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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Delivery via E-mail to regs.comments@federalreserve.gov
and submitted via the Federal Reserve eRulemaking Portal at www.regulations.gov

Re: Regulation II; Docket No. R-1404; Notice of Proposed Rulemaking – Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

The following comments regarding the Federal Reserve's ("Fed") Notice of Proposed Rulemaking – Debit Card Interchange Fees and Routing ("Proposal"), are submitted on behalf of the Independent Bankers Association of Texas ("IBAT"). IBAT is a trade association representing approximately 500 community banks domiciled in Texas. Most of IBAT's member banks are family owned or closely held and several are publicly traded.

As can be seen from the comment letters already filed by members of Congress and the Senate, large and small financial institutions and consumers, the Proposal is not supported as drafted. Although all but two of IBAT's member banks have less than $10 billion in assets, we still have a number of concerns with the Proposal. The Proposal will have negative impacts and implement questionable policy for consumers, financial institutions and the economy. Although the Durbin amendment and the Proposal recognize that setting price caps on small issuers will have a significant negative impact by providing an exemption from the interchange caps for such issuers, there is no guarantee that the interchange caps will not, due to systematic, network and marketplace requirements, negatively affect financial institutions that are seemingly exempted from the legislation and the interchange cap. Sadly, we believe this amendment would never have passed had the small bank exemption not been added. The lack of any enforcement mechanism in the Proposal for the exemption for small issuers means that the exemption may be rendered meaningless. 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." Jeb Hensarling and Spencer Bachus, Letter to Chairman Bernanke (December 17, 2010).

Even though reports have surfaced that VISA is planning to implement a dual interchange system for large and small financial institutions, there are still many indications that VISA's plan will not shield community banks and their customers from the negative impact of debit card interchange rate fixing. VISA itself notes that there is a major degree of difficulty and cost in implementing two separate interchange structures, and any potential changes will depend on actions by all stakeholders in the system from the point-of-sale through the issuer. Under a two-tier system, large retailers would still be able to find ways to route transactions to minimize their cost at the expense of community banks and consumers.

Over the long term, market forces and merchant pressure will erode the proposed exemption and will lead to more consumer fees, fewer product choices and greater consumer confusion regarding card acceptance. As merchants gain the benefit of the proposed interchange rate cap, they will use all methods available to drive down exempted institution interchange fees to the same level as the caps applicable to financial institutions with more than $10 billion in assets. For example, if 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. Thus, smaller issuers will be forced to implement pricing strategies, such as account fees or debit card fees that match marketplace competition, again, at the expense of the consumers and not the merchants.

Merchants are also unlikely to pass any cost savings down to consumers. As has already been seen in the marketplace, banks will implement new fees to offset losses in revenue. Many banks have already discontinued free accounts. Low-income consumers rely on free or low-cost banking accounts that may no longer be available because interchange revenue, which helps to support these accounts, will no longer be available at levels to support such accounts. Debit card reward programs, which provide rewards or cash back to consumers, are also funded by interchange. The loss in interchange under the Proposal will also force banks to cease offering these programs.

This significant reduction in revenue further reduces the amount of funds community banks have available to lend to consumers, which is also impacted by other recent regulatory proposals such as the FDIC's Overdraft Supervisory Guidance and the Department of Justice's changes to the American's with Disabilities Act regarding ATMs. Interest earned from deposits, which also supports the cost of providing free checking accounts, is also at an historic low. Moreover, smaller issuers already incur larger costs to process debit card transactions because, due to a lack of economies of scale, they must rely on third party processors to process transactions rather than processing transactions internally. The reduction in debit card interchange revenue multiplies the negative effect of losses from these other sources of revenue, and the cumulative loss in revenue will stifle development of new products and services that would otherwise benefit consumers. Many small community banks may not be able to weather this regulatory "perfect storm" and will be forced to stop issuing debit cards, sell their institutions, or be forced to close. Fewer banks will result in less competition, which rarely results in a positive outcome for consumers.

Another likely outcome of the interchange rule is the unbundling of checking account products and services. To avoid the losses that the interchange rule will impose on debit card transactions, many banks may simply begin charging a monthly service charge for the availability of a debit card. In turn, this fee could deter consumers from using debit cards as their preferred payment method, turning back to checks or cash. Merchants will potentially face increased costs of processing as well as more risk of loss from theft and non-sufficient funds items if such occurs.

In Texas, although merchants are not responsible for the financial losses associated with fraud, they have also refused to cooperate with financial institutions in loss recovery efforts. Some large retailers refuse to turn over security tapes to local law enforcement. In turn, law enforcement, when it comes to these particular large retailers, refuses to work with financial institutions when investigating potential fraud. To remedy this situation, as a trade association representing community banks, we have attempted to work with state legislators to implement new legislation to require merchants to employ commercially reasonable fraud detection standards, such as verifying signatures, and to cooperate in fraud investigation efforts. Merchants have strongly opposed and successfully fought these efforts through multiple legislative sessions, leaving financial institutions to shoulder the costs of fraud. Merchants should not be allowed to receive all of the benefits of the debit card system without any accountability or financial responsibility.

Although the Durbin amendment provides an exemption for small issuers, there is no exemption from the prohibition of network exclusivity arrangements. Under either of the two alternatives, community banks will be forced to negotiate new contracts with unaffiliated payment networks for both signature and PIN transactions. Many community banks currently benefit from receiving preferred pricing for using affiliated networks, which also enable them to pass on benefits to consumers. If community banks are forced to enter into new relationships, they will be required to pay new network fees and additional fees to their processors, as well as the associated implementation and legal fees. Thus, community banks are likely to be hit by reduced interchange income and increased debit card processing costs at the same time – changes that will eliminate any profit margin from these programs.

The Proposal will likely cause financial harm to thousands of community banks. When faced with operating a debit card program at a loss, community banks will simply end debit card programs or will increase bank fees to consumers to offset the loss. It is axiomatic that the power to regulate is the power to destroy. The Texas experience with credit cards clearly illustrates the truth of that saying. In 1983, at a time when savings account interest rates were soaring, the Texas legislature capped interest rates on consumer credit cards at 14% and eliminated <u>all</u> fees, including late charges. As a result, Texas based institutions could no longer afford to offer credit cards. The product, Texas issued credit cards, quite simply was destroyed. Similarly, a confiscatory interchange rate has the capacity to destroy debit cards.

We strongly urge the Fed to reevaluate the proposed rules and consider the Proposal's impact on the nation's community banks. Additionally, we strongly urge you to extend the implementation date to at least July, 2012 to allow Congress to fully explore the negative implications of this short-sighted and ill-advised legislative action on community banks and consumers. Hastily written rules will end up causing more harm than good to consumers and community banks alike.

Thank you for this opportunity to comment.

Respectfully submitted,

Christopher L. Williston

Christopher L. Williston, CAE
President and CEO