IBC BANK
We Do More

DENNIS E. NIXON
Chairman of the Board

February 27, 2024

Via online submission:

Board of Governors of the Federal Reserve System
Ann Misback, Secretary
Attn: Docket No. R-1818; RIN 7100-AG67
20th Street and Constitution Avenue NW
Washington, D.C. 20006
https://www.regulations.gov

Re: Comments on Notice of Proposed Rulemaking Regarding Amendments to Regulation II: Docket No. R-1818; RIN 7100-AG67

Dear Ms. Misback:

The following comments are submitted by International Bancshares Corporation ("IBC"), a publicly-traded, multi-bank financial holding company headquartered in Laredo, Texas. IBC maintains 166 facilities and 256 ATMs, serving 75 communities in Texas and Oklahoma through five separately chartered banks ("IBC Banks") ranging in size from approximately $470 million to $8.9 billion, with consolidated assets totaling approximately $15 billion. IBC is one of the largest independent commercial bank holding companies headquartered in Texas.

This letter responds to the Notice of Proposed Rulemaking ("Notice") by the Federal Reserve Board ("FRB") regarding certain proposed amendments to Regulation II.

Regulation II implements many requirements of the Electronic Funds Transfer Act ("EFTA") related to card issuers and payment networks. Specifically, 12 C.F.R. 235.3 and 235.4 implement the "reasonable and proportional interchange transaction fees" and the "fraud adjustment" amounts that issuers may charge related to card transactions.

The new proposal would adjust the maximum debit interchange fee to reflect (what the FRB states are) decreases in issuer costs since the initial rule first took effect in 2011. The new proposal encompasses three components: a base component fee for transaction costs that is being lowered from the original 21 cents to 14.4 cents; the ad valorum component (the estimated value of the transaction), which is being lowered from 5 basis points to 4 basis points; and a fraud prevention adjustment, which will increase slightly from 1 cent to 1.3 cents.

General Comments

Timing

P.O. DRAWER 1359 LAREDO, TEXAS 78042-1359 (956) 722-7611 www.iboc.com MEMBER INTERNATIONAL BANCSHARES CORPORATION-FDIC

1. IBC is deeply concerned by the FRB's proposed revisions to the debit card regulations impacting the debit cards of hundreds of millions of Americans. It is IBC's understanding that the FRB is currently under litigation intended to force it to revisit this very question and that the U.S. Supreme Court recently granted the litigants' certiorari petition. IBC urges the FRB to retract or postpone its proposed changes to Regulation II until that case is resolved. Moreover, the proposed interchange amendments suggest the appearance of impropriety given that a defendant federal agency is changing course through regulatory action to benefit plaintiffs (re merchants) while the government expends resources to defend its prior actions in this space. The FRB's proposal is taking place within weeks of the Supreme Court granting merchants' certiorari, creating the appearance of surrendering the FRB's position administratively.

2. IBC also urges the FRB to defer making any proposed or actual changes to Regulation II due to a current lack of adequate data to support policymaking, as well as the foreseeable negative impact on consumers and their financial accounts and services. In the Fall of 2021, the FRB published a proposed Regulation II amendment that would require issuers to allow an electronic debit transaction to be processed on at least two unaffiliated payment card networks. At that time, IBC commented on the proposed amendments and argued the same to the Senate Judiciary Committee, stating its strong objection to the amendments. Those amendments were finalized in the Fall of 2022. Only now is data starting to come in showing the effect those additional debit routing requirements are having on financial institutions and payment network and issuer competition. Notably, IBC understands that all anecdotal evidence is that the routing rule amendments are reducing net interchange paid to issuers in ways that are directly relevant to evaluating the covered issuer cap currently under review and revision by the FRB. Some of these impacts relate to issuer fraud mitigation and costs, but these costs and changes are simply too recent to be accurately measured by the data collections the FRB is relying on and proposing to rely on in the future. The FRB's proposed dataset and its inapplicability to the current fees and costs incurred by issuers and payment networks is distorting and degrading the usefulness of the dataset. The FRB should gather cost data on dual routing to obtain an accurate representation of issuer costs before proposing any changes to Regulation II. The original interchange caps were implemented in 2012 and the FRB has not changed them since that time. And now, after recently implementing a huge, cost-increasing change to debit card processing, the FRB finally chooses to update the interchange cap *yet still* relies on old data collected prior to the mandatory routing changes. The FRB chose to address routing mandates prior to re-evaluating the interchange cap. It must now accept the fact that only data collected after those routing amendments became effective should be used to re-calculate the interchange cap. Any position to the contrary would be wholly specious and in bad faith.

3. The FRB's proposed Regulation II amendments are also inappropriately timed given the current fiscal and monetary environment. Interest rates are skyrocketing

due to FRB action to cool inflation, bank failures are occurring at volumes not seen since the Great Recession, and many small and mid-sized banks are either greatly decreasing current and proposed products and services or simply being acquired by larger institutions. If the FRB further decreases the amount of the interchange cap, banks will continue to bleed money through operational costs and losses. IBC strongly urges the FRB to simply give banks time to consider the new banking environment and adjust accordingly before overturning a ten year old, never changed rate cap. Banks deserve a moment to plan their next steps in a safe and sound manner, and too much has and is changing to also have to consider and address an interchange cap quagmire.

Costs and Fraud

1. Regarding costs and liability obligations, Regulation E ultimately serves to place additional, costly fraud and error resolution obligations on card issuers. These costs and liabilities are completely borne by issuers, while merchants face no increased costs or liabilities. Interchange fees are functionally the sole hope of issuers to mitigate and recover these costs. Card issuer banks have no flexibility in adjusting and accounting for these fraud costs and losses. At best, interchange and card network processing fees and revenues are razor thin, but with the increased options for both card present and card-not-present transactions, fraud has also skyrocketed. The proposed amendments fail to consider the impacts on banks while ignoring the tremendous benefits card issuers have been able to provide to merchants and consumers, all while the merchants argue for heavy-handed and sweeping regulations on card network processing fees.

2. Fundamentally, IBC believes that the FRB and Regulation II do not fully appreciate and consider the effect that Regulation E losses have on card transactions. The FRB notes that the cost of processing debit transactions, including card-not-present transactions, has decreased, but it does not fully appreciate the related increase in fraud and error resolution costs. These costs have skyrocketed due to increased electronic transaction activity, including card-not-present transactions and Regulation E and payment network obligations on card issuers. Card-not-present transactions are more prone to fraud and result in more costs and losses than typical debit transactions. Notably, most of the large payment networks provide additional liability protection to consumers for fraudulent transactions, which is included in the additional costs to card issuers. The FRB has noted that, in 2019, merchants absorbed 56% of such losses, card issuers absorbed 35%, and consumers only 9%. (2021 FRB Memorandum re Proposed Amendments to Regulation II, page 8) The FRB has previously lauded the increase in single-message network processing of card-not-present transactions, yet also stated that the increase is due to changes like no longer requiring PIN entry. These changes are only helping to *increase* fraud, which results in increased losses due to the expansive protections provided to consumers. The FRB itself attempts to rug sweep the glaring increase in fraud losses for card issuers: between 2011 and 2019, fraud losses as a share of transaction value grew 50%. (2021 FRB Memorandum re Proposed Amendments to Regulation II, page 8) The FRB and

other agencies have placed so many additional burdens and costs on card issuers, and card holders have benefitted greatly from these additional protections, but there has been no related outlet to recover or decrease costs related to card transactions and processing. IBC strongly urges the FRB to consider these additional costs in light of the proposed amendments.

3. The FRB states that it is not inviting comments on the allowable costs considered for purposes of the interchange fee standards because its prior analysis remains sound. [Notice at 78113] IBC strongly objects to this position and asks that the FRB revisit its allowable cost analysis. The previous analysis was conducted well over ten years ago. Since that time, Regulation E and its fraud and liability obligations have matured, along with all manner of bank and financial schemes and fraudulent activity. Banks are required to shoulder massive fraud liability, and even the most attentive and proactive banks cannot avoid incurring large liability for rampant consumer fraud by non-bank bad actors. If the regulators cared about decreasing costs for merchants and consumers, they would focus on identifying, punishing, and preventing non-bank bad actors from committing financial fraud and crime. IBC cannot imagine what data the FRB is relying on that says fraud losses (which the FRB bases the *ad valorum* calculation on) have decreased. This simply cannot be true, but is rather only possible due to the FRB cherry-picking data to back into its preferred conclusion. Even taking the assertion at face value, any decrease in fraud losses would only be possible because of the proactive, constant, and exorbitant costs incurred and resources spent by banks on fraud monitoring and prevention solutions. The FRB refuses to acknowledge the time, money, and human effort required in these endeavors. There is an old proverb in IT that when technology is sufficiently funded and overseen, it works without anyone noticing; because it apparently works just fine and no one sees "behind the curtain," funding and resources eventually get cut; because funding and resources get cut, IT systems start to break and malfunction. Currently, banks are doing their absolute best to throw resources and money at solutions to prevent and manage fraud; this system works, so fraud losses (allegedly) go down; resources get cut (i.e., interchange income decreases) and the system breaks and fails; fraud losses skyrocket. The FRB seems to be doing its best at chipping away at the progress banks have made in managing and preventing fraud. The FRB is rewarding this hard work by pulling the rug out from underneath banks and the proposed revisions to the interchange cap will absolutely gut all of the systems and frameworks banks have built to manage financial fraud.

   While banks valiantly fight to prevent and stop fraud, it is akin to playing whack-a-mole on a grand scale. Fraudsters are legion, and refuse to give up. With the ever-increasing availability of artificial intelligence (AI) and machine learning tools, bad actors have a broad arsenal of weapons at their fingertips for relatively cheap, as compared to the potential windfall they could gain through successfully hacking financial accounts. In response, banks have had to greatly increase their spending and resource allotment to building and implementing tools to prevent AI and other technologies from contributing to consumer fraud. As always, banks are left footing

the bill for these bad actors. When banks try to re-structure fees and services, they are more often than not then punished by the regulators for either assessing "junk fees" or not providing robust and full-menu access to financial products and services to every consumer who walks in the door. Moreover, the absolutely exponential growth in online and electronic banking products and services, and the ubiquity of technology to access them, have resulted in an identical increase in fraudulent activity. While this growth has also resulted in more competition for payment processing, the decrease in cost and price has been nowhere near the increase in costs related to fraud and other processing and regulatory considerations. For every economy of scale or competitive entrant helping to decrease processing costs, there is a new regulation increasing the cost of payment processing compliance. The federal banking regulators refuse to give banks time and opportunity to use, enjoy, and grow options that may reduce costs and instead take every chance to increase banks' cost of regulatory compliance either through new disclosure, recordkeeping, fraud and liability, or investigatory obligations.

4. In addition to the financial environment and increasing costs generally, if banks are unable to generate at least moderate revenue through interchange fees, consumers will ultimately be harmed as banks will be required to discontinue their most consumer-friendly products and services. Currently, banks only recover roughly fifty percent of their costs from non-interest revenue. The margins are simply too thin to give up any room on non-interest revenue. Regulation II and its previous amendments have harmed customers of depository institutions, increasing checking account fees and minimum balance requirements following the implementation of Regulation II, all to the benefit of large merchants. Retailers argued for lower debit transaction fees on the basis of passing on the savings to their customers, and we now know that *this never happened* and it *will not happen* even if the amendments are passed as drafted. Large retailers even bragged and reported how their profits increased because of the adverse actions imposed on card issuers by the Durbin Amendment. This most significantly negatively impacts unbanked and underbanked households which are supposed to be some of the primary beneficiaries of these regulations. The proposed amendments will most certainly affect consumer spending in various and profoundly negative ways. Non-interest income, such as interchange fees, is integral to the entire credit and debit card environment. If these fees are cut or disallowed, the entire card industry will lose a fundamental element, and it will result in systemic issues to address and require card issuers to rebalance and try to find income to offset the significant losses. Major adjustments by issuers will result, and they will likely fall on low to moderate income cardholders, where the vast majority of the credit risk is contained. Fees to simply hold a card will increase across the board; cards without annual fees will disappear; rewards programs will evaporate as they already have with debit cards, a change directly attributable to the Durbin Amendment. The giant retailers will be the sole beneficiaries, while card issuers and consumers will bear the tremendous burdens imposed by the reduction of interchange fees. Moreover, retailers are either too obtuse to understand the full cost of banks' card processing

services or actually malicious in their feigned ignorance. Retailers simply look at card processing as a single line item for interchange fees, and they do not consider the costs as a whole in relation to banks' costs related to treasury management costs, losses and collections costs on bad checks and cards, human resource staffing costs, the costs to simply charter and operate as a federally-insured bank, and costs related to the facilities needed to provide processing services. The bottom line is that the choice to accept cards as a payment method is a choice each retailer is free to make. But that choice comes with additional costs, as well as benefits, that each retailer must make for themselves. It cannot be that banks, uninterested third parties to merchant/customer transactions, have to eat the costs of a merchant's decision to accept cards. Retailers can easily avoid all interchange costs by simply not accepting cards as payment. Very few do this, however, because the benefits of accepting cards so greatly outweighs the interchange fees *even at their current levels.* Retailers that accept cards decrease their costs related to handling cash and checks, courier and vault services, and labor due to the availability of automated checkouts, as just a few examples. Decreasing the interchange cap will only further incentivize card acceptance, while banks shoulder the increased costs.

5. This is also of particular concern to IBC given the CFPB's recent crusade against traditional and standard fees that it has chosen to blanketly refer to as "junk fees." Like the various fees the CFPB is attempting to restrict or completely prohibit, if interchange swipe fees are decreased, thus decreasing issuer revenue, the cost of continuing to provide financial products and services to bank customers may result in depository institutions discontinuing, or beginning to charge or increasing charges for, certain products and services in order to continue operating in a safe and sound manner. If banks cannot assess interchange fees sufficient to continue offering the products and services in a safe and sound manner, it may discontinue those products and services (such as free checking accounts and free remote deposit services), terminate its relationship with merchant customers that would have incurred such decreased fees, or refuse to accept any new customers for those products and services. Is that an appropriate way to increase competition in the market or protect merchants and consumers? The largest issuers, such as Chase and Bank of America, rely on consumer card programs to carry many of the expenses of the entire consumer banking products and services lines. As a result, these proposed changes would also profoundly change how major card issuing banks operate into the future. Expenses for other banking services will increase, while some services may be lost entirely. Effectively, the proposed amendments pass all retailer costs directly onto the banks, limit the banks' ability to recover costs, and such costs will be indirectly passed onto the banks' customers. These impacts will be especially terrible in light of the challenges starting with the COVID-19 pandemic, current rapid inflation, and the possible recession lying in wait. Card purchases represent an enormous amount of consumer spending throughout our economy. Consumer spending represents 70% of the United States GDP. These proposed changes will severely damage cards and consumer banking if passed, result in a dearth of consumer spending, and eliminate many of the rich consumer

benefits provided by cards. Only retailers benefit in the short term, and even they will feel the terrible effects of these proposed amendments in the long term as spending ceases everywhere.

6. Many transaction methods are wholly self-serve, and thus have lower or no transaction fees. Those transaction methods that require more robust and manual intervention and oversight by the financial institution typically have related fees to mitigate such additional costs. Debit card transactions are some of the most expensive transactions to banks due to the bank's liability for unauthorized transactions over which it has no control. Would the FRB prefer to return to the days of checking accounts and debit cards requiring recurring fees as a matter of course? Is the increased availability of free checking accounts and debit cards not consumer friendly? Depository institutions have analyzed their products and services and found a way to target the assessment of fees and charges to the actual individuals causing such increased costs due to their actions. The FRB has already hamstrung banks in this regard, and now intends to further do so. Banks will need to re-evaluate income flows and re-structure their product and service offerings and fees to generate sufficient income to remain operating in a safe and sound manner. This will further harm consumers, as banks would be required to increase the price of financial products and services overall to make up for lost interchange income. Increases in prices and fees for traditional banking products will lead to more consumers becoming unbanked and turning to non-bank financial service providers that are not as highly regulated as banks and are more likely to cause consumer harm.

<u>Competitive Concerns</u>

1. In IBC's opinion, the FRB's current proposal also skirts dangerously close to inappropriate governing and business practices, given the FRB's position as the national head of monetary policy and a recent entrant into real-time payments through FedNow. Respectfully, the FRB's policy independence extends only to certain matters of monetary policy *which do not include payment system policy*. On payments, the FRB is only permitted to compete with the private sector and make a profit under strict conditions set by our elected Congress. The FRB recently entered into direct competition with bank-issued debit cards by launching FedNow. During the FedNow launch, the FRB initiated its rulemaking regarding multi-network and card-not-present mandates to impose new, steep operational costs on debit card issuers. Now, after more than ten years of inaction on the interchange cap, the FRB is once again amending regulations on its competitors by tightening price caps on their debit payment products. The timing and intensity of the FRB's actions against its competitors raises fundamental concerns and questions because the FRB's competitors are regulated entities, *which are regulated by the FRB*. While IBC tries to assume no malice or ill-intent, the timing of this interchange cap proposal is incredibly suspect and difficult to accept given recent FRB action regarding Regulation II amendments and the rollout of FedNow. Between these competitive and regulatory concerns, along with the upcoming SCOTUS review of other Regulation II amendments, IBC believes that Congress must closely monitor

any conflicts of commercial interest between the FRB's for-profit payments businesses and its regulatory actions on regulated entities, as well as gain a detailed understanding of the motivations and processes of the FRB stakeholders in making any change to Regulation II.

2. In addition to competitive concerns with the FedNow service, IBC is concerned that the FRB both mandates a choice between two unaffiliated card networks and yet is also attempting to rig the interchange fee market. The FRB finally implemented the multi-network requirement very recently, in part because it felt competition in the market had finally reached a level sufficient to support the requirement. If competition is so robust, then interchange fees should be naturally decreasing as competitors attempt to undercut each other. Why does the FRB believe it needs to act to make this so, when it previously stated the competitive landscape was robust? Clearly, if fees are not decreasing to an amount the FRB finds acceptable, that means the market cannot support fees that low. The FRB should absolutely not put its finger on the scale to force the matter, because that will only result in banks having to turn to other methods to generate that lost income.

IBC believes the proposed amendments pose a safety and soundness concern. The costs of card transaction processing and related fraud and Regulation E costs *are* increasing, and the proposed amendments will only fuel that increase while leaving card issuers no flexibility in adjusting and accounting for such costs and losses. These costs, along with all bank operating costs, are generally subsidized and offset against net interest income. However, this offset falls far short of covering those costs, and the FRB should analyze bank cost recovery directly to understand that banks have no room to give up revenue. The proposed amendments undermine safety and soundness concerns because banks will be forced to accept more credit risk to offset the additional costs, including large compliance costs and obligations. This creates a feedback loop which increases the bank's overhead burden and costs, all while decreasing interchange fee income.

Thank you for the opportunity to share IBCs views on these matters.

INTERNATIONAL BANCSHARES CORPORATION

Dennis E. Nixon
President and CEO