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

Re: Docket N0. R-1404, Regulation II
Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

On behalf of the Colorado banking industry and its members, the Colorado Bankers Association appreciates the opportunity to comment on the Board's notice of proposed rulemaking on new Regulation II, which would implement Section 920 of the Wall Street Consumer Financial Protection Act.

CBA's members represent approximately 90% of the 100 billion in assets held with Colorado banks. The industry provides Colorado with over 19,500 jobs and annually contributes upwards of $63 million in charitable donations.

CBA's member banks are concerned about the significant negative ramifications of the Board's proposed rule, how the Board arrived at the suggested fee limitation, the level of the limitation, the similar impact and limitations this will impose on the uncovered, or exempted, portion of the market, and the broad impact the fee limitation will have on bank customers, Colorado's communities, bank employees, and bank performance.

Section 920 requires that an interchange fee be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction." It then directs the Board to set standards that define what is "reasonable and proportional" in relation to the "allowable costs" defined in the statute.

Pursuant to those instructions, the Board included two alternative approaches to define and implement the "reasonable and proportional cost" provisions. Both proposals call for the implementation of a fee cap below the actual cost of a debit based interchange transaction. This is due to the narrow definition of what is defined as "allowable costs." Under the first proposal, an issuer could charge up to 7 cents per transaction. It could obtain the ability to charge an additional 5 cents per transaction after calculating "allowable costs." The second establishes a blanket cap of 12 cents.

The Board's Proposal includes inadequate consideration of necessary factors when establishing the required assessment standards, which has resulted in the Proposal requiring issuers to process debit card transactions at below cost levels. This would require an issuer to either halt the offering of a widely popular product, or raise the price of other products to subsidize the offering of a debit card.

How can a government-mandated charge that requires a business absorb a loss be "reasonable and proportional" by any standard?

The Proposal as written applies directly to covered issuers, which is defined in Section 920 as financial institutions, including affiliated companies, holding over $10 billion in assets. However, CBA and its member banks believe the statutory exemption from this proposal for institutions with less than $10 billion will ultimately be ineffective. Large merchants can use the power of market forces to drive business to lower cost cards offered by the covered issuers, leaving those exempted institutions with a less effective and less competitive debit card. This will result in either a loss of customers, and/or reduction in number of transactions processed, and/or a reduction in the charge of interchange to compete on the level mandated by this Proposal. This effectively makes the fee cap applicable to all CBA member banks that issue a debit card to customers.

CBA encourages the Board to revisit and consider its assessment of the functional similarities and differences between check based transactions and debit card based transactions, as well as consider the full scope of incremental costs incurred by the issuer to process a debit card transaction. To do this CBA encourages the Board postpone the implementation date, collect complete and accurate data and reissue a proposed rule that will not cause such adverse impact on banks and their customers as noted below.

Interchange Capped at below-Cost Rates

The statute requires the Board to consider the functional similarities between checking and debit card services when establishing reasonable and proportional costs. However the Proposal's analysis of the similarities between the two payment mediums focused solely on one aspect of the checking transaction: the authorization and clearing process. This analysis ignores numerous differences between the two payment mediums. First it excludes numerous direct and indirect expenses associated with check processing that occur outside the specific transaction clearing process. This includes deposit fees, check verification fees, employee and infrastructure costs, and fraud or bad check costs. These costs are specific to the check process and in some cases borne directly by the merchant.

Accordingly, many merchants have shied away from accepting checks and exposing themselves to these costs and hassles. Many of the same merchants accept debit based transactions though, because debit based transactions offer functional differences not offered by checks. Those include access to a network system that processes immediate transactions from virtually any location in the world; guaranteed payment of the transaction (no risk of fraud/nonpayment for the merchant); and the lack of verification fees. Debit based transactions also afford the merchant the ability to operate more efficiently through self-checkout systems, reducing employee and oversight costs.

These differences were assigned no value or consideration in the Fed's proposal, but represent real costs specific to the debit based transaction system, and exemplify important differences between the two exchange mediums. Additionally, the Proposal does not take into account additional upkeep and upgrade expenses to the expansive and complex network which can process up to 10,000 transactions a second. The Proposal's lack of allocation for real maintenance and upgrade costs will stifle future innovation of a system that has developed into a payment mechanism that is preferred by merchants over checks because of the functional differences this system affords them.

Effect on Colorado Banks' Performance

Implementation of the proposed rule would have enormous effects on Colorado banks' gross revenue. In a recent internal survey of Colorado bank President/CEOs, banks of various sizes reported that implementation of the Board's Proposal, would decrease total gross revenue from debit-based interchange fees between 30%-86%. This would amount to an approximated loss of $200 million in gross revenue in Colorado banks - over 20% of the total gross noninterest income estimated to be generated by Colorado banks in 2010.

As mentioned above, Colorado banks technically exempted from this rule overwhelmingly expect to encounter adverse effects due to the power of market forces overriding the effectiveness of the statutory exemption.

In addition to the significant loss of important revenue, Colorado banks are expecting to incur increased expenses from the statutory requirement that an issuer must enable at least two unaffiliated networks on

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its debit cards. Many Colorado banks only enable a single payment card network, and due to the limitation of choices of additional networks, many banks would be forced to offer a pin and signature based card. The implementation of a new type of card will bring about significant expense in reissuing debit cards, educating customers on how to use the card as well as why a new card is being issued, along with updating signage on ATMs and internal training.

An assessment done by one $550 million asset community bank, which currently only offers a signature based debit card, suggested that only 4 out of 950 merchants in their surrounding local market have a pin pad to take debit cards. This rule would force the bank to implement a costly system that is not utilized in their community, and educate their customers on a product they will not have the opportunity to conveniently use in local purchases.

Impact to Customers and Employees

To mitigate the additional expenses and subsequent loss of revenue caused by the Board's Proposal, Colorado banks are having to consider a wide range of adverse options that affect the employees and customers significantly. Nearly all banks responding to the internal survey stated they are considering the reduction or elimination of free checking accounts and imposing monthly or annual charges on debit cards. Other banks reported considering raising surcharges for other services such as ATMs. Some banks are reportedly having to consider making up this loss in interest-based income. This would include a rise in lending rates and/or a reduction in the interest rate paid to deposit account holders and holders of certificate of deposits.
Additionally, banks are reportedly considering a reduction in their workforce. As a direct result of this Proposal, one Colorado bank assessed the need to layoff over 25 employees and close numerous branches. Furthermore, the increase in expense and drop in revenue will make it difficult for Colorado banks to expand operations and expand their workforce in the near term.

Impact within Colorado Communities

Many of these reductions will indirectly impact Colorado communities in a negative way. Free checking accounts are a valuable tool that many Colorado banks use to attract the unbanked and establish a financially responsible banking relationship. The benefits associated with the establishment of new banking relationships help deter the patronage of high-cost payday lenders, check cashing services and other groups outside the scope of traditional regulation.

Furthermore, in Colorado, communities and nonprofits rely on the unmatched amount of charitable giving made by Colorado banks. In 2010 an estimated $63 million was donated to charitable causes and organizations located within this State. Of that, $10 million went to support affordable housing and foreclosure mitigation programs. Many banks reported that they are having to consider a reduction in charitable giving, which would impact important non-profit groups at a time when replacement funds will be hard to come by.

Thank you for the opportunity to comment on the Board's Proposal. We appreciate the Board's consideration of the impact this proposed rule will have on Colorado banks and encourage you once again to postpone implementation of a final rule until consideration of an adequate fee structure that mirrors the true costs of the debit card transaction, and acknowledges the differences between debit card and traditional checking transaction, can be reached.

THE COLORADO BANKERS ASSOCIATION

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