March 11, 2024

Mary C. Daly
President & CEO
Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, CA 94105

RE: Concerns Regarding Federal Reserve's Actions on Debit Card Interchange Fees (Regulation II: Docket R-1818)

Dear Ms. Daly:

On behalf of the undersigned associations, we urge you to oppose the Federal Reserve's proposal to tighten the price caps in Regulation II, which will make irresponsible cuts to the interchange that financial institutions can earn as compensation for facilitating debit transactions from customers' deposit accounts.

This Federal Reserve proposal will raise the cost of basic banking services depended on by families and small businesses in communities across the Twelfth Federal Reserve District. Given the Federal Reserve Banks' role as the voice of local financial services communities to the leadership of the Federal Reserve System, we hope that you will bring our concerns to the direct attention of the Chair and Governors of the Federal Reserve Board.

We are disappointed that this rulemaking has been one-sided in process and substance and has consistently excluded the perspectives of the financial institutions regulated by the Federal Reserve. For example, while the Board asserts an obligation to lower debit card costs for merchants, the Fed is specifically *not* inviting comments about the types of costs incurred by banks in supporting debit card transactions covered by this proposed price cap[1].

By declaring at the outset that the Federal Reserve's existing bank cost framework is "sound" and above critique, the Board memo signaled that that the agency did not begin this public comment period with an open mind. Further, we are concerned that the Federal Reserve payments team met with convenience stores[2] to review their petition[3] for this rulemaking, while simultaneously declining, deferring, or failing to respond to several similar meeting requests from financial sector groups[4] to address the petition's misleading content before a rulemaking was undertaken.

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[1] "… as such, the Board is not inviting comments on the allowable costs considered for purposes of the interchange fee standards."
Federal Reserve Board Notice of Proposed Rulemaking – *Debit Card Interchange Fees and Routing*, October 2023.
[2] Falcettoni, E. et al. (2023) *Meeting Between Staff of the Federal Reserve Board and Representatives and Members of Merchant Trade Associations* https://www.federalreserve.gov/regreform/rr-commpublic/merchant-trade-associations-meeting-20230601.pdf
[3] Hatcher, J. et al. – Petition for Rulemaking Pursuant to Section 920 of the Electronic Fund Transfer Act https://www.federalreserve.gov/regreform/rr-commpublic/trade-association-letter-20221222.pdf
[4] As one of several examples of the Federal Reserve failing to accept financial sector requests for meetings on the merchant petition: *Joint Letter of Banking, Credit Union, and Minority Depository Institution Groups Requesting Meeting with Federal Reserve on Merchant Petition and Fed's Subsequent Rulemaking* (2023)

As you are likely aware, today's Regulation II is one of the most expensive regulations of the modern era and its costs to financial institutions and consumers are unusually direct. Some of the rule's revenue-limiting provisions apply to banks and credit unions of all sizes, including the Federal Reserve's recently enacted card-not-present routing mandate, which is driving up fraud costs and slashing revenue across the regulated financial services community.

For financial institutions as small as $10 billion in assets, the regulatory burden includes hard price caps on the compensation that financial institutions earn for supporting the cards, compliance, and cybersecurity customers' debit card payments to merchants. In 2024, there are not many industries that are forced to operate under price caps – and for good reason. The distortionary effects of these caps have included: financial institutions reducing lending to stay below $10 billion (a phenomenon this proposal will amplify and is counterproductive to community investment), encouraging financial institutions approaching the $10 billion line to merge instead of staying independent (thus "leapfrogging" the impact of the millions of dollars in first-year interchange losses that Regulation II causes), and forcing consumers to subsidize the costs of merchants receiving payments. These burdens borne by relatively small financial institutions, customers, and communities are heavy while big box merchants continue to enjoy many of the economic efficiencies that come with card payments without paying their fair share. Economists have clearly identified this strange situation for what it is: rent-seeking by and subsidization of large merchants at the expense of consumers and small businesses.

We would have hoped that the central bank would raise the alarm about such a broken policy, as the Government Accountability Office (GAO) has, yet the Fed has aligned itself with the large merchants to make this regulation even stricter. The proposal released on October 25, 2023, is no small adjustment.

According to the Fed staff's own memo, one-third of financial institutions (concentrated on the *smaller* end of the entities covered) will not recover their debit card costs. The broad swath of the industry directly covered by this rule provide the vast number of free or low-cost checking accounts, whose sustainability will be put at real risk. The result of the Fed's first rulemaking was higher checking account and ATM fees as well as reductions in bank and credit union staff and branches. Doubling down now is asking to exacerbate those impacts.

As a well-respected payments commentator put it, "I cannot, for the life of me, fathom why the Fed is doing this." We can't, either.[5]

Information Provided to Federal Reserve Governors Has Been Incomplete and Inaccurate
The Staff Memo to the Board[6] before the vote stated: "With respect to merchants, the proposal should lower merchants' costs of accepting debit card transactions. Merchants, in turn, may pass on some portion of their savings from lower interchange fees to consumer."

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https://www.aba.com/advocacy/policy-analysis/joint-trades-letter-to-the-federal-reserve-board-financial-sector-opposition-reopening-regulation-ii

[5] *Fintech* Takes by Alex Johnon. https://twitter.com/AlexH_Johnson/status/1719851942401433699

[6] Eichner, M., Foley, S., Wozniak, K., et al. (2023*) Proposed Revisions to Regulation II's Interchange Fee Cap*. Staff Memo to the Federal Reserve Board of Governors. https://www.federalreserve.gov/aboutthefed/boardmeetings/reg-ii-memo-20231025.pdf

The same reporter noted the improbability of the Fed's claim that this proposal will lower consumer prices: "I honestly can't believe that the Fed put those sentences in their memo. There is no evidence that merchants have ever passed on any savings to consumers in response to the Durbin Amendment, nor is there any evidence of such behavior from merchants in any other country where interchange rates have been capped."

We agree with this observation as well. It is almost axiomatic at this point, evidenced by research from the University of Pennsylvania and the Federal Reserve Bank of Richmond (among others), that Regulation II does not lower consumer prices. However, it is equally well-established that the Fed's actions *did* harm access to affordable banking services[7].

At the October 25, 2023, Board Meeting where the proposal was approved, Board staff were asked by Governor Michelle Bowman for evidence to support this assertion and others in the Staff Memo. We found the answers to be incomplete, unsupported by hard data, and unpersuasive (and at times even contradicting the Reserve Banks' own research).

Unfortunately, the Board insisted on keeping this memo secret until the meeting began, preventing interested parties across the country from providing the Board of Governors with corrections to erroneous and misleading statements in the document. We believe that if the Fed had released the memo to the public when it was finalized on October 18, 2023, our specific feedback over the intervening week would have given several of the Governors pause about voting to promulgate the proposal.

The cumulative result of these decisions was to insulate the Board from the industry's views as they prepared to deliberate, question staff, and vote during the Open Board Meeting. In the end, Governors were asked to vote on a major regulatory proposal without receiving a balanced and accurate briefing. While we will do our best to correct the record during the public comment period, these early procedural missteps put us at an enduring disadvantage. Rulemakings that hold so much in the balance for regulated entities should not be conducted under these conditions.

This Rulemaking is Discretionary

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[7] "Debit card interchange fee limits imposed by the Durbin Amendment and Regulation II are associated with increases in the costs of checking accounts, according to studies we reviewed and some market participants and observers we interviewed. For example, a **study conducted by Federal Reserve economists** showed that certain banks subject to the interchange fee cap increased prices for checking accounts by increasing monthly service fees. The study also found that after the regulation was in place, covered banks were about 35 percent less likely to offer noninterest checking accounts without monthly fees. Based on this finding, the researchers estimated that if the regulation had not been implemented, 65 percent of noninterest checking accounts offered by covered banks would have been free. [T]he researchers found that before the implementation of Regulation II, about half of noninterest checking accounts offered by covered banks were free, compared with less than one-third after implementation."

> U.S. Government Accountability Office (GAO);
> *Studies Found That Debit Card Interchange Fee Regulations Increased the Cost of Checking Accounts*
> (February 2022)

While the Board claims that they must undertake this new rulemaking, no part of the Durbin Amendment requires them to revisit these price caps. ***This is a fully discretionary undertaking.***[8]
It is concerning that a central bank that was long trusted and relied upon by financial institutions for payments services is now undertaking a discretionary rulemaking which will foreseeably harm the ability of our members to serve their communities.

This Rulemaking Will Harm Efforts to Decrease the Unbanked
The proposal would severely harm the progress we have collectively made to reduce the number of Americans who are unbanked. In the latest FDIC report[9] on unbanked households, they found the proportion of U.S. households that were unbanked in 2021—4.5 percent—which is the lowest since the survey began in 2009. That progress is not by accident, it was a result of efforts from regulators and industry together. If this proposal goes into effect financial institutions will have to reconsider cutting back these efforts.

The Federal Reserve's Proposal Includes an Auto-Adjustment that Prevents Public Comment
In perhaps one of the most problematic parts of the proposal, the Board plans to automatically change the price cap every two years, without subjecting these changes to public comment. This "set it and forget it" mechanism will operate using Federal Reserve data that we believe is unfit for policymaking, owing to its incompleteness and other problems. We have made several attempts to explain why the data that the Board is using to justify this action are flawed, however there has been no meaningful acknowledgement or dialogue in return.

The Rulemaking Will Harm Every Financial Institution Regardless of Size
Regulation II has caused significant real-world economic harm to all financial institutions and their consumers—and its recent expansion by the Board is compounding that harm. The Durbin Amendment's "exemption" of smaller financial institutions has proven to be largely illusory, as the Federal Reserve's own data shows that regulatory thresholds in the interchange market do not insulate smaller issuers from harm. Specifically, Regulation II data indicates that the average per- transaction interchange fee for exempt single-message transactions has fallen by nearly 31% in inflation-adjusted dollars from 2011 to 2021.

This Rulemaking is the Latest of Problematic Debit Card Policies Harming Smaller Financial Institutions
This price cap rulemaking follows quickly upon the damaging effects of other payments strategy actions by the Federal Reserve, most notably the 2023 "routing" change to Regulation II. That rule change is a major adjustment to the marketplace, however the Federal Reserve has not taken the time to measure how that rule impacts the baseline assumptions of the current price cap rulemaking.

Rising and new incremental costs at all issuers, some driven by regulatory changes, continue to be ignored. The newly enacted routing rule, despite imposing high costs and enabling fraud cost manipulation by core processors was enacted while waving away financial industry concerns and giving full credit to the claims made by merchants and core processors. These many incorrect assumptions

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[8] "I don't think that the Fed was legally required under the Durbin Amendment -- there are a variety of very clear interpretive practices that would have said that 'we've done what we need to do, we don't need to go further in ratcheting the fees down further' and I think the Fed should have taken that path."
Former Federal Reserve Vice-Chair Randal Quarles on *Banking with Interest* (Nov. 14, 2023).
[9] https://www.fdic.gov/analysis/household-survey/2021execsum.pdf

permeate the limited data that the Federal Reserve collects on debit card processing, including the October 2023 Interchange Fee Revenue Report, which does not mention the word “routing” once.

This Rulemaking Raises Questions About the Fed’s Role in the U.S. Payments Ecosystem
We know that the Reserve Banks have historically held an integral role in the provision of various Fed payments services. However, the consolidated role of the Federal Reserve System as both a provider of bank payments services and simultaneous regulator of banks’ debit card interchange is now being actively scrutinized by Members of Congress. Increasingly, there is a growing concern that this integration of distinct operator and regulator roles is appropriate and being managed in the public’s interest.

The Federal Reserve has effectively called this question itself: at a time when many financial institutions had been hoping to invest in *FedNow* and richer debit card experiences for their consumers, they are grappling with how the severe revenue and cost impacts of Federal Reserve rulemakings may cause them to reevaluate their payments improvement roadmaps. For many, debit card interchange is the source of revenue that supports investments in new payment systems, but that funding is now targeted by regulations like this one.

We fear that this rule will accelerate that divergence in growth trends between a regulator and the regulated. The private sector is increasingly being placed at a competitive disadvantage and innovation will be a casualty. In the past, financial institutions have viewed the Federal Reserve as an ally on the nation’s journey to better payments options, but a series of rulemakings which hamstring their ability to fully use valued private-sector options has created doubts about the Federal Reserve’s overall payments strategy.

We Urge the Fed to Stop, Look and Listen
Financial institutions across the country are working every day to serve consumers and merchants and build the best payments system in the world. Arguably, we do have the best system in many regards, but building and improving it over time has taken constant investment. In many parts of the world, there are only a handful of financial institutions serving entire countries, yet our regulatory system has historically placed emphasis on ensuring that thousands of smaller financial institutions can prosper and bring prosperity and choices to their communities. Financial institutions have always looked to the Federal Reserve as a partner in keeping this uniquely broad and competitive market alive.

It is not an exaggeration to say that this American way of banking is placed at risk by rulemakings from the Federal Reserve that undermine the ability of smaller financial institutions to offer core banking services like checking accounts at competitive prices.

The problems posed by this rulemaking are straightforward. In order to continue staying ahead of trends and risks, financial institutions need to invest but that requires resources. The Federal Reserve’s current approach will drain those resources and over time our nation’s payment system will fall behind, costs will rise for consumers, and smaller merchants will increasing be outcompeted by the largest retailers who benefit from these new payments policies.

There is a better way. The Federal Reserve should withdraw this rulemaking, take the time to authentically engage with a broader group of stakeholders, place consumers at the center of the conversation, and study the impact of existing policy changes rather than embarking prematurely on new ones. Now is the time for the Federal Reserve to take a step back from regulating, observe the changes it has wrought in the market, and allow major decisions like price cap changes to be made in the future based on the results of that more careful study.

This issue may seem complex, but it really comes down to whether the Fed values access to affordable financial services in local communities or if that is no longer a consideration in its policymaking. We ask that you contact the Board of Governors and urge them to reconsider their decision to promulgate this Notice of Proposed Rulemaking. Finally, we would appreciate the opportunity to meet with you to discuss this issue in more detail.

Sincerely,

Alaska Bankers Association
Alaska Credit Union League
California Bankers Association
California Community Banking Network
California Credit Union League
Community Bankers of Washington
Community Banks of Oregon
Hawaii Bankers Association
Hawaii Credit Union League
Idaho Bankers Association
Idaho Community Bankers Association
Nevada Bankers Association
Nevada Credit Union League
Oregon Bankers Association
Utah Bankers Association
Utah Credit Union Association
Washington Bankers Association