KASASA

March 12, 2024

The Honorable Jerome H. Powell
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Via Email: regs.comments@federalreserve.gov

Re: Docket No. R – 1818, RIN 7100-AG67 Debit Card Interchange Fees and Routing
Notice of Proposed Rulemaking; Debit Card Interchange Fees and Routing

Dear Chair Powell & Secretary Misback,

We appreciate the opportunity to provide comments in response to the Board of Governors of the Federal Reserve System ("Board") request for comment on the proposed rulemaking regarding debit card interchange fees and routing ("Proposal"). *(1)* We recognize the challenges associated with the Board's efforts to establish standards for assessing whether the amount of any interchange fee received by a debit card issuer is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Given the debit card payments ecosystem is a vitally important part of the overall payment infrastructure in the United States and that debit cards remain the most popular form of noncash payments, it is important, when considering proposed changes to the fees that support this important form of payment, the Board must take into account the broader context: the wide range of business models and sizes for issuers subject to the interchange fee cap; the effect of the rule on bank capital and earnings; the potential benefits and costs to consumers; the cumulative effect of regulatory changes and rules; and other unintended consequences including the economic harm "exempt" issuers have incurred due to Regulation II.

While we recognize the Board's efforts to ensure the interchange fee is reasonable and proportional to the costs incurred by the issuer with respect to the transaction, we believe the Proposal, as currently written, is substantially flawed because it is based on dated, insufficient and skewed data that favors large issuers, as well as, for the following reasons:

- Continuing their current practices, merchants will not pass on any savings to consumers
- Large issuers will leverage their operational and economic scale to expand their competitive advantages
- Basic banking services will dwindle as the cost of providing these services to consumers will increase
- Exempt issuers have and will continue to be economically harmed by the debit interchange cap.

Introductions

Kasasa, Ltd. ("Kasasa") is a third-party service provider whose primary mission is to help community financial institutions (banks and credit unions) serve their communities and compete with our nation's financial technology ("fintech") providers and larger regional and global systemically important banks. *(2)* Kasasa supports more than 900 community financial institutions across all 50 states, by providing professional banking services, innovative digital enablement platforms, and retail offerings to help such institutions reduce operational expenses, increase executional efficiencies, enhance user experiences, and establish direct relationships, which the institution owns and controls, with individual depositors who live and work within their communities. *(3)*

Background

In 2010, Congress passed the Durbin Amendment as part of the Dodd–Frank Wall Street Reform and Consumer Protection Act. Passed with the intention of increasing competition and reducing both merchant and consumer costs, the amendment (implemented as Regulation II) mandated routing requirements on all debit card payment networks and limited the amount of interchange revenue large financial institutions (> $10 billion in assets) can receive on debit card transactions.

Now, prompted by ongoing merchant requests, the Board of Governors of the Federal Reserve System ("Board") is proposing further changes to Regulation II's debit interchange fee cap. Additionally, the Board intends to update the cap every other year, without public comment, based on the Board's biennial survey of large debit card issuers. Unfortunately, this data is dated, skewed by large issuers information, and does not reflect the economic realities nor the operational challenges associated with small issuers operating debit card programs and the negative impact Regulation II has had and continues to have on "exempt issuers."

Primary Concerns & Recommendations

While the Proposal suggests it could result in benefits to consumers, we are concerned that the costs for consumers—through the form of increased costs for banking products and services—will be real, while the benefits to consumers—such as lower prices at merchants— will not be realized.

This is <u>exactly</u> what occurred with the initial implementation of Durbin Amendment. This is <u>exactly</u> what will occur again if the Proposal is enacted.

Regulation II has been a boon to big box retailers, an unmitigated disaster for consumers and economically harmful to "supposedly" exempt issuers. In addition, large issuers have expanded their significant competitive advantage over small and exempt issuers by leveraging their high transaction volumes, greater negotiating power and operational efficiencies associated with the scale of their debit card programs.

The wrongs of Durbin 1.0 must be righted via whatever changes are made to the current debit card interchange cap.

At bare minimum, the Board should (a) raise the small issuer exemption threshold to $20 billion or at minimum, adjust it annually by tying it to the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), which is a measure of inflation and (b) guarantee exempt issuers (e.g., community financial institutions) are not economically harmed - directly or indirectly - by whatever changes may be made and the cascading unintended consequences that will undoubtably occur.

Please consider the following:

- **Merchants Are Not Reducing Prices & Are Pocketing The Profits**

  Policymakers believed merchants would pass on the savings they received from Regulation II to consumers in the form of lower prices. This simply has not happened. Several studies, including one published by the Federal Reserve Bank of Richmond found only 1.2% of retailers actually reduced prices for consumers, 77% did not change prices at all and an astonishingly 21.6% of retailers raised prices on consumers after the Durbin Amendment was enacted. *(4)* It is also estimated that retailers pocketed almost $106 billion from these reforms as of 2020, a figure that has certainly grown over the past three years. *(5)*

- **Large Issuers Have An Unfair Competitive Advantage:**

  While directly impacted by the Proposal, large issuers have competitive advantages that small and exempt issuers cannot match, specifically - high transaction volumes, greater negotiating power with the payment network and operational and economic efficiencies based on the scale of their debit card programs.

  In prior guidance, the Board stated an imposed limit on interchange was appropriate so long as 80% of issuers could recover their costs. Yet, under the Proposals new methodology, 34% of issuers will be unable to cover there costs. *(1)*

  Is it the Board's place to intentionally cement an already unfair competitive advantage to large issuers by forcing more than one-third (1/3) of debit card issuers to either operate their programs at a loss or exit the market?

  Isn't Regulation II intended to increase competition and expand access and savings to consumers?

- **Basic Banking Services Costs Have Increased**

  The Durbin Amendment fails to recognize consumers are customers of both retailers and financial institutions. Consumers have experienced a "double whammy" as (a) the promised retail savings have not occurred and (b) the cost of basic banking services has increased as financial institutions of all sizes have been forced to fill the revenue void caused by Regulation II as evidenced below:

  - The share of institutions offering free checking accounts have fallen from 60% to 20% *(6)*
  - Average monthly checking account fees have increased from $4.34 to $7.44 *(6)*
  - The minimum account balance to avoid these fees has increased by roughly 25% *(6)*
  - As many as 1 million low-income individuals lost bank accounts forcing them to turn to alternatives such as payday lenders and pawn shops to make ends meet *(7)*
  - The amendment costs the average low-income American about $160 per year *(7)*

- **Exempt Issuers Have Suffered Economically**

  Data published by the Board shows that supposedly "exempt issuers" institutions (defined as financial institutions with less than $10 billion in assets) have actually experienced a 16% reduction in their PIN based debit card interchange fees between 2011 and 2021. *(8)* These fees represent smaller institution's largest source of non-interest, non-fee income and are the primary means by which these institutions offset the cost of offering free checking and savings accounts.

  While exempt issuer's interchange fees for dual-message transactions have increased since Regulation II was enacted, the volume and value of these transactions remain low for community financial institutions thereby limiting their ability to negotiate the favorable terms larger institutions receive from the payment networks. Issuers with low debit card volumes and small transaction values have also been impacted by the payment networks removal of prior small transaction discounts.

Sadly, Senator Durbin is up to his old tricks and wants to apply the same routing requirements to credit card transactions that he did to debit card transactions, which, if enacted, would undoubtedly erode the dual-message interchange revenue community financial institutions currently receive. *(9)*

Governor Bowman's Warnings Should Be Heeded

Board Governor Michelle Bowman, in her remarks *(10)* offered with her dissenting vote on the Proposal correctly recognized setting a single interchange revenue cap, based on data that is reported solely by large institutions, will result in the rich getting richer and the poorer getting poorer.

She notes, that under the Proposal, issuers who have high transaction volumes, greater negotiating power and efficiencies associated with their operational scale will continue to have a significant competitive advantage over small and exempt issuers who enjoy none of these benefits.

Recognizing the proposed cap will result in an ongoing and permanent decrease in gross interchange revenue she fears small issuers will not be able to recover all of the costs associated with operating their debit card programs. Thus, to fill the void, small institutions may have no choice but to start to charge or raise fees on basic banking services, to the determent to their customers / members.

Governor Bowman notes charging fees for banking services is often the only way small financial institutions can offer low-costs or no-cost banking products and services to their customers / members. She warns that lower debit card interchange revenue may result in some financial institutions having to discontinue low-margin products including those designed to increase financial inclusion and access for low-and-moderate income individuals and families.

She also wisely points out that while the newly revised Community Reinvestment Act (CRA) rules create incentives for financial institutions to offer affordable deposit products, other regulation and legislation, like the lower interchange cap; higher capital requirements; new debt-funding requirements; increased data collection requirements; potential credit card reforms and many others, should not impede ongoing progress to improve broader financial product access and availability nor should they create ongoing financial and regulatory risks to the health of smaller institutions and the overall banking system. Complying with this litany of legislative and regulatory initiatives has undoubtedly accelerated the consolidation we have seen amongst community financial institutions.

Governor Bowman voiced her concern that while the Proposal only directly applies to those issuers with more than $10 billion in assets, the impact of the interchange fee cap has and will likely continue to affect a broader range of issuers including community financial institutions. Issuers of all sizes, she notes, use the same payment rails, and smaller issuers inevitably face some degree of pricing pressure, at least indirectly, from the interchange fee cap. And while the interchange fees many smaller issuers have remained fairly stable (albeit a 16% decrease for exempt issuers) since the introduction of the Durbin Amendment, it is difficult to determine if these fees adequately cover the aggregate costs of processing, fraud and fraud prevention, and other expenses associated with running a debit card program. She correctly concludes that even if the interchange fee cap does not directly apply, exempt issuers will continue to face ongoing fee pressure and escalating expenses in operating their debit card programs.

Conclusion: Regulation II Is Poor Policy & The Proposed Changes Will Make It Worse

The Federal Reserve, with the support of big-box merchants, is basing its Proposal for a new debit card interchange revenue cap on dated, skewed, and insufficient data, which fails to adequately account for all of the costs debit card issuers incur to offer debit cards, such as card production and delivery and transaction monitoring costs. Large issuers have a huge economic advantage over small and exempt issuers based on the scale and efficiencies of their

debit card operations. Small and exempt issuers cannot match those advantages and thus must be protected from any and all direct, indirect, or unintended negative consequences caused by the Proposal.

When Durbin Amendment was considered in 2010, big box merchants argued that if the Federal Reserve agreed to help them avoid paying for the service of processing debit card payments, they would return the favor and pass on savings to customers. Instead, merchants pocketed the difference while customers were left with higher checking account fees and fewer free checking account offerings. The Proposal seeks a repeat of history and will only exacerbate this problem further.

Debit cards are the most popular form of noncash payment in the United States and interchange fees derived from these transactions and are reinvested in new technologies and fraud prevention efforts and help to support financial institution's ability to offer deposit accounts. Community financial institutions especially rely on these funds to offset the expense of providing free checking and low-cost deposit accounts. These accounts serve as an important tool to increase financial inclusion and reduce the number of unbanked by bringing low-income consumers into the banking system.

If enacted, the Proposal will result in checking account fee increasing and the available of free account will decline. Consider the following results of from the first few years after Regulation II was implemented.

- The average minimum balance requirement at regulated banks for noninterest checking accounts increased by $400, or 50%. *(6)*

- For interest-bearing checking accounts, minimum balance requirements at regulated banks rose even more, by $1,700, or 55%. *(11)*

- Almost 30 percent of respondents who previously had a bank account reported that they became unbanked because account fees were too high and unpredictable, according to a 2017 FDIC Survey of Unbanked and Underbanked Households. *(6)*

The Proposal also puts consumers at risk as interchange fees are used to pay for fraud protections. Consider the following as documented by the Board's 2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions study issued in October 2023:

- From 2011 to 2021, fraud losses as a share of transaction volume more than doubled (17.5 bps in 2021 vs. 7.8 bps in 2011). As the volume and speed of transactions grow, so does the cost of facilitating these services safely.

- While the Proposal marginally increases the amount banks can charge for fraud prevention (increasing the allowance from 1 cent to 1.3 cents per transaction), these measures may not be sufficient to cover large-scale fraud mitigation and prevention strategies.

The Proposal also contradicts the Board's previous guidance that concluded that an imposed limit on reimbursement was appropriate so long as 80% of issuers could recover their costs. Any issuer that fell in that remaining 20% was tagged as "too inefficient," without regard to a long list of factors that may influence higher costs.

But under the Federal Reserve's new methodology, 34% of issuers will be unable to meet their costs. Therefore, the Federal Reserve is making the unfair assumption that 1/3 of issuers should either offer their services at a loss based on an arbitrarily imposed limit or exit the market. *(1)*

The Proposal will undoubtedly negatively impact exempt issuers as banks of all sizes have been harmed since Regulation II became effective in 2011. Consider the following:

- Between 2011 and 2021, small institutions that were exempt from Regulation II saw a 16% decline in revenue for single-message network transactions – transactions that are typically made using a PIN number. *(12)*
- In 2014, 73.3% of surveyed exempt banks indicated that "debit card interchange fees policy" had a negative impact of some kind (either "significant" 29.1% or "slight" 44.2% on their earnings. *(13)*
- While a wide array of other factors has definitely contributed, there can be no doubt that (a) the increased cost of complying with regulations and (b) the loss of stable non-interest income have fueled the rapid consolidation that has occurred within the community banking space over the past decade. In Q3 2011 there were 14,204 banks and credit unions under $10 billion in assets. By the end of 2022, this number decreased to a combined 9,043 institutions (-36.33%) *(14)*

Simply stated the Proposal is flawed as (a) it is based transaction dated data gathered primarily from large issuers who enjoy operational efficiencies that smaller and exempt issuers cannot match; (b) refuses to consider all the relevant costs issuers incur to provide debit card services to consumers; (c) continues the failed promise of merchants passing on savings to consumers, which by all measures has not and will not occur; and, (d) because it ignores to acknowledge the negative financial impact the original debit card interchange cap has had on exempt issuers and fails to provide guarantees that these issuers will not be economically harmed by the proposed cap.

On behalf of all of the community financial institutions we support, if it is in the Board's authority, we implore the Board to increase the small issuer exemption threshold to $20 billion or at minimum, adjust it annually by tying it to the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), which is a measure of inflation and (b) guarantee exempt issuers (e.g., community financial institutions) are not economically harmed - directly or indirectly - by whatever changes may be made and the cascading unintended consequences that will undoubtably occur.

Thank you for the opportunity to share our thoughts and perspectives on this important matter.

Sincerely,

Patrick J. Laughlin
Chief Compliance Officer

----

1. 88. Fed. Reg. 78100 (Nov. 14, 2023).

2. Kasasa was created in 2003 with a singular mission: Enable a powerful network of community financial institutions to re-establish themselves as the go-to place for banking products and services and compete successfully against fintech providers and our country's large regional and national banks. In pursuit of this goal, Kasasa provides community financial institutions with a host of professional banking services, enabling

technologies, retail products and financial services to assist them to, among other things, drive operational savings, increase executional efficiencies, enhance consumer transparency, and develop deeply connected, long-lasting, in-market, "core" customer/member relationships.

3. Over the past 20 years, our community financial institution clients have distributed over $3.4 billion in account rewards to more than 3 million individual depositors. At the same time, these institutions have received over $3.7 billion in non-interest income from these individual depositors, who are almost three times more profitable for community financial institutions than traditional free checking accountholders.

4. Wang; Schawartz, and Michell. The Impact of the Durbin Amendment on Merchants: A Survey Study. Economic Quarterly, Volume 100, Number 3, 3rd Quarter 2014.

5. Electronic Payments Coalition: Analysis of the Cost of the Durbin Amendment. August 2021.

6. Mukharlyamov, and Sarin. The Impact of the Durbin Amendment on Banks, Merchants, and Consumers. Penn Law: Legal Scholarship Repository. January 31, 2019.

7. The Durbin Amendment: Summary Impact, and Reform. Review of Banking & Financial Law. Vol. 37 Boston University. 2018

8. Board of Governors of the Federal Reserve System: 2021 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions. October 2023.

9. Credit Card Competition Act of 2023.

10. Statement on Proposed Revisions to Regulation II's Interchange Fee Cap by Governor Michelle W. Bowman. October 25, 2023

11. Manuszak, Mark D. and Krzysztof Wozniak (2017). "The Impact of Price Controls in Two- sided Markets: Evidence from US Debit Card Interchange Fee Regulation," Finance and Economics Discussion Series 2017-074. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.074.

12. Board of Governors of the Federal Reserve System (2022), "Average Debit Card Interchange Fee by Payment Card Network."

13. Hester Peirce, Ian Robinson, and Thomas Stratmann, "How Are Small Banks Faring Under Dodd-Frank?," Mercatus Center Working Paper No. 14-05 (Feb. 2014) at 85, available at https://www.mercatus.org/system/files/Peirce_SmallBankSurvey_v1.pdf.

14. Cornerstone Advisors: The True Impact of Interchange Revenue.