UMPQUA HOLDINGS
CORPORATION
Parent company for Umpqua Bank and Umpqua Investments, Inc.

Legal Department - Eugene

February 18, 2011

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

RE: Debit Card Interchange Fees and Routing Restrictions, Docket # R-1404

Dear Ms. Johnson:

Umpqua Bank, headquartered in Roseburg, Ore., is a subsidiary of Umpqua Holdings Corporation (NASDAQ: UMPQ), and has 183 locations in Oregon, Northern California, Washington and Nevada. The company reported just under $12 billion in assets at December 31, 2010. Umpqua Bank has been recognized nationally by *The Economist, The Wall Street Journal, The New York Times, BusinessWeek, Fast Company* and CNBC for its innovative customer experience and industry-leading banking strategy. For the past five years in a row, the company has been included on *FORTUNE* magazine's list of the country's "100 Best Companies to Work For."

Umpqua Bank strongly opposes the Federal Reserve Board's proposed rules implementing the Durbin Amendment, contained in Section 1075 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act.* Under this section, the statute requires debit interchange fees be set at levels that are "reasonable and proportional to the cost incurred by the issuer with respect to the [electronic debit] transaction." The proposed rule fails to meet this standard on several levels and causes significant market disruption, as explained below.

Proposed Reductions in Interchange Fees Are Excessive and Unsustainable. The Board's proposed reduction in interchange fees is neither reasonable nor proportional to the cost. Instead, it would prevent issuers from recovering approximately 80% of their debit transaction costs, thereby preventing them from recovering their legitimate cost of providing the service. Umpqua Bank returned to profitability in 2010, reporting just over $16 million in net income. This proposal represents an estimated $8 million loss of revenue to Umpqua Bank, based on 2010 transactions. Cutting our revenue in an amount equal to one-half of last year's net income significantly reduces our ability to expand lending to small and mid-size businesses and to hire new employees.

The Board should follow Congressional direction to allow broad cost recovery to issuers, and not just the *incremental* costs of authorizing, clearing, and settling debit transactions. The FRB's proposed rule would fix debit interchange fees, regardless of transaction size, at $0.07 to $0.12 per transaction, roughly 80 % below today's fees and far below the actual costs of providing basic debit card services. No business can survive being restricted to charging only incremental costs for goods or services. For example, if the government

restricted a restaurant's food prices to only what it paid for ingredients and labor, without allowing the restaurant to factor in other expenses such as rent, utilities, marketing or management, that restaurant would fail.

Below Cost Interchange Fees Harm Consumers and Issuers. Congress clearly recognized the importance of debit transactions for consumers and expressly determined that merchants should pay the issuer's costs for electronic debit transactions. The Board's proposal improperly attempts to shift most of these costs to issuers and consumers, resulting in below-cost interchange fees. If issuers cannot fully recover transaction costs, consumers will be harmed because issuers will be forced to raise consumer prices, or limit product offerings and functionality (*e.g.* authorizations), or both. The proposed rule does not implement Congressional intent.

- **Comparison to Checks.** The Board's proposed rule improperly construes the requirement to consider costs in checking transactions as prohibiting recovery of any costs not incurred in check transactions. The plain meaning of the statutory language supports higher debit interchange fees because debit provides greater functionality and involves higher costs than checks.

- **ACS Costs.** Issuers should not be limited to recovering only authorization, clearance, or settlement ("ACS") costs for electronic debit transactions. The Board offers no rational basis for ignoring the statute and excluding costs specific to transactions other than ACS costs (*e.g.* responding to customer inquiries and sending monthly statements as required under EFTA). The comparison to the cost of processing paper checks (the rationale offered by the Board) is irrelevant. The Board's interpretation of ACS costs is improperly narrow, because it limits recovery to "variable" ACS costs.

Lowest Merchant Cost Is Not the Statute's Objective. Congress enacted interchange limits to ensure fees are reasonable and proportional to issuer transaction costs, and not to reduce merchant costs to the lowest possible levels. Below-cost interchange fees impose adverse consequences on consumers and debit card issuers not considered by the Board. The need to protect against these consequences and the plain language of the statute are inconsistent with the Board's apparent desire to ensure merchant transaction costs are reduced to the lowest level possible. The statute requires "reasonable and proportional" interchange fees based on issuer costs. An 80% reduction in fees is neither reasonable nor proportional. Indeed, it strains the imagination to assert Congress would have passed the Durbin Amendment if it took the form of the Board's proposal.

Below Cost Interchange Fees Harm Competition. If interchange fees are set below transaction costs for virtually all issuers, as in the Board's proposal, only the largest issuers will have any viable opportunity to compete in the market place. Smaller issuers such as

Umpqua Bank will be forced to match costs of the largest and most established issuers, and would be forced to operate at a loss or increase consumer charges to noncompetitive levels.

Below Cost Interchange Fees Will Increase the Under-banked and Unbanked. The proposal's shift of merchant costs to consumers will have the greatest impact on lower and moderate-income families who can least afford it. They will either pay higher prices that they can ill afford or forego debit cards in favor of more traditional paper-based payments. This will be exacerbated by the proposal's adverse impact on competition as even the largest issuers reduce offerings to more costly consumers in an effort to make up for the Board's draconian reduction in interchange fee revenue. The net impact will be an increase in the under and unbanked due to the constraints of this and other new regulatory burdens impacting debit accounts.

The Proposal Impermissibly Favors PIN Over Signature Debit. The proposed rule should not favor one type of transaction over another (*e.g.* PIN over signature), merely because merchant costs may be lower in PIN transactions. The Durbin Amendment does not reveal any Congressional intent to create incentives for use of one payment type over another. Merchants (especially smaller ones) may not want to accept PIN because of new system expenses, while many consumers may prefer signature.

- **Separate Rates for Signature / PIN.** The rule should set separate rates for signature, PIN, and covered prepaid / gift cards. The statute requires fees to be reasonable and proportional to issuer costs, and proposal recognizes, but ignores, substantial differences in cost structures for these transactions. Adopting a single rate structure will impermissibly distort market availability of various debit products; nothing in the statute suggests that one product (*e.g.* PIN) should be preferred over another (*e.g.* signature). Even if some larger merchants want to promote PIN transactions, consumers and other merchants may want signature for legitimate reasons.

Safe Harbor Appropriate; No Rate Cap. Some type of safe harbor amount is appropriate (if set at proper level) because of the administrative burden of issuers separately calculating costs and the need for some certainty regarding fees. However, the Board should not adopt fee caps. The statute limits issuer fees solely in relation to costs and does not authorize the Board to set a cap. Under the plain language of the statute, fees must be "reasonably proportional." There is no separate "reasonableness" requirement apart from relationship to costs, and proportionality means fees must be comparable in size to costs.

Fraud-Prevention Adjustment. The Board has authority to increase interchange fees for those fraud costs not already covered in ACS costs. Fraud prevention costs embedded in the authorization process, for example, must be included by the Board as part of ACS costs. *The fraud adjustment covers other costs not already included in ACS.* The Board must exercise its authority to provide a fraud adjustment to interchange fees. Failure to allow

issuers to recover the cost of fraud prevention will hinder further investment in, and development and improvement of, systems that are essential to consumers, merchants, and issuers. Limitations on fraud prevention efforts will promote other behavior to reduce fraud, such as higher rates of declined transactions and reduced card utility, to the detriment of all participants in the market.

- **Prompt Action Needed.** It is untenable that rulemaking on fraud adjustment is lagging development of the rest of the rule. Fraud adjustment is an important part of cost recovery that needs to be implemented promptly, especially in light of potentially dramatic decrease interchange fees under the proposal. The Board should be able to provide general guidance in the regulation without undue delay.

No Technology-Specific Approach. Umpqua strongly opposes the Board approving certain technology-specific methods to be eligible for fraud cost recovery. Issuers in the marketplace have adequate incentives, and are far better equipped to determine effective fraud prevention methods. The proposed processes would be cumbersome and limit the effectiveness of prevention methods by providing public notice to fraudsters of prevention methods adopted by the industry. The Board should avoid endorsement of particular technologies and its chilling effect on technology development.

Payment Card Restrictions (Exclusivity and Routing Provisions). Umpqua Bank strongly supports Alternative A, as the lesser of two evils. Alternative A, which would require each debit card to be capable of being processed on at least two unaffiliated networks, properly implements the language of the statute and, although an ill-advised intrusion into free market decision-making, could be implemented. Alternative B, on the other hand, would require each debit card to be capable of being processed on two unaffiliated signature and two unaffiliated PIN networks. As noted by the Board, the express language of the statute merely requires two networks, and expansion to include two networks of each authorization type would be extremely onerous and burdensome.

Multiple Signature Networks Must Not Be Required. As noted by the Board, requiring debit cards to be accepted in multiple unaffiliated debit signature networks would involve substantial changes in card formats and existing authorization and settlement systems, and would be very costly and time consuming to implement. Further, if each card must operate on multiple signature networks, and merchants, not consumers, choose which network to use, incentives to invest in new consumer services and other innovations will be damaged, if not destroyed.

Board Should Recognize Consumer Interests re: Debit Networks. Consumers should be able to choose the debit network they want to use because many card features are provided at a network level (*e.g.* unauthorized use protection or travel insurance benefits). Congress did not place a merchant's interest in choosing the lowest cost network for processing transactions above consumer's choice of network, and neither should the Board. If, contrary

to the statute, the Board were to require multiple signature networks on each card, the net result would be merchants choosing the cheapest network for the merchant rather than each consumer choosing the best network for that consumer. Consumers should have ability to choose which debit network they want to use for a payment, just as they can choose to pay with cash, credit, or debit.

Conclusion. In conclusion, the proposed rule fixes prices based on an artificial concept of cost, instead of pricing based on the value provided by interchange fees to consumers and merchants. As in any price-fixing scheme, consumers, a competitive marketplace and innovation will suffer.

For these reasons, Umpqua Bank urges you to re-examine and re-write the proposed rules in recognition of the well founded and legitimate concerns expressed herein. If I can provide additional information, please contact me at 541-434-2997 or at stevenphilpott@umpquabank.com. Thank you for your consideration.

Sincerely,

Steven L. Philpott
EVP/General Counsel

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