Credit Union Association
of the Dakotas
Mid-America

February 21, 2011

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

RE: Notice of proposed rulemaking – Debit Card Interchange Fees and Routing
Regulation II; Docket No. R–1404

Dear Ms. Johnson,

The Credit Union Association of the Dakotas – Mid-America, in conjunction with Jon Griffin, Director of Risk Management, Capital Credit Union, Bismarck, North Dakota, and Chelsea Smith, Risk Management Specialist, Sioux Empire Federal Credit Union, Sioux Falls, South Dakota, appreciate the opportunity to provide comment to the Board of Governors of the Federal Reserve System regarding the notice of proposed rulemaking concerning debit card interchange fees and routing.

The Credit Union Association of the Dakotas (CUAD) represents seventy-eight state and federally chartered credit unions in North Dakota and South Dakota, whose assets total over $4.5 billion and who have more than 450,000 members.

The Credit Union Association of the Dakotas is strongly opposed to the proposed rules regarding debit card interchange fees and routing as issued by the Board of Governors of the Federal Reserve System. The proposals in any form, if adopted, would do little to protect consumers. Furthermore, there is nothing in the proposed regulation that would ensure that the money saved from the reduced fees is passed on to the consumer and not retained as additional profit by the merchants. This rule, if adopted, will do little more than to increase fees elsewhere for the consumer and potentially limit services available to consumers through their credit union or other small financial institutions.

The Dodd-Frank Act states that "the amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction." *H.R. 4173-693, sec. 1075*. The Act further directs that the Board "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." (Emphasis added) *Id.* This Association is opposed to both of the proposed options relating to restrictions on debit card interchange fees, as the predetermined cap does not accurately reflect all of the actual costs incurred by the card issuer. Furthermore, setting a cap on fees, or price fixing, which is not in the form of a safe harbor for compliance purposes, is not in the consumer's best interest.

As noted above, the Act directs that debit card interchange fees be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." (Emphasis added) *Id.* The Board states that "some issuers that are subject to the interchange fee limitations have debit card programs with substantially higher per-transaction costs than others. These unusually high costs might be due to small programs targeted at high-net-worth customers or newer start-up programs that have not yet achieved economies of scale." *Federal Register, Vol. 75, No. 248, page 81737.* "The Board does not believe it is reasonable for the interchange fee to compensate an issuer for very high per-transaction costs." *Id.* This statement and rulemaking is completely contrary to the Dodd-Frank Act, which requires that the fee be "reasonable and proportional to the cost incurred by the issuer," not, as the Board seems to believe, that the debit card interchange fee be reasonable and proportional to the AVERAGE costs incurred by SOME of the card issuers.

The Board rationalizes their disregard for the costs incurred by some card issuers by stating, "the Board notes that even the highest-cost issuers have sources of revenue in addition to interchange fees, such as cardholder fees, to help cover their costs." It seems the Board's intent is to pass the costs of the card issuer's lost income from the debit card interchange fee on to the consumer, without any provisions that the money saved by merchants would actually be shared with consumer and not kept as additional profit. Very anti-consumer!!

"When institutions are forced to accept a rate for services that is less than the cost to provide particular services, it is going to limit the ability and desire of even providing services simply because it will not be feasible. It affects the entire marketplace," opined Chelsea Smith, Risk Management Specialist with Sioux Empire Federal Credit Union. It seems unfathomable that a government agency, tasked with implementing consumer protection regulations, would write regulations that would create safety and soundness issues. However, that is what is being proposed when the Board prohibits financial institutions from recovering the actual costs for operation of a program.

Even more problematic, is that the Board's cap on debit card interchange fees only takes into account a fraction of the costs associated with a debit card transaction. The Board notes that it used data on the variable cost of authorization, clearing and settlement to determine an issuer's per-transaction cost. The Board fails to consider any costs incurred for preventing fraud and fraudulent transactions. The Dodd-Frank Act went into detail as to the factors to be considered by the Board in issuing the regulations required, which include, "(IV) the fraud prevention and security costs expended by each party involved in electronic debit transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers and payment card networks); (V) the costs of fraudulent transactions absorbed by each party involved in such transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers and payment card networks)." (Emphasis added) *H.R.*

4173-695, sec 1075. Clearly, costs associated with fraud were to be included in the consideration of what is a reasonable and proportional fee for debit card interchange.

The Board does indicate that it would issue future proposals regarding fraud-prevention cost adjustments, but this cost adjustment should have been included in these proposals to be calculated into what is "reasonable and proportional" per the direction of the Dodd-Frank Act. The costs associated with fraud are real and ongoing, they will not cease while the Board contemplates additional rules to allow for a cost adjustment. These costs will be incurred and more than likely passed on to the consumer in increased or new fees while card issuers are prohibited from recouping their actual costs associated with debit cards.

"The proposed legislation states that the interchange fees be "reasonable and proportional", our hope is that that elected officials understand that there are more expenses involved in interchange than just the transaction costs. The "reasonable and proportional" fees should include member support, fraud expenses, marketing and overhead. By decreasing the interchange income between 73% to 84% per average transaction (from around .44 to between .07 to .12 a transaction), the revenue stream to cover these costs will have to made up in other fees to the members," observed Jon Griffin with Capital Credit Union.

It is acknowledged that card issuers under $10 billion in assets are exempt from a portion of the proposed regulations, specifically the debit card interchange fee caps. However, there is nothing in the proposal to protect the card issuers under this exemption from the fall-out that this regulation will have. Chelsea Smith anticipates the negative consequence these regulations will have on credit unions, "[t]he decrease in fee income by roughly 73% will negatively affect more than just one small sector of the market. The interchange proposal removes the competitive edge with debit cards and limits the benefits for consumers. The fee cannot be cut without a domino effect trickling down through other involved sectors."

Any exemption contemplated for cards issuers under $10 billion is irrelevant. The Dodd-Frank Act specifically states that regulations relating to "reasonable and proportional" interchange fee "shall not apply to any issuer that, together with its affiliates, has assets of less than $10,000,000,000, and the Board shall exempt such issuers" from these regulations. *H.R. 4173-695, Sec 1075.* In writing these proposed regulations, the Board failed to include any enforcement provisions relating to this exemption to protect the small financial institutions pursuant to Congress' intent despite being given the authority by Congress. The Act provides that, "The Board may prescribe regulations, pursuant to section 553 of title 5, United State Code, regarding any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction, to implement this subsection (including related definitions) and to **prevent circumvention of evasion of this subsection**." (Emphasis added) *H.R. 4173-693, Sec 1075.*

At this time it is believed that some debit card networks will provide a two-tiered system which will allow for credit unions and other small financial institutions to continue to charge their current interchange fee, however, there is nothing that could be done should this not come to fruition. As cited to by Frank Michael, during his testimony before the House Financial Services Committee, Subcommittee on Financial Institutions and Consumer Credit on February 17, 2011, "80% of debit transactions involve cards issued by institutions with assets over $10 billion." It is perhaps overly optimistic to believe that debit card networks would be able to maintain such two-tiered system, assuming they would be willing to have a two-tiered system, when the greater majority of their resources and services are spent supporting those financial institutions that are not exempt from the debit card interchange fee restrictions.

Even if the Board were to revise their proposed regulations to include an enforcement provision in an attempt to protect card issuers under $10 billion, the exemption would still more than likely be meaningless due to marketplace pressures. If a merchant were given an option between accepting a debit card from a large financial institution subject to the debit card interchange fee restrictions and a debit card from an exempt financial institution, the merchant would have great interest in choosing the debit card from the larger financial institution to save money. Because as stated above, the proposed fee cap would not even be enough to cover the costs of the debit card transaction, it would stand to reason that the exempt financial institution's debit card interchange fee would be greater. The merchant would undeniably look for ways to increase usage of debit cards from the larger card issuers subject to the fee restrictions. They would have a substantial financial motivation to do so. Smaller financial institutions, like all the credit unions in North and South Dakota that offer debit cards, would have no choice but to also lower their debit card interchange fees to stay competitive. Thus, whatever exemption was proposed under the Dodd-Frank Act would be temporary at best. In the end, whether the consumer received their debit card from a large financial institution or from their member-owned credit union, they would be paying increased fees somewhere else or even lose the opportunity to have a debit card through their credit union.

In the Credit Union National Association's *2011 GAC Issues - Background Data: Credit Union Cost/Benefit and Interchange Estimates*, it is predicted that it would cost North Dakota credit unions $4,094,000 and South Dakota $4,080,000, if the Dodd-Frank Act exception for small financial institutions under $10 billion is ineffective. The Board surveyed fourteen debit card networks, who reported "that there were approximately 37.7 billion debit and prepaid card transactions in 2009, valued at over $1.45 trillion, with an average value of $38.58 per transaction." *Federal Register, Vol. 75, No. 248, page 81725.* Debit card use has become a staple in our society. Debit cards will likely remain in demand as consumers want an efficient and convenient way to access their funds to purchase goods and services. Therefore, the costs, over $8 million to the Dakotas' credit unions alone, to continue to provide this sought after service will have to be passed onto the members. In some cases, these costs might not be borne by only debit card users, but potentially spread across a number of services offered by the credit union. Credit unions in the Dakotas made total retained earnings of only around $14 million dollars in 2010. Retained earnings are the only way that credit unions can build capital and make investments in products and services for its member. Reducing these retained earnings even more by reducing the minimal earnings credit unions generate from debit cards, further hinders credit unions' ability to add the products and services its members need and to even continue to serve its members. Limiting such income and forcing credit unions to chose between offering debit cards at all or doing so at a loss, potentially affects safety and soundness of such institutions. And, it simply passes the earnings onto large national merchants (80% of transactions are from 1.5% of the merchants) who are in no way required to pass these savings onto consumers and there is no study required by the law to determine if such cost savings are passed onto consumers or just line the pockets of large national merchants.

Debit card interchange fee restrictions, especially restrictions that do not even cover the reasonable costs of a transaction have only one clear winner in this scenario, the merchant, not the consumer. This result is truly perplexing as it stems from a law meant to protect consumers, the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Credit Union Association of the Dakotas is opposed to these regulations extending to ATM transactions and networks. The Dodd-Frank Act does not address ATM transactions or ATM networks, therefore, as Congress did not include these items within the Act, they should be excluded from the Board's regulations regarding debit card interchange fees and routing.

CUAD is further opposed to the regulations regarding limitations on payment card restrictions, for which there is no exemption for card issuers under $10 billion in assets. "Adding the provision to require 2 signature based and 2 PIN based networks undermines precedent. The requirements of the EFTA only require the use of 2 networks, not 4," stresses Chelsea Smith. The Board again misses the concept of "consumer protection" with this proposed rule, even though the Board contemplates the affects of multiple networks on the consumer. "From the cardholder perspective, however, requiring multiple payment card networks could have adverse effects. In particular, such a requirement could limit the cardholder's ability to obtain certain card benefits…Similarly, insurance benefits for certain types of transactions or purchases or the ability to receive text alerts regarding possible fraudulent activity may be tied to the use of a specific network." *Federal Register, Vol. 75, No. 248, page 81748-81749*.

However, the Board does note that requiring multiple networks is a positive for the merchant. "From the merchant perspective, the availability of multiple card networks on a debit card is attractive because it gives merchants the flexibility to route transactions over the network that will result in the lowest cost to the merchant." *Id.* It is baffling that even with the information the Board considered and cited to in its "Section-by-Section Analysis," it would propose regulations that would help the merchant and hurt the consumer. As noted above, there is nothing in the regulation to require that the merchant pass these saving onto the consumer and it would be an erroneous assumption to believe that merchants would voluntarily do so.

Jon Griffin finds that, "[t]he intent of this legislation is to cut costs to consumers, however, there is no guarantee that merchants will lower prices if this legislation is enacted, the only guarantee is that credit unions and other financial institutions will have to find alternative ways to cover these costs which will result in more expenses for consumers."

"Credit Unions are inherently member driven; however, in this interchange proposal case, the regulation is lessening the ability to adequately serve the needs of members. There is a regulatory power that is limiting the Credit Union's ability in services and the products we offer to our members," states Chelsea Smith.

The Credit Union Association of the Dakotas, along with its affiliates, urges the Board of Governors of the Federal Reserve System to retract the proposed regulations for debit card interchange fees and routing found in Docket R-1404 in its entirety. This Association recognizes that the Board of Governors is required to write regulations implementing Section 1075 of the Dodd-Frank Act and the truest solution to the issues voiced is this, and the many other comment letters is for Congress to step forward and amend the underlying law. Thus, the next step that should be taken is for Congress to stop implementation of Section 1075 of the Dodd-Frank Act, or at the very minimum delay implementation and sincerely investigate the impact of this legislation on consumers, small financial institutions and the market place. Absent Congresses action to resolve these concerns, it is insisted upon that the Board begin again in issuing its regulation that is within the scope of the Dodd-Frank Act, and most importantly, develops regulations that will in fact benefit the consumer and protect financial institutions that fall within the exemption contemplated by Congress.

Thank you for this opportunity to share our comments.

Respectfully,

Robbie Thompson
CEO/President

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