ARVEST®

February 22, 2011

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

Submitted via reg.comments@federalreserve.gov

RE: Docket No. R-1404/RIN No. 7100 AD63
Proposed Rule for 12 CFR 235-Debit Card Interchange and Routing

Dear Ms. Johnson:

We appreciate the opportunity to submit comments on the proposed rule noted above intended to implement Section 1075 of the Dodd/Frank Act ("DFA"). Arvest Bank is an Arkansas-chartered commercial bank with over $11 billion in consolidated assets at December 31, 2010 and that operates over 230 banking locations in Arkansas, Kansas, Missouri and Oklahoma. We also operate over 300 ATMs in our trade territory.

For many years Arvest has made available a wide range of payment options to our transaction account holders including traditional checks, credit cards, ACH, online payments and wire transfers as well as debit cards. Debit cards have been extraordinarily well received by account holders, in large part consumers, as well as welcomed by merchants who have found debit cards to be a safe and highly convenient form of payment by their customers. In addition, we believe our merchant customers find debit cards to be a fast, safe and efficient method of taking payments from their customers. We estimate that well over 50% of all payments from checking accounts for our customers are for debit card transactions.

GENERAL COMMENTS

1. Section 1075 of the Dodd/Frank Act. Unfortunately, Section 1075 is a poorly crafted section within DFA attempting to implement a dangerously flawed logic to what is a business-to-business transaction. Price controls are an extreme measure that should be reserved for extraordinary situations, such as where a business has monopoly power over the pricing, quality and delivery of its products and services or in cases of national emergencies. This is hardly the case with debit cards which is a product with thousands of providers and millions of customers. Price controls have deleterious effects on commerce and trade resulting in misallocations of economic resources which in turn directly and adversely affects economic development and job creation. The fundamental flaw is that no government body will be as efficient in determining the " ... reasonable fee ... " as will market participants engaging in negotiated business arrangements.

   The law is further poorly worded with conflicting use of terms or concepts such as "reasonable fee", "reasonable and proportional" and "incremental cost". This only demonstrates the fallacy of Congress or an agency trying to devise a formula for a price.

The end result is the Federal Reserve is placed in the position of having to try to write a rule to replace a market function. We urge the Federal Reserve to take a broad view of the business transaction involved and refrain from volunteering to become the "cost accountant-in-chief" for the debit card industry.

2. Adverse impact on cardholders. It is astonishing and ironic that the same federal law creating a new federal agency for consumer protection also puts in place price controls that will lead to higher costs to consumers or less availability of checking and payment services to consumers. The extent of this adverse impact on consumers is directly related to how the Federal Reserve develops the price control rules. Card issuers will naturally look for, and find, ways to replace lost revenues resulting from price controls, either through charging new fees, increasing existing fees or reducing costs by reducing product offerings and service levels. To the extent issuers must resort to cost reduction efforts, losses of jobs in the banking industry is quite likely. This is surely not what Congress intended but it almost assumedly will be the outcome. This is another important reason the Federal Reserve should take a broad perspective in establishing any price control rule.

   Assuming the price-controlled fee levels in the current proposed rule survives, we estimate the lost revenue to card issuers to be in a range of $150 to $250 per year per household. This is a very significant portion of the total revenues a bank can expect to earn from a household and will cause major changes adversely affecting consumers.

   We were very surprised that the Federal Reserve is endorsing and even promoting cross-subsidization of debit cards by other products. This is evident on Federal Register Page 81736 (Volume 75, No. 248, 12/28/10) as quoted below:

   > " ... the Board also recognizes that issuers have other sources, besides interchange fees, from which they can receive revenue to help lower the costs of debit card operations."

   This logic is tantamount to asserting banks should offer debit cards as a loss leader and make up the lost revenues from possibly higher rates on loans, lower rates on deposits, additional or higher fees charged to consumers and the like. While cross subsidies may occur in the market, especially in packaged products, the market is between provider and customer, each free to choose what best suits their needs. For a federal rule to rely on cross subsidies is simply bad policy and a dangerous precedence.

   This is another important reason the Federal Reserve should take a broad perspective in establishing any price control rule.

3. Narrow view of increased costs. The essence of the law is found in Section 1075 (a)(2) of DFA in the new Section 920 (a)(2) to the Electronic Fund Transfer Act ("EFTA") entitled "Reasonable Interchange Transaction Fees" as follows:

   > "The amount of any interchange fee that an issuer may receive or charge with respect to an electronic debt transaction shall be reasonable and proportional to the cost incurred by an issuer with respect to the transaction."

   The price-controlled fee as proposed by the Federal Reserve is 7-12 cents (Federal Register Page 81726, Volume 75, No. 248, 12/29/2010) under "Summary of Proposal". This fee level is about 16-27% of the average transaction fee (44 cents per transaction) reported by the Federal Reserve based on the survey of large debit card issuers. Some industry sources have estimated the amount of reduced interchange fees to be at least $12 BILLION annually. This is a stunning amount that represents nearly 11% of pre-tax earnings of all affected US banks and thrifts over $10 billion in assets for 2010.

   The law goes on to require the Federal Reserve to "consider" the functionality of debit cards and checking transactions and to "distinguish between ..... incremental costs ..... and ..... other costs". Furthermore these "other costs" are not to be "considered" in the " ... reasonable and proportional ..." analysis. In the proposed rule, the Federal Reserve is taking an unnecessary and arbitrarily very narrow view of this language. Separating debit card costs between "incremental" and "other" can be done and still take a broader view of " ... reasonable and proportional ...".

Similarly, the law uses the phrase " ... particular electronic debit transaction ..." in the EFTA amendment language found at Section 1075 (a)(2) in Section 920 (a)(4)(B)(i) and (ii). An initial reading of this phrase can easily be construed as equivalent to the "next transaction" which then leads to the way the Federal Reserve has drafted the rule.

However, this logic presumes the "first transaction" is the reason for all fixed cost and the "next transaction" is not connected at all to the fixed costs. Of course, this is not how any process works. In the broader view, "incremental costs" refers to all cost necessary to provide and support debit cards and underlying activity as compared to costs incurred unrelated to debit cards. Unfortunately, the language of the law appears to confuse "direct costs and "incremental costs" and the proposal furthers the confusion with an overly narrow view of what is includible.

There are clearly "direct costs", including both variable and fixed costs, of debit cards that are all "incremental" to the card issuer due to debit cards. In this reading the "other costs" are costs which bear no relation to debit cards. Finally, the law only requires the fee to be " ... reasonable and proportional ..." in relation to " ... the cost incurred by the issuer ...". The normal concept of cost includes not only direct operating expenses but also a means of allocating indirect costs and a "cost of capital" (or return on investment) to support the business activity. Furthermore, the concept of "reasonable" can only rationally be taken to include a "fair return on investment", otherwise in the long run the product would not be offered and available. To deny a business an ability to cover these costs plus a fair return on investment is patently unreasonable and seemingly a violation of the law. Even regulated utilities with a franchise monopoly are allowed rates designed to cover virtually all reasonable operating expenses plus a return on capital invested.

The Federal Reserve could adopt the view that the proper cost basis is the "direct costs" (including fraud losses which are absorbed by issuers as long as merchants perform their limited duties) to provide debit cards along with a "fair rate of return" for the type of service being provided. This would result in a "reasonable" fee that is also "proportional" to "costs incurred".

We believe the Federal Reserve's approach is inconsistent with the language of the law and will result in an interchange fees that are not reasonable. For this reason alone we strongly encourage the Federal Reserve to withdraw the proposed rule and further study how to develop the rule. At a minimum, the proposal needs much more time to perform studies of how best to design a process that results in a reasonable fee and to revise the proposed rule to reflect those design changes. Even if this process takes two years to complete, because of its pervasive negative impact on profits of the banking industry profits and/or higher fees to consumers, it is very important to get this right and not to succumb to the pressure to get it done fast.

<u>COMMENTS ON REQUESTED ISSUES</u>

Following are comments on selected issues for which the Federal Reserve has requested comments.

1. <u>Interchange Fees under "Alternative 1" vs. "Alternative 2"</u>

   It is not clear why these are presented as alternatives. There is no benefit of spending time and effort to justify an interchange fee based on issuer-specific cost when the fee is capped at 12 cents as compared to Alternative 2 which would set a flat 12 cent fee without issuer analysis of cost.

   The more important question that is not asked is why should the rule impose a cap when the law clearly does not? In fact, there is no apparent statutory authority to impose a cap.

   Once again, a far better approach is to allow for market competition to set prices. We believe there are ways to accomplish this well short of a federal price control regime.

   It should be noted the law actually only requires the Federal Reserve " ... to establish standards for assessing whether the amount of any interchange transaction fee ... is reasonable and proportional to the cost incurred by the issuer". No where does the law require (or authorize) the Federal Reserve to set a specific fee, much less a cap.

   Furthermore, it is not clear how often the price-controlled fee would be adjusted for inflation. To do so less often than annually is unacceptable.

Rather than establish arbitrary price controls, we urge the Federal Reserve to withdraw the proposed rule and develop a market approach to determining the interchange fees that avoids federal price setting.

2. Network Exclusivity Under "Alternative A" vs. "Alternative B"

Alternative A is the more practical and reasonable approach to carrying out the language of the law. We estimate Alternative B would require re-issuance of all debit cards issued to our cardholder at a cost of $2 or more per card. The aggregate cost of the reissue would easily exceed $1 million for us. Interestingly, none of these costs would be considered as "allowable costs" under the proposed rule. However, these costs are a direct, incremental and necessary cost of debit card transactions. From a consumer perspective, such a reissue also would inconvenience cardholders and the more data encoded on the back of cards increases the likelihood of errors. Also, a mass re-issue of cards by thousands of issuers in a small window of time is inviting identity thieves.

3. Extension of Rule to ATM Transactions and ATM Networks

The law is clearly intended to address debit card transactions which are transactions between an issuer, a cardholder and a merchant. An ATM transaction has a fundamentally different nature entirely and includes only banks and cardholders. There is no compelling reason to extend a law designed for purchase money transactions to ATM activity. We believe to do so is unquestionably beyond the scope of the law. Interestingly, this question is clear evidence the Federal Reserve understands these are different types of "electronic debit transactions" in support of our General Comment #3.

SUMMARY

We believe the proposed regulation is so flawed that the Federal Reserve should withdraw the proposal entirely and do a re-evaluation of how to implement the law without the use of arbitrary price controls. Since the law only requires establishing standards for assessing that a fee is " ... reasonable and proportional ... to cost incurred by the issuer ... ", we believe there is far more flexibility in meeting the law than the proposal encompasses.

Sincerely,

K. Kevin Sabin
President and Chief Operating Officer

cc: Ms. Candace Franks, Arkansas Bank Commissioner
Mr. James Bullard, President, Federal Reserve Bank of St. Louis