



02/22/2011

Jennifer J. Johnson
Secretary
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Washington, DC 20551

Re: Docket ID: R1404

Dear Ms. Johnson

While First Interstate Bank is not opposed to the law's intent of ensuring merchants pay only reasonable rates when they process customer debit card transactions, we feel that the rules (and underlying law) fail to fully consider the impact of such rules on community banks across the nation. Further, we believe the restricted definition of cost and the short time frame for implementation will significantly impact community banks and will most certainly harm the consumers and communities they serve. It is for these reasons we would like you to consider our following observations:

Issuer Interchange Fee

Large Bank Interchange Fee Limitation

While First Interstate Bank (FIB), has assets below \$10 billion, the rule limiting the amount of interchange fees we can charge are not directly addressed by the Board's proposed rules. However, it would be remiss to conclude that the proposed rules provide smaller banks with any protection from downward fee pressures. It is our belief, as it is in the industry, that the significance of the reduction in revenue imposed on larger institutions will undoubtedly result in reductions in revenue for those banks under \$10 billion in assets. Market pressures alone will force payment networks to provide some level of competitive pricing so as to not disadvantage their large bank participants. Unfortunately, the law and proposed rule do not provide smaller institutions with any firm protection and leaves fee level determination for smaller institutions to the payment network. While it is possible that these payments networks will provide a slightly higher fee to the smaller banks, it is reasonable to assume that community banks will see severe curtailment of this critical revenue stream.

Such a curtailment in revenue is unfortunate for the smaller banks as their transaction costs are consistently higher than their larger competitors, thus making their margins significantly smaller. While it is easy to conclude that smaller banks can absorb these revenue reductions, that conclusion would be inaccurate and would certainly fail to realize the full impact on consumers.

Community banks have historically depended on interest margin to maintain profitability. They are more in tune with their communities and have relied on revenues such as interchange fees to offset costs associated with maintaining our customer accounts. A reduction of these fees will make it more difficult for banks such as ours to provide our customers with some of the products and services that are currently provided at no or very little cost. As a result, it is reasonable to assume that the costs of these products and

services will need to be passed on to the customer or we may have to discontinue providing these services and products all together.

We are firmly against any price fixing measures and believe the free market would best ensure the fair value of services. If, however, the Board move forward with this we ask that firm protections for ensuring community banks are protected from unreasonable fee schedules.

Allowable Costs

One of the most significant issues that seem to have been forgotten in the interchange analysis, is the restricted definition of costs that can be included when determining a fair and reasonable interchange fee. The rule (as dictated by the underlying law) limits what costs can be considered and as such, does not reflect the true costs banks incur when providing this product. Providing debit cards to consumers instantly becomes a losing proposition for banks if they are only allowed to recover costs as defined. Infrastructure cost, settlement and reconciliation, customer support, card issuance, transaction posting, compliance and dispute handling costs cannot be considered, but can comprise a substantial portion of the cost of these products. This is especially true for community banks that do not have the scale to spread these costs over a larger customer base.

We are gravely concerned that the allowable fee calculations do not assess all the necessary costs of providing this service and that banks are not compensated for the value they provide to merchants including increase consumer buying power, increased cash flow speeds and the transfer of payment risk to the banks.

Network Exclusivity

While the rules and underlying law provides smaller banks an exemption regarding interchange fee levels, all banks are subject to the rules regarding Network Exclusivity and Merchant Prohibitions. The final rules governing the prohibition of network exclusivity on the part of issuer have not yet been determined. However, either option would have direct impacts on smaller community banks. Generally speaking, the rules would require that issuers provide merchants with more than one option when settling a debit card transaction. The assumption is that merchants could select the least costly network when processing a debit card transaction. We believe this will have a significant impact on community banks.

Most larger banks have volumes that allow them to negotiate favorable terms with networks and, if needed, could add an additional network with little or no disruption. However, smaller banks with lesser volumes are often faced with a more difficult challenge to negotiate reasonable contracts. As such, many have entered into exclusive contracts with networks to offset this weakened negotiating position. The rules do not provide any guidance or protection for those banks that are currently bound by an exclusivity arrangement, leaving many of us uncertain how to implement this rule without violating current contracts. Requiring smaller banks to expand their network participation will most certainly result in increased costs for these banks. Unfortunately, this part of the rule will largely benefit large merchants. Most of the merchants in our states are small businesses and most likely will not have the ability to automatically route transactions in a manner that would take advantage of lower costs.

We are against requiring more than one network option for PIN based transactions as our volumes would result in less than favorable terms from payment networks, further impairing our ability to offer this service.

Merchant Prohibitions

There has been considerable discussion regarding the language in the Act that would restrict merchants from pushing customers toward lower cost cards. Many have stated that merchants would not be allowed to institute discount programs that would offer consumers incentives to use one card over another (lower fee, large bank card over a higher fee, small bank card). Our interpretation is that while the rules prohibit networks from restricting merchants from incenting customers to use one type of payment over the other (i.e. credit versus debit), it leaves the network in control over whether current restrictions that prohibit merchants from incenting customer to use cards from one issuer (large bank debit card) over a higher cost issuer (smaller bank debit card) will be enforced. While it is true that networks have historically enforced such restrictions, these were not mandated and could be changed at the networks discretion.

We believe that the law and rules do not address acquirer interchange or network fees paid by merchants. The financial incentive for networks to continue these prohibitions is significantly reduced. Additionally, the larger banks control 95% of the acquirer interchange fee revenue and own the vast majority of the transaction volume that drive network fees. Therefore, it is reasonable to assume that pressure from these larger banks could result in a relaxation (or elimination) of these network restrictions. Such actions would put smaller banks at a definite competitive disadvantage.

We request the networks be REQUIRED to continue to prohibit incentives for the use of one issuer's card over another. We also suggest the Board consider the lack of fairness of not including acquiring interchange fees and network fees to community banks.

Unintended Consequences

Customer Impact

The underlying objective behind the law, as passed, is that merchants would pass on these lower costs to consumers. Unfortunately, there is no language in the law or rules that would ensure consumers benefit from these changes. It is also based on the assumption that all revenue received by banks is taken directly to the bottom line. As noted above, banks such as FIB have used revenue from these activities to support products and services offered to our customers that we could not provide otherwise without charging them fees. Losing this revenue will make it more difficult to provide these products to our customers. Additionally, community banks do not have the revenue diversity to offset revenue losses that is available to larger banks, leaving community banks at a clear competitive disadvantage. The result will be the need to derive revenue from our customers directly and hope that these increases are offset by merchant reductions. However, there are no guarantees that this will occur and consumers in our country will see the same increased costs that Australian consumers experienced when a similar law was enacted in that country.

Competition and Innovation

The payment world is changing at a pace never seen before. Once an area dominated by banks, new competitors are entering the market every day. Companies such as PayPal, Google, Verizon and American Express are beginning to play a larger role in managing payments. While the Board asked for comment on how to address these payment players, there does not seem to be much indication that the banks will have a level competitive playing field in which to compete with these types of organizations. The larger national banks may have the resources to address new payment opportunities and competitors. Smaller banks, however, will struggle to provide customers with competitive options as the reduction in capital resulting from these rules limit their ability to adopt payment innovations such as mobile payments. If smaller banks cannot provide these types of services to their customers, retention of these customers will become infinitely more difficult.

We strongly request that the Board ensure a level playing field by imposing the same or similar restrictions and levels on three-party networks and new payment competitors such as PayPal. Not doing so would result in banks be competitively disadvantaged.

Community Involvement

Another unintended consequence of this regulation is the negative impact to the communities we serve. As their name suggests, community banks have consistently been active members of their communities, much more so than their larger counterparts. We regularly contribute to a myriad of organizations and activities that directly enhance the communities in which we live. At FIB, commitment to community is one of our core values. We are able to help make our communities better places to live and work because we have the resources to contribute. The downward pressure on our revenue streams from this regulation, coupled with the increased regulatory burden and slow economic environment, will restrict our ability to continue to support our communities at the level we and they have become accustomed to over the years.

Conclusions and Suggestions

As noted above, we do not disagree with the need to ensure merchants are provided with reasonable rates when processing debit card transactions. Our concern is that the new rules will likely not provide our customers (merchants and consumers) with any significant relief. At the same time, it will leave community banks at a significant competitive disadvantage. While it would be ideal if we could go back to square one and come up with a solution that is fair to all parties, we know that such a request would not likely be considered. As such, we would ask you to consider some or all of the following suggestions:

- 1) We request the Board refrain from final issuance until it has addressed the fraud preventing adjustments and are firmly opposed to the technology-specific standards option. Such rule would place community banks as a disadvantage.**
- 2) Expand what can be included in the calculation of costs used for determining interchange fee limits to include all debit card related activities. We would also suggest that the FRB be allowed to consider the**

value provided to the merchant when accepting debit card payments. These would include faster collection of funds and the transfer of fraud and transaction dispute risk (currently borne by the issuing bank).

- 3) Extend the timeline of July 21, 2011 to July 21, 2013, to allow community banks to have a better understanding of the competitive landscape and to define better strategies to address these changes.**
- 4) Adopt language that would directly prohibit merchants from incenting customers from using one debit card versus another. We understand that networks currently prohibit these types of programs but, nothing in the ruling would require them to remain in place.**
- 5) We believe that an exemption should be allowed for community banks. We also request that the Board expand the network exclusivity rule to allow smaller banks to engage regional payment networks rather than requiring national network options. The vast majority of smaller bank customer debit card activity occurs within the region they reside, so it is likely that a national network would not provide much benefit to merchants that serve small bank customers.**
- 6) Ensure that non-bank competitors such as PayPal, Verizon, American Express, etc. are subject to the same rules and revenue limitations placed upon commercial and community banks.**
- 7) Provide exemptions for the process of payments using new technologies, such as mobile payments, to allow for banks to recover their investment in the development of these customer directed solutions.**
- 8) Offset some of the reduction in issuer interchange fees with reduction in the acquiring interchange and network processing fees also paid by the merchant. As the law and rules stand today, the issuing bank bears all of the cost of the reduction in fees while the two other major players are not impacted at all.**

We understand and support the need to ensure that all parties in this debate are treated fairly and feel it is necessary to provide merchants with some relief. We only ask that you review the impact of this law (and rules) on merchants, consumers, banks and communities. Thank you for your consideration of our observations. We would gladly meet with you to discuss anything further, upon your request.

Sincerely,

Kevin Guenther
Senior Vice President and Chief Information Officer
First Interstate Bank
Billings, MT 59116-0918