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Filed via regs.comments@federalreserve.gov

February 22, 2011

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

Re: **Docket No. R-1404 and RIN No. 7100 AD 63**

Dear Ms. Johnson:

This letter represents the views of the Credit Union National Association (CUNA) regarding the Federal Reserve Board's proposed Regulation II to implement the interchange provisions of the Dodd-Frank Wall Street Reform and Financial Protection Act. (Dodd-Frank Act or Act).[1] CUNA is the largest credit union advocacy organization in this country, representing about 90% of the nation's 7,700 state and federal credit unions, which serve over 93 million members. CUNA's comment letter was developed under the auspices of our Interchange Working Group, comprised of credit union representatives and payment system experts.

The comments in this letter address certain legal issues raised in the proposal as they relate to credit unions that provide debit cards to their members. CUNA has also joined with other financial trade organizations to submit a separate letter on a range of issues regarding the proposal; our participation in the filing of that letter is based on the expectation that the exemption for small issuers should be made effective, as Congress intended.

As we have stated in previous letters to the Board, the Board was given a very difficult assignment from Congress to implement the interchange provisions, and we recognize that Board staff members have worked diligently following the passage of the Dodd-Frank Act to develop the proposal. We appreciate the opportunities we have had to discuss our concerns with Board staff.

[1] See Pub. L. No. 111-203, § 1075, 124 Stat. 1376 (2010), which added new Section 920 to the Electronic Fund Transfer Act, codified at 15 U.S.C. § 1693o-2.

Summary of CUNA's Views

- The regulation of interchange fee income is the most significant regulatory issue facing credit unions that offer debit cards.
- CUNA and credit unions that offer debit cards are extremely concerned about the impact of this proposal on their members, their debit card programs, and their operations generally.
- CUNA urges the Board not to go forward with the proposal as issued for comments.
- Given our deep concerns about a number of aspects of the proposal, addressed below, and the rapidly approaching deadlines for issuance of the final rule and compliance, we believe the most reasonable action the Board could take would be to work with Congress to support a delay in the implementation of the proposal of up to 24 months.
- Such a delay would allow the Board and Congress time to address the range of unresolved issues that we believe cannot be considered as thoroughly as they should be, given the relatively short remainder of the implementation period.
- If a delay is not forthcoming, we urge the Board to make significant changes to the proposal before it is issued in final form.
- Such changes should include:
    - Adopting provisions to implement the exemption for small issuers;
    - Replacing the interchange rate caps with "standards for assessing the reasonableness and proportionality" of interchange fees;
    - Revising the exclusivity provisions to ensure issuers do not have to belong to more than two independent networks; and
    - Amending the routing provisions to help ensure small issuers are not disadvantaged.
- The Board should then issue another proposal for comments, based on the changes it is considering adopting.

CUNA Urges the Board to Work with Congress To Support A Delay In The Proposal's Implementation

For credit unions that offer debit card programs, the Board's interchange proposal could not be more critical and if adopted, would have a significant adverse effect on -- and in some cases dire consequences for – such credit unions. (Seventy percent of credit unions provide debit card programs to their members.)

Congress directed that the rule on interchange rate regulation be adopted by April 21, 2011 and effective July 21, 2011, and the Board was given an extraordinarily short period to develop a proposal, review public comments and adopt a final rule. The importance of ensuring that the final rule is fair to all parties cannot be overstated, particularly in light of the significance of the debit interchange statute for financial institutions, merchants, consumers and debit payments systems.

We believe the compressed time frame contributed to the development of a proposal that does not fully take into account Congressional intent. Rather than advancing this proposal, we urge the Board to work with Congress to support and achieve a reasonable delay of at least 24 months in order to reconsider the issues raised by the legislation and implement a revised rule.

Such a delay would allow policymakers time to address unresolved issues, including how best to protect the interests of small issuers (which include all but the three largest credit unions that provide debit cards to their members), how to include all appropriate costs and a reasonable rate of return, how to ensure consumers will share in any cost savings to merchants that may result from reduced interchange fees, and how to minimize disruptions in the processing and payment of debit card transactions. We believe there is overwhelming support for such a delay in Congress, and we believe it can be accomplished if the Board and Congress will work together to help achieve it.

However, if the Board determines that a delay will not be forthcoming, we urge it to amend the proposal in a number of substantive areas, as we recommend below, in order to bring the proposal in line with statutory requirements and congressional intent.

The Board's Proposal Does Not Fully Implement The Exemption for Small Issuers (Section 235.5)

We are concerned that the Board's proposal will not have the **effec**t of exempting small issuers in practice.[2] The statutory exemption for small issuers from interchange provisions provides:

> This subsection shall not apply to any issuer that, together with its affiliates, has assets of less than $10,000,000,000, and the Board shall exempt such issuers from regulations prescribed under paragraph (3)(A).[3]

The significance of the exclusion was emphasized by the primary author and proponent of the interchange amendment, Sen. Richard Durbin (D-IL), in a statement explaining the interchange provisions. He said the exemption for small issuers:

> [M]eans that (payment networks, parenthesis added) can continue to set the same debit interchange rates that they do today for small banks and credit unions. Those institutions would not lose any interchange revenue that they currently receive.[4]

[2] *See* proposed 12 C.F.R. § 235.5(a).

[3] Dodd-Frank Act § 920(a)(6).

[4] "Durbin Statement on His Debit Card Swipe Fee Amendment," May, 15, 2010, www.durbin.senate.gov.

There is no other statement in the legislative history that indicates any other intent on the part of Congress regarding the exemption for small issuers.[5] While not dispositive, there are at least five letters to the Board from 20 Members of Congress that we believe should not be ignored. These include correspondence from the current Senate Banking Committee Ranking Member Richard Shelby, House Financial Services Committee Chairman Spencer Bachus and Ranking Committee Member Barney Frank, who helped shepherd the Dodd-Frank Act through conference and to a successful House vote, all urging the Board to ensure that small issuers are protected from unintended consequences under the proposal.[6]

Regrettably, the Board's proposal does not protect small issuers and, therefore, does not accomplish the objective of the exemption for this group of institutions. The Board also recognizes that the exemption for small issuers may not be effective:

> The Board's proposed rule does not require payment card networks to distinguish between issuers with assets of more than $10 billion and small issuers.[7]

Federal Reserve Board Chairman Ben Bernanke confirmed those concerns during recent testimony before the Senate Banking Committee. "It is possible that the exemption may not be effective in the marketplace," the Chairman stated.[8]

The statutory exemption for small issuers or any other provisions of Section 920(a) do not specifically address how the Board should implement the exemption. However, we urge the Board not to mistake Congress's silence regarding exactly how the exemption should be implemented for a directive that the Board should not implement the

[5] *See A Hearing on Federal Interchange Fees Payment Before the S. Approp. Subcomm. on Fin. Servs. and Gen. Gov't*, 111th Cong. (2010) (statement of Sen. Collins, Member, S. Approp. Subcomm. on Fin. Servs. and Gen. Gov't.); H.R. Rep. No. 111-517 (2010); S. Rep. No. 111-176 (2010); 156 Cong. Rec. S5925 (daily ed. Jul. 15, 2010) (statement of Sen. Durbin); 156 Cong. Rec. H5254 (daily ed. Jun. 30, 2010) (statement of Rep. Brown); 156 Cong. Rec. H5254 (daily ed. Jun. 30, 2010) (statement of Rep. Frank); 156 Cong. Rec. H5240 (daily ed. Jun. 30, 2010) (statement of Rep. Meeks); 156 Cong. Rec. H5233 (daily ed. Jun. 30, 2010) (statement of Rep. Kanjorski); 156 Cong. Rec. S4977 (daily ed. Jun. 16, 2010) (statement of Sen. Durbin); 156 Cong. Rec. S4840 (daily ed. Jun. 10, 2010) (statement of Sen. Durbin); 156 Cong. Rec. S3130 (daily ed. May. 5, 2010) (statement of Sen. Durbin).

[6] *See* Letter from Rep. Peters to Ben S. Bernanke, Chairman, Fed. Res. Bd. (Jan. 24, 2011); Letter from Sen. McCaskill to Ben S. Bernanke, Chairman, Fed. Res. Bd. (Dec. 17, 2010); Letter from Reps. Bachus and Hensarling to Ben S. Bernanke, Chairman, Fed. Res. Bd. (Dec. 17, 2010); Letter from Rep. Frank to Ben S. Bernanke, Chairman, Fed. Res. Bd. (Dec. 15, 2010); Letter from Sens. Collins and Snowe to Ben S. Bernanke, Chairman, Fed. Res. Bd. (Dec. 10, 2010); Letter from Sens. Carper et al. to Ben S. Bernanke, Chairman, Fed. Res. Bd. (Dec. 9, 2010); Letter from Reps. Michaud and Pingree to Ben S. Bernanke, Chairman, Fed. Res. Bd. (Oct. 29, 2010).

[7] Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722, 81,754 (proposed Dec. 28, 2010)
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[8] "Bernanke: Small banks might be forced to meet interchange limits." thehill.com, (Feb. 17,,2010).

exemption at all, which is the practical effect of the proposal's treatment of the exemption.

While the statutory language provides an exemption for small issuers, it is not self-executing. For the exemption to have any effect, there would need to be a two-tiered rate structure under which large issuers receive interchange fees that comply with the Board's rule, and small issuers receive higher fees that are not limited by the Board's regulation, as Senator Durbin clearly articulated. (As discussed below, CUNA does not support the Board's conclusion that it is authorized to set interchange fee caps, as it is proposing to do. However, whether the Board adopts a fee cap approach or develops standards for assessing whether interchange rates are reasonable, the Board is required by the interchange statue to exempt small issuers from the impact of its rate regulations.)

One of the major payment networks has indicated a willingness to pursue a two-tiered structure but has not indicated whether such a structure would be developed and implemented by the time the final rule is set to take effect. Also, how long such a structure could be maintained is a serious question. While other networks have indicated they are considering such a structure, none of the others has provided any assurances they are working to ensure the structure will be in place by July 21, 2011 when the final rule is scheduled to take effect for the rate regulation provisions.

Quite frankly, some small issuers are concerned networks may not provide a two-tiered structure once the rule is final or may not maintain it into the future. As Senator Durbin noted June 16, 2010 during the Senate debate on the interchange provisions, "even the federal government has not been able to negotiate" with the networks.[9]

Yet, without a two-tiered structure, there is no exemption. Thus, while the networks and not the Board will provide a two-tiered structure, the Board is the only entity that has the statutory authority -- and responsibility -- under the interchange provisions to oversee the development and maintenance of such a structure in order to put the exemption into effect, as Congress intended.

It is unreasonable to assume that by specifically exempting small issuers from the interchange rate regulations, Congress meant the Board could simply note in the rule that small issuers are exempt from the interchange rate provisions without also including provisions to effectuate the exemption for small issuers. As the Board is the only regulator of the interchange provisions, it is clear the Board has a congressionally-imposed responsibility to implement the exemption in order for it to have the meaning Congress intended.

[9] 156 Cong. Rec. S4978 (daily ed. Jun. 16, 2010) (statement of Sen. Durbin).

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, 15 U.S.C. § 1693o-2(a)(1), authorizes the Board to write regulations "to prevent circumvention or evasion of this subsection" (on interchange rate provisions). This is a general grant of authority to the Board and applies to all of the provisions in the interchange amendment that address interchange rate limitations, including the exemption from those limitations for small issuers. There is nothing in the statute or legislative history to preclude the reliance on this language to regulate the exemption.

We believe the implementation of the exemption could be fairly straightforward. Under Section 920(a)(1) and Section 920(a)(3)(B), the Board is authorized to collect data from any issuer or payment card network "to provide the Board with such information as may be necessary to carry out the provisions of this subsection."[10]

Under these provisions, the Board should require the networks to provide periodic reports to the Board on whether they have established a two-tiered system as Congress intended, whether small issuers have lodged complaints with the networks about the fees they are receiving under a two-tiered system during the reporting period, how the complaints were resolved or addressed, and the rate of interchange fees at exempt issuers during the reporting period compared to the rate of such fees for large issuers during the same period. Such reports should be accessible to small issuers and key data provided in the aggregate to Congress and the prudential federal financial regulators.

We believe that requiring reports on the two-tiered system from the networks and the fact that such reports would be subject to congressional oversight should provide sufficient regulatory incentives to ensure the networks will maintain two-tiered systems. However, if that is not the case, the Board and Congress would be able to utilize the information received from the networks to determine if changes to the statutory interchange provisions are needed to further reinforce the exemption.

As discussed in greater detail below, if the proposal is adopted as a final rule, it will impose substantial harm on credit union debit card issuers. However, that is not the only reason the Board should not advance the proposal. Because the language of the statute expressly provides an exemption from the rate regulation provisions of the interchange statute; the clear intent of Congress based on the legislative history is to protect small issuers; and there is a relatively simple mechanism the Board could adopt to ensure the exemption will work, the Board should not adopt a final rule and commentary that fail to implement the exemption fully, as Congress intended.

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[10] 15 U.S.C. § 1693o-2(a)(1).

The Proposed Treatment of the Exemption for Small Issuers Would Not Withstand Judicial Challenge (Section 235. 5)

In our view, a final rule that does not fully implement the exemption would be subject to legal challenge. Congress expressly exempted small issuers from the scope of the Board's rules, and it is unreasonable to conclude that Congress did not also mean to exclude them from the *impact* of the interchange rate provisions. Further, as discussed above, Congress also provided authority for the Board to effectuate the exemption, and the Board is the only entity that has the power to ensure the exemption will be put into place.

The apparent conclusion that there is no authority to implement the exemption for small issuers leads to an unreasonable result due to the fact that the two-tiered structure may not ever be developed by the networks, may not provide for fees to small issuers that are much different from those for large issuers or may not be maintained beyond a relatively short period of time even if developed. Further, as discussed below, merchant practices regarding the acceptance of payments and routing of debit card transactions may also undermine the exemption for small issuers. If any of those results occur, the Board's failure to act for small issuers would be a major contributing factor and the language of the exemption and the intent of Congress would be circumvented.

In assessing the Board's rule, a court would likely consider that the Board is willing to construe its regulatory authority expansively when it wishes to. For example, the Board is apparently willing to read into the statute authority to set interchange fee caps, as opposed to setting standards for assessing whether they are reasonable and proportional to an issuer's transactional costs (this issue is discussed further below). The Board is also apparently willing to assume authority to regulate ATM transactions under the interchange regulation, which is also not envisioned by the statute. At the same time, the Board has not fully implemented the exemption for small issuers.

We also believe that a court, as part of its review, would likely conclude that a final rule that does not fully implement the exemption would be arbitrary and capricious[11] due in part to the considerable harm it will likely cause credit unions and other issuers covered by the exemptions, as discussed below.

Credit Unions That Issue Debit Cards Will Be Harmed If the Proposal is Adopted

At a minimum, credit unions will likely receive less interchange fee income, despite the language of the exemption and congressional pledges to the contrary. To minimize their losses, some credit unions may reluctantly have to stop offering debit cards, and

[11] *See, e.g.*, *Motor Vehicles Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 46-56 (1983); *Ass'n of Data Processing Service Orgs. v. Board of Governors*, 745 F.2d 677, 683-84 (D.C. Cir. 1984) (opinion for the court by Scalia, J.) ("[I]n their application to the requirement of factual support [in rulemaking] the substantial evidence test and the arbitrary or capricious test are one and the same.").

their members may lose an important, low fee, convenient payment mechanism they receive in conjunction with their credit union membership.

At one extreme, through some combination of an ineffective two-tiered pricing system and possible merchant steering (which is discussed further below) in favor of large-issuer cards, credit unions' interchange fees could approach the rate set for very large institutions, 12 cents per transaction. In that case, at 2010 estimated volumes, credit unions would find their net income reduced by $1.6 billion. That would represent approximately 17 basis points of average assets and would amount to a third of credit unions' recent net income of around 50 basis points.[12] This result could be devastating for some credit unions.

If net income recovers to pre-recession levels, the lost interchange income would represent about a fifth of total net income. Absent any alternate price or fee increases by credit unions, such a reduction in income would lower capital ratios at debit-card issuing credit unions by 1% after six years.[13] For those credit unions currently under regulatory Prompt Corrective Action (PCA) restrictions due to low capitalization levels, or close to PCA thresholds, such a reduction of net income would seriously impair their ability to restore capital, since earnings retention is the only source of credit union capital.

Even if we conservatively estimate that after a few years the effect on the debit interchange regulation is only half the reduction that large institutions experience, the effects on credit unions would be substantial. At 2010 volumes, net income would fall by about $800 million or 9 basis points. As a proportion of total net income, the loss would be almost 20% at current net income rates, and almost 10% when net income reaches pre-recession levels. The loss to credit unions would be about the same as the amount they will be required to pay to repay the Temporary Corporate Credit Union Stabilization Fund that was set up by National Credit Union Administration in the wake of the failure of some of the largest corporate credit unions—which provide financial services to other credit unions—during the financial crisis.

If credit unions experience the significant reduction in debit interchange revenue that is expected as a result of this rule, the National Credit Union Administration, which oversees the National Credit Union Share Insurance Fund, will nonetheless expect credit unions to maintain current net income levels and replace the lost revenue. That is because under statutory provisions, federally insured credit unions must maintain at least 7% net worth to be well capitalized.[14]

This means that credit unions will have to take steps to cover their losses to ensure that they continue to operate in a safe and sound manner. Unlike the big banks, which can cover their losses by reducing the profits their shareholders receive, credit unions as

[12] Credit Union National Association. "Credit Union Fees Survey For Strategic Planning 2010-2011." Washington, DC: 2010.4-4.
[13] *Id.*
[14] !2 U.S. C. 1790d.

cooperative financial institutions have but one choice. They must pass the costs on to their members. Credit union members will lose as a result of these rules if credit unions are forced to reduce dividends, recover fees from members for other services, or stop offering debit card services all together. The choices facing board directors and management of credit unions, which were to have been unaffected by this proposal, are relatively straightforward and carry a consistent theme: charge more to consumers for services or reduce the services consumers are offered; this cannot be what Congress intended.

Over ninety percent of credit unions offering debit cards anticipate they will make some sort of change to their rates, fees, and/or services as a result of the negative impact of the regulation. The most common changes credit unions anticipate making will be to introduce or increase debit card fees and to increase nonsufficient funds (NSF)/overdraft protection fees. About 40% of credit unions cite these potential changes as shown in the following graph. Beyond this, 25% to 30% of affected credit unions say they might eliminate free checking accounts and/or lower deposit rates as a result of the regulation.[15]

If the exemption for small issuers proves to be completely ineffective, the Board's proposed $0.12 fixed fee would require credit unions to impose an average annual fee of approximately $34 to each cardholder to maintain pre-reform revenue or a per transaction fee of about $0.25 cents per-transaction (or some combination of the two).[16]

The following two charts demonstrate the manner in which credit unions and their members would most likely be affected if the proposal's exemption for small issuers is not fully implemented.[17]

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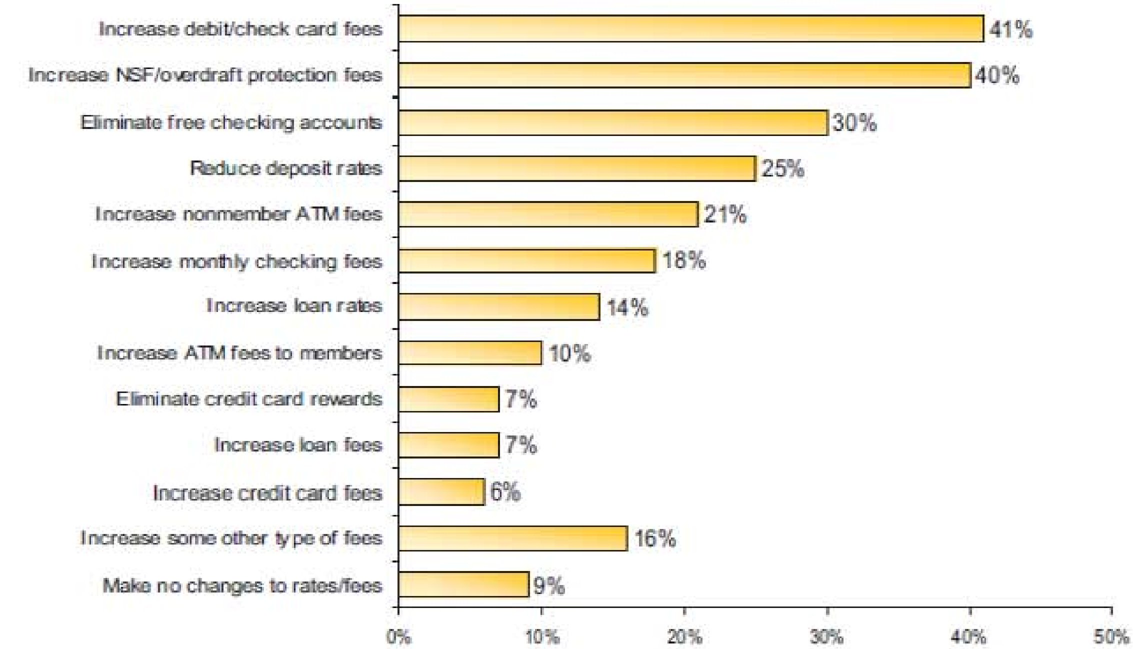
[15] Credit Union National Association. "Credit Union Fees Survey For Strategic Planning 2010-2011." Washington, DC: 2010.4-4.

[16] *Id.*

[17] *Id.*

Changes Credit Unions Would Make Due to Negative Impact of Check Card Interchange Legislation



Note: Limited to credit unions that offer the account/service.

Summary of Debit Interchange Proposal in Worst-Case Scenario*

	Per Card		Per Transaction		In bp of Assets	
Debit Interchange Income and Expense:	Reported 2009 Actual	Fed proposal w/ ineffective carve-out	Reported 2009 Actual	Fed proposal w/ ineffective carve-out	Reported 2009 Actual	Fed proposal w/ ineffective carve-out
	$53	$19	$0.33	$0.12	27	10
Direct Expenses*	$38	$38	$0.25	$0.25	19	19
Net Income**	$12	-$17	$0.09	-$0.13	7	(18)
% of CUs w/negative net income	20%	90%	20%	90%	20%	90%
Fees required to maintain pre-reform net income:						
Median per-card annual fee needed to maintain status quo		$34				
Median per-transaction fee needed to maintain status quo				$0.21		

* Assuming a completely ineffective carve-out for institutions with $10 billion or less in total assets. The worst-case scenario would cause credit union debit interchange to decline by 60%.

** Expenses defined as network and processing expenses including settlement; billing and data processing; fraud; negative balance; cost of plastics including reissuance costs; insurance; and staff expense.

*** Net Income is not equal to the difference between revenue and expense in this table because the reported values are medians. Survey results show that in the aggregate credit union debit interchange net income represented 20% of total credit union net income in 2009.

Source: CUNA 2010 Debit Interchange Survey.

Board's Proposal Does Not Appropriately Implement the Statute Regarding Interchange Fee Standards (Section 235.3)

Section 920(a)(3)(A) of the Dodd-Frank Act directs the Board to :

> [E]stablish standards for assessing whether the amount of any interchange transaction fee... is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. [18]

In order to carry out this mandate, the Board proposes to establish rate ceilings on debit interchange fees for large issuers. If the Board decides to cap rates rather than to establish standards to assess their reasonableness, the consequences would be very significant for all credit union debit card issuers, not just the three credit unions that would be covered by the rate setting regulations. Because of the proposal's failure to implement the exemption fully, all issuing credit unions are concerned they will be significantly affected by the Board's rate limitations.

The Board does not explain why it chose to set actual caps on interchange fees paid to large issuers rather than develop standards to evaluate the reasonableness and proportionality of such fees.[19] Thus, it is impossible to know what legal authority the Board relied upon to deviate from the statute's requirements that the Board develop "standards for assessing" the reasonableness and proportionality of issuers' interchange fees in relation to the issuer's costs.

The Dodd-Frank Act's interchange provision does not include any Board-imposed fee caps. The statute does, however, 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). However, such standards are not included in the proposal, and the Board is not even seeking comments on whether it should employ such standards or whether its rule should set actual rate caps.

There are critical distinctions between these approaches, not the least of which is that the former approach is required by the statue and the latter, rate caps, are inconsistent with it. It is not difficult to predict that outcomes for the regulation of interchange fees would also differ greatly relative to each approach. During the Board's discussion regarding the proposal, then-Governor Kevin Warsh asked why the proposal sets ceilings for interchange rates rather than establishing standards for determining whether they are reasonable or not.

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[18] 15 U.S.C.§ 1693o-2(a)(3)(A).

[19] *See* 75 Fed. Reg. at 81,724-81,740.

> The first reading of the statute says that the Board shall establish standards for interchange fees. It doesn't say we should establish prices…[20]

Board staff responded:

> There were really two reasons why we decided to not just propose an issuer-specific standard but put some actual values in the standards, and that is (sic) to avoid negative economic incentives and to minimize administrative burden.[21]

We agree those are commendable regulatory goals but not the overarching goal in this instance, which is to implement the specific directive from Congress to "establish standards," not rate caps. If Congress intended the Board to set rate caps, it could have easily included words to mandate rate caps, but that is not the course Congress set for the Board. Indeed we can find nothing in the legislative history of section 920 that supports authority to impose caps on interchange rates.

We also note that in defending its motion to dismiss the TCF litigation, the Board has supported the view that the interchange statute does not require the Board to dictate interchange rates.[22]

Because the proposed caps will impose severe limitations on debit interchange fees, as opposed to standards of the nature Congress expressly directed, the rate cap approach is not consistent with the language and intent of the statute.

The Proposed Fee Structures Should Have Included Additional Cost Factors (Section 235.3)

The issue of how the Board has addressed the regulation of interchange fees is discussed at length throughout the joint letter filed by CUNA and other financial trade groups, and we see no need to repeat all of those arguments in this letter. However, there are several concerns we would like to note or reinforce.

Credit unions of all asset seizes are understandably concerned about the interchange fee caps the Board is proposing under two alternative approaches. Large issuer credit unions are concerned because the rate caps will affect them directly; small issuer credit unions are concerned because they fear no one will ensure their exemption will actually work and as a consequence, they will be subjected to interchange fees that are comparable to what will be permitted for large issuers. Also, both alternatives would generally limit maximum interchange fees for issuers to 12 cents per transaction, far

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[20] Transcript of the Federal Reserve Board's Open Meeting, December 16, 2010.

[21] *Id.*

[22] Memorandum in Support of Motion to Discussion, Filed in *TCF v. Bernanke*, Case No. 4:10-cv-04149-LLP at 2 (D.S.D. Feb. 18, 2011).

less than the total costs issuers actually incurred to provide debit card programs. In fact, credit union debit interchange costs were twice that in 2009.[23]

CUNA opposes both alternatives. While the statute directs that the Board must consider "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearing, and settling a particularly transaction" and also precludes the Board from considering "other costs incurred by an issue which are not specific to a particular electronic debit transactions" the statute does not preclude the inclusion of reasonable costs on which it is silent. [24]

In its response to the court in the TCF litigation, the Board noted:

> Contrary to Plaintiffs' assertion, the Board can consider factors other than the authorization, clearance or settlement (ACS) costs that are specific to a particular electronic debit transaction. [25]

We definitely agree with this analysis and believe that additional time to sort through which costs could be included would benefit the rulemaking process tremendously and result in a fairer rule for stakeholders, consistent with the interchange statute. At a minimum, we strongly support the inclusion of additional costs issuers incur in providing debit programs. In addition to fraud prevent costs discussed further below, such costs could include but are not necessarily limited to data security, absorbing fraud losses, handling of erroneous transactions, keeping records, reissuing cards, compliance with relevant regulations, providing call centers and other support services. We also think that the Board should permit network fees to be considered whether determining allowable costs. Also, the proposal would not permit different interchange fee schedules for PIN-based versus signature-based transactions, even though costs for these programs differ, and we think the statute would allow for such a distinction.

Despite the statute's indication that Board may consider fraud prevention and data security costs in determining the standards for interchange fees, the proposal does not include an adjustment for such costs.[26]

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[23] Credit Union National Association. "Credit Union Fees Survey For Strategic Planning 2010-2011." Washington, DC: 2010.4-4.

[24] 15 U.S. C. § 1693o-2(a)(4).

[25] Memorandum in Support of Motion to Discussion, Filed in *TCF v. Bernanke*, Case No. 4:10-cv-04149-LLP at 2 (D.S.D. Feb. 18, 2011).

[26] *Compare* 15 U.S.C. § 1693o-2(a)(5) ("Adjustments to interchange transaction fees for fraud prevention costs."), *with* 75 Fed. Reg. at 81,726 ("At this time, the Board is not proposing a specific adjustment to the amount of an interchange fee for an issuer's fraud-prevention costs.").

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 implementation of the fraud prevention standards. Rather than implement this provision separately, we believe the rule-making process would be improved if the Board addressed 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.

The Routing and Exclusivity Provisions Could Result In Unreasonable and Costly Regulatory Burden on Credit Unions And Will Likely Undermine Their Exemption (Section 235.7)

Under Section 920(b) of the EFTA, the Board is directed to write rules to provide that an issuer or payment card network cannot restrict the number of payment card networks on which an electronic debit transaction may be processed to just one network or two if the networks are affiliated with the issuer. The Board is also required to write rules that allow the merchant to direct the routing of debit transactions over any network that is authorized to process the transaction. These proposed provisions would apply to all issuers, not just those with assets of $10 billion and above.

The Board is proposing two alternatives to address the statute's prohibition on exclusive arrangements. Alternative A would require an issuer to provide debit cards that could be processed on one of two unaffiliated networks, such as one PIN network and one unaffiliated network using signature authorization.

Alternative B would require a credit union to issue debit cards that could be processed on at least two unaffiliated PIN networks and also on at least two unaffiliated signature networks. The Board is also proposing to implement the prohibition on restricting merchants' routing choices. Under the proposal, issuers and card networks could not restrict a merchant from choosing between the various networks that have been enabled for a particular debit card, but the merchant could only route the transaction through a network associated with the debit card at the time of the transaction.

While the uncertainty regarding these provisions extends to large and small issuers, the implications of these provisions may be even greater for small issuers. During the Board's meeting to consider the proposal, Board staff stated:

> If the networks do decide to establish two separate interchange fee schedules and allow higher interchange fees for the small issuer, it is possible that merchants would discriminate against those issuers by declining to accept their cards because there are higher fees associated with accepting those cards…[27]

[27] Transcript of the Federal Reserve Board's Open Meeting, December 16, 2010.

Board staff also noted an additional factor that will undermine the exemption for small issuers, absent regulatory intervention:

> The merchant routing provisions would tend to put downward pressure on interchange fees, in general, because now the merchants can steer transactions toward lower cost networks.[28]

CUNA certainly shares these concerns, but we do not think the Board is excused in any way from implementing the exemption for small issuers because of fears that its failure to properly regulate the routing and exclusivity provisions will undermine a two-tiered system. This is circular reasoning that cannot support good policy and that undermines the intent of Congress to protect small issuers. The first step toward ensuring small issuers receive the protection that Congress intended is for the Board to implement fully the exemption.

However, as the Board has acknowledged, the routing and exclusivity provisions will likely be problematic for small issuers if the Board does not make important changes in these provisions.

The prospect of lower fees may entice merchants and their acquiring banks to find ways to steer or "encourage" purchasers to use cards issued by large banks. While we recognize that the statute provides authority for merchants to offer certain incentives, *see* 15 U.S.C. § 1693o-2(b)(2), we also have serious concerns that merchants and their acquiring banks may find ways to steer transaction payments illegally or to "encourage" purchasers on a discriminatory basis to use cards issued by large banks, in order to obtain the lowest fees. While the interchange statute and payment network rules prohibit such activities, small issuers are concerned that such provisions will not be enforced.

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 to guard against such steering. The statutory provisions under "Rules of Construction," 15 U.S.C. § 1693o-2(b)(4), were added during the development of the interchange amendment to help protect small issuers from unlawful merchant steering. However, like other key provisions of the interchange statute, they necessitate the Board's implementation to put them into effect.

We urge the Board to implement the anti-steering provisions cited above by adding provisions that will protect small issuers against such actions. Such changes could include a provision in the final rule or commentary that would address impermissible merchant steering and that would 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.

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[28] *Id.*

The Board is also proposing to implement the prohibition on restricting merchants' routing choices. Under the proposal, issuers and card networks could not restrict a merchant from choosing between the various networks that have been enabled for a particular debit card, but the merchant could only route the transaction through a network associated with the debit card at the time of the transaction.

While CUNA believes that either alternative to prohibit exclusivity would result in new costs and additional fees for issuers, of the two alternatives proposed for comment, CUNA finds Alternative A the better option. That is because Alternative A would likely be less costly and burdensome for all issuers than Alternative B since under that option, issuers would have to be involved with multiple networks, each with its own fees for services, some of which would be redundant. Indeed, as a practical matter, it is problematic whether Alternative B could be implemented effectively as an operational matter.

Moreover, Alternative B in our view is inconsistent with, and not required by, the language of Section 920(b). Congress did not direct the Board to require issuers to make four separate choices available on debit cards. Rather the requirement is that issuers may not restrict the number of networks on which a transaction may be processed to one network or two affiliated networks. Alternative A conforms to this requirement whereas Alternative B does not.

We strongly oppose the adoption of Alternative B because Alternative B is not supported by Section 920(b)(1), is problematic as to whether or not it can be implemented, and in any event would involve significant costs to implement.

As the Board recognizes, Congress did not establish an effective date for the exclusivity and routing and provisions of Section 920.[29] In view of the complexity of this matter and the difficult issues raised by the proposal, we request that the effective date of the exclusivity and routing provisions be delayed until the Board has sought additional public comment on the implications of these matters.

Routing and Exclusivity Provisions Should Not Include ATM Transactions (Section 235.7)

The Board seeks comments on whether Regulation II should include ATM networks with respect to the routing and exclusivity requirements. (ATM transaction fees would not be covered under the rate restrictions currently because such fees are typically paid by the issuers to the ATM operators. However, the Board notes in Footnote No. 29 that the fee limits could apply in the future "if ATM interchange fees begin to flow in the same direction as point-of-sale debit card transactions, as was the case for interchange fees of certain PIN-debit networks in the 1990's.")

[29] 75 Fed. Reg. at 81723.

CUNA does not agree that either the rate cap provisions or the routing and exclusivity provisions should apply to ATM transactions. First, Congress specifically addressed the transactions that the interchange rule should cover and did not include ATM transactions in any of the definitions of “debit card,” “electronic debit transaction” or payment card network.” [30] Moreover, as the Board noted, the definition of “interchange transaction fee” excludes ATM transactions.

We do not believe the Board has the legal authority to apply the routing and exclusivity provisions now or the rate setting provisions later, to ATM transactions because fees in connection with ATM transactions are not used to compensate issuers. Rather, it is the issuer that pays fees to the network to compensate ATM operators. Moreover, an ATM network is not a "payment card network" and under Section 920 because, unlike a merchant, the ATM operator does not accept a debit card as a form of payment. Rather the card is used to access the cardholder's account for the purpose of obtaining cash, not as payment for a transaction. Accordingly, there is no "payment" when a cardholder uses an ATM. In light of this, we do not believe that Section 920 applies to ATM transactions..

Further, if ATM transactions are included under the routing and exclusivity provisions, issuers would have to provide ATM cards that are associated with at least two unaffiliated networks and the ATM operator would have the authority to select the network a transaction would be routed over, again raising concerns that small issuers will be disadvantaged. We strongly oppose changes in the proposal that would bring ATM transactions under the scope of the rule.

The Process for Developing the Proposal Was Inadequate

We have a number of concerns about the process used to develop the proposal, which we believe contributed to the significant inadequacies that are discussed in greater detail above. For example, in the December 16, 2010 meeting, the Board indicated significant uncertainty about the impact of the proposal, particularly on issuers with assets of less than $10 billion. As Board staff indicated during the Board’s discussion of the proposal December 16, 2010:

> [W]ith regard to the small issuers, we really don’t know what the net effect of the rules will be because it depends on actions to be taken by the networks and the merchants.[31]

One of the reasons for that may be that the Board did not survey small issuers regarding the impact of interchange regulation, as it did large issuers. We appreciate the Board’s press for time to get information about the group of issuers that are covered by the rate standards and its concerns that small issuers should not be overly burdened

[30] *See* 15 U.S.C. § 1693o-2(c).
[31] Transcript of the Federal Reserve Board’s Open Meeting, December 16, 2010. .

with regulatory requests for information. We generally support minimizing all regulatory reporting for credit unions. However, given the concerns about the eventual impact of the rate standards to all issuers, we believe surveying small issuers could be beneficial to the Board and to the process of developing an appropriate regulation. We believe additional time to develop the regulation should include time to survey small issuers.

The legislative history of the interchange amendment clearly shows that benefiting debit card users through lower prices that merchants would pass on to them as a result of merchants' reduced interchange fees was an important objective of the amendment. "Consumers will benefit from the amendment," one key Senator told his colleagues June 10, 2010.[32]

Yet, during the Board's discussion of the proposal, Board staff acknowledged:

> It is hard to anticipate what the overall effect (of the rule, parenthesis added) on consumers will be. [33]

Given the objectives of the interchange amendment, 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. As but one example of how this could be approached, merchants and consumer advocacy groups could be surveyed regarding their expectations of how merchants' cost savings should be shared with consumers.

There is also uncertainty about the impact of the proposal on the payments system generally. Few entities should be in a better position to assess the impact of the proposal on the payments system than the Board. Yet the Board was unable to provide stakeholders and the public generally with any useful analysis in this area. "So it is really somewhat difficult to tell how this will change ultimately the competitive landscape going forward," Board staff stated during the Board's meeting December 16, 2010.

We also note that the interchange amendment directs the Board to consult with the federal financial regulators, the Small Business Administration, and the Consumer Financial Protection Bureau regarding the rate regulation provisions of the proposal and the "Supplementary Information" does not indicate whether or the extent to which that has been done.[34] This is an important step in the process of developing the rule, given the concerns institutions have raised about the loss of fee income, and additional time would allow the Board to work closer with the other regulators to obtain their analyses and impact assessments.

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[32] *See* 156 Cong. Rec. S4840 (daily ed. Jun. 10, 2010) (statement of Sen. Durbin).

[33] Transcript of the Federal Reserve Board's Open Meeting, December 16, 2010. .

[34] *See* 75 Fed. Reg. at 81,722-81,754.

The Board Should Reissue A Proposal For Additional Comments

Given the nature and number of deficiencies with the Board's proposal, we do not think the Board should proceed with the document it approved for comments December 16, 2010. Rather, as stated above, we urge the Board to work with Congress to obtain more time to address issues relating to debit interchange much more thoroughly, provide better analysis and develop a regulation that reflects better public policy, consistent with congressional directives and intent.

If the Board is certain it must promulgate some form of this proposal, we urge 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 to large issuers.

In closing, the significance of the regulation of interchange to the credit union system cannot be overstated. We urge the Board to do all it can to implement the interchange statute as fairly as possible, consistent with statutory requirements, including those regarding small issuers.

Thank you for the opportunity to provide our comments on this important proposal. We would welcome the opportunity to discuss our concerns and recommendations for improvements.

Sincerely,

Mary Mitchell Dunn

Mary Mitchell Dunn
SVP & Deputy General Counsel
Credit Union National Association