PENNSYLVANIA CREDIT UNION ASSOCIATION

4309 North Front Street Harrisburg, PA 17110 Phone: 800-932-0661 Fax: 717-234-2695

February 22, 2011

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

Sent Via Email

Re: Proposed Rulemaking Debit Card Interchange Fees and Routing –Docket No. R-1404

Dear Ms. Johnson:

The Pennsylvania Credit Union Association (PCUA) appreciates this opportunity to provide comments to the Board of Governors of the Federal Reserve (the Board) on its proposed rules Regulation II, implementing the debit card interchange fees and routing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).

As a matter of background, the PCUA is a statewide trade association that represents the majority of the approximate 553 credit unions located within the Commonwealth of Pennsylvania.

The PCUA consulted with its Regulatory Review Committee (the Committee) in order to provide comments on this proposed rule. The Committee consists of twelve (12) credit union CEOs who lead the management teams of Pennsylvania's federal and state-chartered credit unions. Members of the Committee represent credit unions of all asset sizes. No credit union headquartered in the Commonwealth of Pennsylvania has assets in excess of $10 billion.

Before addressing the specifics of Regulation II, we want to point out some overriding policy concerns for the public record.

PCUA appreciates that the Dodd Frank Act imposed deadlines for establishing a final rule. However, when the Durbin Amendment to the Dodd-Frank Act was introduced, neither the Senate nor the House held hearings to evaluate the impact of interchange regulations on financial institutions, merchants, and most, importantly, consumers. As the Board deliberates the final rule, the marketplace is on the brink of an historic shift in terms what types of entities influence the payments system. If Regulation II is adopted as proposed, merchants and retailers, entities that are not supervised in the same manner as credit unions and other financial institutions, will

exert significant influence on the electronic payments system and consumer behavior. Therefore, we urge the Board to take due note of a hearing held in the House Financial Services Committee on February 17, 2011, and any subsequent Congressional actions and extend the compliance deadlines for Regulation II.

Along those same lines, consumer protection is a significant public policy consideration and one of the stated purposes of the Electronic Funds Transfer Act (EFTA). The EFTA is very clear:

> (a) The Congress finds that the use of electronic systems to transfer funds provides the potential for substantial benefits to consumers. However, due to the unique characteristics of such systems, the application of existing consumer protection legislation is unclear, leaving the rights and liabilities of consumers, financial institutions, and intermediaries in electronic fund transfers undefined.
>
> (b) It is the purpose of this title to provide a basic framework establishing the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. *The primary objective of this title, however, is the provision of individual consumer rights.* 15 U.S.C.A. § 1693, emphasis added.

We assert that the regulation of debit interchange established in the Dodd-Frank Act and proposed in Regulation II offers no consumer protections and does not further the purposes of EFTA. Unfortunately, the current proposal opens the door to manipulation of debit transactions by merchants. Without robust enforcement provisions discussed in this letter below, merchants and retailers will possess enormous market leverage to steer transactions and ultimately consumers, to card products or payment networks that are the most advantageous to the merchants or retailers. The proposal contains no analysis of the impact of these rule changes on consumers. That is a significant deficiency in the administrative record, particularly the public administrative record involving a consumer protection regulation. The lack of tangible consumer benefits should persuade the Board to delay compliance dates pending additional Congressional oversight.

Small Issuer Exemption

A. Qualification Process

The Dodd-Frank Act carved out financial institutions under $10 billion in assets from the regulation of interchange rates. The Board asked for comments on the appropriate manner for determining whether a financial institution continues to qualify for the exemption. The EFTA and Regulation E impose significant consumer protection duties on financial institutions. In addition, financial institutions shoulder burdens for data breaches connected to debit cards as well as other transactions or operations not borne by merchants, processors or card networks. See 12 C.F.R. Part 748, Appendix B. Accordingly, a financial institution should have to do no more than file a statement of its asset size before each year end. The card networks and processors

should then bear the responsibility of ensuring that financial institutions earn the appropriate interchange rate.

B. Enforcement, The Proposal Fails to Adequately Enforce the Small Issuer Exemption

The Electronic Funds Transfer Act, specifically section 920(a)(6), created a specific exemption from the interchange rates for small issuers:

> 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).

The proposed language of section 235.5 of Regulation II reflects the statutory language in a vague manner. If the small issuer exemption is to be meaningful, the Board must take a more proactive approach to enforcement of the exemption. The final rule requires a robust articulation of the exemption.

The Board is empowered by the statute to ensure that the interchange fee provisions as well as the exemption will be implemented. Section 920(a)(1) of the EFTA authorizes the Board to write regulations "to prevent the circumvention or evasion of this subsection." 15 U.S.C.A. § 1693o-2(a)(1). Accordingly, the Board should include a new subsection (e) in section 235.5 which states: *Payment card networks and processors shall create such processes and procedures to ensure issuers earn interchange at such rates consistent with sections 235.3, 235.4 and 235.5.* Our suggested language imposes the necessary duties on other payments system participants to carry out the intent as well as the express language of the statute.

A final rule that does not create a means for the enforcement of the small issuer exemption would be contrary to the express intent of Congress. And, a final rule absent affirmative language from the Board imposing a duty on payment card networks and processors renders the exemption meaningless.

<u>Interchange Rates, 235.3</u>

A. Reasonableness Standard

We appreciate that the Board is faced with a very compressed timetable to implement a very difficult set of rules. With all due respect, we assert that the Board's proposed rules for interchange rates amount to a misinterpretation of the statutory mandate.

The EFTA instructed 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 transactions." 15 U.S.C.A. § 1693o-2(a)(3)(A). Regulation II, as proposed

sets strict caps. It does not establish criteria for assessing the reasonableness of the amount of an interchange transaction fee. In the background to the proposal, the Board cited its surveys of financial institutions and network payment systems and reached some general conclusions about the median costs of debit or prepaid card transactions. 75 FR 81725 – 81726.

Reliance on a survey of financial institutions with assets greater than $10 billion fails to take into consideration the consequences on smaller issuers. As noted above, the proposed interchange rate caps present very real consequences to smaller issuers absent a strong enforcement mechanism for the interchange rate exemptions. Therefore, the survey should have included credit unions and community banks so the administrative record contained a more complete cross-section of the financial services industry. If the rule is finalized as written, and if the payment card networks cannot or do not develop two-tiered interchange pricing, smaller issuers will be marginalized by rate caps not reflective of their costs. Such a result is contrary to the express language of the EFTA.

Secondly, the background and summary revealed a process by which the Board seemed very anxious to reduce the costs of debit interchange transactions to a very antiseptic formula of clearing, authorization and settlement of a transaction. This overlooks what goes into the debit relationship between the consumer and a credit union. Also, smaller institutions are unlikely to enjoy the same pricing for processing or settlement as larger volume issuers. Such distinct differences between larger and smaller issuers should be included in the public record. Such findings would be material to finalizing a rule with the aim of establishing standards for assessing the reasonableness or proportionality of interchange fees.

Finally, the specific caps proposed in Regulation II are inconsistent with the clear language of the statute. As noted above, the Board relied on some survey data, identified some median costs and proposed rate caps based on its survey. The statutory mandate requires the Board to establish standards for assessing whether interchange fees are reasonable and proportional to the issuers costs. Setting caps is not the same as establishing criteria or factors to evaluate a set of facts and circumstances. By setting a cap of a certain sum, the Board risks noncompliance with the statute.

B. The Proposed Rate Structure Potentially Harms Consumers

The Committee observed that the proposed interchange rate caps present a significant threat to the financial well-being of consumers. Such a result is incompatible with one of the express purposes of the EFTA noted above: consumer protection. They explained that the proposed rate cap of 12 cents does not come close to recognizing the overall costs of operating a debit card program. The proposed rate caps could result in a 70 percent decrease in interchange fees for credit unions. Lost revenue must be replaced or regenerated from another source. Therefore, the rate caps would compel credit unions, particularly if the small issuer exemption is not enforce, to institute fees and increase rates on their member-owners to pay for the debit card program and fraud protections.

In the context of the rate caps, costs and consumer protection, the Committee continually pointed to fraud as a significant cost of a plastic card program, emphasizing the importance of limiting fraud damages incurred by a cardholder. Fraud prevention, in connection with a debit card, takes on particular importance because the card accesses a consumer's personal transaction account. Costs, particularly those related to fraud, constitute a material element to the entire analysis of interchange rates. That is, in arriving at criteria or factors to determine the reasonableness of interchange fees, the appropriate measure and allocation of the risks related to fraud must be included in the final analysis. Unfortunately, the Board did not take up fraud concerns in any meaningful way in this proposal.

Impact of Fraud, Fraud Prevention Adjustment, 235.4

The Board also seeks comment on possible frameworks for an adjustment to the interchange fees to reflect certain issuer costs associated with fraud prevention. Again, we appreciate that the Board was confronted with a restrictive schedule for preparing a final rule. However, costs associated with or arising from fraud are material in the plastic card environment as a whole. Consequently, it is unthinkable that the Board could undertake an effort to regulate interchange rates without a substantial and thorough analysis of the costs of fraud. Further, any final rule should include a reasonable allocation of fraud risks among the appropriate payments systems participants.

The Committee has concerns with the Board's survey results in that they do not adequately reflect all financial institutions. It is suggested that the Board issue the survey to financial institutions of $10 billion in assets or less. Until all costs are quantified the Board should wait to issue a final rule. For smaller institutions, the cost of providing debit services is greater than larger institutions and those facts are significant.

The Committee also noted that proposed regulation does not include specific language addressing fraud nor does it take into consideration the costs to issuers such as:

- staff monitoring of member accounts and transactions – in essence protecting the member-owner/consumer from incurring fraud losses that could damage their credit rating;
- neural network monitoring and expenses to participate in such networks;
- reissuing compromised cards;
- costs of maintaining zero-liability status for consumers; and
- the inconvenience to the consumer in a compromise scenario.

Unfortunately in today's environment the debit card fraud component falls entirely on the issuing financial institution. Credit unions utilize interchange fees, in no small part, to cover costs associated with fraud. In that context, interchange fees are more properly viewed as a merchant's "fair share" for participating in this payment system – a system where their participation is voluntary.

Participation in the payments system is a critical component of this entire exercise to regulate debit interchange rates. The statue and the proposed regulation ignore the participants and beneficiaries of the payments system. Payment card networks and financial institutions built the infrastructure of the payments system. Consumers are participants and beneficiaries, enjoying the convenience of paying for goods and services with the plastic card of their choice. Merchants are participants and beneficiaries as well, enjoying instant payment (with no default risk) in connection with consumer transactions and the safety and efficiency of settlement services and processing from their financial institutions.

For its part, the Board has held the role of venerable traffic cop of the payments system quite some time. It cannot fail to recognize the consumer-related and commercial-related advantages offered by the payments system. Further, as the agency with rulemaking authority over dozens of consumer protection regulations, the Board must take official notice of the disruptions to the payments system participants and consumers caused by fraud. Consistent with the express authority given to the Board to address fraud in the regulation, the time is ripe to prepare a set of rules to properly apportion the risk of loss. For example, Articles 3 and 4 of the Uniform Commercial Code contain an elegant apportionment of the risk of loss associated with fraud in connection with negotiable instruments. Regulation of interchange rates commands an effort equal to the risk allocation reflected in the Uniform Commercial Code. In the end, interchange rates must take into account costs related to fraud. Additionally, the parties who are participants in the payments system yet fail to take adequate measures to protect it should bear the risk of loss when data breaches or similar comprises occur.

Consistent with the analysis above, we maintain that the Board's constructs for fraud adjustments – the Technology-specific approach or the Non-prescriptive approach – do not present issuers with an appropriate solution to the fraud issue. Fraud prevention is an enterprise-wide priority that requires continued maintenance and expense. The final rule regarding the fraud adjustment must undertake a serious analysis of hard and soft-dollar costs.

Network Exclusivity and Routing, 235.7

The Board asked for public comment on network exclusivity and routing rules. In the proposal, the Board suggested to options for implementing the EFTA's routing provisions:

- Alternative A: Issuers must provide debit cards that can be processed by two (2) unaffiliated networks: one PIN network and one unaffiliated signature network.

- Alternative B: Issuers debit cards must be able to be processed through two (2) unaffiliated PIN networks and two (2) unaffiliated signature-based networks.

The Committee is deeply concerned that, as written, the proposal affords merchants the ability to dictate which cards they will accept and how they will be processed. That is contrary to the express language of EFTA section 920(b)(4) which can be fairly read as an anti-discrimination or "honor all cards" provision. 15 U.S.C.A. 1693o-(2)(b)(4). Consequently, the final rule must include provisions that will protect small issuers from improper steering of consumers by merchants to cards issued by large banks. In addition, accountability and enforcement oversight

should be outlined to prevent merchants from controlling the card network and over-influencing how payments flow through the system.

As for the alternatives proposed by the Board, PCUA and its member credit unions prefer Alternative A simply because it is the least burdensome of the options.

ATM Transaction Routing

While not part of this proposal, the Board is contemplating applying the routing requirements discussed above to automated teller machine (ATM) transactions. The Committee opposes any expansion of the routing rules to ATM transactions. The express language of the EFTA limits interchange regulation to debit cards and debit transactions. Any effort to expand the interchange regulation to the ATM environment would appear to exceed the Board's statutory authority. In addition, an expansion of interchange regulation to ATMs does not advance the consumer protection purposes of the EFTA.

Three-Party Systems

The Board also requested comment on whether the interchange fee standards and network routing rules should apply to debit transactions carried over three party systems. The Board describes a three-party payment system as one where the payment card network serves as both card issuer and merchant acquirer for purposes of accepting payment on the network. Here there is no explicit interchange. Rather the merchant directly pays a merchant discount to the network. If network routing restrictions, similar to those described in section 235.7, are going to be applied in the debit environment, the Committee sees no rationale for not applying such rules to three-party systems. That the Board took note of three-party systems amplifies the need for enforcement of the small issuer exemption and the anti-discrimination provisions of the EFTA.

Reasonable and Convenient ATM Access

The statute created a newly defined term, "designated automated teller machine network." That term means either: (1) all ATMs identified in the name of an issuer or (2) any network of ATMs identified by the issuer that provides reasonable and convenient access to the issuer's customers.

The Board proposes to clarify the reasonable and convenient standard to mean that, for each person to whom a card is issued, the issuer provides access to an ATM within the metropolitan statistical area in which the last known address of the person to whom the card is issued is located.

We urge the Board to delay implementation of this provision of the EFTA pending more study. Nothing in the Board's proposal suggests that consumers lack access to ATMs. The Congressional record contains very little detail. Implementation of this proposed rule could have significant impact on card issuing financial institutions. Accordingly, more study is warranted before finalizing a substantial rule on ATM access or deployment.

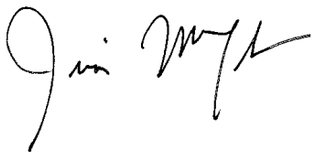
In Conclusion, the Committee and PCUA request the Board to delay implementation of the debit card interchange fees and routing provision of the EFTA. Such a delay will give the Board time to fully study the impacts of this proposed rule on financial institutions under $10 billion in asset size. As written the proposed rule will have a material effect on small issuers, a result that is clearly at odds with the plain language of the statute.

The Committee and PCUA request the Board to include language into the final rule enforcing the small issuer exemption, thus providing the appropriate protection from interchange fee regulation afforded them by Congress. Moreover, oversight verbiage should be added to prevent merchants from discriminating against small issuers with respect to the network exclusivity and routing provisions.

The PCUA appreciates the Board's consideration of the comments contained in this letter. We would welcome the opportunity to discuss our concerns and recommendations with the Board at your convenience.

Very truly yours,

PENNSYLVANIA CREDIT UNION ASSOCIATION



James J. McCormack
President/CEO

cc: Association Board
Regulatory Review Committee
Governmental Affairs Committee
Mary Dunn, CUNA