California CREDIT UNION LEAGUE NEVADA CREDIT UNION LEAGUE

February 4, 2011

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

Re: Proposed New Regulation II, Debit Card Interchange Fees and Routing
Docket No. R- 1404

Dear Ms. Johnson:

On behalf of the California and Nevada Credit Union Leagues, I appreciate the opportunity to comment on the Board's proposal to regulate debit interchange fees and debit card routing, as required by the Dodd-Frank Act (Act). By way of background, the California and Nevada Credit Union Leagues (Leagues) are the largest state trade associations for credit unions in the United States, representing the interests of more than 400 credit unions and their 10 million members.

The Leagues recognize and appreciate the difficult task given to Board staff to develop regulations to implement the interchange amendment, especially given the scope and complexity of this issue, the need to address a statutory exemption for small issuers, and the short implementation timeframe mandated by the Act. We thank the Board and staff for its hard work, as well as its willingness to listen to credit union concerns during development of the proposal. However, we have grave concerns that the proposal does not accurately reflect the intent of Congress, and will cause undue harm to consumers and healthy market competition. Therefore, we do not support the proposal in its current form, and strongly urge the Board to suspend action on it until further study and discussion can be conducted by all stakeholders.

In particular, we believe Congress should have the opportunity to conduct its own review of the intent and impact of the changes enacted by the interchange amendment. It was apparent upon passage of Dodd-Frank that Congress had devoted little time to discussing the impact that regulation of interchange would have on consumers. Indeed, the House Financial Services Committee held only one hearing on the general subject of interchange over the past two years, and none on the subject of interchange routing. While Board staff has done laudable work in surveying and studying such a complex issue in the short period of time afforded it under the Act (nine months from enactment to final rules), we believe that additional time is needed in order to produce more thoughtful, balanced rules.

In the balance of our letter, we will discuss our concerns regarding three critical aspects of the proposal: 1) the small issuer exemption; 2) the determination of "reasonable and proportional" interchange fees; and 3) network exclusivity and routing.

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Small Issuer Exemption—§ 235.5(a)
While the proposal does contain language exempting issuers with assets under $10 billion from the interchange fee rate setting provisions of the regulation, there is no provision that requires networks to maintain separate debit interchange rates for small and large issuers. As a result of the lack of enforcement for the exemption, small issuers may be subject to the fees that will be required for large issuers under the proposal. Further, even if the networks were to maintain separate interchange rates for small and large issuers, networks would have an incentive to minimize the spread between the two rates to make their brand more acceptable to merchants. Merchants would have an incentive to steer customers to use debit cards from larger issuers. These and other factors would serve to either reduce transaction volume at small issuers such as credit unions, or eventually lead to a reduction in the debit interchange rate at smaller issuers to a rate very close to the rate for larger issuers. In our view the small issuer exemption provided in the Act, while well-intentioned, will be meaningless without sufficient regulatory enforcement. We urge the Board to use its authority to reinforce the small issuer exemption to ensure it works as Congress intended.

Reasonable and Proportional Interchange Transaction Fees—§ 235.3
Under the proposal, larger issuers may receive no more than 12 cents per transaction (7 cents under the safe harbor provision). As discussed above, without sufficient enforcement of the small issuer exemption this cap may ultimately be applied to small issuers in the marketplace, including almost all credit unions. This cap represents a 73 percent reduction in the current average interchange fee of 44 cents per transaction, and substantially fails to capture all issuers' costs associated with providing debit card services.

The most obvious omission is the consideration of fraud prevention and data security costs. While the Board is seeking comments on how fraud prevention costs should be factored in to the cap, we assume any such consideration will be made well after finalization of the current interchange proposal (when this will be done is not provided in the proposal). In our view, permitting such uncertainty regarding a critical piece of interchange represents poor economic and supervisory policy. On one hand, the Board has recognized that fraud prevention costs are an integral part in determining the true cost of processing debit transactions. However, on the other hand, the Board is acknowledging that it is currently incapable of determining these costs. Whether this is due to the complexity of the issue or time constraints, we believe it further underscores the need to delay action on the proposal until a full, accurate study of all aspects of the issue can be done.

In addition, the proposed cap does not factor in costs such as actual debit card fraud losses, which the Board estimates at approximately $1.36 billion in 2009, or 8 percent of the estimated $16.2 billion in debit and prepaid interchange fees charged in the same year. Nor did the Board consider issuers' costs related to the administrative and support functions of providing debit card services, such as card issuance and error resolution and chargebacks. While we understand that the interchange amendment language in the Act is limiting, we

are not convinced that the proposed cap represents the full authority and discretion provided to the Board in crafting this provision.

Limitations on Payment Card Restrictions—§ 235.7
The Board has proposed two alternatives regarding the routing of debit transactions and network exclusivity:

- Alternative A – would require a credit union to issue debit cards that could be processed on at least two unaffiliated networks, such as one payment card network for signature debit transactions and a second, unaffiliated payment card network for PIN debit transactions; or
- Alternative B – would require a credit union to issue debit cards that could be processed on at least two unaffiliated PIN networks and also on at least two unaffiliated signature networks.

The Leagues believe that Alternative A would be much less burdensome for small issuers. Adoption of Alternative B would mean that small issuers would have to bear even greater costs associated with having to join additional networks. Actually, it's unlikely that Alternative B would be desirable—or even feasible—for all parties involved in processing debit transactions.

As the Board acknowledged in the proposal:

> *"...enabling multiple signature debit networks on a debit card could require the replacement or reprogramming of millions of merchant terminals as well as substantial changes to software and hardware for networks, issuers, acquirers and processors in order to build the necessary systems capability to support multiple signature debit networks for a particular debit card transaction."*

We would also like to emphasize that the proposal does not exempt small institutions from these network exclusivity and routing provisions. Merchants will have the ability to choose how a debit transaction is processed. Given market pressures and the questionable practicability or effectiveness of a two-tiered system, small issuers will be significantly disadvantaged in favor of larger issuers.

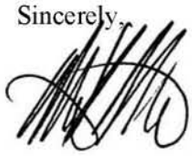
In closing, I would like to thank the Board for the opportunity to share our very serious concerns regarding these proposed changes. To reiterate our position, the proposal 1) lacks any enforcement provisions to implement the small issuer exemption; 2) falls woefully short in accounting for all the issuer costs involved in providing debit card services; and 3) places small issuers at a competitive disadvantage through its routing and network exclusivity provisions. As a result, small issuers face a dramatic loss of interchange fee income combined with the additional costs of having to belong to more than one network.

There are already media reports of large national banks announcing the "end of free checking" and the restructuring of fee schedules in efforts to address lost revenue from interchange fees.

Credit unions have a long history of offering their members lower fees, higher deposit rates, and lower loan rates than bank customers. Credit unions do not want to charge their members more or higher fees. Unfortunately, the tremendous pressure that this proposal will have on credit unions' income and costs—and, therefore, their net worth (capital)—will force most credit unions into making such a decision. If the Board finalizes this proposal in its current form, without taking significantly more time to more fully study the issue, it will ultimately be consumers who end up paying for the merchants' windfall brought by drastic cuts to interchange.

I appreciate your thoughtful consideration of our views and recommendations.

Sincerely,



Diana R. Dykstra
President/CEO