

SchoolsFirst[®]
FEDERAL CREDIT UNION

February 17, 2011

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

Re: Docket No. R-1404

Dear Ms. Johnson,

I am writing on behalf of SchoolsFirst Federal Credit Union, which serves school employees in Southern California. We have more than 460,000 Members and over \$8.5 billion in assets. SchoolsFirst FCU appreciates the opportunity to comment on the Board's proposed rules for Debit Card Interchange Fees and Routing. While SchoolsFirst FCU currently meets the criteria for a small-issuer exemption, we do not believe that the exemption has any force or effect, essentially resulting in no differentiation due to size of financial institution.

In general, we oppose the proposed rule that was drafted as a result of the debit card provisions of the Dodd-Frank Act (Section 1075), also known as the Durbin amendment. The Durbin amendment (adopted by the 111th Congress) was added to the Dodd-Frank Act in the eleventh hour, it was never subject to public debate, floor hearings, or independent review. We urge the current Congress to revisit this amendment and repeal it; at a minimum, it should be delayed until such time that hearings can be held on the impact of the debit card provisions and federal agencies are granted sufficient time to study, analyze and vet the outcomes of these hearings and make recommendations to Congress that have been appropriately scrutinized.

We have serious concerns with the Federal Reserve Board fixing prices for debit cards, particularly when all associated costs necessary to run a debit card payment system are not included. Over time, the electronic payments industry has evolved and consumers have adopted the convenient use of debit cards as one of the primary sources for accessing their funds. The fees associated with providing this payment method should be controlled not by the government, but by those who have invested, and continue to invest, in the advances of this consumer convenience (merchants, financial institutions, and payment networks). Merchants have the ability to influence the market-based rates through negotiation with their financial institutions and the networks. Merchants also have other point of sale payment options, including offering discounts for PIN-based debit transactions or accepting only cash or checks.

As a credit union, we are a not-for-profit organization. This means that our earnings are given back to our Members in the form of lower costs and fees, lower interest rates on loans, and higher dividend rates on shares. In order to serve our Members, provide convenient access to their funds through debit cards, and effectively compete with larger institutions, we must be able to earn sufficient revenue to cover the "all-in" cost of providing debit card services.

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The intent of the Durbin amendment was that merchants will save money with lower interchange fees, and thus consumers will reap the benefits in the form of lower costs. However, this proposal as written allows merchants to maximize their income with no accountability to pass on those savings to the consumers. Clearly, this amendment shifts earnings from financial institutions to the largest volume merchants. Consequently, financial institutions will be forced to pass on debit payment operating costs (not considered in the 12-cent transaction fee) to the consumers by charging their customers and Members higher checking account or debit card fees. In any case, the consumers will bear the brunt of the Durbin amendment on both ends of the transaction – at the merchant and at their financial institution.

Currently, with market-based interchange fees, all parties benefit – the consumer, the merchant, and the financial institutions.

- Consumers enjoy easy access to their funds as well as consumer protections and charge-back rights for signature-based transactions.
- Merchants enjoy efficient, fast and secure transactions at the point of sale, **guaranteed payment of authorized debit card transactions** (not afforded to checks or other payment channels), prompt credit to their accounts, and **no costs** associated with check processing and returns (such as deposit processing time, check deposit holds, returned check fees, and collection efforts and expenses for returned bad checks). **Additionally, the onus for fraud management is on the card issuer rather than the merchant, placing the financial burden for fraud predominantly on financial institutions.** The interchange fee is the cost merchants pay for these benefits as well as for their fair share contribution to manage the risks associated with the acceptance of debit cards.
- Financial institutions are able to compete and attract new customers by offering consumers the products they desire. Market-based interchange fees allow financial institutions to cover the costs associated with providing this product efficiently, effectively, and with fraud controls to protect consumers. Further, it allows for investment in the advancements of payment and fraud management systems necessary to improve commerce.

Requiring that the interchange fee be "reasonable and proportional" to the transaction cost without regard to all other costs associated with the debit card service (such as cost for developing and providing the service, promoting the service, ongoing improvements to fraud detection and risk management, continued investment in innovations, etc.) is imbalanced and will most likely be detrimental in the longer-term. Further, the interchange fees should cover the risk associated with actual fraud losses, not just the cost of fraud prevention.

Placing a fee cap of 12-cents per transaction will seriously damage financial institutions' abilities to provide this service and will adversely impact financial institutions' bottom lines at a time when most are struggling to survive in a difficult economy (unless the cost is passed onto the consumer). This is particularly true for those financial institutions that solely operate as a consumer bank and do not have offsetting revenue sources from commercial, investment banking and/or trading functions. At SchoolsFirst FCU, we project that a 12-cent cap will result in approximately a 70% reduction in fee income, or \$16 - \$18 million annually. The reduced revenue is insufficient to cover the all-in cost of debit card payment operations. To continue providing convenient access to funds through the use of debit cards to our Members, we will be put into a position to pass the cost onto our Members in the form of higher fees, thus making free checking a thing of the past. **We urge you to reconsider this proposal so that merchants continue to pay their fair share of the costs for providing debit payment processing.**

In the event the proposed rule moves forward, we have the following comments on specific issues within the proposal related to the small issuer exemptions, interchange fee cap, network exclusivity and routing, and merchant steering.

- Small Issuer Exemption and a Two-Tier System

While Congress intended to exempt any credit unions and small community banks with assets less than \$10 billion, the proposed carve out does not work. To remain consistent with the proposed regulation, all networks would have to implement a two-tiered structure – one price-controlled rate for financial institutions with assets greater than \$10 billion and one market-based rate for smaller financial institutions and government-administered payment programs. However, there is no enforcement in the proposed regulation to require networks to implement a two-tier system. Without such enforcement, credit unions, small community banks and government-administered payment programs will be subject to the same interchange fees as large banks.

Even with a two-tiered system, the intended small issuer carve out still may not work. Merchants will have an incentive to steer consumers to use debit cards from larger issuers in order to minimize their fee. Market forces will force small issuers to match the interchange fee of large banks in order for merchants to accept their cards or to not induce consumers to use other payment methods.

Further, if networks do create a two-tier system, the massive development and implementation costs will likely be passed on to consumers in the form of increased fees.

- Reasonable and Proportional Fees

The Board has proposed two alternatives for determining whether an amount of an interchange transaction fee is reasonable and proportional. Both options set a 12-cent cap (7-cents under the safe harbor provision of Alternative 1). As stated before, we disagree with the concept of government price fixing, and we have the following comments regarding the proposed 12-cent cap:

- Interchange fees generate the income that financial institutions rely on to pay for the extensive infrastructure costs, fraud risk, actual fraud losses, the expense for collecting insufficient funds and the write-off of uncollected payments involved in the debit card payment system. The proposed 12-cent cap does not include these costs.
- Much of the fraud perpetrated on consumers occurs at the point of purchase, or on the merchant's premises. Under the current and the proposed rules, merchants have no requirements to improve their security or invest in preventing the compromising of cards; this expense falls on the financial institutions – again demonstrating why the proposed cap is imbalanced.
- Also not included in the 12-cent cap is the cost of fraud prevention. While the Board is requesting comment on how fraud prevention costs should be factored in, there is no assurance that the cap will be adjusted to include fraud prevention before a final rule is issued. This reinforces our earlier statement that this proposal should be delayed until a thorough vetting of the provisions is conducted.

- By fixing the price of interchange fees, all merchants will pay the same interchange rate, thus eliminating merchant categories that are risk-based. For example, casino outlets and jewelry and electronics retailers pay a higher interchange fee because they have a higher propensity for risk and fraud. With a 12-cent cap, these retailers would pay the same rate as a low dollar/low risk retailer, such as McDonalds.
- Further, merchants will continue to enjoy the benefits without assuming any of the risks, unless the merchant benefits change as well. If merchants are to enjoy the benefits of convenient debit card payments without bearing their share of the cost structure, then a change of the benefit structure is warranted:
 - Fraudulent transactions originated *on-premise* at the merchant and those resulting from merchant system security breaches should be 100% paid for by said merchant and redeemable to the consumer and the financial institution.
 - Financial institutions should have the ability to return debits when the consumer does not have sufficient funds when the item actually posts, similar to checks and ACH payments.

Finally, the proposed fee cap limits the entrance of new players into the debit card industry, as the start-up costs are high and the initial revenue may be insufficient to offset their capital investment needed to compete. This limits financial institutions' future options and locks-in existing payment networks, such as VISA, MasterCard, etc.

- Exclusivity and Routing

The Board has proposed two alternatives regarding network exclusivity. SchoolsFirst FCU believes that Alternative A – one signature-based network and one PIN-based network, provided both networks are unaffiliated – is less costly and burdensome.

Alternative B – two unaffiliated signature-based networks and two unaffiliated PIN-based networks – would require substantial changes by merchants, networks and issuers, including small issuers (no exemptions). This would be very costly to all parties, and again, the consumers would pay the brunt of those costs that do not exist today.

Furthermore, under Alternative B, issuers could have cards backed by both Visa and MasterCard and merchants are allowed to choose the network through which to send a transaction, affording them the choice of a lower cost transaction. However, for financial institutions this would result in operational burdens and added expense, such as:

- managing settlements from multiple networks; making it difficult to understand how our card portfolio is performing;
- different charge-back rights for cardholder disputes; and
- added expense for network connectivity and certification regarding processing

More importantly, Alternative B would also result in confusion to consumers, particularly when they experience fraud on their account and have to deal with charge-back rights. Each network can have their own charge-back rules, and if a consumer has to deal with multiple sets of rules and forms (depending on which networks the fraudulent transactions occurred on), it will make an already frustrating experience even more unpleasant.

- Steering

Merchants have the ability to route transactions to whichever network payment path is least expensive to them. We are concerned that this will result in merchants steering consumers to one method over another (PIN-based or signature-based transaction), without regard to the

consumer's choice. Some consumers value signature-based over PIN-based due to the protections and charge-back rights they are afforded, while other consumers value PIN-based due to the immediate debit from their transaction account.

The regulation should require merchants to clearly and conspicuously provide consumers a choice between PIN-based and signature-based transactions when both methods are available.

Further, under a two-tier system, merchants will have an incentive to steer consumers to use debit cards from larger issuers in order to minimize their fee. If a two-tier system is established, the regulation should also establish a mechanism by which consumers can report to a government agency (the Consumer Financial Protection Bureau) when merchants refuse to accept debit cards with higher network costs than others.

SchoolsFirst Federal Credit Union appreciates having the opportunity to comment on the proposed rule. As we stated above, we disagree with the concept of government price-fixing and we believe that Section 1075 of the Dodd-Frank Act should be repealed or delayed until hearings can be held on the unintended harm the debit card provisions will cause consumers.

Please feel free to contact me if I may be of further assistance.

Sincerely,



Erin Mendez
EVP/Chief Operating Officer
SchoolsFirst Federal Credit Union

cc: Credit Union National Association (CUNA)
California/Nevada Credit Union League (CCUL)