VIRGINIA HERITAGE BANK
Building Prosperity Together

February 14, 2011

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

Re: Debit Interchange Fees and Routing;
Docket No. R-1404 and
RIN 7100-AD63

Dear Ms. Johnson:

I am writing on behalf of Virginia Heritage Bank (VHB) to comment on the Federal Reserve Board's proposed new Regulation II (Debit Card Interchange Fees and Routing) to implement Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

I. General Comments

VHB is very concerned about the harm the proposed interchange fee limitations would do to banks and the customers and communities we serve. These fee limitations are price controls of the kind that have had a poor record in our economic history. We estimate these price controls will result in a 70-85% reduction in debit interchange fee revenue for the banking industry. This amounts to a loss of more than $14 billion to the industry per year. Such a dramatic loss in revenue will negatively impact the ability of banks to support our payments system – a system under which consumers and retailers have benefitted enormously. We believe some of the efficiencies we take for granted in our payments system will come under stress, and innovation and improvements to the system that otherwise would have occurred will not happen if this proposal is adopted in its current form.

Moreover, banks will be forced to look elsewhere to try to recover this lost revenue. Undoubtedly, deposit account fees will rise as a result of this rule, hurting bank customers and driving some out of the banking system and into cash checkers and payday lenders. Perhaps most importantly, these price controls will strain bank capital such that banks will have fewer resources to make job-producing loans to support our economic recovery.

These price controls, under which banks will not even be able to capture all their costs, simply represent a transfer of $14 billion from the banking industry to big-box retailers to add to their bottom lines. Many more will be hurt by this than helped. In sum, this proposal will harm the debit payment system upon which consumers and retailers rely, create new costs for bank deposit customers, and hurt the ability of banks to serve their communities and stimulate economic growth through loans and other services.

II. Exemption for Small Issuers

The Dodd-Frank Act and this proposal exempt from the price controls any issuer which, together with its affiliates, has assets of less than $10 billion. In establishing this exemption, Congress intended to insulate community banks and small credit unions from the harmful effects of the interchange fee limitations. Unfortunately, this exemption will not work in practice.

In particular, the exemption assumes that the networks will establish a two-tiered pricing system (a technological challenge) under which the smaller financial institutions such as VHB would be able to charge and collect interchange fees at the current rates. The reality, however, is that retailers will have a strong incentive to steer customers to the larger issuers that are subject to the fee restrictions in order to save money. Retailers will seek special relationships with the larger issuers and reward customers who use these issuers' cards. In the end, the smaller issuers will be forced to lower their fees to the same levels as the large issuers in order to compete in the marketplace, or simply get out of the debit card business altogether. Thus, small banks and credit unions like mine will be subject to the interchange fee price controls to the same extent as the large issuers, but with fewer resources to absorb the costs The exemption in the law is illusory and we would urge the Board to keep this in mind in finalizing any interchange fee rules.

III. Allowable Costs

The Dodd-Frank Act provides that "[t]he amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction." In implementing this provision, the Federal Reserve has limited "allowable costs" to those associated with the authorization, clearing, and settlement of a debit transaction. In doing so, the proposal includes variable costs, but excludes important fixed costs and network fees in the calculation of the amount of permissible interchange fees.

We believe the proposal represents a much too narrow interpretation of the statute and fails to capture the actual costs issuers incur in order to provide and maintain debit card services for their customers. In this regard, such fixed costs as capital investments should be included in allowable costs. Likewise, issuer costs to respond to customer inquiries and disputes, the costs of printing debit cards, and fraud losses and fraud prevention should be included. Any network fees paid by issuers should be included in allowable costs as well. Importantly, all these costs are "specific" to debit card transactions. This is important because the statutory language only excludes "costs incurred by an issuer which are not specific to a particular electronic debit transaction ...." Thus, these costs that are specifically related to debit card transactions can and should be included in "allowable costs" for the purposes of calculating the permissible fees under the proposal. We would urge the Board to adopt criteria that would include any and all costs incurred by an issuer in order to offer debit cards to its customers, as well as an appropriate return on investment, in determining allowable costs in any final rule.

IV. Interchange Fee Standards

The proposal sets forth two alternatives for determining the amount of interchange fees that would be allowed. Under the first alternative, an issuer would calculate its costs attributable to its role in the authorization, clearance, and settlement of a debit card transaction and would be allowed to receive or charge interchange fees based on those costs, but subject to a cap of 12 cents per transaction. Also under this alternative, the issuer could simply charge a safe harbor amount of 7 cents per transaction regardless of costs. Under alternative two, an issuer could receive or charge an interchange fee up to a cap, which would initially be set at 12 cents per transaction. Thus, under the two proposed alternatives, an issuer could receive or charge only 7 to 12 cents per transaction. (The average interchange fee for all debit transactions in 2009 was 44 cents.)

The proposed range of allowable fees – 7 to 12 cents – is simply unworkable. Such amounts would represent a dramatic reduction in fees and simply would not include all of the costs incurred in connection with debit card transactions, as noted in III above. These simply are not "reasonable" proposed fees.

We would note our preference for a straightforward safe harbor approach, as set forth in alternative two, so that banks and others do not have to incur the significant expense of calculating allowable costs. Again, however, any such safe harbor amount should be much higher to reflect the true costs incurred by issuers with respect to debit card transactions.

V. Network Exclusivity and Routing Restrictions

The proposal seeks comment on two alternatives to implement the prohibition on an issuer or payment network from restricting the payment card networks on which a debit transaction may be processed to fewer than two unaffiliated payment networks. Under the first alternative, an issuer could comply by having one payment network for signature debit transactions and a second unaffiliated network for PIN debit transactions. Under the second alternative, an issuer would be required to have two unaffiliated networks for signature debit transactions and two unaffiliated networks for PIN debit transactions. We urge the Board to adopt the first alternative. In this regard, we would emphasize that this provision will require banks to enter into contracts with additional networks and pay new network and gateway fees. This will have a particular negative impact on community banks and credit unions whose resources will already be strained as a result of the interchange fee restrictions. For this reason, it is important that the Board avoid the second alternative described above.

With respect to the proposed routing restriction, we are concerned that merchants will now ignore the issuer's routing instruction and select the lowest cost option. Our concern here is that the "cheapest" network is not always the safest and most reliable one. We urge the Board to reconsider its approach on this issue in finalizing this rule.

In conclusion, we would ask the Board to make changes to the proposed rules to minimize the harm that otherwise may occur to the banking industry and the consumers, businesses and communities we serve. Thank you for your consideration.

Sincerely,

David P. Summers
Chairman of the Board and CEO