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1000 Walnut Street
Kansas City, MO 64106

By electronic delivery via www.federalreserve.gov

February 12, 2024

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

RE: Docket No. R-1818, RIN 7100-AG67
12 CFR Part 235 – Debit Card Interchange Fees and Routing (Regulation II); Proposed Rule

Dear Ms. Misback:

Commerce Bancshares, Inc. ("CBI") is a regional bank holding company with one bank subsidiary, Commerce Bank, ("Commerce"), and total assets of $31.7 billion as of December 31, 2023. Commerce is a full-service bank, with more than 400 banking locations in Missouri, Illinois, Kansas, Oklahoma, and Colorado. A full line of banking services, including payment products, mortgage banking, investment management and securities brokerage, is offered by the bank and its affiliates. We take pride in providing over 600,000 customers convenient and secure access to their funds through the issuance of debit cards.

Commerce Bank supports and joins the comment letters submitted by the American Bankers Association (ABA) and the Mid-Size Bank Coalition of America (MBCA). We appreciate the opportunity to comment separately on the proposed changes to Federal Reserve Regulation II to emphasize certain issues.

The proposed rule communicates that the Federal Reserve Board (Board) interprets Public Law[1] (related to 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 debit card transaction) as an obligation to set and adjust the interchange fee cap to the extent that it is equal to cost. However, the set of cost data being used is limited and incomplete, representing only a fraction of the total Debit Card program costs incurred by issuers. Therefore, the current and proposed interchange fee cap is not proportional to costs incurred by the issuer, and the Board's approach to setting the interchange fee cap primarily benefits merchants, at the expense of both consumers and banks.

For the reasons listed below, we believe the impact of the nearly 30% reduction in debit card interchange as proposed would be to introduce risk and uncertainty to the payment ecosystem, as well as the banking

[1] Public Law 110-203, section 1075, 124 Stat. 1376, 2068 (codified at 15 U.S.C. 16930-2).

system more broadly, when the Board's focus and primary directive should be to enhance the stability of the American banking system.[2]

1. **Negative impact on consumers**

   Consumer savings on goods and services have not materialized as promised by the merchant community when Regulation II was introduced. Consumers will likely pay higher fees for basic banking services, and low-cost options for the low-to-moderate income segment could be eliminated over time.

   Commerce Bank recognizes the critical need in our communities for financial products and services that serve low-to-moderate income households[3] and has dedicated resources to reach these unbanked and underserved consumers, in partnership with local coalitions. We have developed a prepaid debit card product that is specifically designed for and targeted to the low-to-moderate income segment and adheres to the standards set by Bank On.[4] The changes proposed by the Board will mean this product and others will operate at a loss without pricing adjustments, and the product in its current form will not be sustainable. As a result, we may not be able to offer a Bank On certified account or participate fully in coalitions as we do today. As a covered institution, we may stop investing in these products and may be forced to raise fees or eliminate certain products over time.

   According to Federal Reserve Economists, debit card interchange fee limits imposed by Regulation II have already harmed access to affordable banking services.[5] At the same time, the anticipated cost savings from interchange reduction, which merchants were to have passed along to consumers in the form of reduced prices, have not materialized. Research conducted by the University of Pennsylvania and the Federal Reserve Bank of Richmond indicates that merchants have not lowered their prices in response to regulated interchange. There is no reason to anticipate that merchants will reduce prices due to the interchange cap in the future.

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[2]https://www.federalreservehistory.org/essays/federal-reserve-history

[3] https://www.fdic.gov/analysis/household-survey/2021execsum.pdf Unbanked Households: Reasons for Not Having a Bank Account • As illustrated in Figure ES.3, "Don't have enough money to meet minimum balance requirements" was the most cited reason and was also the most cited main reason by unbanked households for not having an account in 2021. The proportion of unbanked households that cited this reason as the main reason for not having an account decreased between 2019 (29.0 percent) and 2021 (21.7 percent). • "Don't trust banks" was the second-most cited main reason for not having an account in 2021, and "Avoiding a bank gives more privacy" was the third-most cited main reason. • Almost three in ten unbanked households in 2021 (29.2 percent) cited a reason related to fees or a minimum balance — "Bank account fees are too high," "Bank account fees are too unpredictable," or "Don't have enough money to meet minimum balance requirements" — as the main reason for not having an account, down from 38.0 percent in 2019.

[4] https://joinbankon.org/

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

2. Disruption of competition and negative financial impact on financial institutions

The proposed rule exacerbates the competitive dysfunction that the Board's Regulation II policy has yielded and adds to the regulatory changes that collectively will result in significant financial impact to financial institutions, threatening their safety and soundness.

Mid-size banks like Commerce Bank are disadvantaged when competing against large debit card issuer financial institutions. Large issuers with high transaction volumes have greater negotiation power with networks and vendors, leveraging their economies of scale to lower their costs. Out of an estimated 160 covered issuer banks, each of the four largest covered issuers have well over a trillion dollars in assets, which dwarfs the size of the roughly 100 banks with assets between $10 – 50 billion.[6]

The Mid-Size Bank Coalition of America (MBCA) finds that "neither the existing interchange rule nor the proposal is proportional to the costs incurred by mid-size banks" as stated in its comment letter to the Fed. The proposed rule may result in up to one-third of covered issuers not achieving cost recovery. Fintechs also have a competitive advantage over mid-size banks for different reasons. They are typically sponsored by small (exempt) sponsor banks and able to realize higher interchange, run profitable debit card programs and offer rewards that are enticing to prospective customers.

Mid-size banks are disproportionately impaired by debit card interchange regulation and the proposal will further contribute to financial stress on the banking industry as a whole. By proposing a debit card interchange fee reduction, the Board has added to the onslaught of regulatory changes expected in the coming years. It does not appear that there has been a thoughtful analysis of the collective impact to bank safety and soundness when this rule change is combined with the upcoming implementation and high regulatory burden of such changes as Basel III, Small Business Data Collection Act, and Community Reinvestment Act modernization. Without this type of analysis, the Board may underestimate the impact of this rule on the nation's financial system, including risk of increased consolidation of mid-size banks. Representative Luetkemeyer (MO) has gone so far to propose the "Secure Payments Act" out of concern that the Federal Reserve has not adequately studied the impact of its proposal to consumers, financial institutions, and merchants.

The ripples of competitive uncertainty caused by Regulation II extend in other harmful ways. Small businesses face difficulties competing with large retailers and e-commerce marketplaces that have negotiation power to further drive down the interchange to below cap. Additionally, the exemption of the three-party model could potentially be used by Capital One to further disrupt competition if they are successful at acquiring Discover Financial Services. The idea that one interchange fee fits all and fixes all is a fallacy. The Board should more fully explore and consider competitive and financial impacts when structuring interchange and setting the interchange fee cap.

[6] https://www.mx.com/blog/biggest-banks-by-asset-size-united-states/

3. Reliance on flawed survey and data collection

The Board's current data collection method and survey practices need improvement to support automatic interchange fee cap adjustments.

The Board's instructions for completing the survey used to calculate the interchange fee cap lack specificity and clarity. Issuing banks sift through hundreds of invoice line items and internal expense entries to find applicable cost data to report. Survey questions are open to interpretation and responses could vary based on issuer configuration, level of investment in any given year, and resident expertise at financial institutions, potentially resulting in flawed data. It does not appear that the Board has attempted to verify the accuracy or completeness of issuer responses, or to ensure consistency of data across issuers.

We are already finding that the expense associated with Debit Card Authorization, Clearing and Settlement (ACS) we intend to submit for the 2023 Federal Reserve Debit Issuer survey is higher, and as financial institutions, networks, and processors continue to modernize their platforms, investment will continue, and expense associated with ACS will become more challenging to identify and capture. The data the Board is using to set the interchange fee cap will always lag, resulting in a revenue/expense mismatch and causing variability in profitability that will be difficult to manage and explain.

Furthermore, the recent Board clarification related to card-not-present routing has also resulted in additional expense not reflected in the 2021 survey data. Many alternate networks were not designed to support e-commerce activity, resulting in extensive changes to network, processor, and financial institution systems. Banks are contractually bound to these networks and are required to pay for adjustments to these systems. Banks are now contending with additional costs to support recurring transaction variations that benefit the merchant at a significant cost to issuers.

The Board surveys financial institutions for other expense data that should also be accounted for when setting the interchange cap. For example, banks have incurred expense to adapt to the consumer adoption of digital channels, digital debit card payments (via digital wallets), customer service using chat, and mobile banking that displays transaction history. But it is not clear if or how that information is utilized by the Board when considering an adjustment to the debit card interchange cap. A downward cap adjustment means issuers may limit investment in innovation over time and this would negatively impact both cardholders and merchants. There may be consequences such as: lowering authorization approval rates to take a more protective stance against fraud in lieu of investment in new fraud detection tools; eliminating unique services like instant issue cards; reducing service levels; and heightening attention given to dispute liability.

The Board's proposed approach for collecting data and setting the interchange cap is ill-suited for such a dynamic industry, and any interchange cap adjustment could be out of sync with issuers for up to two years. Implementing a formulaic approach to automatically adjust the interchange fee cap using the current data collection and survey methodology without issuer input or comment[7] could cause many financial institutions to operate their debit card programs at a loss. While the Board targeted cost recovery for 98.5% of covered issuer *transactions*, approximately 20% of all covered *issuers* did not recover costs under the current rule. That percentage of issuers is expected to increase to 34% under the proposal.[8] Instead of adjusting the cap as proposed, the Board should make a commitment to implementing a more comprehensive, timely and robust approach to data collection and survey oversight before acting.

Conclusion

For the reasons stated above, we respectfully request the Board to withdraw the proposal. Should the Board decide to move forward with the proposal, we request the Board consider the following:

1. Reevaluate the structure and adjustment to the interchange fee cap to ensure that no harm is done to vulnerable consumer segments. Consider other factors, including but not limited to other regulatory changes negatively impacting financial institution profitability. Study closely the varying size and cost structures of covered issuers, and consider alternate approaches, such as adopting a tiered approach to interchange fees.

2. Eliminate the formulaic approach to automatically set the interchange fee cap. Setting the cap should include implementing on-going dialogue with issuers, and the process should include a comment period. If the Board determines that a formulaic approach is necessary, the Board should perform a comprehensive assessment of the data collection processes, provide clear instructions for their survey, and implement stringent oversight of survey practices and data accuracy before moving forward.

3. Extend the implementation period to allow banks to adjust their investment plans. Banks need time to adjust product road maps, development, and testing schedules. Given the uncertainty inherent in a two-year update cycle, more time will be needed for long-term planning.

Again, we appreciate the opportunity to comment on the proposed changes to Regulation II. Please contact me with any questions.

Sincerely,

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[7] https://www.govinfo.gov/content/pkg/FR-2023-11-14/pdf/2023-24034.pdf, Federal Register, Vol. 88, No. 218, November 14, 2323, Proposed Rules, Section I. A. page 78101
[8] Debit Card Interchange Fees and Routing, 88 Fed. Reg. 78100, 78113 (Nov. 11, 2023)