From: Farmers & Merchants State Bank, Roger A Hall

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, 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. As President of the Farmers & Merchants State Bank, a banking institution, with total assets of $52 million, I am writing to
express my opposition to the proposed rule. The Farmers & Merchants State Bank is an independently-owned community bank with two branches and eleven employees. Neola (population approx 900) is predominately a farming community located in southwest Iowa, near the Council Bluffs/Omaha, NE metropolitan area. We offer a wide variety of products and services to a stable customer base, most of whom are involved in agriculture-related occupations or are employed in Council Bluffs/Omaha.
The bank has been located on the same corner with the same
ownership and name since 1886. We are proud of our communities of Neola and Minden, IA (population 500). Both have worked hard to keep their communities alive, even when other small towns in Iowa are struggling to survive. New businesses, new housing, energetic and hardworking citizens are all responsible for the recent successes. The Farmers & Merchants State Bank has also worked hard to do our part in supporting these endeavors. We've kept costs down to our customers, offered sensible and realistic financing to businesses. This proposal would negatively impact the bank's interchange revenue by more than 75%. This loss would no doubt result in a reduction in those services now provided at no cost to customers. Other fees would increase. Below are our specific comments regarding each section of Regulation II: the proposed interchange fee, transaction processing restrictions, and fraud-prevention costs.
Proposed Interchange Fee In order to preserve the intent of the small issuer

interchange rate exemption included in the law, we ask that you issue additional rules to guarantee the small issuer exemption in the marketplace and protect the interchange revenue of all small issuers.   As dictated in the law, you need to fully consider the "role" of the issuer in the authorization, clearing, and settlement of an electronic debit transaction. For example: In order to have a transaction processed on the SHAZAM network, an issuer needs to be a network participant. Participation requires the payment of various fees, including but not limited to network fees, participation fees, and debit card residency fees.   The FRB also needs to expand its view of settlement. The primary objective of the Electronic Funds Transfer Act is to protect individual consumers engaging in electronic funds transfers (EFTs). Network operating rules, which also provide consumer protections, require an issuer to maintain responsibility and liability for settlement until a cardholder's dispute rights have fully expired. Any costs incurred by an issuer throughout this settlement process should be considered allowable costs, including the cost of inquiries and disputes; fraud losses and fraud-prevention costs; and fixed costs, including capital investments, used to support settlement.   The law specifies that the interchange fee shall be "reasonable and proportional" to the costs (not the exact costs) to authorize, clear, and settle a debit transaction; therefore, an allowance should also be made for a reasonable profit. If you do not take into account these factors, the proposed interchange cap is not a "reasonable" fee. Additionally, in calculating the permissible interchange fee, the proposed rule does not recognize important value-added differentiators between debit cards and checks. For example: When a merchant obtains a proper authorization for a debit transaction, payment is guaranteed and the issuer suffers the loss in the event there are insufficient funds. Checks may be returned nonpayable, and merchants suffer the loss. Alternative 2 (cap only) is the better alternative. Alternative 1 (safe harbor and a cap) would require the creation of a separate interchange rate for each covered issuer, as each such issuer would have different costs. This would require payment card networks to create a new interchange system for each covered issuer. Alternative 1 would be more expensive to all issuers, including small issuers, as the network implementation costs would be passed on to issuers. Transaction Processing Restrictions Per the transaction processing restrictions portion of Regulation II, Alternative A (two unaffiliated networks) would be the most cost-effective alternative because community financial institutions would not have to join additional payment card networks. Additionally, if ATM transaction routing is included within the finl rule's scope, Alternative A would be the most cost-effective alternative. As a SHAZAM financial institution, we are already in compliance with Alternative A for both ATM and point-of-sale routing. Alternative B (two unaffiliated networks per authorization type) may require reissuance of cards in order to comply with network branding requirements. This is an unnecessary expense and an inconvenience to our cardholders due to such things as recurring payments. If the FRB mandates Alternative B, it should require that an interchange adjustment be made to cover the increased cost to issuers for participation in multiple networks. Additionally, 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 aspect of the law in the final rules to provide protections for all issuers within a payment card network.   The FRB also needs to make allowances
in the final rules for issuers to make decisions on debit card acceptance or routing in order to mitigate fraud. An issuer needs to have the ability to place restrictions or acceptance blocks on its debit cards to maintain or restore the security of an account or the EFT system without being cited for

violating routing rules. Fraud-Prevention Costs In discussing fraud-prevention costs, the FRB should organize and oversee a fraud consortium comprised of representatives of all stakeholders in the electronic payments industry. Its purpose would be to develop a holistic approach to fraud-prevention and liability allocation issues. Primarily, the consortium should come up with fraud-prevention alternatives that not only reduce fraud but also provide a positive return on investment for all stakeholders. The consortium should develop non-prescriptive, fraud-prevention standards for merchants. Implementation of these standards could be monitored through an enhanced review of regulated merchant-sponsoring financial institutions. The consortium should also ensure that all parties have an equal opportunity to implement new technologies, and that small issuers are not denied such implementation opportunities due to excessive cost. Finally, Alternative 2 (non-prescriptive) is the better alternative. It is not practical for the FRB to mandate specific technologies. We believe Alternative 1 (technology-specific) would stifle technological changes, as the FRB is not an expert regarding technologies that could reduce fraud. Because of the many issues related to consumer harm and basic fairness, we urge you to strongly consider each of the points we have addressed in this letter. Thank you for your time. Sincerely, Roger A Hall President Farmers & Merchants State Bank