NORTHWEST CREDIT UNION ASSOCIATION

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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

Subject: Northwest Credit Union Association Comments on Proposed Changes to Debit Card Interchange Fees and Routing, Docket No. R-1404

Thank you for the opportunity to comment on Regulation II implementing the interchange provisions of the Dodd-Frank Wall Street Reform and Financial Protection Act, and relating to debit card interchange fees and routing. The Board has done an outstanding job of interpreting the rules associated with the Dodd-Frank Act and we appreciate once again being able to offer our insights. Owing to the complicated nature of this rule, we adamantly believe it deserves additional scrutiny and consideration before implementation.

The Northwest Credit Union Association represents 194 credit unions with 4.2 million members and $45.2 billion in collective assets. We believe that the proposed changes could have a devastating effect on credit unions that provide debit card programs to their members.

As you know, credit unions are unique non-profit institutions, most of which operate on a much smaller scale than major banks. We are able to offer products and services that larger banks cannot, and build relationships with our members that are unique and individual. Our relationships and personalized products make us an excellent alternative to the larger faceless institutions while allowing us to offer more products and services with lower fees and costs. However, unlike banks we cannot offer stock to help increase capital, and rely on a narrower menu of income sources such as interchange income. Because credit unions often operate on a much thinner margin than other financial institutions, the Board's proposal will have a disparate impact upon them, and other smaller financial institutions.

General Comments

Proposed Regulation II is of concern to credit unions and small issuers for many reasons. Ultimately it eliminates a credit union's discretion to determine the products and services best suited to the needs of its members.

Credit unions already face an onslaught of onerous regulations and rules and have managed to continue to thrive based on the ability to appeal to member needs. As we examine the potential fallout of this proposed rule we ask the Board to carefully consider how these proposals will impact the ability of credit unions and small issuers to serve their members.

Intent of the Rule

The Association remains confident that Congress' intent in passing these provisions was not to disadvantage small issuers, or create a system in which consumers pay more for financial services—rather the opposite is probably true.

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The credit union industry is calling on Congress to delay this proposed rule in order to ensure that the real intent and purpose of the underlying law is achieved and that this is not simply seen as a chance to shift costs between merchants and financial institutions.

The Association believes that taking more time to truly understand the impact of the proposal will be worthwhile and would benefit everyone from credit unions to merchants and ultimately consumers.

Capping Interchange Fees

Congress has continually acknowledged the value of credit unions and small lenders and has done so in this proposal by including an exemption for card issuers with assets of less than $10 billion. Congress clearly understands that credit unions serve a significant need in the community as they are often able to offer credit when no other lender will, able to offer funds at a much lower rate, and consistently give back to their local communities and the members they serve. The Association believes that arbitrarily capping interchange fees, even if initially only for larger issuers, could have an unintended yet devastating effect on the entire credit union industry and while concessions for small issuers exempt them from these pre-set caps, there rule proposed by the Board has no "teeth" in place with which to enforce the provisions on an ongoing basis.

Even major networks acknowledge that this two-tier system is not likely to be sustainable in the long term. Visa announced that it would support a dual system, however noting that with downward pressure caused by the caps placed on large issuers, the dual system may not be guaranteed long-term. As major players begin to reshape the landscape, smaller issuers will soon be facing pressure to abide by the de facto rules established by the marketplace, rather than the rules established by Congress or the Board.

If the two-tier program actually works, how will it be enforced? What is to stop merchants from providing preferential treatment to those issuers with the lower fees? How will this impact consumers? In an industry with already slim margins, discrimination between card providers could cause the loss of additional income for smaller financial institutions and create new headaches for consumers. At present, the Board's proposed rule does not require payment card networks to distinguish between small and larger issuers. The Association strongly encourages the Board to add enforcement provisions to its proposed rule, and strongly believes that this was the intent of the underlying law passed by Congress.

Without a mechanism for enforcement, consumer confidence in the universal acceptance of their plastic card will also be rapidly eroded. Interchange losses incurred by all financial institutions, both large and small, will be passed along to consumers in the form of higher-priced services, fee-based debit cards, and in the elimination of additional programs such as reward points, frequent flier miles, etc. Smaller financial institutions will not be able to compete with larger issuers who are able to better absorb losses. Some small providers have already begun to eliminate costly reward programs in anticipation of the very real and significant impact of the proposed change to interchange fees.

Smaller merchants may also be affected to their detriment. Although merchants were behind the Dodd-Frank Act provisions limiting interchange, the Association believes that as margins tighten on plastic card products, large financial institutions that cater to business accounts will cherry pick the more profitable accounts, making service unavailable to small merchants—at any price.

As customers begin to change their purchasing behavior based on the reality of what the proposed rule would bring—uncertainty over where and when a card might be accepted—we may see an exodus from debit cards provided by small issuers, essentially building a system where government intervention determines the winners and losers by making the system unsustainable for small issuers. Developing rules

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which are unsustainable and when taken to their logical conclusion would be devastating to the industry, is short-sighted and requires further in-depth examination.

Changes to Routing Requirements

The Board has offered two alternatives to implement changes to current routing requirements to ensure that all cards can be processed over more than one network. From the Association's perspective, "Alternative A" requiring two separate unaffiliated networks per card, is the better of the two options. "Alternative B" with its requirement of four networks would task issuers with a considerable amount of work in negotiating and maintaining contracts. Additionally, small issuers in many cases would not be able to negotiate with as much force as larger issuers who are able to bring in a much higher transaction volume.

Requiring more negotiations and more contracting puts an additional burden on smaller issuers which seems unnecessary and burdensome.

Fraud Prevention Costs

The cost of fraud prevention is a serious concern, and the Association is left with more questions than answers resulting from the Board's proposed guidance. As issuers know, preventing fraud is key to maintaining a sound financial institution. The costs of tools required to minimize loss are not easily quantified, and the Board's proposal does not accurately account for the actual costs of fraud prevention. Both of the Board's proposed alternatives would limit interchange fees to 12 cents per transaction, however based on information from our members, credit union debit interchange fees generally range between thirty-five and forty-four cents per transaction.

The Dodd-Frank Act allows the Board to consider fraud prevention and data security in determining the interchange rates it will set, however the proposal issued by the Board doesn't adjust for these costs. If not able to control fraud, issuers will need to limit exposure to potentially fraudulent activity. For example, they may have to reduce withdrawal limits for large purchases or reduce the amount of cash available each day to help minimize risk of loss. Taking such measures would greatly decrease consumer choice and likely push customers to credit cards which feature much higher rates for cash advances and for those who carry a credit card balance, increased monthly payments.

Having the government back specific fraud-prevention programs and technologies again puts the government in the role of deciding who succeeds and who fails. A one-size-fits-all approach will not serve the needs of our varied credit unions. All financial institutions should choose the system best suited to meet its own security needs. With fraud itself, as well as fraud prevention tools in a constant state of change, backing specific fraud-prevention programs, and keeping those programs relevant will be a daunting task. Simply put, having the government dictate what is best for our members is not best for our members.

Conclusion

In conclusion, the Association supports a fair and open debit fee and interchange system. We cannot support the proposed caps on interchange fees as we believe that even the two-tiered system, without means for enforcement, will only be a temporary safeguard for smaller providers and will soon subject small issuers to the same rate caps as large issuers.

Additionally, it is the Association's position that the changes to routing requirements should be limited to two unaffiliated networks per card so that small issuers are not overburdened with negotiations and that ultimately a free market would best determine the winners and losers in this respect.

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Finally, we do not believe that the fraud-prevention options set forth in the Board's proposal do enough to take into account the actual costs of fraud prevention. Issuers need the freedom to select and utilize the system that works best for them. It is essential that innovation in this arena continue and that the newest and best methods be available to all issuers regardless of size.

The Association would like to recognize that the Board was put in a difficult position in adopting this proposed rule, and that many of the mandates in the rule are drawn directly from the Dodd-Frank Act itself. We remain committed to working with Congress to give the Board additional time to study the potential impact of the legislation on financial institutions, particularly smaller financial institutions. We also urge the Board to work with Congress to seek the additional time to study the assumptions underlying the proposed rule.

Thank you once again for the opportunity to offer our comments and perspective in this matter. Please do not hesitate to contact me should you have any questions or would like any additional information on how the Board's proposal will affect the credit unions of Oregon and Washington.

Respectfully yours,

Jaycee Winn, Director of Regulatory Advocacy
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