UNCLE CREDIT UNION

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February 22, 2011

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

Re: Proposed New Regulation II, Debit Card Interchange Fees and Routing
Docket No. R- 1404

Dear Ms. Johnson:

Thank you for the opportunity to comment on the Board's proposal to regulate debit interchange fees and debit card routing, as required by the Dodd-Frank Act (Act). UNCLE Credit Union is located in Livermore, CA and is $220 million in assets, and serves over 24,000 members.

I recognize and appreciate the difficult task given to Board staff to develop regulations to implement the interchange amendment and thank the Board and staff for your hard work, as well as your willingness to listen to credit union concerns during development of the proposal. I have grave concerns that the proposal does not accurately reflect the intent of Congress, and will cause undue harm to consumers and healthy market competition. I strongly urge the Board to suspend action on it until further study and discussion can be conducted by all parties.

I believe Congress should have the opportunity to conduct its own review of the intent and impact of the changes enacted by the interchange amendment. It was apparent upon passage of Dodd-Frank that Congress had devoted little time to discussing the impact that regulation of interchange would have on consumers. While Board staff has done laudable work in surveying and studying such a complex issue in the short period of time afforded it under the Act, I believe that additional time is needed in order to produce more thoughtful, balanced rules.

My concerns are outlined below.

Small Issuer Exemption—§ 235.5(a)
While the proposal does contain language exempting issuers with assets under $10 billion from the interchange fee rate setting provisions of the regulation, there is no provision that requires networks to maintain separate debit interchange rates for small and large issuers. As a result of the lack of enforcement for the exemption, small issuers may be subject to the fees that will be required for large issuers under the proposal. Further, even if the networks were to maintain separate interchange rates for small and large issuers, networks would have an incentive to minimize the spread between the two rates to make their brand more acceptable to merchants. Merchants would have an incentive to steer customers to use debit cards from larger issuers. If merchants began to refuse cards of small issuers, that could have serious and damaging implications for small financial institutions. Our members would have two choices – to either stop shopping at that merchant, or to obtain a card from the large financial institution that the merchant partners with. If they chose the latter, not only would our debit transaction volume and interchange income suffer as a result, but checking products and balances would also be

reduced. Consumers should have a choice in where they bank and shop, yet if this scenario should play out, their choices would effectively be limited or eliminated. In my view the small issuer exemption provided in the Act, while well-intentioned, will be meaningless, and possibly critically damaging, without sufficient regulatory enforcement.

Reasonable and Proportional Interchange Transaction Fees—§ 235.3

Under the proposal, larger issuers may receive no more than 12 cents per transaction (7 cents under the safe harbor provision). As discussed above, without sufficient enforcement of the small issuer exemption this cap may ultimately be applied to small issuers in the marketplace, including almost all credit unions. This cap represents a 73 percent reduction in the current average interchange fee of 44 cents per transaction. For UNCLE Credit Union, this translates into roughly $310,000 per year in lost income. The cap substantially fails to capture all issuers' costs associated with providing debit card services. The most obvious omission is the consideration of fraud prevention and data security costs. There is still not sufficient legislation and/or enforcement of legislation to accurately address this issue. As merchants subject consumer information to data breaches, financial institutions are left to assist consumers in cleaning up the aftermath while the merchants have no accountability to the problems that they caused. The TJMaxx data breaches alone caused untold staff and operational expense, not to mention the headaches for consumers in having to have their cards reissued and closely monitoring their accounts for fraudulent activity. Interchange fees are designed to help offset those costs. While on the subject of costs and accountability, I want to make it clear that interchange fees are costs between merchants and card providers, not costs that the consumer pays. In fact, when merchants were posed with the option of writing into the legislation that they should pass the cost savings they will experience through reduced interchange fees directly on to the consumer, they stated that they could not support the legislation. They say that if interchange fees were reduced, they would be able to reduce their prices. But there is nothing written into the legislation that would require them to do so and in my opinion, it would be highly unlikely that this would happen. While, the Board has recognized that fraud prevention costs are an integral part in determining the true cost of processing debit transactions, it has also acknowledged that it is currently incapable of determining these costs. Whether this is due to the complexity of the issue or time constraints, I believe it further underscores the need to delay action on the proposal until a full, accurate study of all aspects of the issue can be done. In addition, the proposed cap does not factor in costs such as actual debit card fraud losses, which the Board estimates at approximately $1.36 billion in 2009, or 8 percent of the estimated $16.2 billion in debit and prepaid interchange fees charged in the same year. Nor did the Board consider issuers' costs related to the administrative and support functions of providing debit card services, such as card issuance and error resolution and chargebacks. Finally, I do not believe that it is prudent to set pricing in legislation.

Limitations on Payment Card Restrictions—§ 235.7

The Board has proposed two alternatives regarding the routing of debit transactions and network exclusivity:

- Alternative A – would require a credit union to issue debit cards that could be processed on at least two unaffiliated networks, such as one payment card network for signature debit transactions and a second, unaffiliated payment card network for PIN debit transactions; or
- Alternative B – would require a credit union to issue debit cards that could be processed on at least two unaffiliated PIN networks and also on at least two unaffiliated signature networks.

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I believe that Alternative A would be much less burdensome for small issuers. Adoption of Alternative B would mean that small issuers would have to bear even greater costs associated with having to join additional networks. Actually, it's unlikely that Alternative B would be desirable—or even feasible—for all parties involved in processing debit transactions.
As the Board acknowledged in the proposal:
"…enabling multiple signature debit networks on a debit card could require the replacement or reprogramming of millions of merchant terminals as well as substantial changes to software and hardware for networks, issuers, acquirers and processors in order to build the necessary systems capability to support multiple signature debit networks for a particular debit card transaction."
I would also like to emphasize that the proposal does not exempt small institutions from these network exclusivity and routing provisions. Merchants will have the ability to choose how a debit transaction is processed. Given market pressures and the questionable practicability or effectiveness of a two-tiered system, small issuers will be significantly disadvantaged in favor of larger issuers.

In closing, I would like to thank the Board for the opportunity to share my very serious concerns regarding these proposed changes. Should these provisions remain as they are currently written, small issuers face a dramatic loss of interchange fee income combined with the additional costs of having to belong to more than one network. There are already media reports of large national banks announcing that they will begin charging for checking accounts and/or implementing new fees or raising existing fees to recoup lost revenue from interchange fees. Credit unions have a long history of offering our members lower fees, higher deposit rates, and lower loan rates than bank customers. I do not want to charge my members more or higher fees and I definitely don't want to charge for checking. Unfortunately, the tremendous pressure that this proposal will have on my credit union's income and costs—and, therefore, our net worth (capital)—will force most credit unions into making such a decision. If the Board finalizes this proposal in its current form, without taking significantly more time to more fully study the issue, it will ultimately be consumers who end up paying for the merchants' windfall brought by drastic cuts to interchange. It is unfortunate that the very legislation that was intended to help consumers will actually end up harming them, while at the same time placing undue burden on the financial institutions that are trying to do right by them. The only individuals benefiting from this proposal that I can see are the merchants.

Thank you for taking the time to read my comments.

Sincerely,
Wendy Zanotelli
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