From: Bellco Credit Union, Dan R Kampen

Subject: Reg I I - Debit card Interchange

Comments:

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Proposal: Regulation II - Debit Card Interchange Fees and Routing
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Comments:
Ms. Jennifer J. Johnson, Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, N.W. Washington, D.C. 20551 Re: Proposed Regulation II-Debit Card Interchange Fees and Routing Docket No. R-1404 Dear Ms. Johnson: Bellco Credit Union is pleased to submit this comment letter in response to the Federal Reserve Board's request for comment with respect to proposed Regulation II that would set new debit card interchange fees and network routing rules. By way of background information, Bellco is a state-chartered credit union with in excess of 190,000 members and approximately $2 billion in assets. We ask that the Board review the enclosed addendum for a thorough discussion of Bellco's concerns with respect to proposed Regulation II. EXECUTIVE SUMMARY The Federal Reserve Board has proposed artificially low caps on debit interchange that do not reflect the true costs of running a secure, reliable and efficient debit network. The Fed should, but did
not, consider all costs of operating a debit interchange system to the maximum extent allowable by law, including all fraud prevention costs, such as the cost of new technology to reduce potential fraud. Further, the Fed did not survey small institutions with significantly higher cost structures than large institutions. If the Fed continues with the implementation of this flawed fixed price, we recommend the adoption of "Alternative B" with a straight $.12 per transaction cap; however, there are issues the Board should consider from the standpoint of consumers and small businesses: While the Board says it understands the importance of debit cards to consumers, it disregards the interest of consumers in its proposed regulation. The Board admitted to not knowing if consumers were likely to be better or worse off if the proposal is adopted-even the Board concedes consumers could face higher costs as a result of this proposal. We are certain the loss of revenue from financial institutions will be passed on to consumers in the form of new checking account and debit card fees, yet it is unlikely and certainly unsure whether merchants

will pass along any of the savings, resulting in a significant net cost to consumers. The small institution (under $10 billion) exemption will not work. Congress intended small institutions to be exempt, but the Fed proposal does not ensure adequate protection to require networks to implement two-tier pricing systems, and require merchants to not discriminate against cards issued by small institutions. The Fed should use its authority to reinforce the small issuer exemption and ensure that it works as Congress intended. The routing and exclusivity requirements added to the Durbin Amendment will eliminate consumer choice and the ability to deliver secure and reliable debit services- no matter which proposal is eventually adopted. While each of the proposed routing alternatives poses its own unique technological challenges, we urge the Fed to adopt routing "Alternative A", which would only require issuers to provide debit cards that can be used over two unaffiliated networks. Finally, Bellco believes debit price fixing legislation is fundamentally unfair, bad policy, and requires a thorough review and amendment before implementation. Therefore, we encourage: A two-year delay in the effective date for the Federal Reserve's rulemaking. An expanded survey of financial institution costs to include ALL related expenses of running the debit payment process AND include small issuers to capture the higher costs structures of smaller institutions. A series of hearings that include analysts, economists and regulators who can describe the likely effects of these provisions. Joint federal agencies to study and analyze the outcome of these hearings, and present their analysis to Congress for review and debate. Appropriate congressional action after full review of the information presented by the
study results and hearings. CONCLUSION Bellco Credit Union appreciates the opportunity to submit these comments regarding proposed Regulation II. We advocate the Federal Reserve Bank use its authority to reinforce the small issuer exemption and ensure it works as Congress intended. We also suggest the adoption of routing "Alternative A" to ensure the debit card operates on two unaffiliated networks without regard for the chosen authorization method. Bellco Credit Union firmly believes legislative action of this magnitude deserves serious deliberation. Congress never had such an opportunity, as there were no hearings, no debate and no studies related to the debit interchange provisions. At a minimum, implementation should be delayed so Congress can hear both sides in this debate and joint federal agencies can study this issue and provide an objective assessment of the impact before the provisions become law. Respectfully, Dan Kampen Excutive Vice President & CFO Bellco Credit
Union Enclosure-Addendum
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Federal Reserve Board has proposed a maximum debit card transaction interchange fee and set the fee at a level somewhere between $.07 and $.12 per transaction regardless of the authorization type. In short, the Federal Reserve Board has proposed artificially low caps on debit interchange that do not reflect the true costs of running a secure, reliable and efficient debit network. Bellco recommends the adoption of "Alternative B" with a straight $.12 per transaction cap; however, there are a few preliminary issues the Board should consider from the standpoint of consumers and small businesses: While the Board says it understands the importance of debit cards to consumers, it seems to disregard the interest of consumers in its proposed regulation. The Board admitted to not knowing if consumers were likely to be better or worse off if the proposal is adopted-even the Board concedes
that consumers could face higher costs as a result of this proposal. The caps on interchange fees were justified by administrative convenience and a desire to avoid giving banks an economic incentive to continue inefficient practices.

How will price controls affect the pace and direction of future technological innovations in payment systems? Generally speaking, price regulation creates a disincentive for companies to invest in payment networks and inhibits innovation that delivers valuable benefits to consumers and the economy overall. The elimination of economic incentives may deter investment in system improvements and advancements. The entire banking system will suffer unintended consequences of this major government regulation. Only a few very large issuers will survive the regulation, leaving consumers with limited choice of financial institutions! It is reasonable to expect financial institutions to find ways to make up for lost income with higher fees on other services,
which will affect all consumers. With a significant drop in interchange revenue, financial institutions may be unable to continue debit programs in their current form-they may be forced to raise consumer fees or reduce services as a result of this and other recent financial regulations.   If financial institutions have to increase fees or reduce services to customers, what are the implications to consumers? Regulation of debit interchange could lead to a reduction in the benefits available to consumers (such as free checking accounts) and would harm community banks and credit unions that have diminished financial incentives to maintain their debit card programs. Credit unions and community banks serve a unique role in meeting the financial needs of millions of American consumers. Will there be a significant increase in the number of unbanked or under-banked consumers? And if the small issuer exemption fails to protect small banks and credit unions, driving them out of issuing (or out of business), it will also have a negative impact on our target market of small and mid-size community businesses. By removing this revenue source for community banks and credit unions, it creates an unlevel playing field, making it more difficult for small issuers to compete with larger financial institutions. Anything that limits financial growth in local communities is detrimental to the overall economy. To what extent will the Federal Reserve Board ensure that small issuers exempt from these regulations (those with assets under $10 billion) remain protected within the construct of the final legislative rules? It appears to be up to the card networks to determine how, or even if, they are able to "exempt" this issuer segment, which is further complicated by the fact that these same networks don't yet know which interchange fee structure is going to be put into place. The Fed should implement reasonable interchange regulations that will allow small issuers to continue to be
protected from lower interchange fees. The current proposal does not include provisions to enforce the small issuer exemption. We urge the Fed to use its authority to reinforce the small issuer exemption and ensure that it works as Congress intended. The manner in which the debit provisions were constructed effectively means that one part of the amendment (routing and exclusivity) for all practical purposes cancels out another part (small issuer exemption). Unfortunately, the routing and exclusivity requirement gives retailers the ability to steer transactions away from small institutions and their "protected" rates. So while smaller institutions are theoretically eligible for exempted fees, there is no guarantee they will see them as market forces drive volume towards artificially low rates. The proposed debit interchange rates also concern Bellco, especially if the establishment and maintenance of a two-tiered structure cannt be assured. The Fed should consider all costs of operating a debit interchange system to the maximum extent allowable by law, including all fraud prevention costs, such as the cost of new technology to reduce potential fraud. In this regard, Bellco's concerns include: The proposal on fees is based on a premise that debit cards and checks are functionally similar. However, debit cards offer safety, convenience and

payment guarantees that paper checks cannot. There is a cost to these benefits and these costs should be included in the interchange fee determination. Since only a subset of costs associated with operating a debit card program are recognized in the current interchange fee proposal, card programs will be much less cost-effective. Given recent experience, what is the overall impact of the proposed regulation on the safety and soundness of financial institutions in the United States? The Board is proposing to deduct billions of dollars a year from bank capital at a time when regulatory requirements and economic conditions demand an increase in bank capital to both meet those regulatory requirements and to support additional lending. Is this really the time to impose measures that will negatively impact these institutions? The proposal failed to provide an adjustment for fraud prevention. While the Board is likely to allow an upward adjustment of interchange fees to account for fraud-prevention costs, this regulation will not likely be finalized until after the interchange fee standards are set. Should the effective date for the interchange fees be delayed until the critical fraud-related component is in place? As for an allowance for fraud protection, credit unions and small community banks could be adversely affected because they may not have the capital to procure the most sophisticated technology compared to the larger issuers. In addition, their reputational risk may be greater than larger banks should fraud become more problematic for them. Both signature and PIN debit transactions will be indistinguishable to issuers from a revenue perspective. The difference in fraud between these two debit forms indicated by the Fed's survey analysis may indicate a migration to a PIN-only debit market. Even if a two-tiered system is permitted and works in practice, small issuers will be disadvantaged if the provisions on routing and exclusivity that allow merchants to choose how debit card transactions are processed are not implemented properly. The routing and exclusivity requirements added to the Durbin Amendment will eliminate consumer choice and the ability to deliver secure and reliable debit services-no matter which proposal is eventually adopted. Proposed "Alternative A" would require two unaffiliated networks without consideration of the authorization method chosen. Proposed "Alternative B" would require two unaffiliated networks for each authorization method-namely, signature and PIN. At a minimum, debit card issuers, such as Bellco, who are in an
exclusive, one-brand relationship will be required to change its affiliations since this component of the proposed regulation is not subject to the small-issuer exemption. Each of the proposed routing alternatives poses its own unique technological challenges. For example, Bellco currently offers only a signature-based network through Visa, which under routing "Alternative A" would present a host of new issues. Issues with adding another signature-based network include: All Visa issuers will have to pick between MasterCard, Discover, and Amex. Can these networks handle the conversion of all the banks and credit unions? If so, how long will it take to convert everybody? No financial institution is currently allowed to offer two signature networks, so no one knows how it will work or how to do it (i.e. will the cards require two magnetic strips, can PIN numbers be shared by networks, etc?) Consumers will have to live with the different payment protection rules depending on which network the merchant chooses, i.e. dispute timeframes, dispute rules on what is covered, different benefits that the cards offer (rental insurance, travel insurance, warranty protection). Retailer control over the routing of transactions will cause consumer confusion at the register as to how their transactions are being handled. Consumers have expectations about how a particular network will handle their transactions and the security, fraud prevention and benefits they get from their chosen network. They will lose valuable security protections generally not available with low-cost, low-value

networks and this will undermine data security. Regardless of what the ruling states, the networks will demand reissuing plastics with their "bugs" on the cards. The routing and exclusivity requirement will increase costs to all financial institutions adding additional networks to their cards. The cost of adding a network (time, testingand resources) will easily go into the tens of thousands of dollars. What becomes of existing contractual relationships that extend beyond the implementation dates defined by the Fed? Will there be an allowable transition period built into the new rules to accommodate existing exclusive contract provisions? Likewise, the adoption of routing "Alternative B" would pose even greater challenges to Bellco and the industry, as a whole. Issues with adding multiple PIN networks include: Again, regardless of what the ruling states, the networks will demand reissuing plastics with their "bugs" on the cards. The cost of adding even one network (time, testing, resources), let alone multiple networks, will easily go into the tens of thousands of dollars. These added costs weigh heavily in a small financial institution's determination of whether to continue debit card services to consumers. Most PIN networks are regionally based, but the proposal states the network must be national. A more refined definition of what is "national" needs to be determined. Depending on what is ruled as "national", there may only be two to three PIN networks that qualify (STAR, NYCE and Pulse). If every financial institution will have to add one to two of these PIN networks, how can they handle all of the conversions? Maestro and Interlink are owned by MasterCard and Visa, respectively. Because of this relationship, it is presumed that these two networks are invalid for anyone who offers MasterCard or Visa as their signature processor. We therefore urge the Fed to adopt routing "Alternative A", which would only require issuers to provide debit cards that can be used over two unaffiliated networks. Requiring more than two networks is inconsistent with statutory requirements and would place an unreasonable regulatory burden on Bellco Credit Union that would negatively impact service to our members. Finally, Bellco Credit Union believes that debit price fixing legislation is fundamentally unfair, bad policy, and requires a thorough review and amendment before implementation. The fact is the debit provisions adopted by the 111th Congress were crafted in conference committee and were never subject to public debate, hearings or independent review. In this regard, we would encourage: A two-year delay in the effective date for the Federal Reserve's rulemaking, including the interchange fee and network exclusivity restrictions. A series of hearings that include analysts, economists and regulators who can describe the likely effects of these provisions. These hearings would give retailers the opportunity to testify about how much of the savings from below-market interchange costs will be passed along to their consumers. Joint federal agencies to study and analyze the outcome of these hearings, and present their analysis to Congress for review and debate. Appropriate congressional action after full review of the information presented by the study results and hearings. CONCLUSION Bellco Credit Union

appreciates the opportunity to submit these comments regarding proposed Regulation II. We advocate that the Federal Reserve Bank use its authority to reinforce the small issuer exemption and ensure that it works as Congress intended. We also suggest the adoption of routing "Alternative A" to ensure the debit card operates on two unaffiliated networks without regard for the chosen authorization method. However, Bellco Credit Union firmly believes that legislative action with an impact of this magnitude deserves serious deliberation. Congress never had such an opportunity, as there were no hearings, no debate and no studies related to the debit interchange fee provisions. At a minimum, implementation should be delayed so Congress can hear both sides in this debate and joint federal agencies can study this issue in order to provide an objective assessment of the impact before the provisions become law.