



February 22, 2011

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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, RIN No 7100 AD63 – Debit Card Interchange Fees and Routing

Dear Ms. Johnson,

MidFirst Bank, an \$11 billion savings association headquartered in Oklahoma, would like to thank the Federal Reserve Board (the “Board”) for the opportunity to comment on the Board’s proposed interchange fee and routing (the “Proposal”). Although we appreciate the work that Board staff has put into the Proposal, MidFirst has significant concerns. For the reasons set forth in detail below, we believe that if the Board adopts the Proposal as written, consumers and banks will both suffer great economic harm. We are concerned that the Proposal has far too many unintended consequences – from the elimination of free checking accounts to the promotion of use of credit cards as substitutes for debit cards – to be adopted in its present form. As such, we strongly urge the Board to drastically revise the Proposal to eliminate these unintended consequences before adopting the rule in final form.

I. General Comments.

As a general matter, MidFirst strongly urges the Federal Reserve Board to exercise caution in its implementation of the interchange provisions, given the significant adverse effects the proposal is likely to have on consumers, community banks, and mid-size community banks, such as MidFirst, whose asset size only marginally exceeds the exemption threshold, and the payment system in general.

Simply put, the proposal harms the American consumer. Currently, banks typically impose no fees on the consumer for debit card activities and use the revenue generated from their debit card programs to provide bank services at reduced or no cost to the consumer. A good example of this is free checking accounts that many consumers currently enjoy.

If the Board adopts the Proposal as currently drafted, consumers will incur increased bank fees because banks will be forced to recoup the costs associated with debit card activity by implementing deposit account maintenance and usage fees or other similar fees. Low- to moderate- income customers will be the hardest hit, finding it more difficult to maintain no- or low-cost bank accounts and, instead, will have to turn to more expensive, less convenient, non-traditional banking services and service providers. This result is counter to all of the efforts that the federal banking agencies, and in particular the FDIC, has made over the past few years to bring the un- and under-banked within the traditional banking system.¹

Additionally, today consumers enjoy many benefits associated with use of their debit card, including rewards, discounts at merchants, and zero liability for fraudulent charges. All of these benefits are currently paid for through interchange fees by merchants who also enjoy the significant benefits of debit cards – specifically immediate receipt of funds, guaranteed payment, and no risk regardless of the transaction amount. Said differently, all of the parties to a debit card transaction – the consumer, the merchant, and the depository institution - enjoy benefits from debit card use.

Some in the industry anticipate that banks with assets of less than \$10 billion may see a surge in customers attracted to lower fee structures. Others however, believe that the interchange rate received by banks of \$10 billion or more will be the price for all in the marketplace.² In the long run, this Proposal could serve to weaken community banks, an important component of the financial sector throughout the United States.

As debit cards and/or the accounts associated with them become more costly for consumers and benefits such as rewards and discounts diminish at institutions with over \$10 billion in assets, it is likely that consumers will turn away from the debit card product in favor of credit cards. This would certainly be an unintended consequence, given the focus of the Dodd Frank Act on consumer protection.

The proposal will also have a detrimental effect on mid-size, community banks such as MidFirst that are not small enough to qualify for the exemption but do not have the

¹ For more information regarding the FDIC's efforts in this area, go to <http://www.fdic.gov/about/comein/> which chronicles the activity of the Advisory Committee on Economic Inclusion (Come-IN) established by Chairman Sheila C. Bair and the FDIC Board of Directors pursuant to the Federal Advisory Committee Act in 2006. The Committee is tasked with providing the FDIC with advice and recommendations on important initiatives focused on expanding access to banking services by underserved populations.

² See the testimony of H. Charles Maddy, III, President and CEO, Summit Financial Group before the Committee on Financial Services, United States House of Representatives. ("The Fed has proposed a rate that would reduce interchange revenue by more than 70 percent. Smaller banks can theoretically charge a higher interchange fee, but the economic incentives are so large that smaller banks like mine will almost certainly be forced to adopt the same price level or risk losing business to the largest banks. Market share will always flow to the lowest priced product, even if those lower prices are mandated only for some. The result for small banks is either a loss of market share, loss of revenue that supports free checking and other valuable services, or both.").

infrastructure or efficiencies enjoyed by large, national banks. For example, MidFirst is an \$11 billion entity with 72 banking centers in two states and just over 2,000 employees. Our institution more closely resembles a community bank than the megabanks that enjoy sophisticated systems and massive internal infrastructures. MidFirst will be forced to consider increased fees and decreased services as the proposal does not permit our bank to cover the cost of our debit card programs. As a result, we may initially lose customers to smaller banks who can cover their costs and offer rewards, cash back, free checking, etc. There is also potential to lose customers to large national banks that have the infrastructure to enable great economies of scale within their debit card programs. Ultimately, consumers who could be better served by MidFirst than by either its smaller or bigger competitors are the ones harmed.

Moreover, despite the explicit Dodd Frank Act authority for the Board to include anti-fraud fees as an allowable cost, the Board has chosen to implement the burdensome fee restrictions yet defer a decision for fraud monitoring. As a result, it is possible institutions will be forced to comply with the more restrictive fee limitations in addition to existing "zero liability" requirements without the ability to recover reasonable costs associated with maintaining fraud mitigating processes and technology.

For all of the reasons discussed above, MidFirst strongly believes the Board should proceed slowly and carefully in its rulemaking, and construct a rule that is narrowly tailored to implement the statutory provisions in a manner that provides banks with as much flexibility and opportunity as possible to recover debit program costs as well as allow banks to be compensated for the value debit cards present to merchants (*i.e.* immediate funds, guaranteed payment, and no risk regardless of transaction amount). Careful and timely consideration must be given so as to preserve as much consumer choice and opportunity as possible. MidFirst is concerned that the Board may not have fully contemplated the implications of the interchange survey with the above considerations in mind, which resulted in a Proposal that is unduly restrictive for banks and harms consumers while enriching merchants and retailers. Certainly this is not the result that Congress intended.

II. Specific Comments and Feedback Regarding the Proposal.

A. The Board requested comment regarding two alternative fee proposals (Alternatives "A" and "B").

Importantly, the statutory provisions limit interchange fees to amounts that are reasonable and proportional to the costs incurred by the issuer with respect to the debit transaction. The statute does not, however, require or authorize the Board to suppress fees below what is reasonable from the perspective of a particular issuer.

Specifically, MidFirst reminds the Board of its own findings regarding the proposed fee limitations – that the "estimates are based on a sample of data, and because the variation among individual issuers' costs was large, the ability to reliably infer a statistically

significant difference from the data is limited.”³ MidFirst questions how a sample with acknowledged statistical deviances can be used as an appropriate proxy for setting restrictive fee limitations. Additionally, MidFirst agrees with the Board’s statement that proportionality should not be interpreted to require identical cost-to-fee ratios for all covered issuers. Accordingly, MidFirst believes the Board should adopt a reasonable safe harbor without a specific cap. And, rather than requiring annual reporting of operational costs, issuers should be required to maintain appropriate records to justify any fees charged in excess of the safe harbor which shall be the subject of regular examination by the prudential regulator. This reasonable and flexible yet balanced approach acknowledges the unique structure and size of the institutions that will be subject to the rule, and the variable costs presented by their debit programs. Most notably, this approach will provide mid-size community banking institutions like MidFirst the flexibility to continue offering debit products in a manner that minimizes the financial burden to customers.

We offer some more specific comments on Alternatives “A” and “B” below.

1. MidFirst does not believe it is appropriate for the Board to set a cap on fees, as proposed in Alternatives “A” and “B” due to the variable nature of transaction costs and differing structures of banks that will be subject to the rule. For example, banks with a smaller asset size such as MidFirst may be required to pay higher per-transaction costs due to a lower volume of transactions and a smaller infrastructure than the large, national banks. The statutory mandate does not require the Board to minimize or force down the recoverable issuer costs (thus maximizing the savings to merchants) but rather simply directs the Board to allow issuers to charge interchange fees that are reasonable and proportional to the issuer costs.

2. MidFirst believes the initial safe harbor of 7 cents in Alternative “A” is too low and does not account for the legitimate costs incurred by institutions in connection with their debit programs. Keeping in mind suppressing recoverable costs below what is reasonable for a particular issuer will result in debit card program losses and ultimately a decrease in the products and services available to customers combined with higher bank fees, the Board should increase the safe harbor to allow recovery of other valid costs (discussed in detail below) and to the amounts considered reasonable and proportionate.

3. The Board should not require periodic reporting of operational costs by institutions that charge interchange fees exceeding the safe harbor as proposed in Alternative “A”. Such a requirement would only increase the costs and burden of offering debit programs. Rather, issuers should be required to maintain specific records of the costs that justify fees in excess of the safe harbor with the records being subject to annual review by the prudential regulator. Because the statute provides for administrative enforcement of the interchange limitations, this is a reasonable way to provide for ongoing supervision in the least costly, least burdensome manner.

³ 75 Fed. Reg. 81,737 (Dec. 28, 2010).

As a general matter, MidFirst also opposes the Board's single fee structure applicable both to signature based and PIN based card systems. By proposing the single limit, the Board is indirectly discouraging, and perhaps eliminating, signature based systems since these systems are more expensive to maintain. By doing so, the Board is assuming a role beyond the scope of its authority, one of issuer management – determining the type and amount of risk to accept with a debit program. Moreover, eliminating signature based systems creates less choice for customers many of whom enjoy the additional security features of signature based transactions. As stated above, this is not a role mandated or authorized by the statute. Moreover, it would seem Congress and consumers alike should be aware of and provide input on such a consequence.

- B. The Board requested comment on whether the regulation should allow recovery through interchange fees of other costs of a particular transaction beyond authorization, clearing, and settlement costs, as well as any criteria that should be used to determine which other costs of a particular transaction should be allowed.

The following are valid costs of processing debit transactions that are specific to debit transactions but are not included in the proposed rule as recoverable costs:

- All card network processing fees including membership fees, administrative fees, and switch fees. These are hard costs that are directly attributable to the processing of debit transactions.
 - All third party processor fees associated with debit cards and transactions including but not limited to fees charged to house cards and card data on their systems (data storage fees).
- C. The Board requested comment on whether the regulation should include fixed costs in the cost measurement, or alternatively, whether costs should be limited to the marginal cost of a transaction, and if the latter, the Board requests comment on how the marginal cost for that transaction should be measured.

Debit transactions cannot be completed without the issuer first having access to a network. Nor can debit transactions occur without cards, processing technology, and third party services to process and store data. Issuers cannot maintain debit programs without a proper infrastructure including proper staffing, technology, coverage of fraud losses, and other necessary elements to run the programs properly. Coverage of all these costs is absolutely necessary in order for the issuer to authorize, clear, and settle a debit transaction. An interchange fee that must exclude types of necessary and valid costs cannot be “reasonable” in accordance with the statute.

- **Card Production Fees.** There are significant dollars associated with the production of plastics (*i.e.*, the cards). The actual plastic itself, embossing, mailing, and PIN maintenance are all valid, necessary activities with associated direct costs that would not be incurred if there were no debit transactions. Banks rely on interchange fees to cover these costs and will likely have to charge

customers for their cards if they are unable to recover the costs through interchange fees.

- **Operational Costs.** There are certain overhead and infrastructure costs such as staffing, compliance, and technology costs, along with fraud losses, that are directly attributable to and required for debit programs. For example, it should be noted that the issuer bears responsibility for all losses due to unauthorized transactions on “zero liability” debit cards unless the issuer can hold the merchant responsible for the loss. These operational costs are significant to a privately owned community bank like MidFirst and should absolutely be recoverable through the interchange fee on a per-transaction basis.

MidFirst urges the Board to take additional time to carefully consider the significant impact that this rule is likely to have on consumers, community banks, and mid-size banks so as to avoid taking an unduly restrictive approach such as that outlined in the Proposal. We believe that if the Board adopts the Proposal as currently drafted, consumers, especially those who are low- to moderate-income, will suffer significant adverse economic effects through the loss of such important products as free checking accounts. We urge the Board to take a closer look at the unintended consequences of this Proposal.

MidFirst thanks the Board for the opportunity to express its concerns. If additional information is needed, please contact the undersigned.

Sincerely,



Charles R. Lee
Vice President
Director of Regulatory Affairs
MidFirst Bank