



February 22, 2011

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

Re: Regulation II; Docket No. R-1404

Dear Ms. Johnson:

The SHAZAM network appreciates this opportunity to respond to the Request for Comment issued by the Federal Reserve Board (FRB) regarding proposed Regulation II – Debit Card Interchange Fees and Routing, which is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).

Since 1976, the SHAZAM network’s member-owned structure has stayed true to our mission to provide our financial institution customers with competitive products and services related to the electronic payments industry. As a long standing, nationally-recognized pioneer and innovative service provider in the payments system, we have dedicated our organization to providing and enhancing the opportunity for approximately 1,500 financial institutions to compete effectively and profitably in the marketplace through the delivery and support of quality, comprehensive, and timely electronic funds transfer (EFT) services. SHAZAM provides EFT services to financial institutions and processing services to merchants throughout the U.S. We have carefully considered the FRB’s proposed rule and its impact to the EFT industry, and our comments are below.

Overall Impact

SHAZAM believes as a result of the federal regulation of the U.S. debit payments system mandated by the Durbin Amendment, ultimately, consumers will bear the cost of this regulation and small exempt issuers will be disproportionately impacted.

Price controls are dangerous because they may lead to unintended and potentially harmful consequences which can distort free enterprise and evolving markets. Sound public policy interests are codified in Section 904 of the Electronic Funds Transfer Act (EFTA), which requires the FRB to consider the effect of any proposed rule on the following: (i) "costs and benefits to financial institutions, consumers, and other users of electronic fund transfers"; (ii) "competition in the provision of electronic banking services among large and small financial institutions and the availability of such services to different classes of consumers, particularly low income consumers"; and (iii) to the extent practicable, "demonstrate that the consumer protections of the

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proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions".

SHAZAM believes that due to all issuers being subject to the network exclusivity prohibition and merchant routing decisions set forth in the Act, it is likely over time that interchange rates available to exempt issuers will equalize with the proposed government-fixed rate of \$0.12, thereby voiding the small issuer interchange exemption. In order to preserve the intent of the law, we ask the FRB to issue additional rules that guarantee the viability of the small issuer exemption in the marketplace and protect the interchange revenue of all small issuers.

This market evolution, driven by an artificially set government cap on debit interchange, will force all financial institutions to consider (i) implementation of new and revised customer offerings with associated fees, and (ii) discontinuance of current programs attractive to consumers. These strategies will likely be pursued in order to recover the estimated 70 percent reduction in interchange income. This necessitated repositioning will likely have a direct, adverse impact on consumers, such as discontinuance of free checking and debit reward programs. Some larger institutions have already indicated they will consider charging customers checking account fees and other debit card-related fees under various criteria.

It is relevant to look to the FRB staff comments made to the Board of Governors on December 16, 2010, when presenting for approval the proposed rules on the Durbin Amendment. When asked about the impact of the small issuer exemption, the FRB staff spokesperson replied, *"If the networks do decide to establish two separate interchange fee schedules and allow higher interchange fees for the small issuers, 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"* and *"The merchant routing provisions would tend to put downward pressure on interchange fees in general ... so we may find that even if the networks establish a higher interchange fee schedule for the exempt issuers, those issuers have somewhat of an increase in cost and somewhat of a decline in their prices and they may experience some reduction in their profits from these operations."*

This viewpoint was also shared by Jeb Hensarling and Spencer Bachus in a letter to Chairman Bernanke (December 17, 2010). *"If enacted as proposed, the results would be extremely damaging to consumers, the U.S. payment systems, and financial institutions of all sizes. Additionally, as explained later, the small issuer exemption will be muted because of the exclusivity and routing rules. As Representatives Hensarling and Bachus state, "Despite its intent, the small issuers' exemption may end up creating an unlevel playing field in the industry that hurts small issuers like community banks and credit unions by making their cards more expensive for merchants to accept."*

FRB Chairman Ben Bernanke expressed doubt on the workability of exemptions for credit unions and small banks from the debit interchange price controls required under the Act. *"We are not certain how effective that exemption will be,"* said the FRB Chairman during testimony before the Senate Banking Committee. *"It is possible that because merchants will reject more expensive cards from smaller institutions or because networks will not be willing to differentiate the interchange fee for issuers of different sizes, it is possible that the exemption will not be effective in the marketplace."*

New rules that overburden the industry with excessive regulatory constraints and restrict the ability of financial institutions to continue to offer existing financial products and services because they simply cannot afford to continue to do so are not, in the long run, beneficial for any of the stakeholders in the EFT industry. These include financial institutions, payment networks, merchants, and consumers. Community financial institutions will suffer this cost burden more than the large financial institutions because of economies of scale.

Reasonable and Proportional Interchange Fees

The proposed rule does not fully consider all costs to issuers associated with debit transactions, nor does it consider the economic value of debit transactions to merchants. We believe the initial debit transaction cost analysis performed by the FRB was far too narrow and needs to be adjusted to reflect what is written in the law when the final rules are published. The law states: "...the Board shall consider the functional similarity between (i) electronic debit transactions; and (ii) checking transactions...and distinguish between the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction, which shall be considered..." (emphasis added). Below we have highlighted some key points for the FRB to consider before issuing its final ruling.

Debit Card Differentiators

There are several differentiators that make debit cards superior to checks, which need to be taken into account when reviewing the similarities. The suggestion that interchange fees on debit transactions should be reduced because debit transactions are the same as check transactions, and fees are not assessed on check transactions, fails to take into account the important value-added differentiators between debit cards and checks. For example: When a merchant obtains a proper authorization for a debit transaction, payment is guaranteed and the issuer bears the risk and liability for losses in the event there are insufficient funds. Checks, however, may be returned as non-payable and, in that event, merchants suffer the financial loss. Merchants benefit from what is essentially a form of insurance for payment afforded to them by the issuer in connection with a debit transaction. It is not reasonable to expect financial institutions to provide this valuable service to merchants and accept risk of loss on behalf of the merchants without being compensated. We ask you to also refer to the "Authorization Impact" discussion below for potential unintended consequences.

Role of the Issuer

As dictated by the Act, the FRB should fully understand and consider the "role" of the issuer in the authorization, clearing, and settlement of an electronic debit transaction. For example: In order to have a transaction processed on the SHAZAM network, an issuer needs to be a SHAZAM network participant. Participation requires the payment of various fees, including but not limited to monthly settlement fees, debit card residency fees, maintenance fees, network fees, and participation fees. To describe even more, settlement fees are what we charge financial institutions to recover our costs as a network in settling transactions daily. Debit card residency fees are part of the costs for obtaining an authorization. In order to keep the processing system updated, respond to changes by consumers (for example: address change), and avoid fraud, daily maintenance is required to properly handle authorizations. These expanded roles an issuer plays are all advantages the EFT systems have over checks and are needed for the authorization, clearing, or settlement of an electronic debit transaction. As such, we believe these types of fees must be included in the calculation of allowable costs.

Expanded View of Settlement

The FRB needs to expand what we believe is too narrow of a view of settlement. The primary objective of the EFTA is to protect individual consumers engaging in EFTs. SHAZAM network operating rules, which also provide consumer protections, require an issuer to maintain responsibility and, more importantly, liability for settlement if an authorization approval is provided by the issuer. The rights a consumer has within the network operating rules and costs incurred to allow a consumer to exercise those rights should not be overlooked and should be included as allowable costs. When an authorization is approved, funds are guaranteed. Merchants only have chargeback liability when consumer protection rights are not honored (for example: when the consumer does not receive purchased goods or receives defective merchandise). Handling consumer inquiries and processing consumer disputes are just two

examples of an issuer's role in settlement and actual costs that should be considered. By not expanding settlement cost considerations, the FRB's final rule may create the unintended consequence of a consumer being charged a fee for any debit card purchase inquiry or dispute handled by the issuer.

Reasonable Profit Allowance

The law specifies that the interchange fee shall be "reasonable and proportional" to the costs (not the exact costs) to authorize, clear, and settle a debit transaction. An allowance should be made for a reasonable profit. It is not reasonable to expect financial institutions to provide products and services to merchants and consumers and not earn any profit. If the factors described above are not taken into account, the proposed interchange cap is not a "reasonable" fee.

Interchange Alternatives

Alternative 2

SHAZAM believes Alternative 2 (cap only) is the better alternative for the payments industry, as it does not require additional costs associated with significant modifications to the current payments processing infrastructure created under Alternative 1 (safe harbor and a cap). From a network and covered issuer perspective, the administrative and technological costs to implement Alternative 1 would be extremely burdensome. Alternative 1 would require the creation of a separate interchange rate for each covered financial institution, as each would presumably have varied allowable costs. This would require the entire U.S. debit-processing industry to create a new interchange system for each covered issuer through the use of bank identification number (BIN) ranges or another innovative approach to assess proper issuer-specific interchange rates. Without standards to unify this infrastructure overhaul, each network could create proprietary methods and the costs to support multiple methodologies would be significant to implement. Acquirer and issuer processors, in addition to networks, would also need to make changes to support Alternative 1 requirements. Ultimately, the FRB is asking networks to develop a new settlement paradigm. These implementation costs would be passed down to issuers if Alternative 1 is mandated, so such costs should also be considered allowable costs.

Authorization Impact

The potential ramifications on authorization methods should also be considered in the final rule. It is widely accepted within the EFT industry that PIN debit transactions are the superior debit authorization method, as PIN debit results in less fraud for the industry. However, by capping all debit interchange at \$0.12, without differentiation between PIN and signature, signature-only merchants may no longer have a business incentive to purchase PIN pads, and existing PIN-enabled merchants may decide PIN pad compliance and maintenance costs are no longer justified. The likely result would be a reduction in PIN acceptance, which may potentially increase industry fraud for issuers.

Another unintended consequence may be a shift in liability from issuers to merchants. As a result of reduction in interchange income, issuers may push networks to shift liability for debit card transactions to merchants through amended operating rules.

Prohibition on Network Exclusivity

Alternative A Preference

SHAZAM advocates for Alternative A (two unaffiliated networks), as it lessens the impact to issuers while still providing reasonable routing alternatives to merchants. This alternative will provide merchants with the flexibility to choose the least-cost routing option, as the law intends. Under Alternative A, both exempt and non-exempt issuers will still need two unaffiliated networks for available routes. All SHAZAM participants are currently in compliance with Alternative A, so there would not be additional

incremental costs to our small issuers to implement this aspect of the final regulation. If Alternative B (two unaffiliated networks per authorization type) is mandated, the FRB needs to collect estimated cost data from all processing entities utilized by the issuer to ensure a solid evaluation regarding the impacts of Alternative B, particularly the likely disproportionate cost impact to exempt issuers. These costs include network costs, and potential costs of issuer processors and core software providers. As a national payment card network, SHAZAM recognizes that our network may have opportunities to benefit from Alternative B; however, the potential negative impact to our exempt issuers is too high to consider support for this alternative.

While Alternative A is what we support for both covered and exempt issuers, we would also support the implementation of two separate exclusivity systems, such as Alternative A for exempt issuers and Alternative B for covered issuers.

Emerging Technology – Contactless Cards

We believe the FRB should require the addition of a second unaffiliated network to any payment code or device, such as a card with contactless features. Currently, many such devices are only able to be processed as signature-debit transactions due to what we believe is more of network design in trying to eliminate PIN competition and not technological obstacles. Issuers should have the ability to choose which payment devices/methods they enable for their consumers, especially in light of these government changes. Enabling this payments technology for all issuer networks will promote fair competition and foster interoperability and consumer acceptance for these emerging technologies. Technologies should be built to support multiple routing options not only for issuers, but also for acquirers.

National Network Criteria under Either Alternative A or B

The FRB has requested guidance on how best to define what constitutes a national network. SHAZAM, as a national network, believes the following should apply:

- Network provides ATM and point-of-sale (POS) transaction processing services to multiple unaffiliated debit card issuers
- Network maintains direct links to multiple acquirer and issuer debit card processors
- Network operates an EFT switch for ATM and POS debit transaction processing
- Network has financial institution members/participants located in a majority of the states, which are subject to debit transaction processing contracts with the network
- Network supports merchant access points located in a majority of the states
- Network has direct processing links to other PIN debit-branded networks in the capacity as a debit transaction processor
- Network has direct processing links to the card associations to support signature debit, as well as PIN debit transaction processing, to provide for consumer and merchant choice over debit card payment alternatives
- Network demonstrates ongoing capability to support the complex payments system challenges for routing and switching debit transactions between processors and other networks to successfully authorize, clear, and settle debit transactions

Merchant Routing Considerations

Discrimination within a Payment Card Network

The Act states that merchants are not authorized to discriminate among debit cards within a payment card network on the basis of the financial institution that issued the debit card. However, this non-discrimination provision is not addressed in the proposed rule. The proposed rule also does not prevent merchants from refusing certain payment card brands. The FRB should specifically address the non-

discrimination aspect of the Act in the final rules to provide protections for all issuers within a payment card network. Enforcement of this process could be addressed by expanding merchant-sponsoring financial institution examinations to guarantee that small issuer cards within the same payment card network are accepted. Regulatory examiners could review merchant acceptance practices to ensure that merchants are not illegally discriminating against the available networks associated with a debit card.

Risk Management

Nothing in the final rule should prohibit a payment card network from rejecting/blocking transactions based on risk management principles. Issuers and payment card networks should continue to be able to make authorization and routing decisions based on safety and soundness considerations. Specifically, the FRB needs to make allowances in the final rules for issuers to make decisions on debit card authorization or routing in order to mitigate fraud. An issuer needs to have the ability to place restrictions or acceptance blocks on its debit cards to maintain or restore the security of an account or the EFT system without concern of being cited for violating routing rules.

Fraud-Prevention Adjustment

Alternative 2

SHAZAM believes that Alternative 2 (non-prescriptive) of the fraud-prevention alternatives would be the better choice. We do not believe it is practical for the FRB to mandate specific technologies. Alternative 1 (technology-specific) would stifle technological changes, as the FRB is not an expert regarding technologies that could reduce fraud. Overall, technology moves much too quickly (for example: advanced transaction blocking and granular authorization rules), and it is not realistic for the FRB to evaluate various technology alternatives and prescribe specific technologies. Rather, the market should be encouraged to rapidly develop paradigm-shifting technologies to encourage market alternatives of any technology that ultimately reduces fraud losses. SHAZAM believes the FRB should create standards for fraud prevention with an examination and enforcement policy similar to that established by the Gramm-Leach Bliley Act.

Advocate for a Cap Adjustment

The FRB should adopt the same implementation approach for the fraud-prevention adjustment that it adopts for the interchange fee standard we support, which is a cap for all covered issuers. The FRB should review and update the adjustment standards every two years, on the same schedule as the interchange fee review. The FRB should clearly define the fraud-prevention portion of the regulation to allow all parties a six-month window in which to implement changes.

Other Areas Comment is Requested

The following are other areas in which the FRB has requested comment.

Definitions

Payment Card Network: SHAZAM believes the term “payment card network” should be consistent with the spirit of the Act. Overall, the definition as outlined in the proposed rule is satisfactory.

Common Ownership or Control: The proposed rule states that two or more merchants are affiliated if they are related by either common ownership or common corporate control. However, this definition is inconsistent with how “control” is proposed to be defined under Section 235.2(e). We believe the FRB needs to address this inconsistency and use the financial institution definition of “control,” as outlined in Regulation Y (ownership, control, or power to vote 25 percent or more of the outstanding shares of any class of voting securities of the bank or other company, directly or indirectly or acting through one or

more other persons). If this inconsistency is not addressed, merchants may take unfair advantage of this inconsistency. See comments under the “Coverage of Three-Party Systems” section.

Circumvention and Evasion

We concur that the FRB’s approach regarding circumvention and evasion is appropriate. The FRB should review the issuer’s total relationship and expenses incurred, including optional and ancillary network services, when considering this part. As long as the issuer does not receive net compensation from the network, no circumvention or evasion has occurred.

Coverage of ATM Transactions and Networks

ATM transactions and ATM networks should not be included within the scope of the interchange regulation. The definition of interchange within the Act states that this rule is to regulate “payments made to issuers.” ATM interchange flows opposite of POS transactions, making its inclusion in the final rule inconsistent with the Act.

If the FRB does include ATM transactions and networks within the scope of the network exclusivity and routing provisions of this regulation, then it would provide ATM acquirers another brand alternative in which to route, thereby increasing their interchange income and reducing acquirers’ reliance on those networks that implement single-branding strategies. If this is the route chosen, we also believe Alternative A (two unaffiliated networks) would be the more cost-effective alternative.

Coverage of Three-Party Systems

Closed-loop cards that do not have the ability to route outside of the three-party system do not need to be included within the scope of the rule. However, cards issued with the ability to be routed outside the three-party system for authorization, clearing, or settlement should be included within the scope of the rule, as it is no longer a three-party system. Being considered “closed-loop” is one example where the inconsistent definition regarding common ownership using “or” as compared to “and” common corporate control could provide exclusion benefits to merchants that are truly not affiliated.

Issuer BIN Ownership

SHAZAM believes the FRB should mandate the disassociation of BINs (to include extended BINs) from the card networks. Financial institutions should be allowed to take ownership of their BINs or extended BINs, thus allowing them to choose which networks would appear on their cards and the location of those networks on the card, rather than being bound by a specific network’s rules on brand restrictions. This would also allow financial institutions to save on unnecessary network brand and loyalty fees. Financial institutions would have the ability to freely choose and negotiate with each network and make the decisions that are appropriate for their business. This would allow financial institutions to deconvert from a network without having to reissue cards. Instead, cards could simply be reissued as they expire. This would provide cost savings and convenience to the consumer.

Reissued cards would no longer require a new card number, thus providing a huge benefit for consumers who would no longer need to update all of their preauthorized debit card payments with their new card number. By maintaining the same card number, consumers would be able to maintain any debit rewards (provided they survive) they earned based on card usage.

This shift would make it easier for networks to implement the new routing and network exclusivity requirements by promoting card interoperability. Merchants would benefit because card acceptance would no longer be mandated by the payment card brands. A merchant would be able to make a conscious decision regarding which brands to accept, and therefore, with which network operating rules they would be required to comply.

Exempt Card Certification

There is no need for a separate certification process for exempt cards. Payment card networks that allow issuers to charge higher interchange fees than permitted for transactions made using a debit card that meets any of the regulatory exemptions should be able to rely on the BIN list as a means to identify the card accounts that meet the exemption. The BINs for these cards should not be included in the list of impacted BINs submitted to the payment card networks. However, in order for this system to be effective, account features cannot be commingled. For example: A government-administered card should only be able to access the applicable benefit and should have the ability to access additional accounts held by the consumer, as these additional funds may not meet the exemption requirements.

Mandatory Network Reporting

As part of the mandatory reporting process necessary to implement this regulation, we believe the FRB should work with networks to create baseline reporting standards and practices across the industry. As part of this effort, the FRB should issue a comprehensive report every year to networks outlining those institutions with greater than \$10 billion in assets or provide reporting standards for issuers to inform networks of their status as a covered issuer. Networks should then have at least six months to make any necessary interchange adjustments. SHAZAM would be willing to work with the FRB and other networks and organizations to create standards for use across the industry.

Effective Date

It is difficult to predict a timeline for infrastructure and project changes without seeing the final regulation. However, we believe the FRB needs to fully understand the development life cycle and create uniform industry standards to implement such wide-ranging changes. Networks will need a period of time to understand the final regulation and issue guidance for their network participants. Only following the network guidance will processors be able to begin making the changes necessary to become compliant with the FRB's final ruling. This is a significantly timely process; therefore, the FRB needs to carefully consider the complexity of these network changes, taking into consideration the co-dependency within the industry. Given the interconnectivity of national networks, such as SHAZAM, we all are somewhat co-dependent upon each other in order to implement change effectively and consistently throughout the EFT industry without negatively impacting issuers, acquirers, or cardholders.

Conclusion

As a result of the federal regulation of the U.S. debit payments system mandated by the Durbin Amendment and as the FRB rules currently sit, we believe that consumers will bear the cost of this regulation for both covered and exempt issuers. The proposed rule does not fully consider all costs to issuers associated with debit transactions, nor does it consider the economic value of debit transactions to the merchants. Merchants should not be allowed to receive all of the benefits of the debit card system without any accountability or financial responsibility. The FRB needs to understand the unintended and

harmful consequences the proposed regulation will ultimately have on small issuers and consumers. We encourage the FRB to take a close look at all factors and weigh them carefully before making any decisions related to the final regulations.

SHAZAM appreciates the opportunity to comment on the proposed regulation, and we thank you for consideration of our comments.

Sincerely,

A handwritten signature in black ink, appearing to read "R. S. Jenkins". The signature is fluid and cursive, with a prominent initial "R" and a long, sweeping underline.

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