risk management structure but affords payments systems the flexibility to choose the best approach to implement that structure.

Finally, we note that in the Proposal, the Board makes it clear that adoption of the Proposal "is not intended to exert or create new supervisory or regulatory authority over any particular class of institutions or arrangements for which the Board does not currently have such authority." We believe that this is an important clarification that should be retained when the Proposal is adopted in final form.

*   *   *   *   *

Once again, we appreciate the opportunity to comment on the Proposal. If you have any questions concerning our comments, or if we may otherwise be of assistance in connection with this issue, please do not hesitate to call me, at the number indicated above, or Michael F. McEneney at Sidley Austin Brown & Wood LLP, at (202) 736-8368, our counsel in connection with this matter.

Sincerely,

Jodi Golinsky

Jodi Golinsky
Vice President and
Senior Regulatory Counsel

cc: Michael F. McEneney, Esq.

DC1 711239v1