Texas Credit Union League™
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February 22, 2011

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

Sent Via e-mail to: *regs.comments@federalreserve.gov*
RE: Docket No. R–1404 and RIN No. 7100 AD63; TCUL Comments on Interchange Proposal

Dear Ms. Johnson, Chairman Bernanke, and Members of the Board of Governors of the Federal Reserve:

This comment letter represents the views of the Texas Credit Union League (TCUL) regarding the Federal Reserve Board's proposed Regulation II to implement the interchange provisions of the Dodd-Frank Wall Street Reform and Financial Protection Act, requiring amendments to Regulation E (Electronic Funds Transfer Act). TCUL is the official trade association serving over 500 federal and state credit unions and more than 7.4 million credit union members in Texas. TCUL appreciates the opportunity to comment on this very important issue.

TCUL and its member credit unions strongly oppose the proposal and urge the Board to work with Congress to support a delay in its implementation.

Background
Gone are the days of writing checks. Today, consumers and credit union members want the convenience of using debit cards. Debit cards are now the essential payment tool....more convenient than a check book, and much smarter than running up debt on a credit card. As a result, credit unions and other financial institutions began offering debit cards, and the debit card became an essential product and service in the minds of consumers.

The system is costly. General operating costs can be astounding, and that is before factoring in costs associated with fraud, the risk of nonpayment, and data security breaches. The majority of the costs of these additional risks rest solely with the financial institution, even despite the fact that merchants are in the best (and only) position to prevent the fraud. As a result, through fair dealings in the marketplace, the interchange fee was born.

Credit unions and other financial institutions emphatically support the notion that the current interchange fee system very fairly represents what merchants should pay to support their end of the debit card system. To understand why the merchants pay what they do in interchange fees, you must understand what they do NOT pay.

Let's keep in mind, the typical merchant operates under the idea that the more sales it makes (and the less time and money spent in making those sales), the more profit it gains. Payment by debit card is a key factor in speeding up sales. Checkout lines flow by at record speed now that consumers no longer manually fill out checks. Today, debit card payment is the norm, and unfortunately, that makes debit cards a prime target for fraudsters. Sure, merchants could slow down the process and prevent card fraud by checking identification. But why in the world would they do that? Such action would slow down the purchase process. And anyway, the funds are guaranteed! So why bother to check identification? The financial institution will eat the loss!

Along the same lines, many merchants fail to comply with data security standards. Why? Because there is no incentive to protect the private card information they are storing! Why bother with the cost and burden of data security, when the financial institutions eat the loss of any data security breach?!

These factors should give you a better understanding of why the interchange fee came to life, and why Congress' interference in the market place could have a drastic impact on the continuation of the debit card system. The consumers are not winning under this proposal. Merchants have not shown any inclination to lower prices of merchandise in connection with savings related to this proposal. So where is the benefit to consumers? Instead, consumers will be directly affected by the proposal when financial institutions are forced to find new ways to make up lost income due to the cap on fees. Unfortunately, such a turn will likely put an end to "free" checking and debit accounts...products that, to many Americans, are simply necessary to get by in today's economy.

Postponement
As you may already know, the "Durbin Interchange Amendment" was passed last minute. This action was taken, unfortunately, by Congress with little discussion or understanding of how the card system operates. Although Congress included a well intentioned exemption for smaller financial institutions under $10 billion in assets, the fact is, all credit unions of all sizes will be severely negatively impacted by the proposal. As a result, it is vital that the Board work with Congress to support and achieve a reasonable delay of a couple years prior to the implementation of a final rule. This time period is essential to properly research and study the debit card system and the effects of the proposed rule on consumers, the payment card networks, financial institutions including credit unions, merchants, and the overall debit card electronic payments system.

Enforcement & Steering
Although well intentioned, the exemption provided to credit unions under $10 billion is essentially useless and ineffective for several reasons. First of all, the law and regulation do not provide for enforcement powers to ensure that payment card networks offer a two tier debit transaction interchange system for small and large issuers. Even if a two tier system is in fact established, the current proposal would permit merchants to "steer" transaction processing to an electronic payment network of their choice. This could result in merchants steering consumers away from credit union debit cards.

Cost Recovery and Price Setting
The Fed has proposed a rule that would reduce the interchange per transaction fee from an average 44 cents today, to between 7 and 12 cents per transaction with a cap, at least a 50-70% reduction from current rates. The Fed was bound by the language of Dodd-Frank and could not include certain costs that contribute to the overall cost of providing and running a debit card program, most notably fraud losses from stolen debit card information. TCUL suggests that the Fed needs to take a broader view of allowable costs where it does have discretion under the legislation.

First, we must question the constitutionality of the federal government mandating that business must sell a product for less than the cost of providing that product, which deliberately incurs a loss for that business. This is a very dangerous precedent and overreach in our view. If the intention of the statute is to regulate the profit, such as in the case of government regulated utilities, then it should allow all the costs plus some determined fair profit margin before setting a rate by which all must abide. The current situation is similar to legally complying General Motors, Ford and Chrysler to only charge a price equivalent to its raw material costs for making cars, but nothing for labor, assembly line construction, paint, or vehicle distribution to dealers. It's simply not fair.

Businesses cannot sustain loses without making up the lost income elsewhere. In the case of Texas credit unions, millions of Texans will be forced to pay new fees created out of necessity. These consumers should not be penalized while merchants are receiving the economic benefits of interchange rates not set by the market or even the total costs being included, but by a sliver of allowable costs defined by statute.

Fee Structure
The 12 cent fee cap developed for large issuers is far too low and does not take into consideration the cost associated with the card system. Operating a card system is very expensive for a financial institution. Beyond the typical operational expenses (staff, cost of cards, etc), financial institutions absorb enormous costs associated with fraud and data security. Such careless action is almost unbelievable, when, in most instances, such fraud is entirely preventable by the merchants. Despite the merchants' "ability" to prevent the fraud, it just does not happen because there simply is no incentive to do so when the loss is passed entirely to the financial institution. In additional to the financial costs of fraud and data security, financial institutions also suffer reputational consequences. Most credit union members are frustrated and disappointed when the credit union cancels their card and issues a new one due to a data security breach at a merchants' place of business. The credit union members often don't understand that there was nothing the credit union could have done to protect them...other than reissuing cards.

As discussed in the recently hearing, the Fed stated that it did not consider the cost of debit card programs born by smaller financial institutions under $10 billion in assets. As mentioned above, this data is extremely important as smaller institutions are going to be affected despite the exemption.

Routing
The routing and exclusivity provisions represent an unreasonable and costly regulatory burden on credit unions. Of the two alternatives proposed, TCUL suggests that "Alternative A" is the better option, as it would be less costly and burdensome for all issuers. TCUL again raises concerns that merchants may "steer" consumers away from credit union cards.

As Chairman Bernanke said in his testimony before the Senate Banking committee last week, in practical terms the two-tier system proposed or "carve out" to protect most credit unions simply will not work in free-market sense. We strongly support extending the $10B system exemption to the routing and exclusivity provisions which is currently not the case. But ultimately the elegance of the current system is that large and small card issuers compete on the same price grounds in the marketplace; by creating two tiers of cards, one that is more expensive for merchants to accept, over time there is no question that the market will ultimately favor the lower cost cards, thus helping large banks but hurting credit unions and community banks.

Summary

The Texas Credit Union League will be urging Congress to stop, study, and start over. We urge the Fed to do all it can to include ALL the costs permissible, with a liberal interpretation of the Dodd-Frank prescription. The Fed should ask Congress for time to study this and "get it right" – too much as at stake. A hasty rush to implement this proposal without extensive study – we are talking about the electronic payment systems network for the entire country after all – is sure to lead to devastating consequences, not because of market forces, but because of direct government intervention in the markets. Quite possibly it could needlessly push some marginal financial institutions over the edge in terms of safety and soundness. Regulators should assume the proposed new interchange fee and resulting income shortfall in their models/projections before proceeding. Under the proposed rule, FIs will be hurt, credit unions will be forced to raise other fees, and consumers will be the ultimate losers.

In sum, TCUL and its member credit unions strongly oppose the proposal and once again urge the Board to work with Congress to support a delay in its implementation. Thank you for considering our comments. If you have any questions, please contact Suzanne Yashewski, SVP Regulatory Compliance & Legal Affairs at (512) 853-8516.

Sincerely,

Richard L. Ensweiler
President and Chief Executive Officer