David C. Epke
Senior Executive Vice President and COO

February 16, 2011

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

Re: FRB Docket No. R-1404
RIN No. 7100 AD63
Debit Interchange Fees and Routing

Dear Ms. Johnson:

On behalf of First National Bank Texas, I appreciate the opportunity to provide comments to the Board of Governors of the Federal Reserve System ("Board") on the proposed new Regulation II, Debit Card Interchange Fees and Routing, FRB Docket No. R-1404 and RIN No. 7100-AD63.

First National Bank Texas is a federally chartered bank operating over 230 branches throughout the State of Texas with headquarters located in Killeen, Texas. First National Bank Texas provides full service banking products and services throughout the State of Texas.

Our understanding of the proposal is that the Electronic Funds Transfer Act (EFTA) would be amended with a new section (Section 920). This section would consist of two key components:

- New limitations on interchange transaction fees in connection with debit card transactions would be established.
- New limitations on certain debit card network exclusivity and transaction routing restrictions would be established.

Given our understanding of the proposed changes, I must inform you that our organization is categorically opposed to the new rule for several reasons.

Perhaps the biggest shock during our review of the proposed regulation was the establishment of both a maximum debit card transaction interchange fee and the fee set at a level somewhere between $.07 and $.12 per transaction, regardless of transaction type. Ignoring for a moment the

extreme reduction in the interchange fee of approximately 400%, the fact that both signature and PIN debit transactions are being treated as the "same" is difficult to understand. Notwithstanding the difference in the cost to issuers these two very different types of transactions may have, perhaps the most distinguishable difference is the fraud loss experienced between the two. As reported in several different industry surveys, fraud losses on signature-based transactions are 7-8 times the rate of losses on PIN-based transactions. By our most conservative estimates, income related to debit card transactions will be reduced in excess of 70%. Additionally, we would like to emphasize that implementation of the proposed limitations would actually create a net loss to our organization for each transaction we process. Obviously, that is not a sustainable business model to endure over the long term. Given the limitations being proposed, the only way to continue offering this service to our customers is to change the product structure for the customer to share the expenses of this increased burden upon our bank.

It was also noted during our review of the proposed regulation, that community banks with assets less than $10 billion would not be subjected to the interchange transaction fee limitations but the limitations on network exclusivity and transaction routing would be applicable. While this may sound attractive and protective in theory, we believe the unintended consequences are that it is highly unlikely this limitation is practical in application. While VISA and others have announced plans to support a multiple tiered system to support different interchange transaction fees, there appears to be no enforcement capability within the proposed rules, the merchant processing rules, or agreements with acquirers, that transactions initiated with debit cards issued by banks with under $10 billion in assets would be treated without prejudice. The history of economics would lead us to believe that transactions originating at the merchant will eventually be driven to the least costly venue for those transactions.

The other main component of the proposed regulation centers on network exclusivity and transaction routing. The proposed rules offer two different options for comment regarding how many unaffiliated networks should be considered for each card. One of the options would require two unaffiliated networks without consideration of the authorization method and the second option would require two unaffiliated networks for each authorization method. In theory, either of these network routing options if adopted would provide greater opportunity to merchants for "least cost routing" of transactions. We feel strongly that either of these options will benefit primarily the largest of merchants. Smaller merchants are largely dependent upon merchant acquirer processing systems to provide the necessary transaction processing and routing. The largest merchants who perform their own processing are the ones who stand to win the most from this legislation thus placing the small merchants at a further cost disadvantage.

When reviewing the sum substance of these proposals it appears to us that the banks lose the ability to offer a profitable service to the customer, the customer will lose by having to participate in paying for the shortfall, and the small merchants will not be in a position to negotiate lucrative contracts with acquirer networks or participate equally with large merchants in least cost transaction routing. That would leave the big winner in this legislation the large merchants.

We have been asked to offer specific feedback on a number of options included in the proposed rule.

1. Two alternatives have been offered for comment regarding Interchange Fees.
(Alternative 1) – An interchange fee may not exceed the issuer's allowable costs subject to a $.12 per transaction cap and with a $.07 per transaction safe harbor.
(Alternative 2) – An interchange fee may not exceed a $.12 per transaction cap with no need for issuers to demonstrate costs at or below the cap.

   Response – Given the fact we may face no choice to a cap we would support alternative 2 over alternative 1. The administrative burden on smaller organizations such as ours would be overwhelming to provide the necessary oversight related to expenses, etc. We would further ask the Board to reconsider the data used to derive the $.12. Our understanding of the Durbin Amendment is that any interchange transaction fee charged or received by an issuer in connection with a debit card transaction must be "reasonable and proportional" to the incremental costs to the issuer in connection with authorizing, clearing, and settling the transaction. $.12 is neither reasonable nor proportional. We also feel that consideration should be given to the differences between signature and PIN based transactions related to the comparable costs and subsequent fees allowed for each.

   We do not believe that interpretations such as "variable only" costs are appropriate and within the spirit of the amendment. It seems highly unlikely the intent was to arrive at a fee that would be substantially less than the direct and/or variable costs associated with that transaction. Appropriate fee limits would include at a minimum the variable costs plus network fees, processing fees and losses associated with these transactions.

2. Two alternatives have been offered for comment regarding the prohibition of network exclusivity arrangements.
(Alternative 1) – Prohibit issuers and networks from restricting the number of networks on which a debit transaction may be processed to less than two unaffiliated networks *regardless of authorization methods that may be used by the cardholder.*
(Alternative 2) – Prohibit issuers and networks from restricting the number of networks on which a debit transaction may be processed to less than two unaffiliated networks *for each method of authorization that may be used by the cardholder.*

   Response – While either of these options appears to be quite onerous, we would have strong objections to alternative 2. (Two networks for each method of authorization)

   While having to possibly re-negotiate contracts made in good faith to add one or more networks, it is inconceivable to us the difficulties and cost to our organization to manage two unaffiliated networks for each type of authorization. Having to manage one such agreement for each form of authorization is enough of a challenge for community banks such as ours.

3. The Board has requested input regarding possible adjustments to the interchange fee amount for fraud-prevention costs.
(Alternative 1) – A technology-specific approach would permit issuers to recover costs for implementing "major innovations" that would result in reductions in fraud losses.

(Alternative 2) – A non-prescriptive approach would establish a more general standard that an issuer must meet to be eligible for fraud adjustments to costs.

Response – The biggest shortcoming in either of these alternatives as stated previously is the lack of consideration for the losses incurred by issuers for fraud. Once again for community banks, the non-prescriptive approach would be more amenable than the technology-specific approach. Community banks will have a much more difficult time making significant capital investment in a product line that provides a negative net return to the bottom line.

4. The Board has requested comment on how rules such as signing bonuses to attract or retain issuers should be addressed.

   Response – This request is difficult to provide comment other than free and open markets should allow contract negotiations between networks and issuers to be business agreements between the two parties. We find it difficult to understand the reasoning behind limitations on what and/or why a network is willing to negotiate with an issuer especially given the fact the Board is imposing fee caps to begin with.

In summary, we find it most difficult to support any portion of this proposed regulation. We strongly urge the Board to extend the implementation dates suggested for at least twelve additional months to provide time for a complete and thorough review by Congress. The Durbin Amendment was added on the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act with little or no substantive debate or even consideration. Senator Frank has publicly stated his opinion that the "fees are too low and "it does not reflect the full cost…". Frank further expressed concern that whatever savings are achieved will not be passed on to the consumer. Frank stated, "Unfortunately the evidence we've seen elsewhere is that consumers don't get any benefit". Frank has expressed concern the limit will hurt community banks even though technically exempt from that provision of the law.

We urge the board to reconsider the approach that has been presented and again, urge for a deferral of the implementation timeline to allow a fair and open debate on the merits of the legislation in Congress.

We appreciate your consideration of our comments and concerns for the proposed rules regarding debit card interchange fees and routing.

Respectfully submitted,

David C. Epke

cc: Senator John Cornyn
Senator Kay Bailey Hutchison
Congressman John Carter