PSCU FINANCIAL SERVICES®

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February 22, 2011

Jennifer J. Johnson
Secretary
Federal Reserve Board of Governors
20th Street and Constitution Ave., NW
Washington, DC 20551
Via email:

Re: Docket No. R-1404 and RIN No. 7100 AD 63
Federal Regulations II, Request for Comment

Dear Ms. Johnson:

PSCU Financial Services, Inc. ("PSCU-FS") is a not-for-profit cooperative owned by over 680 member credit unions. We are the nation's largest Credit Union Service Organization ("CUSO"). The Company provides a broad array of financial services that include complete signature and PIN debit processing with ATM Terminal driving, point-of-sale debit card, and gateway processing. PSCU-FS is an advocate for its Members and promotes credit union industry growth initiatives. We are submitting these comments on behalf of our credit union members.

General Comments

Delay Implementation of the Regulations

We believe that additional time is needed for the Federal Reserve Board to conduct a thorough study of debit interchange processing prior to issuing final interchange rules. The Board needs time to study the debit transaction costs of small issuers, time to develop provisions that protect the small issuer's exemption, time to incorporate fraud provisions into the interchange rate standards and time to develop rate standards that ultimately allow small issuers to have a self-sustaining product that includes a reasonable rate of return, without resorting to adding costs to consumers.

Given a mandate by Congress to issue the final rule on interchange rate regulation by April 21, 2011 with an effective date of July 21, 2011, the Board was handed an extraordinarily limited

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window to develop a proposal, particularly in light of the significant impacts of the debit interchange statute to financial institutions, merchants, consumers and debit payments systems. We believe such a compressed time frame produced a proposal that has several significant misinterpretations to the interchange statute. Rather than continuing with the current proposal, we urge the Board to work with Congress to reach agreement that a delay of twenty-four months ensures the achievement of a more evenly-balanced implementation of the interchange provisions.

A delay of twenty-four months would allow policymakers time to address unresolved issues, including how best to protect the interests of small issuers as Congress intended, how to ensure consumers are not harmed by reduced debit services and/or increased fees, how to ensure consumers will share in any cost savings to merchants that may result from reduced interchange fees, how to minimize the loss of jobs in the financial services industry resulting from reduced interchange revenues to financial institutions, and how to minimize disruptions in the processing and payment of debit transactions. Given the objectives of the interchange amendment to benefit consumers, the failure to assess the impact of the proposal on consumers is a significant shortcoming that should be addressed; additional time for implementation would accommodate this important undertaking. Last week's hearings reflect that there is growing support for such a delay in Congress, and we believe it could be accomplished if the Board and Congress work together to achieve it.

Consumer Harm

The key effect of the proposed rule is the transfer of revenue from the banking sector to the merchant sector which, as it stands today, will happen without regard to the impact to consumers. To maintain current levels of capital and current levels of member service, credit unions will likely have to raise prices and add new fees to make up for this transfer of revenue. In fact, we have already seen many large issuers add new fees and increase existing fees to make up for the expected loss in interchange revenue.

Credit unions are working to restore capital that was lost over the past two years. Compounding the hit to revenue in the loss of debit overdraft fees and revenue limitations imposed by the CARD Act, the drastic loss of interchange revenue to credit unions will likely have a downstream impact to the services each can offer its members. The survival of credit unions hinges on how successfully it makes these price adjustments. Many services credit unions provided in the past at negligible, no or low cost will now probably be paid by their members. Credit unions will likely have to ask consumers to contribute more to the cooperative through new fees, higher account maintenance fees and higher loan rates. Other financial institutions may be forced to lay off employees as a result of lost debit interchange revenue, which seems to be a clear consumer harm that will result from the rule.

We can expect that the timeframe for issuers to pass on increased costs to consumers will be accelerated if the rate rules are implemented this July. The increased fees and rates will be necessary to fund the expected shortfall for the many costs that would not be covered by a $.12 fee cap, such as card issue and re-issue, compliance, cardholder's customer services, and a reasonable return on investment.

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Moreover, our credit unions have returned millions of dollars to consumers in the form of low loan rates, high deposit rates and year-end loan interest refunds or dividends. The rule would not only prevent credit unions from returning profits to consumers in the future but as indicated above would also cause them to search for alternate sources of revenue from those consumers.

We are puzzled how this rule can further the objectives of a "Consumer Protection Act". It seems more appropriate to call it a "Merchant Protection Act" given the clear benefit to merchants and the harm to consumers and issuers.

***Maintaining the Exemption* for Small Issuers Under $10 Billion**

In order to implement the interchange provisions as Congress intended, the Board cannot be indifferent as to whether the exemption for small issuers works or not. The same holds true of the exemption for general purpose reloadable and government-administered payment cards. Although the statute itself clearly includes an exemption for small issuers, it is not self-executing. There must be a two-tiered rate structure, under which large issuers' interchange fees comply with the Board's rule, and small issuers receive higher fees that are excluded from the Board's regulation, as Senator Durbin clearly set forth. As discussed below in the Considered Costs and Allowable Costs section, PSCU-FS does not support the Board's conclusion that it is authorized to set interchange fee caps, as it is proposing to do. Nevertheless, we believe that regardless of the Board's approach for either setting fee caps or developing standards for reasonable interchange rates, the Board is required by the interchange statute to proactively exempt small issuers from the impact of its rate regulations. Quite simply, without a two-tiered structure, there is no exemption. We believe that requiring reports on the two-tiered system from the networks and the fact that such reports should provide sufficient regulatory incentives to ensure the networks will maintain two-tiered systems, subject to Board and Congressional oversight of those reports over time.

It is clear the Board has a congressionally-imposed responsibility to implement the exemption since the Board is the sole regulator of the interchange provisions. It is also clear that the Board is empowered under the statutory interchange provisions to ensure the exemption will be implemented. Section 920(a)(1) of the EFT Act authorizes the Board to write regulations "to prevent circumvention or evasion of this subsection" (on interchange rate provisions). That general grant of authority applies to all of the interchange amendment provisions that address interchange rate limitations, including the exemption for small issuers. We find no indication in the statute or legislative history to diminish a reliance on this language to regulate, and thereby protect, the exemption. We believe Congress intended the Board to adopt a final rule and commentary that fully implements the exemption.

Further, we note that in assessing the Board's rule a court of law would consider that the Board undertook to read into the statute authority to set interchange fee caps, rather than limit itself to setting standards for assessing whether fees are reasonable and proportional to an issuer's transactional costs. The Board also undertook to assume authority to regulate ATM transactions under the interchange regulation, which is also not envisioned by the statute. Yet, the Board would ignore its statutorily designated responsibilities to implement the exemption. A court would likely conclude that the Board's selective implementation goes beyond the authority provided in the interchange statute and would be an indication that the proposal is arbitrary and capricious.

We are gravely concerned that the fee cap will ultimately be applied to small issuers despite an exemption based on an under $10 billion asset size. While one network has informally indicated it will support a two tiered interchange system, implementing that technology is quite costly. That network and other networks have also stated that they need to retain the ability to reprice according to the marketplace. Without regulation, merchants and large issuers will influence the networks to minimize the differences in any two tier system and to increase the system fees paid by small issuers – the net result on small issuers will be a marginally or negligibly higher effective interchange rate, which result would contravene the clear intent of the statute. We urge the Board to issue regulations that require the networks to maintain a two tier interchange system at no charge to small issuers, with a requirement that the higher tier offer exempt issuers a <u>materially</u> higher effective rate of interchange after factoring in the network costs, fees and charges paid by the exempt issuers.

Merchants may ultimately discourage the acceptance of higher-interchange-rate cards issued by exempt issuers. How the enforcement of the exemption will work is not yet known. We urge the Board to adopt regulations detailing the enforcement of the exemption and also requiring that networks enforce the exemption under their network rules. In addition, the Board should issue regulations that: (a) prohibit merchants from discriminating against exempt issuers either individually or as a group, by either steering consumers to other cards or payment forms, charging consumers for using small issuer cards or refusing to accept small issuer cards; and (b) establish penalties that merchants would incur for such prohibited activities.

<u>Request for Comment Issues</u>

Definition of Issuer

The Board is seeking comment on proposed §235.2(k), which provides a definition of the term *Issuer*. The statute defines *Issuer* as "any person who issues a debit card or the agent of such person with respect to such card." In its commentary to proposed §235.2(k), the Board suggests that the removal of the clause "or agent of such person with respect to the card" will not have any substantive effect on the rule. This change would revise the term *Issuer* as "any person who issues a debit card."

The Board should not further narrow the definition of the term *Issuer*. In fact, we recommend that the definition retain the spirit of the statutory language as well as provide further clarification as to avoid circumvention of the rule by non-exempt financial institutions.

For example, proposed §235.2(k) does not seem to directly address instances where a non-exempt financial institution makes arrangements to perform the debit card issuance, processing and settlement functions through an agent or subsidiary holding less than $10 billion in assets.

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In this case, the agent or subsidiary, being exempt, would seem to have the ability to collect unregulated interchange and pass those unregulated dollars to the non-exempt financial institution that holds the underlying deposit account. The Board should clarify that such exemption would not be permitted.

Definition and Inclusion of Three Party Networks

The Board is seeking comment as to whether or not the required interchange fee standards should be appropriately applied to transactions carried over three-party payment system. In a three-party payment system, a payment network plays the roles of both the card issuer and merchant acquirer for purposes of accepting payment on the network. Examples of networks involved with a three-party system are American Express, Discover and PayPal.

Most - if not all - payment networks involved in a three-party system have the ability to process debit card transactions, as defined by the statute. In this type of arrangement, there is no explicit interchange fee. However, merchants are required to pay a merchant discount to the payment network, which includes the sum of items such as network switch fees, other acquirer costs, and interchange costs.

We believe that transactions carried across networks involved in a three-party arrangement should consistently be held to the same interchange fee standards as transactions carried over a more traditional four-party arrangement. If not, payment networks involved with a three-party system would hold an unfair advantage of receiving higher, unregulated interchange as compared to card issuers participating in an interchange-regulated four-party system.

We acknowledge that within today's three-party payment system arrangements, interchange is generally implicit and essentially 'baked into' the merchant discount. It is possible for three-party issuers to make adjustments within the merchant discount to circumvent the rule for the purpose of preserving today's rate of interchange. In its final rule and accompanying clarifications, the Board should account for this possibility of circumvention and hold three-party issuers accountable for complying with the final rule as it relates to interchange rates.

Considered Costs and Allowable Costs

Any regulation of electronic debit transactions should retain and promote the economic viability of these transactions. Debit card issuers must make significant investments in their debit card operations. The costs should include a reasonable rate of return on the issuer's investments; if these investments do not yield a market rate of return, then over time the funds will simply not be available for investment. Just as regulated utilities are allowed to earn a reasonable rate of return, so too debit card issuers must be allowed to earn a reasonable rate of return.

Historically, interchange was structured to compensate issuers for the cost of offering and managing card programs, including fraud loss and fraud prevention. It is our opinion that the Board took an overly narrow view of the costs which can be considered. For instance, the costs

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associated with clearing and settlement should include the posting and statementing of the transaction as well as the resource expense of supporting responses to consumer inquiries and exception research. Core and transaction processing systems require development and maintenance to stay up-to-date and compliant for the benefit of consumers.

It is our opinion that the Board did not get sufficient cost data by surveying only the covered issuers. Community financial institutions, such as credit unions, will typically have higher operating costs than large national banks. Because the lowering of interchange rates will impact all debit card issuers (as discussed above), the Board also needs to take the costs of credit unions and community banks into consideration when setting rate caps.

The current proposal takes into account only three elements of interchange (authorization, settlement and clearing costs) and has priced each transaction at a maximum of $0.12. Although these three components define the actual function of a debit transaction, there are many other additional costs that allow a card transaction to be executed and are <u>necessary</u> for a debit program to exist in the first place, without which there would be no transactions. It is these additional costs that will directly impact credit unions and other issuers.

We believe that the following costs should be reviewed and included in setting the interchange rate:

1. Overhead - to manage card infrastructure which includes phone calls, integrated voice response systems, call center employee salaries
2. Plastic - to include Shipping/Embossing/Encoding/Security of Encryption/Reissuance
3. Issuance - Activation, PIN encryption, Unique bins and varied debit programs
4. Exception processing - chargeback, disputes and arbitration
5. Fraud - Prevention and losses, Skimming, Phishing, Merchant breaches and compromises
6. Compliance - PCI mandates, card technical specifications, international transaction support
7. Technology - 64 bit keys, Dynamic Key, Chip (EMV), Triple DES Authentication, support for ISO 8583 specifications, etc.
8. Payment Infrastructure - Association, Payment networks, Merchant processors, Core processors, Internet, Card processors
9. Going green - Card life is 2-3 years versus paper checks.

Exclusion of these line items could be prohibitive to maintaining solvency of a credit union's debit card program for its members. Allowing a credit union to recover only authorization, settlement and clearing costs would be like setting retail coffee prices and allowing Starbucks and others to recover only the costs of the coffee beans.

Furthermore, the Board has decided to cap rates rather than to establish a regulatory system to assess their reasonableness. The difference is very significant. In today's volume-based processing environment, the largest issuers who bring the largest numbers of debit cards and transactions generally pay the lowest costs to third-party network and processing providers. Smaller issuers with a lower number of debit cards and transactions generally pay higher costs to third-party providers. As such, we believe that it is flawed logic to apply an interchange cap equally across all issuers, regardless of size. Smaller issuers will generally continue to pay higher processing costs than large issuers and yet would still have their revenue capped at $0.12 per transaction. From a net income perspective, this simply does not make sense. Issuers above $10 billion but only by a little will likely be forced to terminate their debit card programs, since they cannot compete against large issuers. Issuers under $10 billion, if there is no enforcement mechanisms on the under $10 billion exemption, could potentially be receiving the same rate of regulated interchange as large issuers and would similarly have issues competing against large issuers.

Moreover, the statutory interchange provisions do not include any references to fee caps as the Board is proposing. In contrast, the statute does include four references to "standards for assessing" debit interchange fees that the Board is directed to develop under Section 920(a)(1),(3), and (5). Despite those references, no such standards are included in the proposal, and in fact the Board is not even requesting comment on whether "standards for assessing" or actual rate caps should be applied.

Finally, the statutory language requires the Board to consider the similarity of debit cards' functional to checks. Functional *dissimilarity* between debit cards and checks should also be considered. Unlike checks, if a merchant follows the proper authorization procedures, they are guaranteed payment on a payment card transaction regardless of the status of the accessed account. Also, unlike checks, the payment card system is funded solely by the voluntary users of the system.

PIN versus Signature

The current market-driven interchange rates are lower for PIN than for Signature debit activity. While it may be appropriate for the rules to allow for differences in the interchange cap based on the authorization method, if the allowable rate remains as low as the proposed rules, we would be opposed to any further reduction regardless of how it would be applied.

The impetus for merchants to add PIN capability to Point-of-Sale terminals has been that the networks fees and interchange rates are lower for those transactions. With no differential in the interchange rates of PIN and Signature transaction activity for merchants, merchants will choose to remove PIN capability at the Point-of-Sale. This will create inconvenience to consumers, who enjoy the speed and ease of using their PIN rather than signing their name. Signature transactions are also more costly in part because they involve a two-step authorization process, as opposed to the single step used for PIN transactions. And signature transactions may carry with them a higher rate of fraud than PIN transactions. It is per se unreasonable not to recognize interchange rate differences between PIN-based transactions and signature-based transactions.

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Fraud

The statutory language allows for the adjustment of the interchange rate based on fraud prevention costs. In its proposal, the Board acknowledged the framework for a fraud adjustment standard was too complex to be offered in December when it provided for a longer timeframe to issue regulations based on the need to gather extensive fraud cost details. We do not agree that final rules for interchange can be issued without the full consideration of fraud costs. The application of a reduction in interchange rates without concurrent consideration for issuers' fraud costs was not the intent of Congress.

One of the original and primary considerations for interchange pricing has always been the recovery of Issuer costs of Fraud prevention and detection. The reality is that for actual Fraud losses, the financial exposure is predominantly carried by the issuers not the merchants. As such, efforts to mitigate this exposure have fallen to the issuer community, and interchange (as priced by the payment networks) has historically been used to offset some of those costs. We urge the Board to abandon their current position relative to fraud costs, and include them into the calculation of regulated interchange rates for all covered issuers.

The fact that issuers predominantly carry the financial exposure for fraud has led to a great deal of Issuer investment and sophistication in the fraud prevention arena. The other side of that story is that card fraud, today, rarely originates on the issuer side but often does on the merchant side. Issuer side anti-fraud technology provides a stop-gap, which is arguably inferior, to prevention activities on the part of the overall merchant community. By excluding issuer fraud prevention costs from the regulated interchange equation, the FRB runs the distinct risk that issuer fraud efforts will erode.

The Board should not enter into the fraud prevention standards business because: (1) fraud prevention technology is so dynamic that any adopted standards would be out of date before they would even be formalized as a standard; (2) the level of investment in fraud prevention is the business decision of an individual issuer (the current amount of money received within interchange for issuers to invest in fraud prevention and/or offset losses is a small fraction of the actual cost); and (3) the Board, in trying to keep up with proper standards in an effective, credible manner, will create substantial costs and additional bureaucracy. Standard setting by the Board could only drive up cost, reduce the number of issuers, and create additional, unnecessary structure within the Board.

In addition, the Board has requested comment on whether fraud cost recovery should be allowed for both signature debit fraud and PIN debit fraud. We do not believe that consumers or other participants in the payments system would benefit from excluding fraud cost recovery for signature debit fraud. All efforts to reduce any type of fraud (PIN or signature based) benefit consumers and others. Recovery for fraud costs increases consumer confidence, encourages innovation, and minimizes the consumer harm from fraud and identity theft. Payments system participants should be encouraged and incented to reduce signature fraud and PIN fraud.

The Board indicated it will develop a separate proposal on these issues, although it would seem such a proposal and comment process will be rushed in order to meet the July 21 deadline for

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implementation of the fraud prevention standards. Rather than implement this provision separately, we believe the rule making process would be improved if the Board addresses these issues in a cohesive manner, as part of one proposal. That would enable issuers to have a better understanding of how the interchange rate caps would be affected by the adjustments and what steps large issuers would have to take to qualify for the fraud adjustments.

Interchange Rate Compliance

Compliance certification for the regulated interchange rates should fall squarely on the payment networks. These entities which set and monitor interchange rates today are best positioned to certify compliance tomorrow. Additionally, assigning compliance responsibility to the payment networks instead of all regulated issuers (an alternative approach to certification), provides the Board with far fewer endpoints to contend with – which should reduce the private and governmental costs of compliance monitoring.

Generally, we have no objection to the payment networks using a variety of rate schedules for regulated interchange. There is a long history of differing rates being applied by merchant category and there are business reasons for that approach. However, we do object to those rates being monitored for compliance at the payment network 'system level'. We propose that the payment networks report by the <u>average rate earned by each regulated issuer</u>.

The very largest issuers could abuse a system if all covered issuers on a network were measured in the aggregate. For example, assume a payment network with two issuers having the same debit volumes and the \$.12 cap -- that payment network should report the average rate for Issuer1 as \$.12 and for Issuer2 as \$.12. If 'system wide' averaging is allowed, a payment network could differentiate and report Issuer1 at \$.20 and Issuer2 at \$.04 – effectively allowing payment networks to manipulate issuer interchange rates based on pressure from large issuers. This is not the case in today's environment, nor is it consistent with the spirit of the legislation. Our small issuer members would be concerned that the networks could manipulate the revenues of small issuers due to the pressures of, and in favor of, their larger issuer customers. The very largest issuers could abuse a system if all covered issuers on a network were measured in the aggregate.

In regards to exception rates for certain card programs (ex. prepaid cards), payment networks currently support separate interchange rate schedules for certain card types. They also know which issuer these card types belong to. This bolsters our position that all interchange rate compliance certification should be performed by the payment networks, at the issuer level, as the networks have the tools to do so.

Network Exclusivity

In the December 16th meeting, the Board acknowledged the routing and exclusivity provisions will likely be problematic for small issuers if the Board does not make important changes in these provisions. Merchants may offer incentives and may steer transaction payments to

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encourage purchasers to use cards issued by large banks, in order to pay the lowest interchange fees. The Board has the authority under Section 920(b)(4) of the interchange amendment to help ensure merchants will not illegally steer card payments and it should amend the final rule accordingly. By adding provisions to protect small issuers against steering, the final rule should require the networks to report to the Board on an annual basis their efforts to enforce network rules that address discriminatory steering. We also think the Board should establish a complaint process under which issuers could request that the Board investigate allegations of merchant steering.

As stated above, we believe that implementation should be delayed. However, if the Board nonetheless moves ahead with implementation, we encourage the Board to adopt Alternative A of the network exclusivity provisions, requiring issuers to offer two unaffiliated networks over which transactions can be routed. Alternative B would require issuers to offer more than two networks which is not what the statute intended and is not currently supported. Alternative B would be unreasonably expensive and complex for the entire industry while providing no benefit to the consumer. In fact, it is likely that consumers would ultimately bear part or all of the significant additional costs to deploy Alternative B. Moreover, Alternative B in our view contravenes Section 920(b). Under that section, Congress did not direct the Board to write a rule that would allow merchants to be able to choose from among four separate debit payment networks. Rather, the statute only directs that merchants be provided two choices, except where networks are affiliated with an issuer.

Regional or Limited Networks

We believe that **all** payment networks should be considered as complying with routing regulations. If a network is enabled for processing debit merchant purchases, the network should 'count', regardless of geographic acceptance footprint. This is one topic in the overall regulatory package where routing and interchange intersect. For regulated issuers, the interchange cap nullifies any material advantage in network selection. For unregulated issuers, where interchange is still market priced, choice of network is driven by acceptance and the current economic models will prevail – which we believe is the intent of the $10B asset exclusion as codified in the statute.

Impacts to Innovation

The Board requested comment on whether adding a second unaffiliated signature debit network to new "debit" technologies (key fobs or contactless chips) could inhibit the development of these devices in the future. The Board also requested comment on steps the Board should take to avoid creating impediments to innovation. PSCU-FS believes that as new technology has made its way into the market, interchange revenue has given credit unions and other community financial institutions the opportunity to invest in the innovative new products that consumers expect. The proposed reduction in the rates of interchange will result in fewer innovative product options being available at both small and mid-size institutions and will increase the competitive advantage for the largest issuers.

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Implementation Timeframes

As stated above, we believe that implementation should be delayed. However, if the network exclusivity Alternative A is adopted by the Board, the proposed effective date of October 1, 2011 is not enough time to implement any necessary changes. Adding a network relationship to a debit card program is a complicated process that includes contract negotiation, coding and testing, card reissue, consumer education and marketing, and ATM configuration changes. It involves the coordinated efforts of multiple parties and can typically take up to a year to complete. We suggest an implementation date one year after issuance of final regulations.

If Alternative B of the proposed network exclusivity rules is adopted requiring card issuers to support two separate signature networks on their debit cards, the complexity and expense of implementation would require more time than the proposed effective date of January 1, 2013. We would suggest an implementation date of three years after issuance of final regulations.

Summary

We believe that the Board has taken an overly narrow interpretation of the Durbin Amendment. The statutory language states that the Board may establish standards for assessing interchange transaction fees and does not specifically require that the Board set the interchange rates. Given that issue and the nature and magnitude of other issues with the Board's proposal, we encourage the Board to withdraw the proposed rules and republish only after full consideration of the requirements of the law, all available options and the potential impacts to consumers and the economy.

If the Board nonetheless moves forward to finalize some form of this proposal, we encourage the Board to: implement the exemption for small issuers so it will have the impact Congress directed; drop the rate caps and include a set of standards to assess interchange rates; and regulate the routing and exclusivity provisions so that merchants will not be able to steer transactions illegally away from exempt issuers.

Thank you for the opportunity to provide our comments. If you have any questions or would like additional information on these comments, please contact me at (727) 561-2227.

Sincerely,

Steven A. Salzer
Executive Vice President and General Counsel

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