



June 18, 2021

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitutional Avenue NW
Washington, DC 20551

Via Electronic Mail (to regs.comments@federalreserve.gov)

Re: Docket No. R-1748 – Request for Extension of NPRM on Debit Card Interchange Fees and Routing and expansion of the Scope of the Proposed Rules

Re: Federal Reserve Proposed Amendments to Regulation II (Proposed April 30, 2021)
Statutory Authority provided by the Dodd-Frank Wall Street and Consumer Protection Act (enacted July 21, 2010)

Dear Ms. Misback,

There are 34 state or federally chartered credit unions and 69 state or federal chartered banks for a total of 103 community financial institutions in North Dakota.

Because all 103 of these community financial institutions are less than 10 billion in assets (see the attached list), they qualify as Exempt financial institutions as defined in Regulation II. (Note: One state-chartered institution is close to exceeding the 10 billion in assets threshold).

The Durbin Amendment was originally created to benefit Exempt institutions such as those outlined above. However, specific vendor practices designed to mitigate the Durbin Amendment are instead adversely impacting those community banks and credit unions.

Durbin Amendment Recap (Dodd-Frank Wall Street and Consumer Protection Act)

The Durbin Amendment intended to address three specific areas relating to E-Commerce and the use of Debit Cards.

Excessive Interchange Fees

The industry agreed that interchange fees being charged by large financial institutions had become excessive. Merchants paid huge fees to issuer banks in exchange for accepting a card-holders card to facilitate a purchase. It should be noted that these merchants were excluded from the "Accept All Cards" lawsuit that was resolved in an out of court settlement between the parties.



Wanting to level the playing field for merchants, the amendment gave the Federal Reserve the statutory authority to conduct a study and set the interchange cap for the Covered class of institutions (institutions over 10 billion in assets) and for the most part provided the merchants that were excluded from the out of court settlement essentially the same economic benefit.

Least Cost Routing (Prohibition on Network Exclusivity)

The second aspect of the Durbin amendment was to provide to the merchants a least cost routing choice that would also reduce the interchange fees they would have to pay. The least cost routing required all issuers to have a minimum of two unaffiliated Card Payment Networks that merchants could choose from to route debit cards transactions for clearing more economically.

This also was considered by the industry as a reasonable compromise, and it gave merchants the choice. The roll-out of the EMV chip on debit cards provided some technical challenges at first, but for the networks and the brands (Visa, Mastercard and Discover) were able to overcome them. This requirement eliminated network exclusivity.

Community Financial Institutions (Exempt Issuers)

The third aspect of the Durbin amendment created the Exempt class of issuers for financial institutions that were less than 10 billion in assets. The class of issuer exempted them from the interchange cap imposed on covered issuers by Regulation II (the Fed).

Note: Exempt issuers still must comply with the second aspect of the Durbin Amendment regarding least cost routing requirement (Prohibition on Network Exclusivity).

The objective of the exempt status of issuer focused on preserving income for community financial institutions. The justification is based on the need to ensure that community financial institutions (banks and credit unions) can offer debit card services at a competitive cost to their customers given the absence of the economy of scale benefits enjoyed by very large financial institutions enjoy.

Circumventing Durbin (Card Present and Card Not Present Transactions)

The Federal Reserve Board is proposing for Card Not Present Transactions that two unaffiliated networks be available for Card Not Present transactions, but the board has not even considered the abuses that are being imposed on Exempt financial institutions for card present transactions (particularly PINLess Debit rules) that circumvent the intent of the Durbin Amendment.



Even though the complaint filed in the state of North Dakota (Case 1:21-cv-00095-CRH Document 1 Filed 04/29/21) points to the growth in dollar value for debit card transactions and allege that Covered financial institutions are circumventing the regulations, the lawsuit also deflects attention away from the plight of community financial institutions and what they are facing. We do agree that Regulation II does need to be reformed, but not in the way the plaintiffs assert, nor will the current proposed rules resolve the problem.

The lawsuit filed asserts that the Board of Governors of the Federal Reserve, by virtue Regulation II, failed to cure the market failure that Dodd-Frank tried to fix. Furthermore, The Fed needs to expand the proposed rules to include the Card Present Transactions and to provide relief to community financial institutions that are being victimized by the collusive behavior between Card Payment Networks and Merchant/Acquirer Networks owned by the same companies.

Large core processors provide community financial institutions (Banks and Credit Unions) with the systems they need to offer accounts, internet banking, mobile banking and debit cards to their customers. These same processors own card payment networks (switches) and have also purchased Acquirer/Merchant networks. Two of the top three domestic core application vendors that process financial institutions, own card payment networks and Acquirer/merchant networks. This combination of owned subsidiaries is used to manipulate the clearing of these transactions by virtue of unilaterally re-writing the Network Operating Rules that reduce interchange income of the financial institutions affected. At the same time, this shifts liability in the event of fraud back to the issuer and off of the merchant. In other words, PINLess debit card fraud, based on these network rules, can't be charged back to the merchant. Every exempt community financial institution has been adversely impacted by these tactics and they have suffered millions in lost income.

According to Nilson Report (Issue 1193 March 2021) two of the top three processors are FIS and Fiserv. The sum of the volume they control is 52.6% of all transactions. When Chase is added, only three entities control 80.2% of all merchant acquirer volume domestically. More importantly, two of the three vendors control the processing of over 75% of the community financial institutions domestically (estimated). This creates a significant disadvantage for every exempt community financial institution the state, let alone domestically.

Regulatory reform is absolutely a must to return the Exempt benefit so desperately needed by community financial institutions. Regulation II does need to be revised to respond to these adverse practices.

We request that the Federal Reserve delay the implementation of the proposed rules and expand the scope and provide greater options and flexibility to exempt institutions to be to thwart these predatory practices and ask the Department of Justice investigate these business practices immediately.



Needed Reforms (Community Financial Institutions)

1. Financial processors should not be allowed to own Merchant Acquirer Networks and Card Payment Networks at the same time.
2. Exempt Financial institutions should have the right to join any network they choose, and only the networks they choose.
3. Exempt Financial institutions should have the right to select how their debit card payments are processed, and the order in which it's processed as long as it complies with Regulation II. Card payment networks should not be allowed to usurp these preferences or enable merchants to go around through processing back-doors.

Example: Special contracted switching relationships via merchant acquirer networks when a card payment network is owned by the same vendor. Because of this, that vendor diverts transactions through the manipulation of its own network operating rules.

4. PINLess Debit Transactions (Card Present) that unilaterally shift transaction liability from the merchant to the issuer should be banned. If the exemption institution does not want to participate in this product that should have the right to opt out (no charge-no penalty).
5. Linkage Language in membership agreements and Network Operating Rules that force financial institutions to join Card Payment Networks that they do not choose should be banned.
6. Exempt financial institutions should have the option to require the use of a PIN on all Card Present POS transactions. Covered financial institutions have this option and they insist that a PIN be used at the P.O.S. for card present transactions which gives them a distinct advantage of exempt institutions.

Federal Reserve System 12 CFR Part 235 (Regulation II: Docket No. R-1748) Proposed Rules (Federal Register Vol. 86 No. 91 Thursday, May 13, 2021)

The proposed rules do not go far enough to correct this adverse situation as it relates to the perceived anti-trust activities imposed by processors that own card payment networks and merchant acquirer networks.

The Federal Reserve should expand the proposed rules to include the above reforms for Exempt institutions and ask the Department of Justice to investigate the tactics associated with the manipulation of Network Operating Rules of Card payment Networks (Switch Networks) and the connection with Merchant/Acquirer networks that are specifically designed to mitigate the benefits Durbin intended to help community



financial institutions in preserving interchange income (include card present and card not present transactions).

Summary

Large financial institutions have the resources and the economy of scale to achieve the desired interchange income from debit card transactions. Merchants have a right to a choice (under Regulation II), but Dodd-Frank did not consider nor did the Federal Reserve Board of Governors of the Federal Reserve System the adverse impact to community financial institutions regarding rule manipulation.

Community financial institutions have limited resources to defend against large processors that take advantage of them through rule manipulation. The losses to these institutions in the state is millions and continues to grow. The Exempt community financial institutions have experienced a significant decline in their interchange income because of this collusive activity and are now losing money on providing debit card services to their customers. They are caught between Card Payment Networks and Merchant/Acquirer Networks taking advantage of the lack of adequate supervision and scrutiny. Furthermore, the rules and tactics currently deployed by vendor participants are covered by Non-Disclosure provisions of the rules that govern this vendor activity.

At this juncture we are asking the Fed to take action and force an investigation, discovery, identification and the public disclosure to force these tactics out into the open for the Federal Reserve correct.

Respectfully Submitted,

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