American Bankers Association
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December 13, 2010

Ms. Louise Roseman
Director
Division of Reserve Bank Operations and Payment Systems
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: The Impact on Community Banking from the Provisions of Section 1075 of the Dodd-Frank Act related to Debit Card Interchange Fees.

The American Bankers Association[1] ("ABA") understands the difficult task the Federal Reserve Board (the "Board) has undertaken to determine "reasonable and proportional" costs to assign to debit card interchange fees assessed to banks with assets greater than $10 billion. Finding the "right" fee for the largest banks that will be affected directly by the regulation will be difficult for the Board. The impact of this fee, however, is not limited to just the largest banks that are directly affected by the change. Unfortunately, the interchange price cap is likely to disproportionally harm the 16,000 financial institutions with assets less than $10 billion.

The comment letter will raise concerns over several aspects of the Durbin Amendment:

- The impact of the two-tier pricing system on community banks and their customers
- Inclusion of growing costs associated with fraud prevention and loss
- The financial burden of the withdrawal of network exclusivity arrangements

The Durbin Amendment Impact on Community Banks

The provision enacted recognized that setting price controls would have a significant negative impact on roughly 16,000 small banks and credit unions. It ***attempted*** to remedy this problem by providing an exemption to the price controls for institutions with assets of less than $10 billion. While this idea sounds good, it does appear to provide little protection to small banks because it likely will require a two-tier pricing system that will be technically challenging to implement by the card networks and more importantly, likely will be undercut by marketplace pressures. Simply put, the "community bank safe harbor" may not exist.

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities. Learn more at www.aba.com.

As conceived, the Durbin Amendment could subject 80 percent of all debit transactions (those generated by the large issuers) to price caps which may be below current interchange fee levels. The remaining 20 percent of debit transactions, initiated by the smaller card issuer banks and credit unions, technically would not be subject to regulator imposed price constraints. This artificially bifurcated economic model likely is doomed to failure because merchants will have an economic incentive to drive transactions to the lowest cost payment vehicles – those offered by the large banks. As consumers receive incentives from merchants and large issuers to move their accounts to larger banks, small banks likely will have to choose between losing transaction volume or lowering their interchange fees to unprofitable levels. This is an untenable choice and one that then will force smaller banks to adopt pricing strategies that match marketplace competition in order to retain their customers. In effect, these smaller banks will thus be subject to the same price constraints as their larger competitors with fewer resources to absorb the costs.

Community banks are at a competitive disadvantage already when it comes to the cost of processing and posting debit card transactions in comparison to larger debit card issuers. Every transaction a community bank processes costs more than a large bank, even without considering fraud costs. Community banks must rely on a third party processor because they do not have the size and scale for it to make economic sense to process transactions internally. A community bank may not have the same level of processing sophistication as a larger bank. A community bank may be unable to verify real time balances during the authorization process. As a result, a community bank may bear a greater burden and financial risk when they are asked to provide a payment guarantee to a merchant for an approved transaction. By not considering the difference in fraud costs for community banks versus large banks, this rule will amplify the existing competitive disadvantage community banks have in processing transactions and make it worse.

Customers Will Be Hurt By Price-Setting

The caps on interchange fees will have a significant impact on customers of these so-called exempt institutions, both community banks and credit unions. These customers include low-income consumers who rely on free or low-cost banking accounts that may no longer be available or available only at a much higher price because the interchange, which supports these accounts, is greatly reduced. Financial institutions must consider how to replace revenue lost due to interchange price caps and expenses related to managing additional network relationships due to the routing requirements. These losses of revenue and increased expenses must be offset by other sources of income or the financial institution would be placed at risk. The less revenue received by a community bank reduces its ability to provide its basic service, making loans.

Income attributed to debit card interchange for community banks ranges around 8-12 percent of total fee income. However, these estimates were made before recent regulatory changes reducing bank overdraft program income went into effect in August 2010. In addition, interest earned from deposits, also a primary revenue source used to support the cost of providing checking accounts is at historical lows. Thus, interchange now represents a much greater percentage of the revenue used to support checking accounts. Accordingly, the importance of debit card interchange income is greatly increased and multiplies the negative effect of drops in that revenue. During these difficult economic times when bank earnings derived from loans has stagnated, fee income is very important. This increases the importance of maintaining a reasonable income.

Consider a community bank that generates $100,000 in debit card interchange on an annual basis. Reducing that revenue by $10,000 or $20,000 or $50,000 would have a devastating effect on that institution's income. Unprofitable banks are not able to serve their customers in the long term. And, over the long term, fewer banks means less competition and less competition does not serve customers either.

Measurement of Fraud Costs and Reputational Risk

As the Board determines the proper "reasonable and proportional" price cap for large debit card issuers, it is analyzing the cost of fraud and fraud prevention. This is an essential cost that should be included. However, it is also essential to consider the vast economies of scale of the institutions that the Board is reviewing. These large institutions have larger card bases, more transaction volume, and more sophisticated and expensive fraud tracking programs. Small card issuers have fewer cards, fewer transactions, and many do not have the resources to install costly data fraud detection protocols. The result is that small issuers cancel and reissue debit cards suspected of being compromised at a higher rate than large issuers. This strategy limits large potential losses, but raises the fraud cost floor. It indicates that the percentage of expense related to fraud is higher for community bank issuers than it is for the small pool of large banks that the Board is surveying.

Thus, if the Board issues its price cap and only considers the cost of fraud for large issuers, it will have a devastating effect on community bank issuers who will be uncompensated for higher fraud costs.

The cost of fraud to a bank may be calculated with some precision. The cost of fraud to a bank can be significant. In fact, fraud costs can more than offset all of the revenue a bank issuer may receive from interchange fees and cause losses that banks must absorb. These spikes in losses are difficult to predict and many times they are the result of merchants' systems being compromised. While the merchant creates the opportunity for fraud, it is the banks that must pay the price.

The cost of preventing fraud may also be estimated with a degree of accuracy. However, the harm that banks suffer due to a loss in reputations is much more difficult to measure. When community bank customers have their card data compromised at a retailer or payment processor, card issuers often reissue the cards to limit large losses. Unfortunately, while the information that the breach occurred is communicated to the bank, it is the rare merchant that admits to or communicates its failure to safeguard data. The result is that the bank customers are aware that there has been a security breach, but due to a vacuum of knowledge, customers blame the bank which is reissuing the card. Customers subject to multiple card reissuances may close the account at a bank that they associate unjustly with security breaches and move to a larger bank, which may not have to reissue cards and so is not perceived as impacted by the breach. This compounds the financial damage done to banks through fraud and security breaches that they do not control – and for which the retailers may have been responsible. A reduction in interchange transaction revenue to support these efforts would multiply the negative effect on banks.

Additional Network Routing Requirements on Community Banks

Under the Durbin Amendment, more burdens fall on all debit card issuers, including community banks. The first is the "Prohibition of Network Exclusivity Arrangements." This provision would prohibit a debit card issuer from restricting the number of payment card networks on which an electronic debit transaction may be processed to a single network or restricting a merchant from routing an electronic debit transaction for processing over any payment card network that may process the transaction. This may require that all debit card issuers negotiate new contracts with unaffiliated payment networks for both signature debit and for PIN transactions. Currently, many debit card issuers benefit financially from receiving preferred pricing from networks that process their transactions. If a community bank is forced to enter into an additional payment relationship that falls outside the services their current processor provides, the community bank would be required to pay the fee associated with the "new" network and it would also have to pay a gateway fee to its processor. The result is not that a community bank would absorb the cost of one network instead of another, it would be subject to the "new" network fee plus the gateway fee. Larger banks have the size and scale to implement direct connections to new networks and will avoid the gateway fee. If this practice of network exclusivity is eliminated, it will increase costs to debit card issuers at the same time debit card interchange is being reduced. The proposed rules implementing this requirement have not been issued and the final rule is not required to be issued until July 2011.

The second burden is related to the "Prohibition on Merchant-Directed Routing Transactions" that require that merchants route PIN transactions to the network designated by the debit card issuer. Under this provision, it is possible for a merchant to ignore the issuer's routing preference and to select the "lowest cost" option for a merchant. Depending on how the Board develops the governing regulation, a merchant may direct a transaction over any payment network that has a direct or indirect relationship with the card issuer. Debit card issuers select payment networks based on reliability, cost and level of security. A "cheap transaction" is not cheap if it is not processed properly or if the card data is compromised due to poor security controls. This provision has the potential to increase debit card issuer costs radically at the same time that that debit card interchange is being reduced.

Again, we understand the challenge the Board has in drafting a rule that is fair to the largest card issuing banks. We ask that the Board recognize that its rule will affect far more banks in the industry that have fewer resources and lack the economies of scale available to squeeze all of the efficiencies out of the debit card process than do the largest issuers. This debit card interchange rule likely will cause financial harm to thousands of small banks at the same time other aspects of the Durbin Amendment will be putting additional revenue pressures on community banks. Thank you for allowing us to comment on this very important issue. If you have any questions concerning these comments or if there is any way we can be of assistance, please contact Stephen Kenneally at ABA at 202.663.5147.

Respectfully,

C. Daniel DeLawder
Chairman and CEO
Park National Corporation
Co-Chair ABA Interchange Task Force

Thomas L. Hoy
Chairman, President & CEO
Arrow Financial Corporation
Co-Chair ABA Interchange Task Force