



February 22, 2011

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

Re: Regulation II; Docket No. R-1404

Dear Ms. Johnson:

Thank you for the opportunity to respond to the Request for Comment issued by the Federal Reserve Board (FRB) regarding proposed Regulation II and its supplementary information.

With more than 425 member community financial institutions, including state-chartered and federally-chartered commercial banks, savings banks and savings and loan associations, the Community Bankers Association of Illinois (CBAI) is the third largest state-organized financial institution trade association in the United States. CBAI's member institutions serve communities and neighborhoods in Chicago as well as the smallest towns in Illinois. They serve the financial needs of a diverse clientele including manufacturing, small businesses, educational centers, and agriculture. Their contribution to job creation and economic growth is invaluable. Equally important, Illinois' community banks conduct traditional banking operations that do not include subprime, predatory, and other high risk practices that have harmed consumers and our nation.

All CBAI member banks have assets less than \$10 billion; however, we believe the small issuer exemption from the interchange rules will not protect consumers or community banks from incurring higher costs. Specifically, there is no mechanism in the proposed rules to enforce or guarantee that the small issuer exemption will work as intended in the marketplace. In fact, we believe market forces and merchant pressure will compel exempted institutions to reduce interchange fees to the same level as the caps set under this proposal.

It has been reported that VISA plans to implement a separate interchange rate schedule for small and large issuers, but VISA itself has noted that the new system will be expensive and challenging to implement, and community banks will likely shoulder a significant portion of that cost. Meanwhile, not only will merchants receive a windfall without taking on any further risk or liability, they will likely route the transaction to the lowest cost option which will force exempt issuers to lower their interchange fees or risk losing transaction volume. It is also extremely unlikely that merchants will pass any of their cost savings along to consumers, while community banks will have no choice but to discontinue debit card reward programs and implement fees to make up the loss of interchange revenue. Therefore we believe that, over time, a two-tiered system is unsustainable, and the VISA tiered approach will dissolve.

In our opinion merchants, particularly the largest chain stores, are the clear winners from debit interchange price fixing. It is also just as clear to us that the American consumer will experience rising

fees for other banking products and services, or the features of other programs will be curtailed, all to compensate for unprofitable debit card programs. Community banks, which do not have as many alternate sources of income as the large Wall Street banks, will be especially adversely impacted at a time when community banks can hardly avoid another hit to their bottom lines. On the heels of the Regulation E changes implemented by the Fed last summer, the recent Overdraft Guidance proposed by the FDIC, and this interchange price fixing proposal, non-interest income for community banks is being regulated out of existence. This will result in the reduction of funds available to lend to consumers and hinder the overall growth of small businesses in a struggling economy.

CBAI recommends that the rulemaking be reevaluated, and the FRB should adhere to the strict letter of the law and not impose specific fee limitations. The deleterious combination of lower rates, higher costs, and potential loss of transaction volume gives community banks little reason to support debit interchange price controls. However, in the event the FRB does go through with this rulemaking, CBAI offers the following suggestions to dampen the negative effect on community banks:

1) The law does not require the FRB to impose interchange fee limits, only that the FRB “establish standards for assessing whether the amount of any interchange transaction fee ... is reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” As a result, CBAI urges no specific fee limitations;

2) All costs incurred by an issuer in authorizing, settling, and clearing debit transactions should be considered allowable costs; these costs should include, but not be limited to, the cost of inquiries and disputes, fraud losses and fraud-prevention costs, and fixed costs including capital investments used to support transaction settlement. The current FRB proposal does not allow fraud losses to be considered as cost when, in most cases, financial institutions bear the entire burden of fraud losses. Additionally, the law specifies “reasonable and proportional” to costs and not the exact costs; therefore, an allowance should be made in the “standards” for a reasonable profit;

3) Regarding the transaction processing restrictions, Alternative A (two unaffiliated networks) is the most cost-effective alternative for community banks because it would not require community banks to join additional payment card networks; on the other hand, Alternative B (two unaffiliated networks per authorization type) may require reissuance of cards to comply with network branding requirements which would be an unnecessary expense to the issuers and an inconvenience to customers; and

4) The law states that merchants are not authorized to discriminate between debit cards within a payment card network on the basis of the institution that issued the debit card; the FRB should specifically address the discrimination aspects in the final rules to provide protections for all issuers within a payment card network to insure that merchants accept all cards regardless of interchange rates.

In conclusion, the best option is for the FRB to delay implementation until Congress can fully explore the negative implications of an eleventh hour amendment to a comprehensive legislative proposal. In the event the FRB does not delay implementation, CBAI would appreciate your consideration of the above-mentioned suggestions to re-work the price fixing element of this proposal and implement **Alternative A** as it relates to transaction processing.

Sincerely,

/s/

Kraig Lounsberry  
Senior Vice President Governmental Relations