Illinois
Credit Union League

VIA E-MAIL TRANSMISSION
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February 11, 2011

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
Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson:

We are pleased to respond to the Federal Reserve Board's ("FRB") proposed rules regarding debit card interchange fees and routing. We submit this response on behalf of the Illinois Credit Union League ("ICUL") and its four hundred (400) member credit unions doing business in Illinois which provide financial services to approximately three million consumers as well as on behalf of ICUL Service Corporation ("LSC"), which provides debit card services to credit unions and consumers in forty seven (47) states. Our comments address the main issues under consideration.

The small issuer exemption is a distinction without a meaning, given the statutory and regulatory lack of enforcement.

The FRB proposes merchant interchange fee caps. Issuers with less than $10 billion in assets are exempt from these caps. Approximately ninety nine percent (99%) of issuing financial institutions are exempt, including approximately 7,700 credit unions. Proponents of the regulation tout the exemption as a victory for small issuers and as a means to level the debit card playing field. The exemption does nothing of the sort. In fact, the fee caps for non-exempt issuers will trickle down to small issuers, forcing small issuers to introduce fees for checking accounts and debit card services, to compensate for an interchange return which is not based upon the costs of providing debit card services.

As a result of the proposed fee caps, networks may develop two tier pricing, with the non-exempt tier having a lower interchange schedule and the exempt tier having a higher interchange schedule. The two tier system is designed to shield small issuers from reduced interchange revenue. In practice, this will not occur. Given the lack of any

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enforcement mechanism, merchants will steer transactions through the use of discounts to non-exempt issuers, with lower merchant fees. That pressure will erode the "carve-out" and network rates will trend to the government-controlled price levels for exempt and non-exempt issuers alike.

Operationally, the small issuer exemption is a distinction without a meaning. Market conditions will force small issuers to parrot the merchant interchange fees for non-exempt issuers, as market forces and networks narrow interchange fees. It is for these reasons as well as the reasons set forth in this correspondence that small issuers oppose the FRB's attempt to regulate merchant interchange fees.

FRB's action is an impermissible exercise of congressionally delegated authority

The FRB's proposed debit card interchange fees and routing rules are a blatant misrepresentation of the legislative parameters under which it is delegated authority. Not only are the proposed rules a logically impermissible exercise of authority, they are unconstitutional. Through its seminal decision in *Chevron v. Natural Resource Defense Council*, 467 U.S. 837 (1984), the United States Supreme Court articulated an "either/or" test to determine the constitutional validity of an administrative agency's regulatory action. If the statute is clear about an agency's authority to make rules, it must be honored. Conversely, if the statute is silent or ambiguous about the agency's rulemaking authority, there is a statutory gap. When there is a gap, an agency still has the authority to regulate, unless the regulations are arbitrary, capricious or manifestly contrary to statute. *Chevron*, 467 U.S. at 842-43.

The FRB's proposed regulations do not survive the *Chevron* analysis. Section 1693o-2 delegates authority to the FRB to prescribe interchange fees. 15 U.S.C.A. §1693o-2(a)(1). The fees must be reasonable and proportional to the issuer's costs. 15 U.S.C.A. §1693o-2(a)(s). "Reasonable and proportional" is undefined; this is a statutory gap. *Chevron* requires the FRB to draft regulations which are not arbitrary, capricious or manifestly contrary to statute.

As proposed, the regulations are arbitrary, capricious and contrary to statute. The FRB misconstrued its role in drafting merchant interchange fees. First, it has no authority to propose an interchange cap. An interchange cap is static. The fee is supposed to be "reasonable and proportional". "Reasonableness" is a flexible, fact specific standard, not a static one. The fee cannot be a cap.

Nor is the merchant interchange fee reasonable when it is based upon information obtained in response to a survey, absent a hearing and without appropriate public comment. A fee is not "reasonable" because the FRB deems it so; the FRB does not have carte blanche rulemaking authority. Neither the statute nor the *Chevron* holding allows the agency to satisfy the interests of one party (e.g., merchants) at the expense of others (e.g., issuers).

Additionally, under §1693o-2(b)(4), the FRB is delegated with the authority and responsibility to prohibit discriminatory routing provisions. There is no statutory gap yet the FRB has not exercised its authority. Ironically, where the FRB is delegated with authority to implement regulations, it does not. Where the authority is limited, the FRB exceeds its rulemaking authority. The FRB may not cherry pick statutory provisions to suit its purposes.

Section 1693o-2 clearly articulates Congressional intent to require the promulgation of rules that are reasonable and fair to all parties. FRB's proposed rules create an unambiguously unreasonable marketplace for small issuers, and in turn, consumers. As such, the proposed rules are blatantly contrary to statute and fail *Chevron*. The FRB has misused and abused its regulatory powers.

QUESTIONS FOR COMMENT

INTERCHANGE TRANSACTION FEES

Question. The statute requires that the amount of any interchange transaction fee that an issuer receives or charges with respect to an electronic debit transaction must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." Proposed §235.3 sets forth two alternatives (referred to as "Alternative 1" and "Alternative 2") for determining the level of the allowable interchange fee. Alternative 1 proposes an issuer-specific approach combined with a safe harbor and a cap. Under Alternative 1, an issuer may receive or charge interchange transaction fees at or below the safe harbor amount or based on a determination of its allowable costs, up to a cap. The Board proposes to adopt only one of the alternatives and requests comment on each, as well as on any other alternatives that could be applied.

Answer: When establishing a merchant interchange fee, the FRB is regulating rates. Presumably, interchange rate establishment is designed to ensure debit cards are provided at a consumer-affordable rate, which ensures issuers will continue to provide the service.

There is a balance - too high a rate will decrease debit card use. Conversely, if the rate is too low, issuers will be forced to implement fees to the consumer or no longer provide debit card services. Rate regulation is designed to balance corporate and consumer interests. Net revenue is not guaranteed; however, there must be enough revenue to cover operating expenses and business capital costs. *See, Commission v. Hope Natural Gas*, 320 U.S. 591 (1944). Unfortunately, the FRB, when calculating the merchant interchange cap, did not balance consumer interests with those of issuers and acquirers. Issuers are faced with a lopsided interchange fee.

When determining interchange fee rates, the FRB is bound to implement the following statutory constraints:

- the interchange fee must be an amount that is reasonable and proportional to the cost incurred by issuer with respect to the transaction 15 U.S.C.A. §1693o-2(a)(2);

- it must consider the functional similarity between electronic debit transactions and check transactions. 15 U.S.C.A. §1693o-2(a)(4)(A); and

- distinguish between the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance or settlement of a particular electronic debit transaction and other costs incurred by an issuer which are not specific to a particular electronic debit transaction. 15 U.S.C.A. §1693o-2(a)(4)(B).

The proposed interchange fee is contrary to statute. It is based upon the presumption that debit transactions are a component of demand deposit accounts rather than a separate product and cost center. Second, the proposed cap is neither reasonable nor proportional to the incremental costs of providing debit card transactions. Finally, the proposed fee does not consider all of the elements which comprise accounting, clearing and settlement costs.

Small and large issuers are faced with the unfortunate dilemma of advocating whether Alternative 1 or 2 is a "reasonable and proportional" merchant interchange fee. Neither is. Historically, debit card issuers earned a 44 cent interchange fee. The FRB establishes a median processing fee between 7 and 12 cents, regardless of the authorization type. With the cap, issuers will experience a 73% reduction in debit fees. Conversely, merchants will benefit from reduced pricing with no guarantee that any portion of the savings is passed on to the consumer.

If a choice must be made, then Alternative 2, with the 12-cent cap, is the lesser of two evils. However, the cap does not allow cost recovery, let alone a profit. Accordingly, the concept of any cap, which is nowhere to be found in the enabling legislation, should be discarded. A rate incorporating the fixed and variable costs of providing debit card services is the preferred alternative.

The costs associated with demand deposit and debit accounts are similar, though not identical.

When determining the merchant interchange fee, the FRB incorrectly presumes the costs associated with providing debit cards are identical to demand deposit accounts. This is untrue and contrary to statute. Section 15 U.S.C.A. §1693o-2(a)(4)(A) requires the FRB consider the functional similarities between the two accounts. To presume the accounts are identical is to presume the accounts have no separate functions with associated costs. To provide debit transactions, an issuer must join a network and choose a processor (under the proposed regulatory scheme, issuers must now join a minimum of two and possibly up to four networks), pay network and processor membership and processing fees and guarantee funds for signature transactions, which are not costs associated with demand deposit accounts. Debit card issuer activities are more expensive to maintain than demand deposit account and check clearing account activities. Although the FRB acknowledges differences between the two accounts, it makes no corresponding price adjustments. The FRB failed to calculate debit transaction costs as a separate cost center, thereby creating an artificially low merchant interchange rate.

The proposed merchant interchange fee cap of 12 cents is neither reasonable nor proportional to the issuer's cost of providing electronic debit transactions.

By statute, the interchange fee must be reasonable and proportional to the costs for electronic debit transactions. The proposed 12-cent interchange fee cap is unreasonable, because an issuer will recover only a small portion of costs incurred to provide debit card services. The interchange fee does not include fraud adjustment costs and does not appropriately calculate the costs for authorization, clearance and settlement.

Even the FRB's survey results establish the issuer's debit card transaction costs are higher than the proposed 12-cent cap. The audience for the survey was the non-exempt issuers, whose transaction volume and sales purchase dollars are far less than those for exempt issuers. Thus, the median amount used to establish the 12-cent cap is not inclusive of costs as exempt issuers historically have higher costs.

Proposed §235.3(b)(iii) provides the interchange fee cap should have adjustments for fraud prevention costs, yet the FRB calculated a proposed fee without them. From the date the capped merchant interchange rate is effective, July 21, 2011, until fraud adjustment costs are included in the interchange fees, issuers will be deprived of revenue to which they are entitled to help cover the cost of providing debit card services free of data security breaches that harm consumers - further evidence of unreasonable and disproportionate fees.

The statute authorizes the FRB to consider authorization, clearance and settlement costs when determining an interchange fee rate. When making this calculation, the FRB narrowly defined an "exclusive list" of the least expensive components of authorization, clearance and settlement costs, while ruling out all others. The inclusion of authorization and settlement costs should include the following:

> ***Authorization costs*** should include dual authorization requests, identity verification, and card validation costs; and
>
> ***Settlement costs*** should include Fed service fees for lines of credit fees charged for daylight overdrafts, cost of "on deposit" as well as "non-earning deposits", settlement, overdraft funds and costs and loss revenue to guarantee merchant transactions.

The exclusion of these incremental costs, as well as fraud adjustments, in the interchange fee cap, is unreasonable. The interchange fee cap is merchant-driven, designed to reduce merchant costs for debit card routing. This is accomplished by reducing the income earned by issuers, acquirers and payment card networks. Issuers do not recover the costs associated with providing debit transactions. Apparently, this is inconsequential as "issuers have other sources of income, besides interchange fees, from which they can receive revenue to cover operation costs and earn a profit". 75 Fed.Reg.Vol. 75, No. 24; 81733, fn 43 (December 28, 2010). The FRB requires issuers to rely upon other products or sources to supplement the reduction in interchange fees, yet ironically excludes the actual costs of providing debit card services when calculating the cap.

Question. The Board requests comment on whether it should allow recovery through interchange fees of other costs of a particular transaction beyond authorization, clearing, and settlement costs. If so, the Board requests comment on what other costs of a particular transaction, including network fees paid by issuers for the processing of transactions, should be considered allowable costs. The Board also requests comment on any criteria that should be used to determine which other costs of a particular transaction should be allowable.

The proposed merchant interchange fee should include costs for additional variable and fixed costs, as well as network and gateway costs, associated with providing debit card transaction services.

Answer: The FRB should allow issuers to recover costs beyond authorization, clearing and settlement when calculating an interchange cap as well as adjustments for the type of merchants and type of transactions. The interchange fee should include calculations for the following:

The merchant interchange fee should include additional costs.

> ***Additional variable costs*** for card production, embossing, mailers, monthly statements, postage, card residency and processor fees, electronic warning bulletins, and systems security;
>
> ***Network and Gateway costs.*** Since the proposed rules require access to at least two additional networks to enable merchant routing selection, corresponding network processing and gateway costs should be factored into the interchange cap. Gateway fees should be included as not all processors have direct network access, especially smaller networks which need to subroute to gateways for access to larger networks. Issuer "costs" can be recovered for authorization, clearance and settlement should be factored in the interchange transaction fee. The median amount of 12 cents is not inclusive of allowable fees; and
>
> ***Fixed costs*** attributable to providing debit services, such as insurance, POS and signature-based equipment, staffing and facilities costs.

The FRB narrowly reads 15 U.S.C.A. §1693o-2(a)(4)(B)(ii) as excluding all costs of doing business. This is an incorrect interpretation. The statute prohibits consideration of costs shared with other products, not costs which are a component of debit card services.

The merchant interchange fees should be distinguished based upon merchant and transaction types.

The FRB should calculate interchange fees based upon type of merchant and whether the transaction is PIN or signature-based and considering the following:

> ***Merchant type.*** Interchange fees should include cost variances based upon the type of merchant and risk involved. For example, merchants with higher incidence of fraud, such as an internet merchant or merchant who accepts

transactions without a card being present or without sufficient authentication tools should pay higher interchange fees as they expose the debit card issuer and payment card network to more liability; and

Transaction type. Interchange fees should include cost variances based upon whether the transaction is signature or PIN-based. Signature-based transactions require two authentication methods and clear in two to three days, during which time the issuer guarantees funds until the transaction is cleared. PIN-based transactions have a single authentication method, are verified immediately and the funds are not issuer-guaranteed. Signature transactions cost approximately 50% more than PIN-based transactions and the fees should reflect the disparity or a separate rate should be established.

The proposed interchange rate in not reasonable, as it does not appropriately calculate the costs associated with providing debit cards services. The disparate fees will impact all issuers- exempt and non-exempt. To limit interchange fees to variable costs, without including fixed costs is contrary to statute, sound business principles and general accounting procedures.

Despite reduced income, issuers are expected to provide identical services. This will come with accompanying consumer costs. Issuers cannot afford to provide debit services, without recouping their expenses. Consumers may be charged transaction fees and "free" checking may disappear. Credit unions are founded on the basis of "people helping people"; they are consumer-owned financial cooperatives. Their foundation is based upon providing affordable financial services. The proposed capped debit interchange rate will not permit credit unions to continue providing consumer-friendly products in other service areas, without assessing new or higher fees for those services.

Conversely, merchants benefit, with no accompanying costs or regulatory requirements. Merchants are not required to pass their decreased costs to consumers nor are their prices capped. Merchants receive the same debit card services, at a reduced rate, without any corresponding fraud liability at the expense of issuers and consumers.

Question. The Board requests comment on the alternatives for implementing the prohibition on network exclusivity arrangements. Comment is requested on the cost and benefits of each alternative, including issuers, merchants, cardholders and the payment systems overall. In particular, the Board requests comment on the cost of requiring multiple payment networks for signature-based debit card transaction and the time frame necessary to implement such a requirement.

Answer: In §235.7, the FRB proposes two alternatives for the prohibition of network exclusivity. Alternative A requires an issuer to provide access to two unaffiliated networks for processing electronic debit transactions. Alternative B requires an issuer to provide access to two unaffiliated payment card networks for each authorization method-PIN or signature-based.

ICUL supports Alternative A, with reservations. Alternative A is preferred, as the statute does not require issuers to provide multiple unaffiliated networks for each transaction type. The prohibition is against exclusivity and mandatory routing among affiliated networks, not the number of networks an issuer or merchant may participate. Alternative B suggests issuers must participate in as many as four unaffiliated networks-two for each method of authorization, which is contrary to statute. Issuers will incur significant new costs, by being required to participate in additional networks, pay additional annual network fees and receive redundant fraud service and authorization, clearing and settlement fees, when there is no statutory basis for this requirement.

This regulation is designed to promote network competition and eventually pricing, by routing transactions through two unaffiliated networks. Notably, there are no restrictions on merchants. Section 1693o-2(b)(4) establishes antidiscrimination debit card standards. This effectively implements the "Honor all cards" operational provision which card associations require merchants to follow. This provision was inserted in the interchange rate amendment to ensure that, notwithstanding the establishment of a two-tier interchange rate structure, small issuers would not be discriminated against by merchants. Without compliance, merchants will steer transactions to less costly non-exempt issuers. Discriminatory routing will occur. Exempt issuers will suffer and their exemption will erode.

Despite the statutory authority and obligation to promulgate regulations, the FRB has not proposed any rules to effectively implement the non-discriminatory access provisions. The FRB has an affirmative statutory responsibility to ensure there is no discrimination among debit card issuers within a payment card network. It has not done so. The FRB must draft regulations imposing non-discrimination rules to protect issuers to implement its statutory obligations. To intentionally omit these provisions is to circumvent its statutory responsibility and authority.

The FRB's inaction is an abuse and inherent oversight, which works to the benefit of merchants. Merchants receive routing freedom of choice. Networks receive pricing freedom of choice. Issuers may not recover processor or network fees as a component of "allowable" interchange fees. Neither merchants nor card networks or processors are regulated. Merchant routing freedom of choice is a consumer's restriction-merchants can encourage PIN over signature transactions and route payments to the payment card network with the lowest merchant costs. Merchant activity is unrestricted. There is no obligation whatsoever placed on the merchant to pass any savings onto the consumer. As there are no tools to enforce, challenge or restrict merchant or network activity. The FRB must incorporate enforcement and penalty provisions in the proposed regulations.

Issuers will incur costs for adhering to the network rules they will need to join under the FRB's proposal, as well as costs to issue new plastics and establish new network relationships and contracts. Those costs include legal fees for network agreements and operational rules review, consultation, negotiation and execution, which incidentally are not allowable costs incorporated in the interchange fee.

Question. The Board requests comment on whether the proposed rules on prohibition or circumvention of the interchange rules are appropriate to address concerns about circumvention or evasion of the interchange fee standards.

Answer:

Network routing

In §235.7(b), the FRB addresses the statutory prohibition against the establishment of routing restrictions by issuers or networks. However, the FRB fails to make any reference whatsoever to the countervailing statutory obligation of merchants not to discriminate against issuers. §1693o-(2)(b)(4) affirmatively directs the FRB to prevent merchant debit card discrimination against issuers. The FRB should accomplish this task through the establishment of an appropriate regulatory framework. The regulations as proposed provide that issuers and payment card networks may not direct the routing of electronic debit transactions. By failing to address the anti-discrimination obligations of merchants, merchants are free to route transactions to the least expensive non-exempt issuers. Ironically, when the FRB is provided with explicit directions by Congress regarding the agency's development of regulatory standards, it shirks its responsibilities and promulgates a proposed rule totally devoid of that guidance. Again, to the benefit of merchants.

As proposed, there is no protection for small issuers because there is no restriction on merchants. Merchants control routing, not issuers and clearly not consumers. They will route transactions to the lowest cost networks, with no requirement for data security systems, responsibilities for data breach, fraud losses or consumer protection from fraudulent transactions. All of which today are components of interchange and merchant guarantees by the issuers. They can offer cardholder discounts for using a merchant cost effective network. There are no mechanisms to prohibit or penalize merchant steering. For this rule to have any impact, the FRB must draft regulations which apply to all actors in the debit card payment arena as well as incorporate procedures to monitor routing, as well as establish penalties for merchant routing.

Net Compensation

Issuers may not receive "net compensation" from payment card networks for debit card transactions. There are no similar restrictions on merchants or networks. Merchants and networks may route transactions at the expense of small exempt issuers. Nor are there prohibitions against merchants providing consumers discounts for using a particular card or initiating a PIN rather than signature-based transaction. Merchants should not be allowed to accept payments or incentives for network steering. Nor should they be allowed to provide consumer discounts for using merchant friendly networks. The regulations must be revised to incorporate enforcement and penalty provisions, which are necessary to protect the smaller issuer from merchant steering to non-exempt issuers. The FRB must follow the statutory lead set forth in §1693o-2(b)(4), and must implement its administrative authority under *Chevron.*

Further, the FRB should define "net compensation" and provide examples of what is and isn't allowed and articulate consequences for violations.

FRAUD COST ADJUSTMENTS TO MERCHANT INTERCHANGE FEES

Question. Should the Board adopt technology-specific standards or non-prescriptive standards that an issuer must meet in order to be eligible to receive an adjustment to its interchange fee? What are the benefits and drawbacks of each approach? Are there other approaches to establishing the adjustment standards that the Board should consider?

Answer: The FRB should not adopt technology-specific standards. Technology varies by issuer, processor and payment card network size and software and hardware used. Compliance costs will vary based upon software and technological changes, as well the introduction of new fraud schemes and breaches. If adopted, the FRB should draft regulations which allow for flexibility and are applicable to all merchants, issuers, processors and payment card networks alike.

Non-prescriptive standards are the preferred alternative and are consistent with the approaches in the Gramm Leach Bliley Act ("GLBA"), and the identity theft, red flag provisions of the Fair Credit Reporting Act ("FCRA"). For example, the GLBA requires guidelines for protecting customer financial information. Similarly, the FCRA requires identity theft prevention guidelines. The issuer, not the FRB, needs to determine what efforts it must undertake to provide sufficient fraud prevention techniques. A uniform standard will not fit all. Non-prescriptive standards establish guidelines for industry-accepted fraud tools, such as neural networks, name matching, and dynamic key exchange.

Question. If the Board adopts technology-specific standards, what technology or technologies should be required? What types of debit-card fraud would each technology is effective at substantially reducing? How should the Board assess the likely effectiveness of each fraud-prevention technology and its cost effectiveness? How could the standards be developed to encourage innovation in future technologies that are not specifically mentioned?

Answer: The FRB should not adopt technology specific standards.

Question. If the Board adopts non-prescriptive standards, how should they be set? What type of framework should be used to determine whether a fraud-prevention activity of an issuer is effective at reducing fraud and is cost-effective? Should the fraud-prevention activities that would be subject to reimbursement in the adjustment include activities that are not specific to debit-card transactions (or to card transactions more broadly)? For example, should know-your-customer due diligence performed at account opening be subject to reimbursement under the adjustment? If so, why? Are there industry-standard definitions for the types of fraud-prevention and data-security activities that could be reimbursed through the standard differ for signature and PIN-based debit card programs?

Answer: The fraud prevention non-prescriptive standards should be adopted with consideration for the network industry wide standards and issuer costs.

The statute requires consideration of the "reasonable and proportional" costs; therefore, only fraud preventive costs associated with debit card transactions should be considered. Fraud adjustments for debit transactions require the same cost, whether it is debit-signature, PIN or credit. On average 19% of issuer debit program expenses are attributable to fraud prevention. The costs are comprised of processor and payment card network expenses for neural networks, transaction scoring, name verification, address verification, software systems, and rule writing systems for financial institution specific fraud. These costs should be considered in the fraud-prevention and fees.

Issuers bear the majority of fraud losses and have a vested interest in implementing fraud prevention tools offered by the processor and payment card networks. Fraud adjustments should be based upon issuer costs to implement fraud tools. Currently, the fraud prevention tools include:

- consumer name matching, address verification, and neural network transaction scoring, using consumer shopping patterns and merchant location with consumer comparing demographics to verify transactions which occur after the transaction is approved;

- automatic blocking the cardholder account if a pattern indicates "extreme out of character" transactions or high risk transactions conducted by compromised merchants. This automatic blocking prevents the transaction from being authorized and neither the merchant nor the issuer may approve the transaction;

- the ability to write fraud rules based on a financial institutions fraud experience; and

- exercising chargeback rights for transactions reported as fraudulent.

Unfortunately, not all merchant systems have updated technology to support these fraud tools. Similarly, it is unfortunate that the payment card networks do not require merchants to implement fraud tools. The FRB should not cherry pick what fraud components it deems essential. Each part is a component of the total fraud package and each part should be considered in calculating a fee.

Insurance costs should also be included in the fees. Credit unions are risk adverse and have subscribed to a practice of purchasing plastic card insurance. Plastic card insurance works like the typical insurance program where the credit union pays a premium, establishes a deductible and files consumer card loss claims against this deductible. Insurance premiums are based upon credit union experience. The more frequent the claims, the higher the premium or deductible, fewer claims result in lower premiums. Credit unions have implemented fraud preventive tools, established fraud departments with employees and have aggressively taken ownership of managing fraud losses to protect consumers. Staff expenses for employees specifically dedicated to the monitoring, reporting and call center operations for fraud, as well as insurance premiums, are other components of providing debit card services and should be included in the calculations.

Like insurance costs, chargeback fees should be included. The payment card network rules and Regulation E are very specific in allowable transactions and permissive issuer chargebacks. On average, 87% of chargebacks presented are declined, with no issuer chargeback rights. If a merchant swiped the card, received a valid authorization and had a signature on the transaction (the signature doesn't even have to match the name on the card), the transaction is valid. The transaction is returned to the issuer for settling the alleged fraud transaction with a consumer, i.e., taking the loss by crediting the consumer the full amount of the transaction. Payment card networks have zero liability for signature transactions; the issuer retains the loss.

Question. Should the Board consider adopting an adjustment for fraud-prevention costs for only PIN-based debit card transactions, but not signature-based debit card transactions, at least for an initial adjustment, particularly given the lower incidence of fraud and lower chargeback rate for PIN-debit transactions? To what extent would an adjustment applied to only PIN-based debit card transactions (1) satisfy the criteria set forth in the statute for establishing issuer fraud-prevention standards, and (2) give appropriate weight to the factors for consideration set forth in the statute.

Answer: The FRB should not isolate fraud adjustments for PIN and signature based transactions. Each transaction type has associated fraud incidences and chargebacks. To exclude one transaction because of lower costs is non-sensical. Costs are incurred under both. Given the regulatory temperament to lowball interchange fees, the FRB's fraud adjustment costs should include all costs, to preserve these protections.

As provided in §1693o-2, the FRB must incorporate all debit card costs in the adjustment. It may not piecemeal them. The assumption that PIN debit has a "lower incidence of fraud and lower chargeback rate" is flawed. Payment card network rules and Regulation E have specific guidelines for PIN debit fraud. If a PIN is used to perform the transaction, the issuer provides provisional and permanent credits; there are no chargeback rights. Issuers do not chargeback these expenses; they write them off.

Typical PIN-based chargebacks are for incorrect transaction amounts resulting in an adjustment for the difference between the settled transaction and the actual transaction or funds for a duplicate transaction (the same transaction being presented multiple times). To provide an adjustment for only PIN-based transactions is neither "reasonable nor proportional". It could be a precedent setting event which impacts adjustment amounts for signature-based transactions. A debit transaction whether PIN or signature based has the same costs for fraud prevention, neural network, transaction scoring, name matching, and CV verification components. Signature based transactions have only one additional PIN verification. Each fraud prevention activity has a direct expense to the issuer, regardless of transaction type.

Question. Should the adjustment include only the costs of fraud-prevention activities that benefit merchants by, for example, reducing fraud losses that would be eligible for chargeback to the merchants? If not, why should merchants bear the cost of activities that do not directly benefit them? If the adjustment were limited in this manner, is there a risk that networks would change their rules to make more types of fraudulent transactions subject to chargeback?

Answer: The purpose of fraud cost adjustments is to compensate issuers for providing secure, authenticated and guaranteed merchant payments. Merchants do not bear the costs of fraud risks or losses, and in fact receive preferential pricing under the proposed rules. In the debit card system, the risk of loss for fraudulent and uncollectible payments is borne by the issuers. The risk of loss is placed on issuers by network rules, which limit issuer defenses. Debit card transactions are guaranteed; merchants may discontinue providing risky checking alternatives to consumers, with the attendant expense of attempting to recover payment from a consumer who tendered a NSF check. Under the proposed regulations, merchants receive reduced interchange fees, without a corresponding loss in services or fraud protection risks. Any loss to the merchant is incorporated in its capped interchange fee.

Fraud adjustments must include costs incurred by issuers, processors and networks, as they are the ones bearing the cost of the electronic payment system infrastructure and accompanying technology costs, as well as the expense of guaranteeing funding amounts for debit signature transactions.

Question. To what extent, if at all, would issuers scale back their fraud-prevention and data-security activities if the cost of those activities were not reimbursed through an adjustment to the interchange fee?

Answer: If interchange fees do not include fraud prevention and data security risks, non-exempt issuers will bear even more uncompensated expenses and may discontinue providing debit card services. To be competitive with large issuers and non-traditional payment card networks, such as PayPal, GreenDot and Wal-Mart, issuers must provide "best practices for fraud prevention" and consumer "zero liability" rules. These come with a cost. Issuers will suffer additional losses and may be compelled to provide debit card services, particularly signature- based transactions, for a fee.

Time and resources must be allocated by issuers to properly perform fraud-prevention and data security tasks and functions. Arbitrarily capping interchange fees will compromise those efforts, because the expense of the service is not recovered.

Ultimately, the interests of consumers in advancing the secure handling of their personally identifiable information will be harmed.

Question. How should allowable costs that would be recovered through an adjustment be measured? Do covered issuers' cost accounting systems track costs at a sufficiently detailed level to determine the costs associated with individual fraud-prevention or data-security activities? How would the Board determine the allowable costs for prospective investments in major new technologies?

Answer: Issuers should be compensated for actual debit card fraud prevention activities and losses, data breach expenses and processor and payment card network costs for implementing fraud prevention and data security systems.

Question. Should the Board adopt the same implementation approach for the adjustment that it adopts for the interchange fee standard, that is, either (1) an issuer-specific adjustment, with a safe harbor and cap, or (2) a cap?

Answer: The FRB should not adopt a cap for fraud adjustments like the proposed cap for interchange fees. As stated above, the interchange fee cap is not reasonable, proportional or based upon costs incurred by issuers. Instead, the FRB should conduct hearings and obtain cost information and analysis prior to implementing any governmentally mandated limit on fraud prevention activities.

Question. How frequently should the Board review and update, if necessary, the adjustment standards?

Answer: Adjustment standards, which should contain no caps, should be reviewed in conjunction with revisions to the interchange fees and with statutory or industry-wide changes which alter an issuer's obligations.

Question. EFTA Section 920 requires that, in setting the adjustment for fraud-prevention costs and the standards that an issuer must meet to be eligible to receive the adjustment, the Board should consider the fraud-prevention and data-security costs of each party to the transaction and the cost of fraudulent transactions absorbed by each party to the transaction. How should the Board factor those considerations into its rule? How can the Board effectively measure fraud-prevention and data-security costs of the 8 million merchants that accept debit cards in the United States?

Answer: As stated above, merchants bear no responsibility for issuer losses nor are they required to implement fraud protection suggestions by PCI industry or payment card networks. Issuers guarantee transaction costs for signature-based transactions. Any chargeback losses should be assumed by the merchant as a cost of doing business especially since chargeback reasons may be attributable to the merchant. Since the FRB expects issuers to bear the actual costs of doing business, so too should merchants.

When making a fraud adjustment determination, the FRB should not lock in or endorse a particular fraud prevention tool. The FRB should request comment from networks, processors and exempt and non-exempt issuers regarding actual fraud losses, associated dispute costs and examples of industry "best practice" standards for appropriate and cost-effective fraud prevention responses.

Question. Should non-traditional or emerging payment systems be covered by the statutory definition of 'payment card network'?

Answer: The definition of 'payment card network' should include non-traditional and emerging payment systems, such as Pay Pal and networks which access mobile phones for internet banking. They are third party intermediaries that provide authorization, clearance and settlement services.

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The proposed regulations do not enforce or mandate a specific interchange schedule exemption, nor protect small issuers from merchants steering. Small issuers do not have the infrastructure to support debit card programs with fees which do not reasonably or proportionally support the costs associated with providing debit card programs. Market realities will force small issuers to accept the merchant interchange fee cap imposed on non-exempt issuers. Essentially, small issuers lose their exemption.

During the last two years in Illinois alone, eighty-eight credit unions merged. This regulation arrives in a time of mergers and increasing financial institution regulation, reduced revenue with increased credit risks and reduced consumer spending and borrowing. Issuers will have no choice but to pass the costs onto consumers. Merchants win and profit. Consumers and issuers lose and pay.

For the reasons set forth in this correspondence, the Illinois Credit Union League and the Illinois credit unions it serves that, in turn, provide financial services to almost 3,000,000 consumers, object to the regulations proposed by the FRB. Additionally, ICUL Service Corporation and the hundreds of credit unions it serves throughout the nation that, in turn, offer debit card services to hundreds of thousands of cardholder members, also object to the rulemaking. Thank you for providing us with the opportunity to comment.

Very truly yours,

ICUL SERVICE CORPORATION

By: Cathy E Pettis

Cathy E. Pettis
Senior Vice President

Very truly yours,

ILLINOIS CREDIT UNION LEAGUE

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