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From: Pioneer Trust Bank, NA, Betsy Steinberg & Deryl Yunck

To: Federal Reserve Board Proposal: Regulation II - Debit Card Interchange

Fees and Routing Document: R-1404

Thank you for the opportunity to comment on the proposed debit change rules. The Board has been charged with a daunting task, to implement an amendment which by-passed critical elements in our law-making process. The Durbin Amendment was passed with virtually no public debate. Many commentators have chosen this forum to articulate their opinions on the matter. Rather than add our voice of dissent to a narrowly targeted, poorly written law which will ultimately negatively impact the consumer, we will focus our remarks to the Board's interchange proposal itself.

General Comments

Pioneer Trust Bank acts as both a debit card issuer and as a merchant acquirer, and we are familiar with the arguments and challenges from both sides. Two observations about the proposed rules in general:

1. The Board has overlooked the role of the merchant acquirer, who is ultimately responsible for setting the discount fee for the merchant. Many merchant fee complaints attributed to networks and issuing banks should in fact be attributed to the pricing practices of their merchant acquirer. There are no assurances in the Board's proposal that the merchant acquirer will pass on the lower interchange fees to the merchant, or that the merchant will in turn pass on any savings to consumers.
2. The Board was charged with considering the functional similarity shared between electronic debit transactions and checks. Value-added services for merchants such as check guarantee and fraud protections were not factored in the transaction expense for interchange. Both are core services in card payment transactions, and the commentary noted merchants can purchase these same services separately for checks. Basing interchange upon minimal transaction expenses and excluding the costs of value added services is comparing apples to oranges, and provides no incentive for networks and card issuers to continue to provide these services without compensation. Costs will either be absorbed by the consumer, or issuers will cease to provide these services to merchants. Innovation and industry development could take a giant step backwards.

Interchange Caps

As a small financial institution with less than \$10B in assets, we are exempt from the interchange cap. However, we think market pressures will ultimately impact the interchange reimbursement for small issuers as well. Of the interchange fee options the Board presents, option two would be far simpler to administer, but the artificially low cap proposed is disconcerting. We feel the Board was too narrow in their definition of allowable expenses, and make the following observations:

1. In their data collection, the Board arrived at their cap by using the median figure of signature and PIN based transactions. As the commentary points out, signature transaction expenses are greater than PIN. A “median” expense will not fairly compensate an issuer in the event their number of signature transactions outweighs their PIN. The Durbin Amendment does not call for a single interchange, and we recommend the Board separate the transaction processing modes and establish two separate caps.
2. The second proposal does not provide concrete guidance to assure the interchange cap is periodically reviewed and re-adjusted based upon current expenses.
3. To accommodate the small issuer exemption, card networks will have to deploy a dual interchange system. Although some networks have indicated they will support it, the proposed rule does not guarantee it will be honored by the networks. Small issuers may find themselves reimbursed at the interchange cap, and without the economy of scale of a large issuer, may not be able to support a debit card program.

Network Exclusivity

Of the two proposals, we endorse option A as the lesser of two evils. However, if interchange fees are capped and the issuer’s reimbursement is fixed, we question the necessity of requiring issuers to support competing networks. As pointed out in our general comments, the merchant’s pricing is ultimately set by their acquirer, not the card issuers or networks. Furthermore:

1. Each network assesses monthly gateway fees to their card issuers, which were not included in the Board’s calculation of interchange reimbursement. The added expenses to support additional networks will be an undue burden on small issuers that do not have the economy of scale of a large card base.

For example, Pioneer Trust Bank supports one signature and one PIN network on our cards. In 2009, gateway fees for these two networks amounted to 11% of our gross debit card expense. Doubling the number of required networks as proposed under Option B will increase our issuance expenses over 10%.

2. Merchants currently have the ability to choose whichever card networks and debit transaction processing modes they wish to support. The routing restrictions merchants encounter are the practices of their merchant acquirer, not the issuer or card network. With this in mind, mandating additional networks serves no purpose. Imposing the provision to eliminate the card network rules on exclusivity for issuers adequately addresses this provision.
3. Networks offer different rules and benefits to their cardholders, such as zero liability. Multiple card networks will add confusion to the consumer as to which network their transaction was routed and which rules apply.
4. The requirement to add competing networks may have the unintended consequence of stifling competition between networks, which in turn could cause industry innovation to stagnate.
5. Much of fraud deterrence is centralized with the individual networks, and the strategies of their neural networks are developed using the transaction trends of their member base.

Routing transactions through multiple networks may have an unintended consequence of impacting the logic of these strategies.

6. As currently written, the exclusivity rule is vague. Potentially, it could be interpreted as allowing merchants the ability to refuse higher priced cards, which would adversely affect small issuers.

Fraud Monitoring

The Board has refrained making a proposal on the cost reimbursement for fraud monitoring. Under the existing rules of most networks, if a merchant follows all of the rules for card acceptance and processing, the burden of fraud falls upon the card issuer. Because of this risk, most issuers have already invested heavily in fraud monitoring programs.

1. As the commentary points out, fraud differs significantly between signature and PIN transactions. Allocating monitoring costs would be simpler if interchange on these transaction modes were separated.
2. Without adequate reimbursements for fraud monitoring, there is no incentive for issuers to continue the current practice of accepting liability on fraud. Unintended consequences may include shifting fraud losses back to the merchant, stricter card issuance criteria, and higher card costs for the consumer.

Conclusion

The only thing worse than a bad law is its hasty implementation. We understand the time constraints were set within the Durbin Amendment, but as the “Highlights” of the Nov. 2009 GAO report to Congress on interchange concludes, options to control interchange “presents challenges for implementation”¹. The Board has not had sufficient time for thoughtful implementation. Additional time is needed for a complete analysis of the transaction costs, an evaluation of the various participant roles in transaction pricing, and a thorough review of the proposal for unintended consequences.

Debit card transactions are complex, and the proposed rules will have various impacts on participants which have yet to be fully analyzed. We encourage the Board to go back to Congress and ask for a more suitable timeframe to complete their job.

Sincerely,

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¹ United State Government Accountability Office Report to Congressional Addressees “Credit Cards- Rising Interchange Fees Have Increased Costa for Merchants, but Options for Reducing Fees Pose Challenges” November 2009